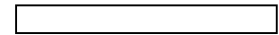




Director of  
Central  
Intelligence

~~Secret~~



# Implications of the Decline in Soviet Hard Currency Earnings

National Intelligence Estimate

~~Secret~~

NIE 11-23-86  
September 1986

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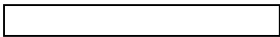


NIE 11-23-86

IMPLICATIONS OF THE DECLINE  
IN SOVIET HARD CURRENCY EARNINGS

Information available as of 12 September 1986 was used in  
the preparation of this Estimate, which was approved by the  
National Foreign Intelligence Board on that date.

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SCOPE NOTE

This Estimate looks at the implications through 1990 of the decline in hard currency purchasing power of the Soviet Union. The key issues are (a) the extent of the decline, (b) how Gorbachev will deal with the shortage, and (c) how Gorbachev's tactics will affect foreign relations and domestic spending priorities. A major variable is the price of oil, which is assumed to be \$18 per barrel throughout the period for the average blend of Soviet crude oil and refined product exports. This is equivalent to \$15 per barrel for benchmark global crude oil prices such as Saudi light.

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## KEY JUDGMENTS

We expect Soviet *hard currency export earnings* during the period 1986-90 to average roughly *30 percent below* those attained over the last several years—when favorable raw material prices allowed the Soviets to import record quantities of agricultural goods and Western equipment and technology:

- The decline in *Soviet purchasing power* will be even greater, amounting to a *40-percent reduction* compared to the early 1980s because of the lower value of the dollar, in which about two-thirds of Soviet exports are denominated.

In an attempt to limit the impact of these coming declines on the domestic economy and on Moscow's policies abroad—especially Eastern Europe and the USSR's Third World clients—the *Soviets are cutting back on a wide range of foreign purchases*. The range and nature of the cuts indicates Moscow is still in the process of developing priorities for spending its limited earnings.

Should the drop in purchasing power of exports remain in fact on the order of 40 percent during the period 1986-90, we expect the Soviets to take some measures to improve earnings and gradually evolve a set of priorities to allocate scarce hard currency among nonstrategic domestic needs:

- They will be likely to raise the inflow of hard currency by *increasing foreign borrowing*—perhaps \$1-2 billion per year—and *boosting gold sales*. These and other less significant measures would only replace a small portion of lost revenues, however, and import capacity would still drop by one-third from the 1984 level.
- On the import side, nonstrategic purchases will be cut by:
  - Reducing expenditures on consumer goods and agricultural imports, the latter made easier by the continuing world grain glut that depresses world prices.
  - Cutting imports of machinery and equipment deemed not vital to modernization.
  - Scaling back purchases of turnkey projects.

The Soviets also will make a major effort to convince Western firms to accept more barter and buyback arrangements.

*The impact of such cutbacks on broad gauge economic measures such as overall growth and labor productivity will not be significant. Nevertheless, the foreign exchange limitation poses a serious challenge for Gorbachev both in terms of internal discussions over allocation of scarce resources and as a constraint in responding to any other economic setbacks, at least some of which, in all probability, will take place in the next few years.*

Each setback would require an offsetting, and, in some instances, painful response:

- A resumption of the decline in oil output would compel Gorbachev to take some combination of measures—further reduction in imports, additional cutbacks in oil deliveries to Eastern Europe, and/or reductions in oil deliveries to the domestic market. An alternative view, held by the Director, Defense Intelligence Agency, holds that the Soviets will not be forced to reduce oil consumption whether or not oil production declines or is maintained at current levels. For a complete discussion of this view, see footnote 2 on page 8 of this Estimate. These differences of view, however, do not materially affect the magnitude of the decline in Soviet purchasing power:
- One or more poor harvests would force choices between badly needed Western machinery and grain imports.
- Failure of the economy to deliver adequately the machinery for modernization would result in more pressure to import, especially from Eastern Europe, to make up the deficiency.

We do not believe the hard currency constraint will spur a major shift in foreign policy or significant moves toward economic reform. Nevertheless, the need for Western credits and high-technology goods will encourage Moscow to consider Western attitudes, particularly those of Western Europe and Japan, when formulating foreign policy, resulting in some new initiatives to improve relations. New initiatives toward China in hopes of promoting barter trade are also likely to occur. The hard currency constraint will force the leadership to make tough choices among resource claimants, will create problems in relations with Eastern Europe, and will undermine Gorbachev's "human factors" campaign by failing to improve living standards:

- Unlike Brezhnev, who used hard currency to paper over agricultural failures, Gorbachev would have to ask consumers to sacrifice if faced with a bad harvest in order to maintain important machinery imports.



- Even though we do not expect substantial aid cutbacks to key client states, the Soviets will be likely to become more niggardly in their aid programs and Gorbachev will most likely call for improved economic performance on the part of the clients when the aid is not being well used.
- Also, we can expect Gorbachev to be more demanding for machinery deliveries from Eastern Europe as setbacks to his modernization program occur.

The timing and seriousness of these pressures depend in large measure on factors beyond Gorbachev's control such as weather-related domestic agricultural problems and global oil and grain prices. Should oil prices decline once again and remain in the \$10 per barrel range, deep cuts would be needed in imports of agricultural goods and machinery. On the other hand, events that would raise significantly the price of oil—such as a major disruption of Persian Gulf oil supplies—could boost Moscow's import capacity substantially above our baseline projection and alleviate Soviet problems. Other events—particularly related to higher prices and increased demand for Soviet gold, platinum-group metals, and diamonds—could also boost Soviet import capacity substantially.

