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USSR: Coping With the Decline in Hard Currency Revenues

An Intelligence Assessment

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SOV 88-10014X
April 1988

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Directorate of Intelligence

USSR: Coping With the Decline in Hard Currency Revenues

An Intelligence Assessment

This paper was prepared by
, Office of Soviet Analysis, with
contributions from
SOVA

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directed to the Chief
, SOVA

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USSR: Coping With the Decline in Hard Currency Revenues

Key Judgments

Information available as of 20 February 1988 was used in this report.

The USSR is likely to spend the remainder of the decade coping with the impact of reduced energy revenues and a depreciated US dollar on its hard currency earning capacity. Lower world energy prices, alone, have already cost the Soviets an estimated $15-18 billion in lost revenue during the past two years. The Soviets' import capacity has been further eroded by the lower valued US dollar. While Moscow's oil and gas exports are priced in dollars, most of its purchases are made in other currencies.

The Soviets have weathered the storm to date by increasing foreign borrowing, gold sales, and arms exports to keep imports from falling too sharply. Moscow, nonetheless, has pared imports four consecutive years, with the steepest cuts coming during 1986 and 1987. Estimated 1987 imports of $23 billion are down 17 percent in dollar terms from 1983 and probably 30 percent in real terms. Two consecutive large grain crops and lower world grain prices, however, have allowed Moscow to hold real purchases of Western machinery and equipment constant, on average, over the past two years. Even so, the Soviets have postponed, scaled back, or canceled numerous industrial projects slated for the current five-year planning period (1986-90).

The stepped-up borrowing that began in 1985 and the impact of a depreciated dollar have pushed Soviet gross hard currency debt to an estimated $41 billion by yearend 1987, compared with just $22 billion in 1984. The debt buildup, however, has not reduced Moscow's excellent credit rating. The debt service ratio still is a healthy 26 percent—about the same level as recorded in the late 1970s—and the Soviets maintain sizable reserves of both gold and assets on deposit in Western banks

The Soviet leadership does not appear ready to deviate much from the course it has steered in recent years. We believe that Moscow plans to continue constraining imports in the near term, not only to slow the rise in debt, but also to assess the progress (or lack thereof) of Gorbachev's domestic modernization program. Such a strategy should help Moscow maintain an acceptable hard currency position at least through 1990, especially if dollar depreciation has bottomed out and oil exports can be maintained. Even if oil exports to the West begin to falter over the next three years, as we believe is likely, Moscow may still be able to hold gross indebtedness to under $50 billion by keeping a lid on imports

Moscow's hard currency position will become more difficult to manage should the Soviet leadership decide that markedly more imports from the West are needed. Such a change in direction could come as early as this year. Gorbachev's *perestroyka* program is already creating problems in industry and slowing growth because of production bottlenecks, bureaucratic confusion, and lagging consumer welfare. But even should Moscow turn markedly more to the West, we believe that near-term constraints would come from a Soviet leadership fearful of too large a debt buildup and not from bankers, who are willing to finance Moscow to a much greater degree.

If Moscow opts for a larger Western role in its modernization program, it could provoke greater economic tensions in the Western alliance. While the West might benefit from Moscow's pursuit of a more benign international environment to foster economic ties, a Soviet Union more actively seeking Western help would also make it more difficult for the West to maintain current agreements—or reach new consensus—on controlling trade and financial flows to the Soviet Bloc.

Contents

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Scope Note

This paper provides an analysis of the USSR's trade and financial activity in the wake of the sharp reduction in world oil prices. It focuses on how Moscow has juggled revenues and expenditures over the past two years to maintain some semblance of balance in its hard currency position. It does not address the effect of falling hard currency revenues on various sectors of the domestic economy. These issues have been treated in several papers published during the past year.[1]

The debt and balance-of-payments numbers presented in this paper are based on a recently completed study that has reestimated Soviet hard currency debt. Thus, some of the numbers in the tables cannot be linked to previously published series.

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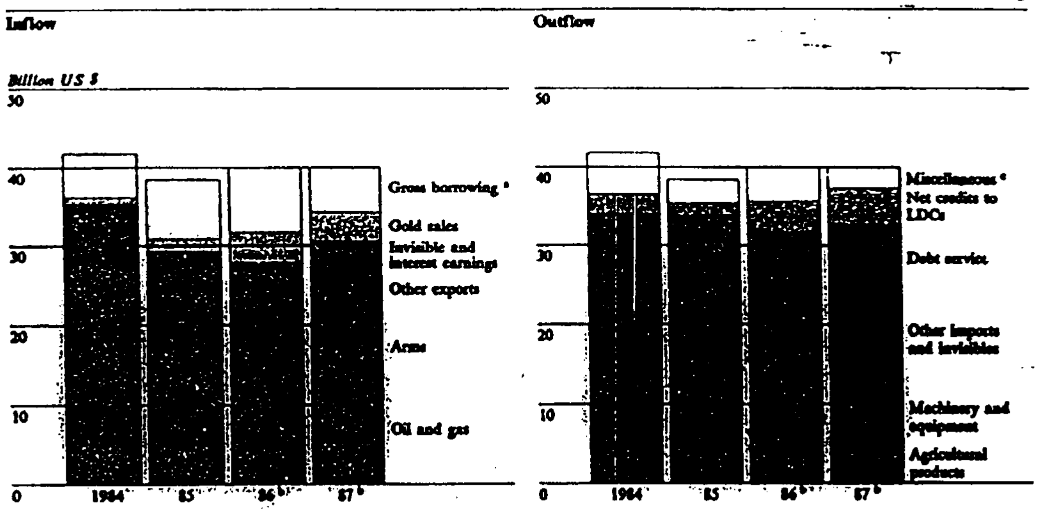
Intelligence Assessment SOV 87-10004X January 1987, *Modernization of the Soviet Steel Industry: What Lies Ahead?*

Figure 1
USSR: Coping With the Decline in Hard Currency Revenues, 1984-87



[a] Estimated drawings on official credits, commercial bank credits, net short-term credits, and promissory notes.
[b] Preliminary estimates.
[c] Includes hard currency assistance to and trade with Communist countries, credits to the West for oil and other commodities, unspecified hard currency expenditures, and errors and omissions.

