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Soviet Hard Currency Trade and Payments: Performance and Prospects

An Intelligence Assessment

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September 1979

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Soviet Hard Currency Trade and Payments: Performance and Prospects [redacted] 25X1

An Intelligence Assessment

Information available as of 21 September 1979 has been used in the preparation of this report.

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This report has been coordinated with the National Intelligence Officer for Political-Economy. [redacted] 25X1

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Soviet Hard Currency Trade and Payments: Performance and Prospects 25X1

Key Judgments

Following two consecutive years of decline, the USSR's hard currency trade deficit rose slightly in 1978 to $3.8 billion. It will grow substantially this year, perhaps to $5.0 billion or more. 25X1

A slackening in domestic economic performance and the continued need for Western technology are largely responsible for the growing deficit:

- A disappointing 1977 grain harvest and the likelihood of a substantial shortfall in grain production this year, together with the leadership's determination to steadily increase meat supplies, have led to a rapid rise in grain and soybean imports. Hard currency outlays for these commodities in 1978 amounted to $2.6 billion and probably will jump to about $4.0 billion this year.

- Mounting difficulties in steel production have led to more imports of steel products. Last year imports rose by 42 percent in value, to $2.5 billion, and will rise to more than $3.5 billion this year if present trends continue.

- Soviet machinery and equipment imports climbed to a record $6.0 billion last year and could run to $4.5 billion or more in 1979. 25X1

Moscow has been able to increase its hard currency earnings from natural gas, chemical products, and manufactured goods as a result of increased export volume and higher prices. Earnings from exports of these commodities rose substantially in 1978 and should rise again this year. But the USSR is having difficulty in increasing or even maintaining deliveries of other goods to Western markets. Tightness in the Soviet oil balance caused by a leveling off of production will reduce the availability of oil for export to the West this year. Oil shipments to non-Communist countries from Black Sea ports during the first half of 1979 were down by almost 20 percent from last year's January-June rate. Although higher oil prices will mitigate the effect on hard currency receipts, a reduction in the volume of oil exports would prevent Moscow from taking full advantage of the oil market to cover a substantially higher import bill. 25X1

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The USSR had little trouble covering its hard currency trade deficit last year; heavy gold sales and record hard currency receipts from arms deliveries allowed Moscow to achieve its first current account surplus since 1974:

• The USSR was thus able to hold down the growth of hard currency debt; gross indebtedness to the West grew by only $1.5 billion to $17.2 billion. Soviet assets in Western banks increased by a similar amount to $6.0 billion, leaving Moscow's net debt to the West virtually unchanged.[1]

• Moscow also took advantage of its increased liquidity and favorable Euromarket conditions to resturcture its outstanding Eurodollar indebtedness. Roughly $1.0 billion in medium-term loans syndicated in 1975-76 were either prepaid or refinanced on better terms. 25X1

In part because of last year's success, the USSR should have little trouble financing this year's trade deficit, which—depending on oil export policy and the timing of grain and equipment deliveries—could run to $5.0 billion or more. Net earnings from arms sales and invisibles, although probably down somewhat from last year, should be substantial and would offset roughly $1.5 billion of this year's trade deficit. To cover the balance of its foreign exchange needs Moscow could (a) reduce its Eurocurrency assets by up to $2.0 billion; (b) earn up to $3.0 billion from gold sales if prices remain relatively high and demand relatively strong; and (c) readily borrow several hundred million dollars from Western commercial banks at favorable rates. 25X1

The longer term outlook for hard currency trade and payments is much worse. Higher grain imports and the likelihood of a further reduction in the volume of oil exports will almost certainly lead to an increased trade deficit in 1980. In planning for its hard currency trade and payments in the 1981-85 Plan, the USSR must deal with the likelihood that declining oil sales will lead to even larger trade deficits than the USSR can finance through gold sales and arms exports. 25X1

The USSR, in these circumstances, most certainly would try to avoid prolonged balance-of-payments financing on a massive scale. The Soviet leadership would thus have to squeeze the merchandise trade account by (a) limiting imports of steel, equipment, and grain, and/or (b) allocating increasingly scarce commodities—timber, oil—to the export market. These unpalatable alternatives would mean further strains on an already overtaxed economy. 25X1

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Introduction

Although hard currency imports are small compared with domestic production, the USSR counts heavily on such imports to bridge gaps between domestic supply and demand and to obtain badly needed state-of-the-art equipment and technology. These imports, however, are limited by Moscow's ability to market its goods in the West and by its ability (and willingness) to sell gold and increase its debt to Western governments and commercial banks. The pattern and composition of Soviet hard currency trade is to some degree an index of domestic economic conditions and an expression of the perceived tradeoff between the costs of export expansion and the benefits from additional imports.

Soviet trade and payments behavior in any year also incorporates the legacy of past decisions and Soviet perceptions of future conditions. The past runup in hard currency debt, for example, combined with uncertain prospects for future foreign exchange earnings led the USSR to take a cautious approach to balance-of-payments financing in 1977-79 and to push harder than ever for compensation agreements which guarantee future exports. These factors have combined to limit the growth of imports of Western goods, particularly equipment, and to reduce substantially the net transfer of resources to the USSR from the West compared with previous years.

This paper assesses the USSR's hard currency trade and payments in 1978-79 in the light of (a) Moscow's efforts to strengthen its external financial position, (b) mounting domestic economic problems, and (c) uncertain prospects for expanding hard currency earnings in the 1980s. We review the developments that produced the rapid buildup of debt in 1975-76 and recent moves to reverse this trend. We examine the impact of the USSR's declining economic performance on its trade account and examine Moscow's ability to cover sizable trade deficits this year and next. Finally, we outline the difficulties looming for hard currency trade in the 1980s and the resulting policy options that are likely to confront the Soviet leadership.

Besides presenting general trends, we have examined Soviet foreign trade for several commodities in some detail. The extended treatment is warranted for several reasons. The commodities themselves are of importance; oil export policy and grain import policy, for example, merit particular attention. In addition, the uncertainties in our projections can be better appreciated at the commodity level. Lastly, understanding the impact that domestic economic problems are having on particular parts of the foreign trade accounts is vital to an appreciation of the severity of the problems Moscow faces in managing its foreign trade in 1980 and beyond. 25X1

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Background

In the 1970s, the Soviet Union has relied heavily on Western credits to manage its hard currency balance of payments (figure 1). Moscow, realizing that economic growth was becoming increasingly dependent on technological progress and production efficiency, turned to Western technology and equipment for help. The willingness of Western governments to support their equipment sales with long-term, low interest supplier credits allowed the Soviet Union to rapidly accelerate technology and equipment imports after 1971. Purchases of grain also trended upward, though their volume varied with the fortunes of the Soviet harvest. To the extent that the USSR could not generate sufficient hard currency earnings from merchandise exports, arms sales, tourism, and transportation services to cover that portion of its rising import costs not financed by government-backed credits, it has depended on gold sales and borrowing on the Eurocurrency market to balance its hard currency payments. Apart from heavy gold sales and some commercial bank borrowing to pay for large grain imports in 1973, however, the USSR was able to keep its trade deficits close to planned levels in 1970-74.

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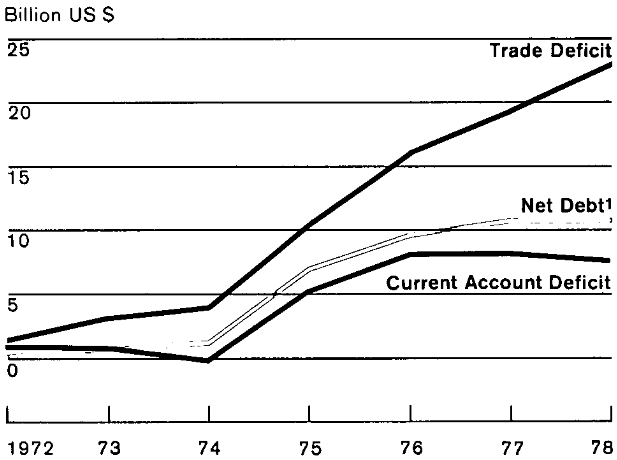
Figure 1
USSR: Cumulative Hard Currency Trade and Current Account Deficits Compared With the Growth in Net Debt



1 Yearend debt estimates understate total net debt by $582 million, the estimated net debt at the end of 1971.

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Moscow's traditional trade and financial policies had to be abandoned in 1975 and 1976. Despite a drop in export growth caused by Western recession, the USSR bought large quantities of grain in the wake of the 1975 harvest disaster and still increased capital goods imports from the West. The failure to scale back nongrain imports produced unexpected trade deficits of $6.4 billion in 1975 and $5.6 billion in 1976. As a consequence of unprecedented and unplanned Soviet borrowing, the USSR hard currency debt to the West soared from more than $5 billion at yearend 1974 to almost $15 billion at yearend 1976.

