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DDI 2942-82  
12 April 1982

MEMORANDUM FOR: Director of Central Intelligence

VIA : Henry S. Rowen, Chairman  
National Intelligence Council

FROM : [redacted] Acting National  
Intelligence Officer for USSR-EE

SUBJECT : [redacted] Soviet  
Economic Questions

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[redacted]

2. In the letter to Under Secretary Buckley, mention is made of a comprehensive CIA study now being carried out in a briefing for him and members of his mission to Europe on that study. That briefing will be held Thursday, 15 April, at 1030 in Room 7D32. You may wish to attend. We have already had several meetings, both internal and with policy agencies, about the study. We will have a run-through of the latest findings on Wednesday morning. Harry Rowen and I could bring you up to date on those findings Wednesday afternoon, that is prior to the briefing for Under Secretary Buckley.

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Attachments:  
As stated

State Dept. review completed.

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\_\_\_\_\_ DCI to be briefed by Harry Rowen on Wednesday  
afternoon at \_\_\_\_\_

\_\_\_\_\_ No briefing for DCI, but DCI will attend Thursday  
meeting

\_\_\_\_\_ No private briefing or attendance at meeting for  
DCI but keep me up to date informally

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DDI 2942-82

12 April 1982

MEMO FOR: DCI

SUBJECT : Cooperation with Western Allies on Soviet Economic Questions

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## The Soviet Bloc Hard Currency Problem

### Introduction

A fundamental reassessment of the risk of lending to Soviet Bloc countries has curtailed those countries' access to Western private credit and made some of the remaining credit flows vulnerable to new negative developments. The Soviet hard currency position has worsened greatly in recent months. The USSR is in the midst of a short-term liquidity problem, due partly to bad crops and the Western recession. With large assets (gold reserves of 1,825 tons worth some \$20 billion at a price of \$350 an ounce) and small fixed obligations (long- and medium-term debt service requirements of \$2-2.25 billion a year, or less than 10 percent of merchandise and arms exports), Moscow has the flexibility to cope with this problem. But a fundamental long-term problem will remain—the USSR's hard currency exports are likely to stagnate or fall, with the result that hard currency imports will also stagnate or decline unless the West is prepared to provide substantially more credit than in the past. Eastern Europe's hard currency position is far worse than the USSR's. Most East European countries either cannot meet their hard currency obligations or must make severe economic adjustments to do so.

The severe deterioration of the Soviet and European hard currency positions has been due to the following factors:

- Increasingly evident systemic deficiencies, resulting in declining growth of productivity.
- The logical implications of the rapid accumulation of hard currency debt in past years—a process which obviously could not continue unless hard currency earnings were also growing rapidly, which they are not.
- In the Soviet case, and to a much lesser extent the East European countries, events outside their control (Western recession, bad crops, lower oil and gold prices).

- The Polish political crisis and economic collapse and its fallout.
- The general worsening of East-West relations, especially in the past year.

Western government policies played a role in encouraging the accumulation of Soviet and East European debt by providing credit on easy terms during the 1970s. Without Western government encouragement, private bank exposure would not have increased to the extent that it did. In the past few months, the possibility that Western governments might restrict or discourage credit to Eastern Europe has created added uncertainty in financial markets and has further discouraged bank lending.

### The Crisis of 1981-82

Following two years of soaring foreign exchange earnings as a result of the 1979-80 oil price rise and continued increases in arms sales, Moscow suddenly encountered a severe hard currency bind in the latter part of 1981. The Soviets probably expected some worsening in their hard currency position during the year, but the speed of the turnaround appears to have caught them by surprise. The following appears to be a plausible reconstruction of events:

- In the first quarter, Moscow gave Poland nearly \$1 billion in emergency hard currency aid.
- Oil prices unexpectedly began to fall so that Moscow had to revise downward its expected earnings from oil exports.
- A third successive bad grain crop forced Moscow to buy even more grain, meat, and soybeans than had been planned.
- The weakening of the Western economies after the first part of the year reduced the demand for Soviet exports.

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These unexpected expenditures and shortfalls were probably responsible for the precipitous decline in Moscow's hard currency assets in foreign banks from \$8.6 billion at the beginning of 1981 to only about \$3.5 billion six months later. The mid-1981 level appears to be the lowest for at least 10 years relative to Soviet hard currency imports, being equivalent to only about one month's imports. Moscow must have concluded that a severe liquidity problem had developed and had to take some drastic action immediately.