USSR: Coping With the Decline in Hard Currency Revenues

Reduced energy earnings and a depreciated US dollar have made it more difficult for the USSR to balance hard currency sources and uses over the past three years (see figure 1). This turn of events followed a period of relative calm for Moscow's hard currency position: in the period 1982-84 sizable trade surpluses enabled Moscow to hold gross debt roughly constant at about $22 billion and even to cut net debt by $2 billion to just under $11 billion. But the Soviets have seen their gross debt rise more than 85 percent since 1984, and only favorable circumstances—two large harvests, a recovery in oil production, and high gold prices—have prevented the debt from climbing higher.

Battered Energy Trade

The collapse in world oil prices in early 1986—coming on the heels of reduced Soviet oil production and exports in 1985—seriously undermined Moscow's ability to earn hard currency. Oil earnings had plummeted from an average of $15.2 billion during 1982-84 to just $7 billion or 28 percent of total hard currency exports by yearend 1986 (see table 1). The recovery in Soviet oil production as well as somewhat higher world oil prices helped boost oil earnings in 1987, but estimated oil revenues of just over $9 billion were still well below peak revenues. Moreover, low world oil prices also took a toll on Soviet hard currency gas earnings by holding gas revenues under the $4 billion mark despite a 40-percent hike in export volume for 1986-87.

Moscow's problems were compounded by the depreciation of the US dollar. The purchasing power of Soviet energy revenues has eroded sharply because oil and gas sales are priced in dollars, while most Soviet purchases are made with nondollar currencies in West European and Japanese markets. The official dollar-ruble exchange rate, set by the Soviet state bank, Gosbank, is based on a weighted basket of currencies and therefore serves as a rough proxy for exchange rate movements. This rate increased from $1.20 per ruble in 1984 to $1.57 per ruble by yearend 1987 (see inset)

Seeking Alternative Hard Currency Earners

Reacting to the drop in energy revenues, the Soviet leadership made a concerted effort during the past two years to increase sales of nonenergy goods. Arms sales to the Third World grew sharply and, indeed, were largely responsible for Moscow's ability to generate sizable hard currency surpluses despite lost oil earnings (see figure 2). The value of arms sales jumped to an annual average of $7.3 billion for 1986-87; it was $4.9 billion in 1985.[2] Continued tensions in the Middle East and ongoing struggles between Soviet client states and insurgency movements have kept demand high for Soviet arms: munitions, support equipment, and spare parts have accounted for the bulk of increased sales. In addition, increased competition from Western suppliers—including some newly industrialized countries (NICs)—has spurred the Soviets to demonstrate more flexibility in setting prices and arranging financing to keep old customers or attract new ones.

The immediate foreign exchange benefits to the USSR from these higher arms sales are suspect, however. The Soviets have had to finance much of the arms sales growth via credit extensions to the less developed countries (LDCs), thus earning hard currency only on paper. Indeed, current sales are probably bringing in only $2-3 billion in cash per year. We estimate that the share of annual hard currency arms sales to the LDCs on credit has risen in recent years and now is at least two-thirds.

Moscow's drive to push nonenergy, nonarms merchandise exports achieved less satisfactory results. These sales were up about a billion dollars in 1986; the increase was due mostly to sales of traditional Soviet exports such as diamonds, precious and strategic

[2] While real deliveries rose, dollar depreciation also accounted for a good share of the increase: Soviet military goods are priced in rubles but payable in dollars

Table 1
USSR: Hard Currency Trade by Major Commodities

Million current US $

	1970	1975	1980	1981	1982	1983	1984	1985	1986
	Exports								
Total	**2,405**	**9,453**	**27,874**	**28,254**	**31,975**	**32,429**	**32,173**	**26,400**	**25,111**
Oil and oil products	387	3,170	12,123	11,887	14,824	15,569	15,111	11,471	7,001
Natural gas	1	220	2,710	3,968	3,673	3,194	3,754	3,813	3,638
Machinery and equipment	123	450	1,227	1,206	1,347	1,407	1,229	1,149	1,196
Wood and wood products	365	714	1,510	1,018	853	857	824	711	1,037
Chemicals	61	242	758	807	703	748	1,017	1,015	791
Agricultural products	167	522	458	555	474	333	181	182	274
Military	240	1,903	5,131	5,980	7,220	7,162	6,889	4,937	7,100
Other	1,061	2,232	3,957	2,833	2,881	3,159	3,168	3,122	4,074
	Imports								
Total	**2,711**	**14,257**	**26,060**	**27,889**	**27,507**	**27,717**	**27,446**	**25,881**	**23,098**
Agricultural products	613	3,914	8,804	11,829	9,919	9,127	9,468	8,125	4,483
Grain	101	2,323	4,503	6,327	5,506	4,876	6,315	5,253	2,178
Other	512	1,591	4,301	5,502	4,413	4,251	3,153	2,872	2,305
Nonagricultural products	2,098	10,343	17,256	16,060	17,588	18,590	17,978	17,756	18,615
Machinery and equipment	927	4,593	6,039	4,523	6,114	7,009	5,822	4,824	6,509
Ferrous metals	285	2,627	3,622	3,605	4,284	3,713	3,460	3,644	3,587
Chemicals	248	800	1,953	1,771	1,724	1,763	1,814	2,265	2,249
Fuels	8	497	831	503	1,579	2,100	2,732	2,734	2,162
Other	630	1,826	4,811	5,658	3,887	4,005	4,150	4,289	4,108