The Soviet Foreign Trade Bank, which is responsible for financing Moscow's foreign trade, compounded the damage from the trade deficits by failing to fully coordinate and control Soviet borrowing. In 1975 and 1976, the USSR had to raise roughly $7 billion in medium- and short-term funds from Western commercial banks. The Soviet Foreign Trade Bank and Moscow's commercial banks in the West entered the Eurodollar market to obtain substantial direct bank-to-bank credits. The hectic and apparently uncoordinated Soviet borrowing elicited widespread publicity about mushrooming Soviet debt and put some major Western banks close to internal lending limits, leading to demands for higher interest rates on loans to the USSR.[2] 25X1

Perceiving that its image was being tarnished by adverse publicity about the rising hard currency debt and banker demands for higher interest rates, the Soviet leadership in October 1976 called on its most astute international financier, then Deputy Foreign Trade Minister Vladimir Alkhimov, to put Soviet finances in order. Alkhimov, who had been overseeing the Ministry of Foreign Trade's Foreign Currency Administration, was moved from his second-rung job in the foreign-trade bureaucracy to the chairmanship of the USSR State Bank. 25X1

In line with his view that a central banker must exercise discipline over resources, Alkhimov laid out a strategy for tightening control over Soviet hard currency trade and finances. Statements by Alkhimov and decisions attributed to him by Soviet officials illuminate the elements of this strategy: 25X1

- Placing limits on further debt growth during the 1976-80 plan period and ordering the deferral of a number of major industrial projects until the 1981-85 plan period.

- Ordering a reduction in direct borrowing from Euromarket banks in favor of greater use of Western government-backed credits.

- Increasing hard currency export earnings by expanding raw materials exports and establishing specialized export industries. In the case of oil, severe domestic rationing was initiated in 1976 to permit an expansion of exports in spite of a declining rate of growth of production. 25X1

[2] Schmidt, Charles F., "COMECON's Borrowing Requirements in 1976," *Euromoney*, January 1976, pp. 12-14; Brainard, Lawrence J., "Financing Eastern Europe's Trade Gap—the Euromarket Connection," *Euromoney*, January 1976, pp. 16-21; and *Euromoney* Interview with West European Bank Loan Officers. "Will Euromarket Lending Favor COMECON in 1976?", *Euromoney*, January 1976, pp. 26-28. 25X1

- Forcing greater coordination between the Soviet Foreign Trade Bank and USSR foreign trade organizations, in particular by giving the bank veto power over all foreign trade deals.

- Demanding more compensation arrangements with Western suppliers, thus making imports of material and technology contingent on generation of sufficient foreign currency to pay principal and interest. 25X1

By following this discipline Moscow regained control of its current account, restrained the growth of its debt, and lessened its dependence on Western bank borrowing in favor of government-backed financing. In 1977:

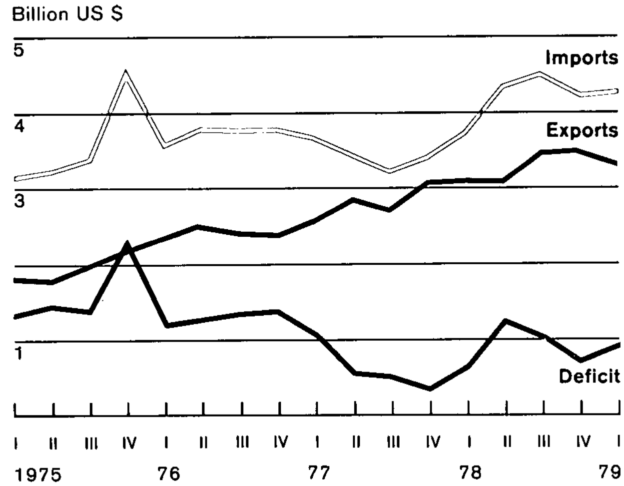
- The trade deficit was cut to $3.3 billion—the net result of a higher volume of oil exports, a slowdown in the growth of equipment imports, and a substantial fall in Western grain deliveries.

- The current account was brought roughly into balance as the USSR, taking advantage of a buoyant gold market, earned roughly $1.6 billion from gold sales and delivered an estimated $1.5 billion of arms for hard currency.

- The rise in gross commercial indebtedness was held to 3 percent while total outstanding debt rose by less than $1 billion, to $15.7 billion. The USSR did not attempt to raise any syndicated Euroloans in 1977.

Figure 2

USSR: Hard Currency Trade[1]



[1] Seasonally adjusted. Official Soviet foreign trade data were used to develop the unadjusted series for hard currency trade. Data also incorporate the movement of US dollars against the market basket of Western currencies which determine the Soviet foreign exchange ruble.

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Trade in 1978

Hard Currency Imports

Soviet hard currency imports rose to a record $17 billion[3] in 1978 led by record Western deliveries of plant and equipment (figure 2). Imports of grain rose substantially as a result of a disappointing 1977 harvest while mounting steel production problems and continued construction of energy transmission networks led to increased imports of nontubular steel and large diameter pipe from the West. 25X1

Machinery and equipment imports increased by 17 percent in value to a record $6 billion (table 1).[4] West Germany, with sales of $1.5 billion, continued to be the USSR's major equipment supplier, although France, Japan, and the United Kingdom racked up large gains (table 2). Deliveries from Italy were up only slightly, while imports from the United States fell by 16 percent to $402 million. The US share of the Soviet hard currency equipment market thus fell from its 1976 peak of 16.3 percent to 6.7 percent last year; the drop reflects, in part, the unavailability of Eximbank credits. 25X1

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[3] Soviet trade data are given in foreign trade rubles; the dollar data presented in this paper were derived by multiplying rubles by $1.47—the average official ruble-dollar exchange rate in 1978. The average ruble-dollar ratio in 1977 was $1.36 per ruble. The change reflects the fall of the dollar against major European currencies in 1978. The data are all in nominal terms; the growth in real terms is considerably lower. An "index of physical volume of foreign trade" published by the USSR shows that exports to capitalist countries (a category that roughly approximates hard currency areas) increased 4 percent in 1978, while imports were up 15 percent.

[4] These figures do not include equipment and pipe imports worth $286 million that were reported in footnotes as imports for the Orenburg natural gas pipeline 25X1

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Table 1

Million US $

USSR: Selected Hard Currency Imports [1]

	1975	1976	1977	1978
Imports	**14,257**	**15,316** [2]	**14,645** [2]	**16,951** [2]
Of which:				
Machinery and equipment of which:	4,593	5,074 [3]	5,114 [3]	5,969 [3]
Transportation	456	304	230	243
Chemicals	503	1,084	1,853	1,938
Energy	184	153	161	605
Motor vehicle manufacturing	346	260	233	123
Rolled ferrous metals	2,565	2,251	1,750	2,480
Of which:				
Pipe	1,509	1,165 [3]	801 [3]	1,269 [3]
Chemicals	742	632	617	831
Of which:				
Plastics	242	181	183	272
Rubber and rubber products	217	216	175	187
Textile and textile raw materials	390	434	535	588
Food	3,319	3,401	2,412	3,175
Of which:				
Grain	2,323	2,627	1,354	2,360
Other consumer goods	436	428	429	340

[1] *Vneshnyaya torgovlya SSSR*, 1970-77.
[2] Includes $420 million in 1976, $888 million in 1977, and $286 million in 1978, which the USSR reported in footnotes as imports associated with the Orenburg natural gas pipeline. The imports consist largely of large-diameter pipe and equipment for the Orenburg natural gas pipeline.
[3] Excluding imports associated with Orenburg.

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Equipment for the chemical industry continued to dominate machinery imports, rising slightly in value to $1.9 billion. In large part these imports entered the USSR under the first stage of compensation agreements that Moscow had signed with Western firms. The USSR is to pay for these machinery imports by deliveries of chemical products to the West. The largest increases in equipment imports were posted in the energy area. Deliveries of energy-related equipment rose from $161 million in 1977 to $605 million 1978, reflecting recent Soviet purchases of natural gasline compressors, submersible oil well pumps, and other equipment for the oil and gas industries. 25X1

A disappointing harvest in 1977 coupled with the leadership's commitment to expand meat production led to imports of 23 million tons of grain (worth $2.4 billion) from hard currency countries last year. Grain deliveries were heavy during the first nine

Table 2 Million US $

USSR: Major Equipment Suppliers

	1977	1978
Total	**5,114**	**5,969**
West Germany	1,421	1,479
Japan	931	1,220
France	770	1,012
Italy	664	701
United States	477	402
United Kingdom	137	339
Other	714	816

months of the year; the record 1978 grain harvest of 237 million tons allowed Moscow to rebuild stocks while cutting back on imports beginning in late 1978. The United States supplied more than 60 percent of Soviet grain import requirements, including 11 million tons of corn. Moscow also stepped up its purchases of soybeans; imports totaled $222 million, of which $215 million came from the United States.