#### **The Soviet Policy Reaction**

During the final quarter of last year, Moscow took the following steps to quickly improve its hard currency position:

- Selling large amounts of gold, despite a weakening market. After largely staying out of the market for the first three quarters of 1981, Moscow sold an estimated 200 tons between August and the end of 1981 (twice the amount sold in all of 1980) and at least 50 tons through mid-February 1982.
- Increasing its use of short-term credit.
- Severely rationing expenditures for hard currency imports other than food, by requiring additional authorization and controls throughout the Soviet economic decision structure.

Moscow has not entered the Eurodollar market for mid- or long-term nonguaranteed bank credits as it did in 1975 when faced with a similar foreign exchange crunch. One can only speculate as to the reasons. Many Western bankers have been reluctant to make new large Eurodollar syndications to the USSR. Even so, Moscow probably could obtain Eurodollar credits, but on less favorable terms. That it did not do so may be due to a desire to avoid the widespread publicity that such a step would have stimulated in view of the situation in Poland and the tense state of East-West relations generally. There would have been speculation in the Western press that the Soviets were borrowing money to pay off Polish debts; others would have pointed to the borrowing as a

sign of Soviet economic weakness and vulnerability to Western government pressures. In recent months, the Soviets have been investigating borrowing possibilities in Arab banks, apparently with little success as yet.

#### **Short-Term Prospects**

The emergency measures adopted late last year almost certainly enabled the Soviets to return their liquid hard currency assets to more normal levels, but did not eliminate the need for various other forms of extraordinary financing to meet expenditures in 1982. Forces beyond Moscow's control are even less favorable to Moscow's hard currency situation this year than they were last year:

- Oil prices are continuing to fall.
- Demand and prices for Soviet exports are probably also falling.
- Moscow's food import bill will probably be a billion dollars or so higher than last year.

Since other major balance-of-payments items—arms sales, service receipts and payments, and so forth—are unlikely to change much, this means that unless nonfood imports are cut very sharply indeed, Moscow will have to sell substantially more gold or borrow more short-term capital than last year.

It is impossible to know what combination of import cuts, short-term borrowing, and gold sales Moscow will select. For example, if the Soviets cut their nonfood imports by 10 percent in volume (which, given higher prices, would mean little change in value), with exports down and food imports up, their trade and current account deficits would be some \$2 billion larger than last year. By selling their net annual gold production of 275 tons, worth a little more than \$3 billion at \$350 an ounce, they would still have to borrow about \$3 billion in short-term credits to cover the deficit. This is by no means infeasible, although the interest cost would be high.

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Short-term borrowing is a reasonable means of filling a financial gap for a year or so, but obviously not over much longer periods. Import cuts, too, would be viewed differently as a means of coping with a brief foreign exchange shortfall than as part of a longer term problem. The USSR, like most bureaucracies, tends to spread short-term cuts fairly evenly among users, except for a few priority areas like food. Over a longer period, priorities among different types of imports and their uses would have to be much more carefully worked out.

Moscow probably believes that the foreign exchange bind is partly a temporary phenomenon. There is a reasonable basis for Moscow to hope that Soviet grain crops will return to normal or better, which would make some reduction in food imports possible. In addition, the likely cyclical upswing of the Western economies during 1983-84 should increase both the price of and the demand for Soviet exports. These factors alone could add several billion dollars to meet Moscow's other hard currency needs.

#### The Long-Term Bind

Even with some likely improvement in the hard currency position during the next year or two, the USSR faces a scarcity of hard currency through the 1980s. The chances are that the volume of Soviet hard currency exports will stagnate or decline during the coming decade. Specifically:

- The volume of Soviet crude oil exports has been declining for three years and, with domestic oil production likely to be at best constant, and at worst in steady decline, it will be extremely difficult to prevent a further drop, and eventually perhaps a complete cessation, of oil exports for hard currency.
- Gas exports will continue to increase—but not on a large scale until the Yamal Pipeline can be completed—which will probably not be before the latter part of the decade. Even then the increase in gas exports will probably less than offset the decline in oil exports.

- Arms exports for hard currency appear to have leveled off for lack of large new clients. Even current large customers, such as Libya, may have to pare purchases if oil export revenues continue to decline.
- Other Soviet exports (wood, metals, manufactures) are likely to stagnate because of supply limitations and Soviet inability to adapt to Western market needs.