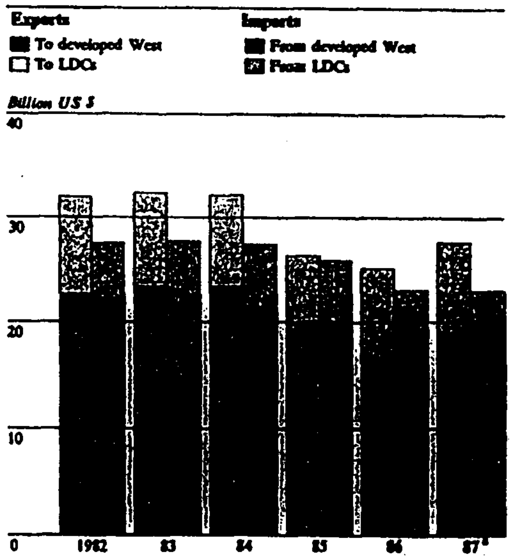
metals, nickel, and timber. But on the basis of preliminary partner country data and Western press reporting, sales of some of these items appeared to have tapered off last year. The Soviets have been unable to generate increased machinery and equipment exports to the West, with this category holding steady at just 5 percent of total hard currency merchandise exports.

The Soviets have benefited from substantially increased gold sales. The USSR sold a record volume of gold to the West in 1986—an estimated 330 metric tons—which increased gold earnings to $4 billion. Gold sales volume in 1987 is estimated to have fallen 25 percent to 250 tons, but earnings remained high at roughly $3.5 billion because of higher world prices (see table 2). The USSR [redacted] sold about 200 tons of gold through the first 10 months of the year and [redacted] planned to sell substantial quantities during the last two months of the year and in early 1988 to help finance purchases of Western agricultural commodities. Recent Western press reports indicate that such sales have taken place. The Soviets are also showing greater interest in Western gold sales practices such as futures trading, options, and swaps, as well as in more direct sales in smaller lots to hide the level of sales and reduce market reactions (see inset)

Measuring Soviet Foreign Trade: Ruble Versus Dollar

Although the ruble is a nonconvertible currency, the Soviets report their trade flows with hard currency countries in rubles. As a matter of convention, however, we report Soviet trade in dollar terms, converting from the ruble to the dollar at the rate set by the Soviet state bank, Gosbank. This can create some problems in trying to interpret Soviet trade flows, given the fluctuation of the US dollar during the 1980s. For example, the "dollar" value of Soviet imports of machinery and equipment from hard currency countries rose 35 percent during 1985-86. In contrast, these imports increased only 12 percent in rubles and showed no growth at all in West German marks. The exchange rate effects can be even more pronounced on Soviet trade flows since the bulk of Soviet exports to the West (oil and gas) are priced in US dollars while Soviet imports are priced largely in nondollar currencies such as the mark, franc, or yen. Trade flows in this paper are usually presented in dollars, with an occasional reference to "real" imports or exports in which adjustments are made to account for exchange rate and price movements.

Figure 2
USSR: Hard Currency Trade, 1982-87



[a] Preliminary estimates.

Tapping Financial Markets

The Soviet hard currency problem has also prompted a return to Western capital markets in recent years. Increased Soviet borrowing helped push gross debt at yearend 1987 to an estimated $41.2 billion (see table 3). A substantial share of the increase in dollar-denominated indebtedness was attributable to the depreciation of the US dollar relative to other Western currencies because about one-half of debt is held in other currencies (see figure 3 on page 6). Indeed, net new borrowing was much lower last year due, in part, to renewed oil earnings. We also believe that the USSR used a portion of its new loans to refinance older, costlier hard currency debt, thus improving its payments position in the near term and helping to hold down interest costs

Soviet net debt grew to an estimated $26.2 billion in 1987 from $10.7 billion in 1984. Assets on deposit in Western banks were estimated to be roughly $15 billion by yearend 1987, compared with $11.5 billion in 1984. As with the growth in liabilities, more than one-half of the asset change was the result of dollar depreciation. The growth in assets was somewhat surprising given Moscow's financial straits, but may have reflected a desire by the leadership to maintain a sufficient stockpile of funds in the face of uncertain oil and credit markets