Soviet steel imports rose substantially in value in 1978, returning to pre-1977 levels. Although the pace of domestic pipeline construction apparently slowed in 1978, large-diameter steel pipe imports—roughly 1.5 million tons—increased nearly 60 percent in value to $1.3 billion. Japan and West Germany split 75 percent of the market with the Japanese, West Germans, French, and Italians all providing Moscow with government-backed credits to finance its large-diameter pipe needs.

Mounting Soviet problems in steel production were reflected in the 28-percent rise in the value of nontubular steel imports, comprised largely of a wide variety of structural and flat-rolled steel products. Soviet steel production has been increasing at a slow rate since 1975, mainly because of (1) the failure to bring new production capacity on stream, (2) shortages of iron and steel scrap, and (3) increasing difficulties in iron ore extraction. Although Moscow is undoubtedly concerned over the increased hard currency drain, it cannot afford the economic disruption that would result by forgoing imports. 25X1

Soviet purchases of nonferrous metals and ores, although amounting to only 10 percent of the value of steel imports in 1978, have risen gradually in recent years. On balance, the USSR is a substantial net exporter of nonferrous metals, but it has failed to develop ore mining capacity for some metals rapidly enough to keep pace fully with its domestic needs. To prevent domestic shortages, the USSR bought about $250 million worth of nonferrous metals in 1978, up about $50 million since 1975. The principal import commodities have been tin, bauxite, rolled aluminum, 25X1
lead, and cobalt as well as ores and concentrates of copper, lead, zinc, tungsten, and molybdenum. 25X1

Hard Currency Exports

Moscow was able to limit its hard currency trade deficit in 1978 to $3.8 billion limit as a result of a 16 percent increase in the value of its hard currency exports (table 3). The pattern of exports remained largely unchanged although domestic economic problems, mainly on the production side, appeared to limit exports of traditional hard currency earners such as 25X1
timber products, cotton, coal, and metals. On the other hand, the USSR realized substantial hard currency gains from chemical and natural gas sales and shipments of machinery and equipment to the Third World. 25X1

Earnings from the sale of oil and oil products increased slightly to $5.7 billion last year and accounted for 43 percent of total hard currency export revenue. Exports to hard currency markets were estimated at 1.1 million b/d, almost 10 percent of total Soviet oil production. 25X1
With oil prices approximately unchanged from 1977 (Moscow's prices closely follow OPEC's), the small increase in earnings appears due to the addition of Greece as a hard currency trading partner and possibly to some slight increase in sales of higher priced products relative to crude oil to the West. Italy, West Germany, France, Sweden and the United Kingdom continued to be the major hard currency recipients of Soviet oil. 25X1

Table 3 Million US $

USSR: Selected Hard Currency Exports [1]

	1975	1976	1977	1978
Exports	**7,835**	**9,721**	**11,345**	**13,157**
Of which:				
Machinery and equipment	561	657	797	1,209
Petroleum and petroleum products	3,176	4,514	5,275	5,716
Coal and coke	390	368	357	293
Natural gas	209	347	566	1,063
Ferrous ores and metals	298	282	225	128
Nonferrous metals [2]	465	444	453	525
Of which:				
Platinum-group metals [2]	201	187	177	230
Nickel [2]	53	46	43	85
Aluminum [2]	75	96	152	180
Wood and wood products	712	852	1,029	975
Of which:				
Lumber	262	400	437	403
Cotton	298	392	514	344
Diamonds [2]	478	511	606	600

[1] *Vneshnaya togovlya SSSR*, 1975-78.
[2] Data estimated from Western trade statistics.

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Natural gas exports in 1978 nearly doubled in value to $1.1 billion. The USSR pipes gas to West Germany, Italy, Austria, and France for hard currency under long-term agreements. Quantity data are no longer reported by the USSR, but data are available from partner country statistics which indicate a 19-percent increase in volume to nearly 630 billion cubic feet, some 5 percent of Soviet gas producton (table 4). According to our estimates, prices increased more than 60 percent—from an average of $1.10 per thousand cubic feet in 1977 to $1.80 per thousand in 1978, accounting for most of the growth in earnings.

[redacted]

Exports of solid fuels—primarily coal and coking coal—declined for the third consecutive year. Because of sluggish growth in domestic production, exports were down to virtually all European customers and dropped by 21 percent to Japan. [redacted] 25X1

Meanwhile, the value of wood and wood products exports fell to just under $1 billion. Exports to Japan, roughly half of which were under the 1974 agreement for development of Siberian timber resources, were down from $458 million to $415 million. Log sales registered a slight increase in volume, but lower dollar prices reduced earnings by 10 percent. Exports of coniferous sawn lumber to the United Kingdom, the

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Table 4 — Billion Cubic Feet

USSR: Hard Currency Natural Gas Exports

	1977		1978	
	Scheduled	Actual [1]	Scheduled	Actual [1]
Total	**541.0**	**525.0**	**650.0**	**625.0**
Austria	81.0	86.0	85.0	99.0
West Germany	177.0	198.0	247.0	282.0
Italy	230.0	177.0	247.0	173.0
France	53.0	64.0	71.0	71.0

[1] Estimates are based on Western reporting which in some instances is inconsistent. Reconciliation of various reports is hampered by the fact that in some instances volume data are provided while in other cases information is provided in thermal units. These problems are most apparent in the case of West Germany where reporting on 1978 deliveries ranges from 210 billion to 280 billion cubic feet. The latter figure, taken from a Soviet statement, was used because it is most consistent with data provided by *Eurostat*, a European Community publication.

principle forest product the British buy from the USSR, similarly fell from $151 million in 1977 to $138 million in 1978 on virtually unchanged volume of 1.3 million cubic meters of lumber. Sales to West Germany were down 9 percent to 543,000 cubic meters in 1978; earnings fell from $70 million to $60 million.

Soviet inability to expand earnings from wood and wood product sales is attributable to softer Western markets and Soviet production problems. Timber cuttings were planned to increase 2 percent annually during the present five-year plan. From 1976 through 1978, however, cuttings fell at a 3-percent annual rate. Despite Moscow's efforts to move into higher value-added categories of wood products—pulp, paper, and plywood—sales of these products have lagged because of quality problems.

Exports of nonferrous metals climbed substantially in 1978 as a result of impressive gains in exports of platinum-group metals, nickel, and aluminum. In the case of ferrous ores and metals, however, export earnings in 1978 of $128 million were 43 percent less than in 1977 and 55 percent less than in 1975. The decline, registered in each of the principal export categories—iron ore, pig iron, ferroalloys, and scrap—reflected the raw material supply stringencies that have beset the Soviet steel industry in recent years.

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Exports of chemical products were up 47 percent to $209 million, largely because chemical compensation agreements concluded several years ago began to generate exports. Sales to the United States jumped from $5 million to $33 million as ammonia exports from the Occidental Petroleum fertilizer project began. Other countries also took more Soviet chemical products, but the real surge of chemical shipments to Western Europe under compensation agreements is yet to come; most of the projects will come onstream in 1979-81. 25X1

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The sensitivity of Western chemical industries to these deliveries is likely to grow as Soviet exports rise, especially if Moscow continues to price its exports below Western prices. Exports to the United States have already prompted a group of ammonia producers to ask the International Trade Commission to impose a tariff on Soviet ammonia.[7] Nonetheless, the USSR remains a net importer of chemicals from the West by a 4-to-1 margin. 25X1

The 50-percent jump in machinery and equipment exports to $1.2 billion was a major surprise. Three-fourths of the equipment exports went to LDCs; deliveries to Iraq alone rose to $444 million. Soviet sales to Iraq were highlighted by $140 million in aircraft sales (compared with $7 million in 1977), mostly for six IL-76 jet cargo planes for Iraqi Airways. Other exports to Iraq included equipment for power plants ($94 million) and an irrigation project

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[7] "US Concerns Seek Import Restrictions on Russian Ammonia," *Wall Street Journal*, 12 July 1979, p. 10. 25X1

($30 million). Equipment exports to Nigeria were also up sharply—to $82 million, compared with $17 million in 1977—as a consequence of deliveries for a pipeline project. Exports to other oil-producing countries are either small or under clearing agreements.

Although the big gain in machinery and equipment sales to LDCs was doubtless a welcome source of hard currency, the USSR still has made little headway in penetrating Western markets. Sales to developed countries, up by 17 percent, amounted to only $300 million. Exports of machine tools, presses, hammers, and forging equipment were only $40 million. The only bright spot has been Moscow's successful auto export program. Exports of nearly 85,000 passenger cars to developed countries—a 26-percent rise over 1977—accounted for half of machinery and equipment exports to the West (table 5). The Soviet Lada, based on Fiat design, is priced some 15 percent to 20 percent below competing models in Western Europe and Canada and Lada dealerships are reportedly providing satisfactory after-sale service.[8] Combined sales to West Germany, France, and the United Kingdom, for example, grew from 6,000 autos in 1974 to 44,000 in 1978.