Without the Yamal pipeline a sizable decline in exports would be inevitable, even if Moscow redirected some of the gas to its own and Eastern Europe's use in order to free some oil for export to the West. With the pipeline and some good luck in oil development, the volume of hard currency exports may be held about constant.

Moscow's main hope for sizable increases in hard currency earnings would be another large jump in the prices of oil, gas, and gold—in the case of oil, an event that appears unlikely in the next two or three years, but increasingly likely during the second half of the 1980s.

If Soviet hard currency earnings are stable or declining in the long term, Moscow will need to increase its new borrowing from the West to avoid a decline in its hard currency import capacity. Soviet debt service payments will slowly increase, reflecting the past growth of new credits; consequently, if drawings on Western long- and medium-term credits remained constant, the net inflow of long-term Western capital would slowly decline, and import capacity would fall.

A constant or declining hard currency import capacity would pose serious problems for Moscow. In the 1980s slower economic growth will present the Soviet leadership with increasingly tough and politically painful choices in resource allocation and economic management. Annual increments to national output will be too small to simultaneously meet mounting investment requirements, maintain growth in defense spending at the rates of the past, and raise the standard of living. Simply stated, something will have to give. The Soviet need for Western goods and

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technology will therefore increase greatly. Imports can relieve some economic problems by raising the technological level of key Soviet industries and by reducing shortages of grain and such important industrial materials as steel. Western equipment and know-how will be particularly important to raising productivity in the critical machine-building and energy industries. The Soviets must continue importing large amounts of agricultural products and will probably expand their purchases of steel and some other industrial materials.

#### **The East European Hard Currency Problem**

East European countries' hard currency problem is far more severe than the USSR's. Their gold and foreign exchange assets are minimal and their debt service obligations are enormous. Leaving aside Poland, which is in a class by itself, East Germany has a debt service ratio above 60 percent, and the rest, except Czechoslovakia, are all above 25 percent. These ratios put the East European countries in the same class as Brazil, Mexico, and Chile, countries with far more flexible economies and generally rapidly increasing export earnings.

Poland aside, the fact is that Romania cannot meet its obligations, and that East Germany could not achieve any substantial reduction in its indebtedness without wrenching economic adjustments. Hungary, too, would have great difficulty reducing its debt. Even if existing debt were just rolled over, the East European economies would at best limp along with little or no economic growth for the next several years. It is important to keep in mind that Western credits played an important role in financing a large increase in investment in nearly all East European countries during the 1970s, and that this investment was an important factor in sustaining tolerable, if generally slow, growth rates. This important prop for inefficient economies has disappeared.

#### **The Soviet-East European Connection**

Soviet-East European economic relations rarely involve transfers of hard currency. Last year's Soviet hard currency aid to Poland was clearly viewed as an exceptional step, outside the normal framework of

economic cooperation and aid. Some trade is paid in hard currency, but the net flows are probably small.

More basically, Soviet trade with Eastern Europe helps to knit the Soviet empire together, but at substantial cost to Moscow. By denying East European countries the possibility of developing economies and economic systems that could be reoriented mainly toward the West, Moscow has little choice but to provide some direct and indirect forms of aid. The direct aid is in the form of credits on bilateral account. The indirect aid takes the form of delivery of undervalued Soviet raw materials and foods in return for overvalued East European manufactured goods. Many of the Soviet exports are sold on the world market and some of them, notably oil, are sold to Eastern Europe far below world market price. Most of the East European exports can be sold on world markets only at severe discounts, if at all, but the Soviets pay world market prices for them.

A worsening of the East European hard currency and economic situation is bound to impose additional burdens on the USSR. Moscow simply cannot afford to let the East European countries go begging to the West by themselves, or alternatively to let their economies deteriorate to the point that serious political consequences could follow. Additional Soviet assistance to Eastern Europe may or may not take the form of hard currency, but even if it did not, there would be indirectly an unfavorable impact on the Soviet hard currency position.

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Suspense - <sup>12</sup>~~8~~ April

is preparing a response for  
the Acting DCI's Signature.

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HR --

We have the action on this one to prepare a response for the Acting DCI's signature by Monday, 12 April. Who's drafting?

Lynn



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→ HR

(Copied to NIO/Econ,  
NIO/USSR-EE, NIO/WE,  
NIO/EA)

**EXECUTIVE SECRETARIAT**  
**Routing Slip**

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		SUSPENSE	12 April		
			<small>Date</small>		

**Remarks:** Please prepare a response for the A/DCI's signature.

[Signature Box]

D/ Executive Secretary  
5 April 1982  
Date

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