Table 2
USSR: Estimated Hard Currency Balance of Payments

Million current US $

	1975	1980	1981	1982	1983	1984	1985	1986 [a]	1987 [a]
Current account balance	−4,565	1,485	−395	4,348	4,772	4,664	137	1,373	3,465
Merchandise trade balance	−4,804	1,814	365	4,468	4,712	4,727	519	2,013	4,600
Exports, f.o.b.	9,453	27,874	28,254	31,975	32,429	32,173	26,400	25,111	27,600
Imports, f.o.b.	14,257	26,060	27,889	27,507	27,717	27,446	25,881	23,098	23,000
Net interest	−521	−1,219	−1,760	−1,220	−1,040	−1,163	−1,482	−1,740	−2,235
Other invisibles and transfers	760	890	1,000	1,100	1,100	1,100	1,100	1,100	1,100
Capital account balance	6,178	20	5,685	−3,579	−1,023	−124	1,868	2,118	200
Change in gross debt [b]	5,755	−1,059	2,244	−1,258	665	224	6,804	7,175	5,000
Official debt	1,492	−280	−1,370	967	340	−375	463	1,089	1,900
Commercial debt	4,263	−779	3,614	−2,225	325	599	6,340	6,086	3,100
Net change in assets held in Western banks [c]	−391	−35	−166	2,122	277	−664	1,787	1,635	0
Estimated exchange rate effect on debt and assets	−22	−414	−1,445	−821	−1,039	−688	3,248	3,322	3,500
Net credits to the LDCs	715	950	870	2,120	3,200	2,700	1,700	4,100	4,800
Gold sales	725	1,580	2,700	1,100	750	1,000	1,800	4,000	3,500
Net errors and omissions [d]	−1,613	−1,505	−5,290	−769	−3,749	−4,540	−2,005	−3,491	−3,665

[a] Preliminary.
[b] Including additions to short-term debt.
[c] A minus sign signifies a decline in the value of assets.
[d] Includes hard currency assistance to and trade with Communist countries, credits to developed Western countries to finance sales of oil and other commodities, other nonspecified hard currency expenditures, as well as errors and omissions in other line items of the accounts.

Table 3
USSR: Estimated Hard Currency Debt to the West [a]

Billion current US $

	1975	1980	1981	1982	1983	1984	1985	1986 [b]	1987 [b]
Gross debt	12.6	20.4	22.6	21.3	22.0	22.2	29.0	36.2	41.2
Commercial debt [c]	8.3	10.9	14.5	12.3	12.6	13.1	19.5	25.6	28.7
Government and government-backed debt [c]	4.3	9.5	8.1	9.0	9.4	9.1	9.5	10.6	12.5
Assets in Western banks	3.8	10.0	9.8	11.9	12.2	11.5	13.3	15.0	15.0
Net debt	8.8	10.4	12.8	9.4	9.8	10.7	15.7	21.2	26.2

[a] This series is based on a recently completed revision of the methodology for computing Soviet debt; therefore, the data may not correspond to previously published series.
[b] Preliminary estimates.
[c] Estimates of government-backed and commercial debt are measured in current dollars and reflect fluctuations in exchange rates. Commercial debt also includes estimates for promissory notes held outside banks.

Soviet Gold Market Initiatives

The Soviets have traditionally followed a conservative marketing strategy and sold gold—when hard currency was short—through well-established markets in London and Zurich. Over the past several years, however, Moscow has become a more sophisticated player, taking a number of steps to improve selling practices and to market gold outside its normal channels:

- *It has increased its presence in gold spot markets, becoming more active in Hong Kong, Tokyo, and Singapore. In addition, Soviet gold traders have increased direct sales to buyers and have contacted dealers in the United States, France, West Germany, Italy, and the Middle East to establish new trading links.*
- *Its traders are aggressively selling gold options to earn revenue and to hedge against a price drop.*
- *It is continuing to "swap" gold to receive hard currency premiums. In this case, Moscow's higher purity gold is traded for another country's vault gold of lesser quality, and the difference is accredited to the Soviets' account in a Western bank.*

[redacted] *the USSR is seriously considering using some of the newest techniques in the gold market to borrow hard currency at less-than-market rates. For example, Moscow may "borrow" gold from an agent who sells the gold on the spot market and remits the proceeds to the USSR. The Soviets repay the "borrowed gold" at a later date with gold plus an interest rate of 1 or 2 percent. (The agent will profit if the price of gold rises.) Another scheme is a "participation deal" or "minimaxi" in which a Western partner loans hard currency to the USSR (presumably an investment loan although the money is untied) and in return is granted the right to purchase a quantity of Soviet gold at below-market prices. If the market price of gold rises above a stipulated maximum price, both partners share the profit. The Soviets have even investigated depositing gold in major banks as collateral for loans.*

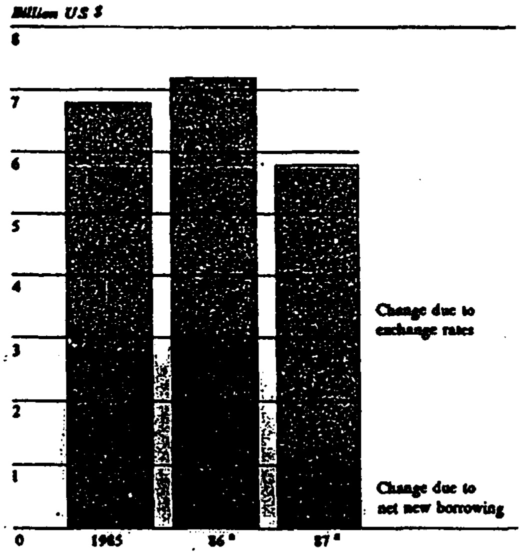
Recent Soviet initiatives are likely to generate higher earnings and to make it more difficult to track sales. Moreover, the increased sophistication and more astute timing of sales will enable Moscow to sell larger quantities of gold without seriously depressing world gold prices.

Most of the debt growth was accounted for by Moscow's increased reliance on commercial credits as falling commercial interest rates—represented by LIBOR, the London Interbank Offered Rate—made these loans more attractive than the consensus rate prescribed by the Organization for Economic Cooperation and Development (OECD) for official lenders (see figure 4). The share of Soviet gross debt comprised of commercial obligations rose from 50 percent in 1980 to 70 percent by 1987. But there were some signs last year of renewed interest in government-backed, project-related financing. For example, major credits extended to the Soviets last year—though only partially drawn—included $600 million [redacted] for the construction of a polyester complex, roughly $700 million in project-related credits [redacted] and about $500 million each from France and Italy. The pendulum might be swinging back, not only because of lower interest rates from governments, but also because of a desire by Moscow to lessen its dependence on commercial lending while its credit rating remains strong.