Hard Currency Payments Balance in 1978

The USSR easily handled its 1978 trade deficit of $3.8 million; its current account position improved for the third straight year (table 6). Receipts from gold sales, arms deliveries, and invisibles more than offset the trade deficit and other current outlays, yielding an estimated $312 million current account surplus. This result was a decided improvement over the $219 million deficit recorded in 1977 and was, in fact, Moscow's first surplus since 1974.

The Soviet Union took advantage of the steady rise in the price of gold last year to market approximately 400 tons earning a record $2.5 billion. In 1977, sales of 330 tons had garnered $1.6 billion. Gold production in

[8] Welihosky, Toli, "Automobiles and the Soviet Consumer," in Joint Economic Committee, US Congress, *Soviet Economy in a Time of Change,* to be published fall, 1979.

Table 5

USSR: Hard Currency Passenger Car Exports 25X1

	1977		1978	
	Quantity	Value (Million US $)	Quantity	Value (Million US $)
Total	**90,541**	**149.2**	**95,595**	**178.2**
Developed Countries	67,067	113.3	84,618	150.5
Less Developed Countries	23,474	35.9	10,977	27.7

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these years is estimated at 275 tons and 270 tons respectively. Hard currency receipts from arms deliveries—mainly to oil-rich Middle Eastern nations—also set a record last year at $1.7 billion. 25X1

Net income from services declined to $86 million in 1978 from $309 million the year before. High 25X1 Euromarket interest rates helped boost net interest payments by $1.1 billion. Net income from transportation—although substantial—dropped slightly from the 1977 level. A drop in the carriage of oil exports on Soviet ships contributed to the stagnation of transportation revenues, while hard currency outlays for shipping rose due to an increase in grain imports carried on Western ships.[9] Estimated net income from tourism grew slighly. 25X1

Known official transfers carried out in hard currency and hard currency purchases under bilateral trade agreements totaled $202 million in 1978, $123 million 25X1

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Table 6

Million US $

USSR: Hard Currency Balance of Payments

	1970	1971	1972	1973	1974	1975	1976	1977	1978 [1]
Current Account Balance	**−40**	**68**	**−795**	**118**	**769**	**−5,332**	**−2,747**	**−219**	**312**
Balance of sales and purchases of goods and services	15	125	−729	201	870	−5,234	−2,640	−94	457
Balance on merchandise trade	−500	−313	−1,356	−1,757	−978	−6,422	−5,595	−3,300	−3,794
Exports, f.o.b.	2,201	2,630	2,801	4,790	7,470	7,835	9,721	11,345	13,157
Imports, f.o.b.	−2,701	−2,943	−4,157	−6,547	−8,448	−14,257	−15,316	−14,645	−16,951
Hard currency trade under bilateral trade agreements [2]	0	0	0	0	0	−450	−200	−200	−57
Sales of gold	3	24	289	962	683	750	1,361	1,597	2,522
Military sales	35	50	5	250	250	600	1,500	1,500	1,700
Net income from services	477	364	333	746	915	288	294	309	86
Net income from tourism	43	45	53	116	117	136	150	175	200
Merchandise freight balance	397	257	220	480	570	390	470	590	560
Income	400	260	250	640	640	520	640	710	700
Outlays	−3	−3	−30	−160	−70	−130	−170	−120	−140
Net income from other transportation	120	110	120	230	330	330	390	390	410
Investment income balance	−83	−48	−60	−80	−102	−568	−716	−846	−1,084
Income from direct investment abroad [3]	0	0	0	0	1	2	8	2	0
Interest on outstanding assets in Western banks	NA	87	110	252	405	234	288	292	685
Interest paid on outstanding debt	−83	−135	−170	−332	−508	−804	−1,012	−1,140	−1,769
Government transfer outlays	−55	−57	−66	−83	−101	−98	−107	−125	−145
To the UN	−44	−46	−54	−59	−77	−98	−107	−125	−145
Settlement of lend-lease debt	−11	−11	−12	−24	−24	0	0	0	0
Capital account balance	266	227	−77	522	386	5,694	2,952	1,917	173
Direct investment abroad [4]	0	−6	0	−9	−11	−3	−31	0	0
Borrowing from abroad	291	288	602	1,340	1,426	5,402	4,694	1,777	1,785
Not backed by Western credit guarantees	NA	NA	452	1,183	746	4,160	2,720	191	458
Backed by Western credit guarantees	291	288	150	157	680	1,242	1,554	686	1,041
East European loans for Orenburg	0	0	0	0	0	0	420	900	286
Lending to other countries	−25	−55	−679	−809	−1,029	295	−1,711	140	−1,612
Net increase in Soviet assets held in Western commercial banks	NA	NA	−629	−729	−939	395	−1,611	240	−1,512
Net increase in outstanding supplier credits	−25	−55	−50	−80	−90	−100	−100	−100	−100
Net Errors and Omissions [5]	−226	−295	−872	−640	−1,155	−362	−205	−1,698	−485

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less than the 1977 level.[10] The decline reflects reduced purchases of Cuban sugar for hard currency. In all likelihood, additional transactions in these categories—that is, other hard currency trade with CEMA partners and financial support to foreign governments and movements—account for some of the net funds outflow recorded under net errors and omissions. [redacted] 25X1

By engineering a hard currency surplus in 1978, Soviet financial managers precluded an increase in the USSR's $11.2 billion net hard currency debt (figure 3). Gross debt grew from $15.7 billion in 1977 to $17.2 billion, largely from drawings on Western government-backed credits. Net debt remained unchanged as Moscow increased its assets in Western banks by $1.5 billion to $6 billion. [redacted] 25X1

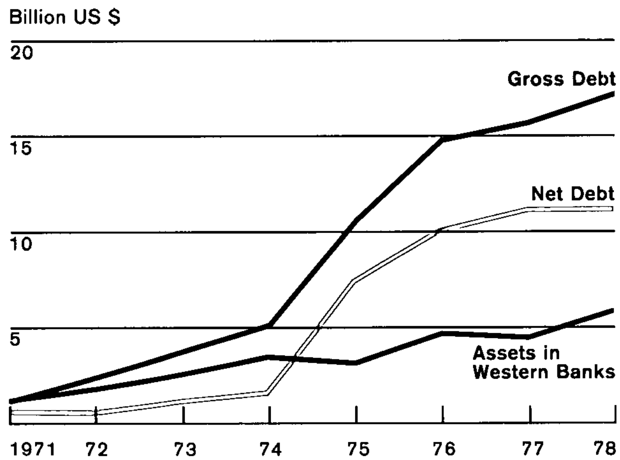
Nearly 70 percent of the growth in gross Soviet liabilities to the West in 1978 resulted from an estimated $1.0 billion increase in debt covered by Western government guarantees. In contrast, commercial credits accounted for nearly 70 percent of Soviet borrowing in 1975-76. This shift in financing apparently stemmed from USSR State Bank Chairman Alkhimov's determination to reduce drastically the USSR's dependence on Euromarket borrowing in favor of less costly official credits. Indeed, the USSR's net exposure to Western banks declined by 20 percent or $1 billion in 1978 as a result of the reduced reliance on commercial borrowing and a simultaneous buildup of Soviet deposits in these banks. Consequently, the share of net debt secured by government guarantees grew from 52 percent at yearend 1977 to 62 percent at yearend 1978. [redacted]

[redacted]

Government transfers equal the USSR's hard currency contributions to the United Nations as reported by the United Nations General Assembly, Report of the Committee on Contributions, Addendum, Supplement No. 11 (data gathered from reports of the 26th, 28th, 30th, and 32nd sessions, estimates were made for contributions in 1977-78). [redacted]

Figure 3

USSR: Hard Currency Debt to the West[1]



[1] Excludes Soviet hard currency asset position vis-a-vis Third World countries. Preliminary estimates for yearend 1978.