Although still relying largely on traditional trade credits and syndicated loans, the USSR has begun to broaden the scope of its financial dealings with the West.[3] In the summer of 1986 the Soviets invested in

3 [redacted]

Figure 3
USSR: Estimated Change in Gross Debt, 1985-87



a Preliminary estimates.

an international bond issue for the first time, and at the beginning of 1988 they issued their own sovereign bond. In addition, Soviet or Soviet-owned banks in the West increased their use of acceptance facilities and other nonbank financing (see inset for a more detailed discussion of new financial initiatives).

Imports Take a Beating

Moscow also reacted to the fall in energy earnings with substantial cuts in imports. Imports averaging roughly $23 billion in 1986 and 1987 were 12 percent below those of 1985 and 17 percent below the peak 1982-84 annual average in dollar terms and probably 25 to 30 percent less in real terms

Decisions on which imports to cut were made somewhat easier by two consecutive large grain crops.[4] A 210-million-ton harvest in 1986 enabled the USSR to slash the volume of grain imports by about 40 percent; purchases from the United States and Argentina were affected the most. The lower volume, coupled with markedly lower world grain prices, reduced Soviet hard currency grain expenditures in 1986 to roughly $2.2 billion—some $3 billion less than in 1985. The dollar value of grain purchases probably held steady in 1987. Although Moscow claimed a grain crop of 211 million tons that year, the volume of grain imports rose an estimated 25 percent. The poor quality of the 1987 harvest—a result of unusually wet weather during the harvesting—spurred the additional purchases. The higher volume, however, was offset by lower world prices and subsidized sales from the major grain exporters.

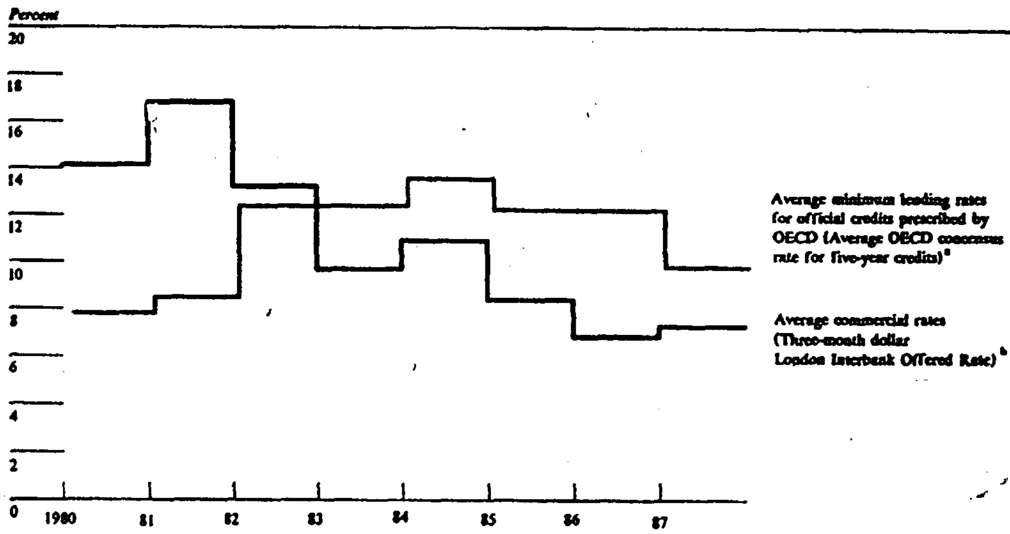
The lower outlays for grain only partially eased the pressure on Moscow to cut sharply into other hard currency purchases. On the one hand, nominal imports of Western machinery and equipment increased by 35 percent in 1986 to an estimated $6.5 billion. After discounting for inflation and the depreciation of the dollar, real growth amounted to an estimated 10 percent; purchases of equipment for metal processing, steelmaking, and road building accounted for most of the rise. The plunge in world oil prices at the beginning of 1986, nevertheless, prompted Moscow to cancel, postpone, or scale back a number of major projects slated for the 1986-90 Five-Year Plan. These actions, we believe, led to a 10- to 15-percent drop in real imports of machinery and equipment in 1987.

Little Help From Foreign Trade Initiatives

Moves to restucture the foreign trade sector that took effect at the beginning of 1987 were too new and too

4 [ ]

Figure 4
USSR: Average Minimum Lending Rates for Official Credits Prescribed by OECD Versus Average Commercial Rates, 1980-87



[a] Source: Euromoney Guide to Export Finance, 1986; OECD Press Reports.
[b] Source: International Financial Statistics, IMF.

limited to have aided Moscow's trade and financial picture last year. The centerpiece of the reforms—granting direct foreign trade privileges to 22 ministries and 77 enterprises—was to have improved trade by breaking the Ministry of Foreign Trade's (MFT) monopoly and removing the Ministry as a cumbersome middleman in foreign trade transactions. Yet the MFT retained control over a substantial portion of hard currency trade because trade in raw materials and food and roughly 60 percent of machinery imports remained in its charge

For those organizations granted direct trading rights, the reforms, to some extent, probably had a dampening effect on trade in the short run. Soviet trade officials have acknowledged that trade with Western countries was disrupted by confusion and paralysis stemming from the new rules. Many ministries and enterprises were ill equipped to handle the new responsibilities; the major complaint was a lack of personnel knowledgeable in trade affairs

The development of joint ventures with Western firms on Soviet soil also did not meet initial Soviet expectations. Despite an aggressive campaign that resulted in over 300 proposals from the West, Moscow concluded only about 18 deals by yearend 1987. Western firms shied away from signing deals largely because of their

Expanding Financial Horizons

In recent years, the Soviet Bank for Foreign Economic Affairs (VEB)—formerly the Bank for Foreign Trade (VTB)—and Soviet-owned banks located in the West have expanded their use of international financial markets and experimented with new instruments. These initiatives are being pursued by a new breed of Soviet banker, one who is younger, better educated in Western banking techniques, and more willing to take risks than his predecessor. In most cases, the new options that these bankers are trying—in addition to being more cost effective and flexible—may not be reported in Western banking statistics, thereby potentially disguising the level of the USSR's debt:

One other aspect of Moscow's financial "breakout" is a substantially increased effort to expand contacts, in general, with international bankers and organizations:

- *Last summer, the USSR sent its first representatives to the annual meeting of the Asian Development Bank, and a Soviet economist expressed interest in a meeting with International Monetary Fund officials to discuss the USSR's role in the world monetary system.*
- *Soviet bankers have stepped up their attendance at numerous world banking seminars and hosted Western bankers to discuss new trade and financial instruments.*
- *Soviet bankers have met with a number of Western bank representatives to establish arrangements to help finance joint ventures on Soviet soil.*

Update on Joint Ventures

Moscow has recently shown increased flexibility regarding the formation of joint ventures in an effort to make such projects more attractive to Western firms. A decree published in early October 1987 gives the Western partner more control over sales in the Soviet market, simplifies the procedure for joint-venture approval, and clarifies some tax provisions. [redacted] *12 new instructions covering a host of problems such as currency regulations, customs, and taxes have already been written and are being prepared for release.*

The Soviets are also allowing barter and other arrangements to enable Western firms to earn hard currency for profit repatriation without having to resort to direct sales of the venture's output. For example, [redacted] *—will recoup its investment by receiving Soviet petrochemical products to sell in the West.* [redacted] *that the USSR Council of Ministers can now authorize the use of state funds for profit repatriation if the venture's output can substitute for hard currency imports.*

Despite these efforts, we expect only a limited number of joint ventures will be in operation within the next year or two, and they will probably have little impact on Soviet hard currency earnings or the quality of domestic production during the remainder of the current five-year plan. Indeed, some Soviet officials have claimed that only 20 to 30 agreements will be concluded during the first two years, and that Moscow will then impose a temporary moratorium on signings. Most of the deals concluded to date or those close to signing appear to be relatively small endeavors that involve simple production processes, low-level technology, and little foreign capital. A few large projects are under negotiation, but, even if agreements are reached sometime this year, it will be several years before these projects begin full operation. Over the longer term, Moscow stands to reap some benefits from even a small number of joint ventures. These projects could help improve the performance of certain industries, increase skills of selected personnel, and provide access to some new foreign markets.

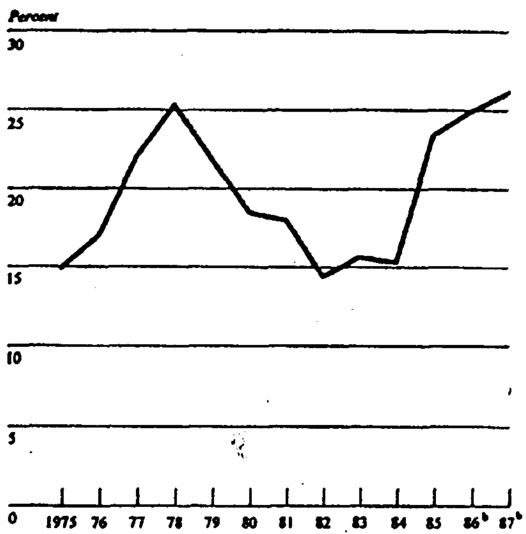
concern about profit repatriation and management control. As with the trade reforms, the push for joint ventures may even have been somewhat counterproductive because Soviet officials probably overlooked some traditional trade deals while they were searching for joint-venture arrangements (see inset for an update on joint ventures).

Near-Term Outlook: Staying the Course

Although Moscow's hard currency position has worsened in recent years, the Soviets do not yet find themselves in a serious financial bind. Their debt service ratio has climbed to an estimated 26 percent, but this is not much higher than levels recorded in the late 1970s (see figure 5). Moreover, Moscow retains gold reserves well in excess of 2,000 tons; these add further support to the sizable assets held in Western banks. Thus, the Soviets have maintained their credit rating throughout this difficult period and still have relatively easy access to Western funds.