[redacted] 25X1

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Besides checking the growth of debt, the USSR's healthy current account position in 1978 enabled Moscow to restructure much of its medium-term liabilities to Western banks. During the year, the Soviets prepaid—or arranged to prepay in early 1979—almost all of the $1 billion raised in Eurodollar syndications in 1975-76. Moscow took advantage of the Euromarket's high liquidity in 1978 to refinance a major share of the prepayments through two syndications carrying more favorable terms than the old loans. These credits—Moscow's first syndications since 1976—included a $400 million loan raised in March and a $250 million loan concluded at yearend. The March syndication was a seven-year credit carrying an interest spread of 0.75 percentage point above the London Interbank Offer Rate (LIBOR); the second credit was for eight years at a spread of 0.625 percentage point above LIBOR.[11] The prepaid loans had been five-year credits with interest spreads of 1 to 1.25 percentage point above LIBOR. [redacted] 25X1

[11] *Wall Street Journal*, 15 March 1978. *Reuter: East-West Trade News*, 20 December 1978, p. 3. [redacted] 25X1

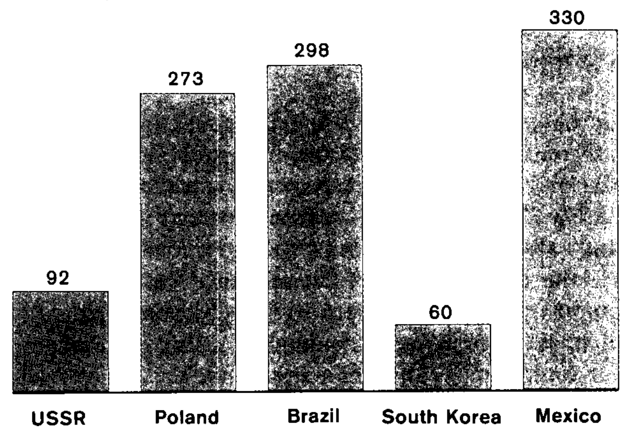
Financial Position at Yearend 1978

Moscow's tightened control over hard currency expenditures and borrowings put the Soviet Union in a solid financial position at yearend 1978. The rapid buildup of debt in 1975-76 had sparked concern among Western bankers and governments about the quality of Soviet financial management. But by any conventional measure, the USSR's finances at the end of last year were in good order: it enjoyed considerable liquidity, excellent debt service and debt-to-export ratios, sizable untapped borrowing capacity, and a solid credit rating with Western banks (figure 4). Since the Soviet leadership seems most solicitous about protecting the Soviet Union's standing in the international financial community, the unfavorable publicity and speculation of previous years undoubtedly contributed to the imposition of tighter financial controls. Nonetheless, the prospect of severe balance-of-payments disequilibrium in the 1980s, discussed below, could well explain some of the policy retrenchment and the reinforcement in Soviet finances. [redacted]

Figure 4

Debt Burden Comparison Yearend 1978

Debt to Export Ratio[1]



[1] Total outstanding debt as a percentage of exports of goods and services. Export revenues for the USSR equal hard currency earnings from merchandise exports, sales of gold and arms, transportation, and tourism. Revenues for Poland comprise exports to noncommunist countries and hard currency earnings from services. 25X1

[redacted] 25X1

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Although USSR's short-term commercial debt at yearend 1978 was a sizable $4.8 billion, the Soviets should have little problem meeting these obligations. [redacted] Indeed, as long as Eurobanks have excess liquidity and the USSR manages its borrowings conservatively, the Soviets should be able to roll over their short-term debt easily. [redacted]

Although debt service rose sharply in the wake of the 1975-76 borrowings and higher Eurodollar interest rates, Moscow can meet interest costs and principal repayments on medium- and long-term debt without straining its import capacity. In 1978, debt service equaled 18 percent of earnings from merchandise exports and sales of gold, arms, and services, or 24 percent of earnings from merchandise exports alone. These debt service ratios are below levels that would provoke concern about the USSR's ability to manage its debt. Debt service is projected to increase to roughly $3.5 billion in 1979, compared with $3.2 billion last year, but should fall as a proportion of the Soviet Union's hard currency revenues. [redacted] 25X1

Through its financing strategy, Moscow has addressed the problem of debt service beyond 1979 as well. By prepaying and refinancing the syndicated loans, the Soviets reduced future interest payments and the bunching of debt-service obligations that would have occurred in 1979-81 when payments on the 1975-76 loans were due. Greater reliance on Western government-backed financing is also beneficial; these credits typically carry fixed (and usually subsidized) interest rates and lengthy repayment terms. Furthermore, a sizable share of outstanding debt is self-liquidating because of credits tied to compensation agreements that guarantee future export revenues. [redacted] 25X1

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The debt-to-export ratio, which is often used as a benchmark estimate of the burden of debt over time, delineates the improvement in the USSR's financial position. The ratio peaked in 1976 when outstanding debt was equal to 111 percent of total hard currency earnings. By 1978, the ratio had fallen to 92 percent as the growth of hard currency revenues outpaced the growth of obligations to the West. 25X1

Because of the slowdown in debt accumulation, substantial untapped borrowing capacity exists. By yearend 1978, Western governments had committed nearly $7 billion to finance future exports to the USSR and extended credit offers for an additional $7 billion. Furthermore, the Soviet Union markedly improved its credit rating with Western bankers by regaining control of its current account and cutting its demand for commercial bank financing. Thus, the Soviets had available $4 billion in unused credit facilities with Western banks. 25X1

Trade in 1979

Despite its continued financial conservatism the USSR will incur a substantially larger hard currency trade deficit in 1979. Imports are expected to rise rapidly despite a forecasted decline in Western equipment deliveries. This year's harvest shortfall will lead to a substantial rise in grain and soybean imports; continued Soviet production problems should lead to a runup in purchases of Western steel. The rise in Soviet exports will depend to a great extent on the volume of Soviet oil exports to the West. Judging from Western data, export volume may have risen in the first quarter (over a comparable period in 1978) but may have fallen off substantially thereafter. Prospects for other Soviet exports are mixed. 25X1

Trade data released by Moscow for the first quarter of 1979 show a hard currency trade deficit of $2 billion. Imports reached a record level of $4.7 billion, $600 million more than in the first quarter of 1978. Exports, at $2.7 billion, were up only 7 percent in dollar terms over the first quarter of last year. The USSR does not report quarterly commodity data but such data from several of the major trade partners are available for the first three to six months. 25X1

Table 7 — Billion US $

USSR: Hard Currency Trade

	1978	1979 Projected
Exports	**13.2**	**14.8 - 15.7**
Oil	5.7	6.2 - 6.9
Natural gas	1.1	1.5
Wood	1.0	1.1 - 1.3
Chemicals	0.2	0.4
Other	5.2	5.6
Imports	**17.0**	**19.0 - 20.6**
Machinery and equipment	6.0 [1]	4.0 - 5.0
Grain and soybeans	2.6	3.8 - 4.2
Pipe	1.3 [1]	1.8
Other steel	1.2	1.6 - 1.8
Chemicals	0.8	1.1
Meat	0.4	0.6
Oil	0.6	0.7
Other	4.4	5.4

[1] Excluding equipment and pipe for the Orenburg project. 25X1

Hard Currency Imports

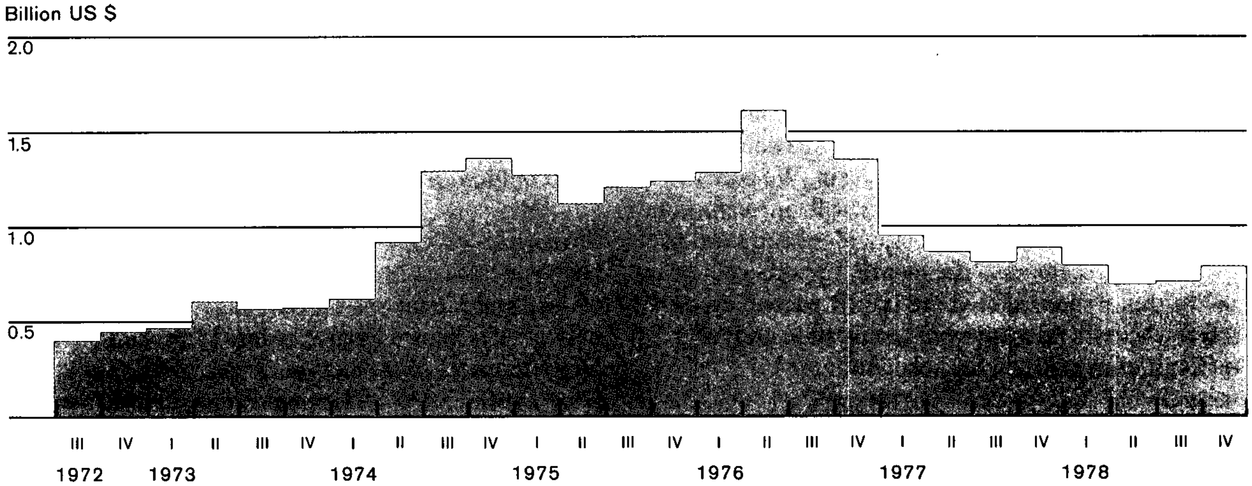
The dollar value of Soviet hard currency imports in 1979 could rise by more than 20 percent over last year's level of $17 billion (table 7). The strong import growth was largely unanticipated because of the substantial drop in Soviet orders for Western plant and equipment in 1977-78. It is attributable to the extremely poor domestic economic performance, which will greatly increase Soviet reliance on imported grain and steel. The extent of the rise will depend, in part, on (1) the amount of grain the USSR will be able to physically import in calendar year 1979, (2) the prices it will have to pay for its grain, and (3) the magnitude of the drop in equipment imports. 25X1

Thus far machinery and equipment imports have run only slightly behind last year's $6 billion pace according to partner country trade data.[12] They are thus 25X1

[12] Six-month data were available for Japan, West Germany, and the United States; four-month data for France and first quarter data for Italy. 25X1

Figure 5

USSR: Soviet Equipment Orders From the West [1]



[1] A five month weighted moving average was employed to smooth the trend in orders. The weight vector assigned was 0.1, 0.2, 0.4, 0.2, and 0.1.