Moscow could face a much tougher road ahead in maintaining its hard currency position. Ongoing efforts to expand exports of manufactured goods will result in only marginal gains for a few selected products. The volume of gas sales will continue to climb, but Moscow will be hard pressed to repeat last year's near-record volume of oil sales. And, in any event, depressed world oil and gas prices will still keep

Figure 5
USSR: Debt Service Ratio, 1975-87 [a]



[a] Debt service ratio=(interest plus principal repayments) divided by total hard currency earnings.
[b] Preliminary estimate.

total energy revenues far below peak earnings. Moscow may be able to keep up its arms exports as long as it extends credits, but this policy does not provide significant hard currency receipts

The Soviets will move ahead with their foreign economic initiatives, but these, too, will reap few short-term dividends. Indeed, the further revamping of their foreign trade apparatus at the beginning of the year will add to already existing confusion in the short run among both Soviet and Western traders (see inset). Moreover, the ultimate success of reforms in the foreign trade arena is linked heavily to the pace of domestic reform, which we believe will proceed slowly. Efforts to open new markets to Soviet goods, either

Further Tinkering With the Foreign Trade Apparatus

In mid-January 1988, Moscow replaced the Ministry of Foreign Trade and the State Committee for Foreign Economic Relations—the body that administered economic aid—with a single Ministry of Foreign Economic Relations. the Soviets have not yet determined the exact structure and functions of the new ministry, but there are several indications of what the Soviets may have in mind:

- *The appointment of Konstantin Katushev, the former chairman of the State Committee for Foreign Economic Relations whose background is in socialist government relations, suggests that the new ministry will retain responsibility for foreign economic aid.*

- *Moscow may grant additional ministries and enterprises the right to engage in foreign trade since staff cut from the two defunct bodies—up to 30 percent —can be reassigned to new trade departments at these entities. The lack of trade experts at the ministry and enterprise level has been a serious problem for Moscow in its attempts to decentralize foreign trade decision-making.*

- *The USSR Chamber of Commerce and Industry is also likely to gain a greater role in foreign trade policy under the current reshuffling: its new chairman, Vladislav Mal'kevich, former First Deputy Minister of Foreign Trade, has considerable contacts with Western businessmen. In addition, a Soviet official reported that this organization will now serve as a contact point for Western firms interested in joint-venture discussions.*

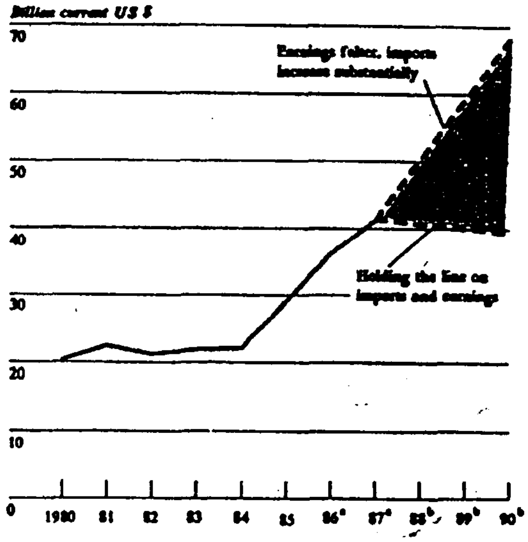
through direct bilateral ties or international organizations such as the General Agreement on Tariffs and Trade (GATT), are also long-term undertakings with uncertain outcomes.

With limited short-term prospects for boosting hard currency earnings, Moscow is likely to see its debt continue to grow for the next few years. By how much and how quickly depend largely on Soviet plans to expand imports to aid the modernization effort or, to a lesser intent, to boost consumer welfare. At present, it appears the Soviet leadership is not planning to deviate from current policies. The most definitive statement to date has been by Viktor Gerashchenko, vice president of the Soviet Bank for Foreign Economic Affairs, who stated in the Western press that hard currency sources would account for 2 percent of future investment needs. This amounts to roughly $6 billion per year, given current annual Soviet investment of 200 billion rubles. Soviet purchases of Western machinery and equipment averaged almost $6 billion the past three years, suggesting little change is anticipated.[1]

Statements from other Soviet officials suggest the same cautious policy. Gorbachev, while not specifically addressing the issue, has repeatedly chastised past efforts to rely on imports because of their high costs and poor paybacks. Indeed, the thrust of *perestroyka* to date has been to modernize from within, with foreign trade initiatives designed, in part, to improve the assimilation of those goods imported, but not necessarily to import more. Most Soviet banking officials—those with the ultimate power of the purse strings—are also playing down any heavy borrowing plans at the moment,

If Moscow manages to hold the line on imports, we do not foresee any financial bind by the end of the decade. Indeed, under very favorable circumstances—maintaining current real exports and gold sales as well as experiencing no further dollar depreciation—Moscow's pursuit of a very conservative import strategy would actually allow it to reduce its gross debt by the end of the current five-year plan (see figure 6). We

Figure 6
USSR: Gross Debt Growth Scenarios



[a] Preliminary estimates.
[b] Projected.

project that Moscow would be able to use its large trade surplus and profits from gold sales to reduce borrowing and thus cut gross debt to about $39 billion. Similarly, net debt would drop to about $22 billion, and the debt service ratio would fall to 23 percent.

More likely, however, Moscow will face some problems in maintaining its current level of hard currency earnings. Oil exports will probably be the biggest problem; and the volume of sales to hard currency countries is likely to drop over the next several years unless the Soviets are willing—and able—to continue pumping enormous investment funds into production. Other potential earnings problems could arise because

[1] Deriving an accurate dollar figure for future equipment purchases is subject to a great degree of error: domestic rubles must be converted to foreign trade rubles and then to dollars

of weak gold or arms markets. But, even with difficulties that decrease real exports by roughly 10 percent from current levels, we project that Moscow could keep gross debt under $50 billion by 1990, again assuming no real import growth or further dollar depreciation. Such a debt level would still be small in comparison with the size of the Soviet economy and would present few concerns to most Western bankers.

An Eventual Turn to the West?