[redacted] 25X1

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substantially greater than expected, given the dramatic fall in equipment orders from the West in recent years (figure 5). Equipment orders plummented from a peak of $5.8 billion in 1976 to $3.8 billion in 1977 and $2.8 billion last year. They have rebounded in the first six months of 1979 to an annual rate of more than $4 billion, in part because Moscow has apparently decided to wrap up contracts before the end of the current five-year plan period. [redacted]

The slowdown in equipment orders seems to have been in large measure due to nonmonetary considerations. A substantial backlog of unfinished construction of plants to house Western equipment probably has curtailed orders. [redacted] the slowdown in orders was due more to construction and absorption problems than to financial constraints.[13] [redacted]

[redacted]

The history of the Cheboksary Tractor Plant illustrates how construction problems have impinged on imports. In the past several years imported equipment worth about $70 million has been delivered to the plant; as of April 1979, none had been installed. [redacted] 25X1

Metallurgimport, the Soviet foreign trade organization that handles such equipment, has refused to authorize further purchases for Cheboksary until the equipment on hand has been installed. [redacted] 25X1 25X1

A statistical analysis of the past relationship between known Soviet orders and subsequent Western deliveries strongly indicates that Soviet equipment imports in 1979 should fall below $4 billion. The pace of Western deliveries through midspring, if continued, would lead to well over $5 billion in equipment deliveries in 1979. [redacted] As a result, while 25X1 25X1 25X1

[redacted] 25X1 25X1

we continue to expect Western deliveries to fall off substantially, total Soviet equipment imports in 1979 will probably be well above previously predicted levels, perhaps on the order of $4.5 billion.

We currently estimate this year's grain production at 180 million tons if average weather conditions prevail for the rest of the growing season. To maintain the momentum of its livestock program and the current low level of carryover stocks, the USSR would have to import nearly 60 million tons of grain. We believe, however, that Soviet port capacity will, on average, not allow imports of grain, oilseeds, and oilseed meal in excess of 3 million tons per month. Imports could run below this amount should the USSR encounter, as it has in the past, excessive port congestion and/or difficulties in railroad car scheduling.

Assuming imports of 2.5 million tons per month in July-December, we expect the USSR to import a total of 24 million tons of grain and soybeans in the current calendar year. Soviet grain and soybean imports in the first half of the year are estimated at 9.1 million tons, worth $1.5 billion. At prices of $2.74 per bushel for corn, $4.26/bu for wheat and $7.00/bu for soybeans, the remaining 15 million tons of imports would cost an additional $2.3 billion, bringing total 1979 expenditures on grains and soybeans to $3.8 billion.[15] Should Moscow be able to handle monthly shipments of 3 million tons in July-December, total 1979 imports would reach 27 million tons worth, assuming the above prices, $4.2 billion. The import bill could also be considerably changed by price movements between now and the time of shipment; every $1/bu increase on the average price of corn or wheat imported in the last quarter of 1979 would mean an additional $300 million in Soviet outlays.

Imports of meat and poultry will also rise substantially this year. Moscow has been unable to translate last year's record harvest and large grain imports into improved livestock productivity and is counting on meat and poultry imports to narrow the gap between growing consumer demand and unchanged meat production from government packing plants. So far this year the USSR has purchased nearly 100,000 tons of meat and poultry, worth $300 million.[16] This amount is well above last year's total of 9,000 tons but far short of the heavy volume of imports in 1976-77. Moscow could conceivably buy an additional 100,000 tons of mutton and small additional quantities of beef and poultry without disrupting Western meat markets. Such imports would cost an additional $300 million to $350 million.

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Soviet imports of Western steel will also be well above last year's levels. Moscow, which must step up the pace of constructing oil and natural gas transmission networks, is known to have ordered 1.65 million tons of large diameter pipe from the West, 700,000 tons each from Japan and West Germany, and 250,000 tons from Italy. Deliveries of this magnitude would represent a small increase in volume. Partner country data through midspring indicate, however, that the volume of deliveries is running at roughly 35 percent above last year's pace with dollar prices up by 10 percent. Should this pace continue, pipe imports could total 2 million tons, worth $1.9 billion.

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Domestic production problems that contributed to a runup in nontubular steel imports last year have worsened. For the first time in the entire postwar period Soviet steel production over the first six months declined from the comparable period in the preceding year. The decline can be attributed to shortages of raw materials, particularly iron ore and perhaps coal.

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Soviet imports of nontubular steel from Germany during the first five months of 1979 were 33 percent higher in volume and 25 percent higher in price compared with January-May 1979; imports from France for the first four months are up by 36 percent in volume and 15 percent in price, while imports from Italy (January-March) are up 39 percent in volume

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[15] Closing prices for September contracts as of 12 September 1979. We further assume that f.o.b. prices would be increased by 0.50 per bushel to cover transportation costs to US Gulf ports, and that Moscow will import 9 million tons of corn, 5 million tons of wheat, and 1 million tons of soybeans in July-December 1979.

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and slightly down in price.[17] Should this trend continue, Soviet outlays for Western nontubular steel could easily increase over last year's record $1.2 billion by some 35 percent to 50 percent, or to between $1.6 billion and $1.8 billion.

Imports of nonferrous ores and metals may also increase but not nearly as dramatically as steel purchases. The press reported heavy Soviet buying of various metals early this year, but these reports were misleading. They exaggerated the volume of trade and failed to mention the established pattern of substantial Soviet buying in recent years. We have no firm evidence of a broadly based surge in Soviet buying above those recent levels, but believe—in view of continuing problems in expanding ore mining capacity—that a further moderate increase in Soviet imports is possible.

Chemical imports should be up. Large deliveries of phosphoric acid from the United States under the chemical exchange agreement with Occidental Petroleum have begun and could amount to more than $100 million for the full year. Purchases of pesticides and other chemicals may also increase.

Hard Currency Exports

The dollar value of Soviet hard currency exports in first quarter 1979 rose by 7 percent over the comparable period in 1978, to $2.7 billion. But Moscow will have to push up exports even faster if it is to keep this year's hard currency trade deficit close to last year's level. Its willingness and/or ability to do so is doubtful. The USSR will be able to count on increased earnings from natural gas and chemical exports; its export policy regarding oil, the major factor in Soviet export earnings, remains unclear. We estimate 1979 exports at between $14.8 billion and $15.7 billion.

In 1979 at least, growth in Western Europe and Japan should be adequate to sustain demand for the USSR's exports. Real GNP in the Big Six[18] foreign countries grew at rapid rates in the first quarter, particularly in Japan and Italy. The OPEC price increases, both throughout the first half of the year and the rises resulting from the Geneva meeting, will inflict a drag on the West. This resulting growth rate, albeit lower than would otherwise have occurred, will still be close to the 1978 rate of 3.8 percent. Accordingly the effect on Soviet nonoil exports will be negligible.

The chief constraint on Soviet exports this year is likely to be producing enough to have surpluses available for export. Figures for plan performance in the first months show slow growth in industrial production and actual declines from first-half of 1978 in several important sectors (table 8). As in 1978, these shortfalls can be expected to have an impact on hard currency trade.

According to mounting evidence, Soviet oil exports for hard currency will be down from last year's estimated 1.1 million b/d rate. Soviet oil output for the first seven

Table 8 — Percent Change

USSR: Industrial Production

	1978 Over 1977	1st Qtr 1979 Over 1st Qtr 1978	2nd Qtr 1979 Over 2nd Qtr 1978
Civilian industry	**3.7**	**0.8**	**2.8**
Electric Power	4.5	3.4	3.6
Fuel	3.4	3.5	2.8
Ferrous metals	2.2	−1.6	0.9
Forest and paper products	−0.1	−5.1	4.4
Construction materials	0.6	−5.6	−2.4
Chemicals	3.1	−6.1	3.2
Civilian machinery	6.9	5.5	4.6
Consumer nondurables	1.9	−1.0	1.6

[17] Imports from Japan in January-May were down 58 percent in volume but relatively unchanged in value terms, suggesting a major change in composition.

[18] Japan, West Germany, France, the United Kingdom, Italy, and Canada.

months of 1979 remained at the same level as the last half of 1978, averaging almost 11.6 million b/d, about 250,000 b/d below the 1979 annual plan. Increasing tightness in the domestic energy balance, combined with Moscow's continued determination to make good on (a) standing export commitments to CEMA, (b) new commitments to Turkey (60,000 b/d), and (c) increased deliveries to India may well reduce the availability of oil for export for hard currency despite the attractiveness of substantially higher prices. [redacted]

Soviet oil trade during the early part of the year as revealed by partner country data can be characterized by business-as-usual in crude oil movements but reduced product deliveries:

- During the first quarter crude oil deliveries to Italy and France were up by a combined 41 percent at roughly unchanged prices.

- Soviet deliveries of petroleum products to West Germany in January-June fell by 16 percent in volume from a similar period in 1978. Prices on average doubled to $32 per barrel. Similarly, product deliveries to Japan during the first half of 1979 were down by 12 percent in volume with prices rising, on average, by 31 percent. In both cases Moscow after reducing export volume in February-April, increased substantially exports in May and June, presumably to take advantage of higher spot prices.

- Deliveries of petroleum products to France were down by 14 percent in volume in the first four months of the year, but average prices rose by almost 50 percent. Exports of petroleum products to Italy rose slightly in both volume and price in the first quarter of 1979 as compared with the first quarter of 1978. [redacted]

The increased volume of exports of oil to Italy and France was reflected on the movement of oil from the Black Sea ports in the first quarter of 1979. Subsequent shipping data indicate a sharp falloff in deliveries. Total deliveries of oil from Black Sea ports to non-Communist countries were estimated at 353,000 b/d in the first quarter of this year, compared with deliveries of 327,000 b/d in first quarter 1978. Shipments to non-Communist countries in April-June averaged 351,000 b/d as opposed to the 545,000 b/d registered in the second quarter of last year, a dropoff of 195,000 b/d. Although part of the falloff in exports from Black Sea ports might have been offset by shipments from other Soviet ports, such as those in the Baltic Sea, we have no evidence to this effect. [redacted] 25X1

On balance, we now estimate that hard currency oil exports for the year as a whole could fall by as much as 20 percent to roughly 900,000 b/d. This order of magnitude is based on (1) expected levels of production and consumption in the USSR, [redacted] (3) some increase in exports to CEMA countries, albeit considerably below the rate early in the year claimed by Moscow, and (4) increased exports to India and new commitments to Turkey. [redacted] 25X1 25X1 25X1 25X1

The good news for the USSR is that the boom in prices that began early this year permits increased hard currency oil earnings on a lower volume of oil shipments to the West. Although the wide range of price due to various surcharges and to the volatile spot market makes an accurate estimate of average Soviet prices difficult, prices this year should average some 40 percent to 50 percent higher than in 1978. At an average annual price of $19 per barrel, Moscow would earn $6.2 billion on exports of 900,000 b/d, $500 million more than in 1978. Should export volume fall less—to 1.0 million b/d—Moscow could earn $6.9 billion, a rise of $1.2 billion over 1978. This figure is highly sensitive to (1) the timing and volume of oil exports, (2) the mix between sales of crude oil and products, and (3) Soviet sales volume on the lucrative spot market. [redacted] 25X1

Natural gas exports should pull in substantially more hard currency this year. Deliveries under long-term contracts are scheduled to total 710 billion cubic feet, an increase of 70 billion cubic feet over last year's estimated shipments. Italy and Austria hope to receive additional gas this year, but despite rapid growth in Soviet gas production, both countries experienced significant shortfalls in deliveries in the first few months of 1979. The reasons cited were the cutoff of 25X1

Iranian gas in effect until this April, the unusually cold winter, and pipeline problems.[19] In June, Moscow promised Austria an additional 10 to 20 million cubic feet to make up for the delays in the first part of the year.[20]

Whatever the final volume of deliveries, Moscow will clearly benefit from higher gas prices. Moscow probably cannot extract price increases as large as in 1978, when it was able to reduce substantially the gap between the price of its gas and alternative West European energy suppliers. Nonetheless, booming oil prices should lead to increased natural gas prices in 1979, particularly in cases where Soviet prices are explicitly tied to West European fuel oil costs.

Moscow will probably increase moderately its sales of manufactured goods, especially automobiles, to the developed West. Iraq, with at least $2 billion in outstanding development contracts with the USSR, shows no sign of cutting back on its equipment imports. In first quarter 1979, exports of all goods to Iraq were up by 85 percent from a comparable period last year.

Soviet timber sales could also rise considerably this year on the strength of higher prices and the possibility of increased export volume. Although exports to Japan in the first five months were running slightly below last year's pace, higher dollar prices have led to a 20-percent rise in earnings. The Soviets have received higher prices for their exports to the United Kingdom as well, with British pound prices up 20 percent to 30 percent above last year's level. In addition, the volume of Soviet timber ordered by UK buyers in the first quarter of the year was 62 percent more than that contracted for in a similar period last year.

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Prospects for exports of metals are mixed. The USSR probably is counting on continued heavy sales of platinum-group metals, aluminum, and nickel, but, in the aggregate, sales of nonferrous metals are not likely to earn more than in 1978. As for ferrous ores and metals, the odds are against a reversal of the recent decline in exports. In fact, top Soviet officials, concerned about raw material supplies for their steel industry, have ordered further cuts in exports to non-Communist countries. Some of the cuts reportedly are being carried out.[22] The Soviets, however, have not pulled out of the market completely, and, in the case of chrome ore, may sell more than in 1978. On balance, considering the drastic cuts in recent years, exports of ferrous ores and metals probably will fall only marginally this year.

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Coal exports to Japan through May are running 15 percent below last year's volume pace as a result of a substantial decline in Soviet exports of coking coal. Given Soviet production problems mentioned earlier, this trend is unlikely to be reversed.

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Financing the 1979 Deficit

As in 1978, Moscow should be able to cover this year's trade deficit, as much as $5.5 billion, without too much difficulty. With continuing excess liquidity in the Eurocurrency market, record Soviet Eurocurrency holdings, and the high price of gold, Moscow has a good deal of flexibility. If it opts to sell large quantities of gold, the USSR may well be able to balance its current account this year (table 9). In any event, Moscow should—under most foreseeable conditions—be able to limit the growth of its gross debt in 1979.

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Table 9 Billion US $

USSR: Financing the 1979 Trade Deficit

Projected trade deficit	-4.5 to -5.5
Errors and omissions [1]	0 to -1.0
Amount to be financed	-4.5 to -6.5
Possible sources of financing trade deficit:	
Gold sales	2.0 to 3.0
Other current account earnings [2]	1.5 to 2.0
Reduction in Eurocurrency assets	1.0 to 2.0
Increase in Eurocurrency liabilities	0 to 1.0

[1] Available data consistently underestimate Soviet hard currency expenditures leading to substantial errors and omissions in past years.
[2] Net earning from arms receipts, tourism, and transportation earnings, transfer payments, interest payments, and hard currency trade not otherwise specified.

The USSR's current account deficit net of gold sales should rise markedly this year, however, because of the higher trade deficit and a potential drop in earnings from hard currency receipts from arms shipments:

• A decline in new sales to Moscow's traditional hard currency arms customers portends a decline in 1979 revenues. Contracts under negotiation could change this projection dramatically, however.

• Increases in world shipping rates should boost transportation earnings, although outlays for importing grain on Western ships late in 1979 will limit this growth.

• Net tourism income will probably increase substantially since nearly all visitors who have made advance bookings for the 1980 Olympics must make full payment by the end of the year

• Although the dollar gains are not large, the Soviets have been resorting to various ploys to squeeze additional hard currency out of foreigners living in or doing business with the USSR

The Soviets could raise $2.5 billion or more from gold sales this year if prices remain high and substantial quantities are marketed during the second half of 1979. 25X1 25X1

During the first seven months of the year the Soviets thus earned a total of roughly $1.2 billion from gold sales. 25X1

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Since the gold market boomed in August-September and should continue to remain strong over the next few months, the Soviets should be able to market a large amount of gold at attractive prices. If Moscow continued to sell gold at its second quarter pace and earned an average of as little as $350 per ounce, it would chalk up close to $3 billion in earnings from gold for the year as a whole. 25X1 25X1

The gold market is not the only source available to Moscow to cover its projected 1979 trade deficit. Moscow ended 1979 with record assets in Western banks and could probably tap up to $2 billion in Eurocurrency holdings to finance imports without endangering its ability to meet trade related financial requirements. In this regard the chairman of the Soviet Bank for Foreign Trade stated that the USSR is "suffering" from an excess of cash on hand as a result of previous borrowing in the West. 25X1 25X1 25X1 25X1