While we believe that Moscow's trade and borrowing plans are unlikely to change markedly in the near term, we cannot rule out a greater role for the West. In fact, Gorbachev's modernization drive could reach a critical juncture by the end of this year as Moscow implements disruptive measures designed to change the way workers, factory managers, and central planners operate. Since the beginning of the year, enterprise directors have had to contend with new "self-financing" and "full economic accountability" regulations, the expansion of an already jolting quality control system, ongoing plant retooling, and the phasing in of untried supply and planning reforms. [redacted], the changes have already begun to create chaos in industry. If this situation continues, the Soviets could face a decline in industrial production, increased worker restiveness, and severe supply shortages and bottlenecks, all of which would heighten their perception that the modernization program is failing and that they are falling even further behind the West technologically.

Such a turn of events could prompt Gorbachev to step up the infusion of foreign inputs on a scale much larger than currently envisioned. He is likely to give the nod first to countries in the Council for Mutual Economic Assistance (CEMA), given the intensive campaign under way to expand CEMA's role in Soviet economic development. But because of Eastern Europe's already weak response to Soviet demands, the Soviet leadership may look as much—if not more—to the West as to its CEMA allies. The economic troubles being experienced by some of its East European neighbors may make Moscow uneasy about adding to their strains. In addition, Eastern Europe may simply be unable to provide—even under Soviet pressure—the types and quality of goods the Soviets will be looking for to revive growth.

In contrast, Moscow would probably find willing suppliers in the West. Western businessmen have been geared up since the start of the current five-year plan to increase sales to the USSR, only to find their expectations dashed. Yet Moscow's increased activity in the past 18 months to expand its role in the world economy has rekindled Western interests.

Stepped-up imports would also pick up the pace of debt growth. Modest nominal import growth on the order of 8 percent a year would present few, if any, problems. In fact, such import growth under a favorable earnings scenario would only raise Soviet debt to a projected level of $45 billion by 1990 with a corresponding debt service ratio in the early 1990s of roughly what it is now. Should the Soviets seek 8-percent import growth under conditions of falling hard currency earnings, their debt would climb to a projected $55 billion level by the end of the decade, with a corresponding debt service ratio of roughly 33 percent in the early 1990s

We believe Moscow could embark on an even more serious import binge and still encounter few financing problems. For example, nominal import growth of 15 percent a year would—even with falling hard currency earnings—push Soviet debt to just under $70 billion by 1990, with a debt service ratio of around 50 percent in the early 1990s. Most Western bankers would probably be willing to underwrite such an increase, given the size of the Soviet economy and Moscow's reserves of gold, oil, gas, and other natural resources. Indeed, under such a scenario the investment climate in the USSR would still look quite attractive compared with the debt problems of many of the world's major debtors. The objections would more likely come from a Soviet leadership that would be unwilling to go that far for fear of the potential economic leverage it would be giving to Western governments and bankers. Moreover, the Soviets recognize that plans for any debt buildup can go awry should Moscow unexpectedly confront a further depreciation of the dollar or a bad harvest or two.

Implications for the United States

A conservative Soviet import/borrowing strategy in the near term would present US policymakers with an international economic environment that differs little from what they now face. The Soviet leadership will most likely continue with its deliberate pace to expand its role in the world economy, attacking on those fronts where success is probable or the rewards potentially large, and pulling back in areas where it has little to gain:

- Soviet hard currency trade will continue to be dominated by West Europeans and Japanese. Moscow will press for improved Soviet-US economic ties, but largely with the intent of opening US markets that are either directly closed to Soviet products or effectively closed because of high tariffs. US sales will continue to hinge on Soviet grain purchases, and even then the Soviets will exploit glutted grain markets to drive for better terms.

- Moscow will continue to tap new sources of finance, seeking out both new lenders and new financial instruments. Dabbling in new markets is apt to be small, however, with additional bond offerings likely to see the most growth given the unqualified success of the first Soviet bond issue. For the most part, the Soviets will still look largely to syndicated loans and trade credits if borrowing remains on the lean side.

- The Soviets will also maintain their steady pursuit of membership in key international economic organizations, focusing efforts on those bodies perceived as most likely to enable them to gain increased access to foreign markets. Thus, organizations like GATT and arrangements such as the Multi-Fiber Accord (MFA) will remain high on Moscow's list, while the IMF and World Bank will be largely ignored.

- Additional piecemeal moves to decentralize the foreign trade sector will continue, but truly radical measures are not likely soon. For example, Moscow recently stated that it does not envision a "convertible ruble" until the second half of the 1990s.

Greater opportunities and/or concerns would arise for the United States should Moscow opt to allow the West a greater stake in Soviet economic development. In such a case we would expect to see continued attempts to create a benign international environment more hospitable to increased East-West economic ties. In conjunction with such moves, however, we would also expect to see an intensification of Soviet foreign economic initiatives, including increased concessions to Western firms to conclude joint-venture agreements, a stepped-up campaign for GATT membership and MFA participation, and the possible release of more trade and financial data to facilitate borrowing.

Sales by US companies should increase if Moscow expands economic ties to the United States to help pave the way for its overall political and economic agenda. But substantially larger sales may not be in the cards. At a time when the USSR is willing to increase its dependence on the West, it probably would remain leery of the reliability of US suppliers. Moscow would probably still look largely to the West Europeans and the Japanese, believing that unilaterally imposed US embargoes are still possible.

The risk to the United States of such Soviet overtures is that other Western governments might increase their trade and financial concessions in hopes that their firms would gain the upper hand in tapping Soviet domestic markets. Of particular concern could be increased pressures to pare further the list of controlled technologies specified by the Coordinating Committee for Multilateral Export Controls (COCOM). Such pressure would make it more difficult for the West to maintain a unified stance on current agreements—or reach a new consensus—concerning trade and financial flows to the Soviet Bloc.