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How Soviet financial managers choose between asset drawdowns and gold sales will depend on their perceptions of the future market for gold compared with the desirability of hard currency liquidity. The likelihood of an even greater trade deficit in 1980 and of a recession-induced weakening of the gold market and lowering of Eurodollar rates by next year may prompt Moscow to opt for gold sales now and leave its 25X1 other sources of funds available for the future. However, according to Western press reports, the Soviets did not sell much gold in August despite the continuing price surge. This indicates that either (a) Moscow's gold traders are awaiting still higher prices before stepping up sales or (b) the USSR has opted to rely less heavily on gold sales this year. If Moscow has adopted the latter strategy, total sales for 1979 could be closer to $2 billion. [redacted]

The Soviet Union probably did not increase its borrowings from Western banks in early 1979, limiting its activities largely to rolling over maturing obligations. More recently, however, the need to finance grain purchases may have induced the USSR to begin increasing short-term and medium-term borrowings which it could later replace with major syndications. [redacted]

Unless the hard currency trade deficit is much larger than anticipated, Moscow should not have to borrow heavily in 1979. The projected drop in deliveries of machinery and equipment indicates that drawings on officially backed credits would only equal repayments on outstanding officially backed debt. Thus Moscow, to the extent that it relies on gold sales and asset drawdowns, will be able to keep the growth of its gross debt in check for the third straight year. [redacted]

An additional factor impinging on Moscow's ability to finance its trade deficit may be the need to provide hard currency support to Poland. This issue is assuming ever greater significance as the likelihood of Poland's defaulting on its obligations mounts. In the past Soviet officials asserted to Westerners that the USSR is not the guarantor of Eastern Europe's debts and specifically ruled out a Soviet role as creditor of last resort for Poland. Nevertheless, two Soviet economists recently stated that the USSR would probably help Warsaw if the Poles could not meet their obligations to Western creditors, but that the decision would have to be made at the highest political level of the Soviet Union. [redacted]

The amount of hard currency Moscow might advance to Poland would almost certainly be small. Soviet support would be forthcoming only as a last resort and presumably on very strict terms. At most, the USSR would probably help bridge a short-term cash shortfall, buying some more time for the Poles to correct their financing problems. Moscow's current need for hard currency and its own uncertain earnings prospects preclude an open-ended commitment of support to a faltering ally. [redacted] 25X1 25X1

Beyond 1979

We are far less sanguine regarding Soviet trade and payments after this year. Higher grain imports and the likelihood of reduced oil export volume will, all else equal, lead to an increased trade deficit in 1980 and may force Moscow to seek balance-of-payments financing from the West. Over the medium term, the USSR faces the prospect that the continued decline in oil exports to the West will force an adjustment in its merchandise trade account. It is unlikely that the USSR will opt for sustained balance-of-payments financing or that Western bankers would respond positively to such requests for many years at a time when Soviet oil exports are declining. The decision over what imports to reduce or nonoil exports to expand (at the cost of reduced domestic availability) will not be easy. [redacted] 25X1 25X1 25X1

Outlook for 1980

Soviet grain imports in response to this year's poor harvest will continue well into calendar year 1980. Moscow will probably import at or near the maximum rate allowed by port capacity through September 1980 or longer; in addition the USSR will continue it's practice of importing grain even in years of good crops. Thus grain and soybean imports for the year as a whole will be 30 to 35 million tons and possibly at higher average prices than this year's estimated imports of 24-27 million tons. Equipment imports will likely remain at or below 1979 levels, but there will continue to be upward pressure on pipe and nontubular steel imports. [redacted] 25X1 ? 25X1 25X1

Although natural gas export revenues should climb in response to higher prices and export volume, we expect oil earnings to level off or turn down in 1980. Moscow is also expected to continue to have problems in meeting its increased export obligations under compensation agreements, primarily chemicals. Exports of other commodities may be hurt if there is a marked economic slowdown in the West; demand for Soviet goods will slow and the recent runup in commodity prices could be reversed.

The resultant increase in the Soviet hard currency trade deficit in 1980 will almost certainly push Moscow's current account back into the red and may produce the largest jump in Soviet debt since 1976. The USSR cannot hope to offset a substantial deterioration in its merchandise trade balance from increased arms sales or invisible earnings. In addition, the prospects for heavy gold sales seem less favorable than in 1976-79. Western market observers predict that recession in the West will likely weaken the gold market;[23] moreover, Moscow would probably want to cut back marketings after selling out of its reserves for four straight years (assuming sales in excess of 235 tons in 1979).

The USSR should nonetheless be able to borrow the funds needed to cover the 1980 deficit without undue strain. Government backed credits tied to imports of capital goods will provide some financing. However, the likely magnitude of the current account shortfall and of repayment obligations indicate that the USSR will have to approach Western banks for balance-of-payments financing. Since recession in the West will likely keep loan demand from prime borrowers weak, Moscow should be able to raise the needed funds from the Euromarket on reasonably favorable terms.

Hard Currency Trade in the 11th Five-Year Plan

In a sense, 1980 will probably turn out to be a transition year for Soviet foreign trade officials. The USSR faces hard choices in establishing a hard currency trade and payments strategy for the 1980s. Increasingly severe economic problems in the domestic sector are likely to intensify import demand for agricultural commodities and steel products. The need to spur productivity and boost energy production will be greater than ever before, pressuring the leadership to boost imports of Western equipment and technology above present levels. 25X1

Moscow had originally hoped that the import expansion begun in the early 1970s could be financed by a rapid growth in manufactured products exports and—via compensation agreements—by sales of products produced with imported equipment. In truth, import growth was possible largely as a result of heavy borrowing and increased world market prices on a higher volume of oil sales. Domestic production problems combined with growing domestic and East European demand has made it increasingly difficult to expand, or even sustain, traditional exports such as oil and wood products or to make good on its export commitments—natural gas, chemicals—under compensation agreements. Most importantly, Moscow faces almost certain prospect of a severe drop in oil exports to the West unless it is willing to accept a reduced growth in domestic production or reduce substantially its exports to CEMA trading partners.[24]

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The balance-of-payments problems looming in 1980 can be managed in the short run by increased borrowing. These problems, however, would lead to increasingly severe strains in the longer term. Moscow must devise a balance-of-payments strategy for the 1980s consistent with rising demand for Western imports and the declining oil exports. Within a balance-of-payments framework, the strategic options open to Soviet foreign trade planners are (a) boosting earnings from nontrade current account items, (b) sustaining a net inflow of resources on the capital account, and/or (c) correcting the fundamental disequilibrium in the USSR's trade position. 25X1

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[23] "Gold Hits New High in London," *The Journal of Commerce*, 26 July 1979; "Gold Analyse der DG-Bank; Eine Hausse mit Hindernissen," *Handelsblatt*, 6 August 1979: "Rambunctious Gold Market Has Traders Pacing the Floor, Wondering What's Next," *The Wall Street Journal*, 16 August 1979.

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Unlike the 1970s, the Soviets will not be able to count on rapid increases in revenues from gold sales, arms deliveries, and services to cover widening trade deficits. The prospects for sustained rapid growth in gold sales are limited by the rate of Soviet gold production—and the uncertainties of industrial and speculative demand for gold. The large drop in new commitments for arms sales in 1978-79 will probably result in lower arms deliveries, possibly as early as 1980. Increasing resistance by Western governments to the predatory pricing of Soviet shipping companies operating in the West will likely slow the growth of Soviet transportation earnings. Future increases in tourism receipts, with the exception of Olympic-related earnings in 1980, will probably be steady but not substantial.

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That the USSR could, or would even attempt to, cover large repeated current account deficits by large balance-of-payments financing is quite unlikely. Of course, Western competition for Soviet contracts should assure an ample supply of government-backed financing for purchases of capital goods while untied financing would be available for short-run emergencies such as a harvest shortfall or a drop in exports due to Western recession. Western bankers, however, would be loath to provide massive balance-of-payments financing to cover deficits resulting from a long-term downturn in oil exports. Moscow probably would not, in fact, try to offset such a downturn by large borrowings, particularly if exports were expected to be a problem over the loan repayment period.

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In view of the limited potential for increasing revenues from nontrade current account items or from the capital account, the Soviet leadership has little choice but to squeeze the merchandise account. Yet, as outlined above, the available options in this regard all carry high costs. Moscow is unwilling to commit more raw materials to hard currency markets in view of production problems, increasing extraction costs, and rising demand in the USSR and Eastern Europe. Soviet ability to expand exports of manufactured goods, on the other hand, depends greatly on the willingness of the USSR to allow Western participation, particularly quality control, in Soviet production. Failure to take positive action in either of these areas would carry the cost of a diminished import capacity. The calculus that the USSR will employ in weighing in relative cost/benefits of export expansion is still uncertain. What is clear is that the fall in oil exports will cause a major disequilibrium in the USSR's traditional trade and payments strategy. It will force a compensating readjustment in the merchandise account—either by a reduction in imports or by a rapid expansion of nonoil exports.

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Approved For Release 2008/09/15 : CIA-RDP08S01350R000100120002-2

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