Although the hard currency dilemma is unlikely to cause Moscow to be conciliatory enough to achieve major breakthroughs in East-West negotiations, the initiatives that Moscow is likely to undertake will have some impact on US policy interests:

- Soviet attempts to maximize hard currency earnings, particularly from arms sales, will result in a more aggressive search for markets in Third World countries.
- The Soviets also will be tempted to supply more state-of-the-art weaponry to secure sales, a tactic that will be likely to spur sharp internal debate.
- The Soviet desire to expand export markets and tap international financial markets will lead them to press more aggressively for greater participation in the international economic arena, exemplified by recent overtures to GATT.
- Added pressures on the East Europeans to aid Moscow will exacerbate economic, political, and social problems in the region.
- Moscow's difficulties in earning hard currency raise the opportunity costs of aiding its client states and may reduce prospects for new economic aid to non-Communist LDCs.

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## DISCUSSION

### Declining Export Earnings

1. From the mid-1970s through 1984 the Soviets benefited from a substantial rise in hard currency export earnings spurred by high dollar prices for energy. Their foreign purchasing power was further enhanced by the decline of the West European currencies against the US dollar in the latter part of this period. Most hard currency imports are purchased in Western Europe at national currency prices, and the bulk of Soviet exports are sold for dollars. This peak allowed the Soviets to import record amounts of grain and food to cover a string of poor harvests and to import Western equipment and technology. The favorable hard currency position was one of the few bright spots in an economic picture otherwise clouded by slowing growth and low productivity, a growing technology gap with the West, and a heavy defense burden. [ ]

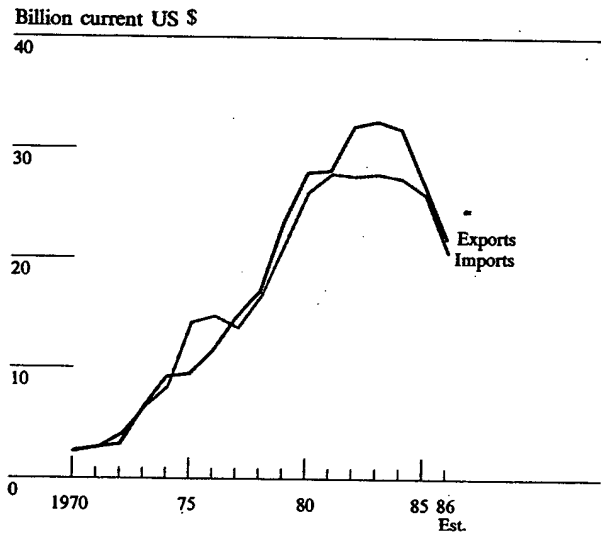
2. That strong position has changed radically over the last year. Moscow's favorable trade position began to deteriorate in 1985, the result of reduced earnings from both oil exports (lower prices and lower volume) and arms sales. We expect Soviet hard currency earnings in 1986 to total only \$23-26 billion, compared with a peak of \$34 billion in 1984, as energy prices are expected to remain depressed. The accident at Chernobyl will add to the hard currency problem as the Soviets are forced to use oil-fired power to make up for electricity shortages in peak demand periods and to compensate for generating capacity lost over at least the next year or two during shutdown and modification of other nuclear reactors.<sup>1</sup> [ ]

3. Although there naturally exists great uncertainty surrounding projections of international commodity and foreign exchange markets, we believe that for the rest of the decade Moscow's hard currency export earnings will average roughly 30 percent below the level of recent years:

- Surplus capacity in oil worldwide will keep downward pressure on prices throughout the rest of the 1980s.

<sup>1</sup> See footnote 2 for an alternative view held by the Director, Defense Intelligence Agency. [ ]

**Figure 1**  
**USSR: Hard Currency Trade,**  
**1970-86**



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- An increase in gas sales will only partially compensate for falling oil revenues because the price of gas—following that of oil—will limit gas revenues.
- Arms exports will also be likely to remain depressed as long as low oil prices limit the ability of oil exporters in the Middle East to import goods.
- Attempts to increase exports of other nonoil items—such as machinery and equipment, timber, and other raw materials—are likely to have limited success given generally weak demand for raw materials and Western resistance to shoddy Soviet-manufactured items.

Moreover, the low value of the dollar vis-a-vis other Western currencies will reduce the value of Soviet exports, because about two-thirds of their exports are

denominated in dollars, while roughly 70 percent of Soviet imports are purchased with other hard currencies. This amounts to about a 40-percent reduction in Soviet purchasing power during the period 1986-90 compared to the early 1980s. Although there is some disagreement within the Community about the future path of Soviet oil production and demand,<sup>2</sup> the differences materially do not affect the magnitude of the decline in Soviet purchasing power, which is driven primarily by price changes.

### Options and Constraints

4. The Soviets have a variety of policy options that could reduce the impact of the downward trend in export earnings on their capacity to import, but numerous constraints—economic, political, and strategic—will limit their ability to exercise these options to mitigate the effect of the earnings decline. Moreover,

<sup>2</sup> *The Director, Defense Intelligence Agency holds an alternative view that the Soviets can continue to produce oil at current or slightly higher rates, continue to reduce domestic oil demand, and maintain or increase hard currency exports of oil throughout the rest of the decade:*

- *If, as expected, current investment priorities are maintained, the Soviets will be in an excellent position to maintain current levels of production because the energy industry remains strong and Soviet oil reserves are more than adequate. Because of hard currency shortages, however, the focus of investment will be the domestic production of required equipment. The Soviets will also continue to rely on soft currency purchases of supplies from Finland and East Europe, particularly for exploration and development of the Arctic offshore areas. Because hard currency energy imports will not be a high priority, relatively minor development projects, such as in the Pre-Caspian area, have been postponed.*
- *This view further holds that the Soviets will make every effort to gain additional oil through the continuation of their substitution and conservation programs, which have already allowed them to reduce domestic demand by about 2 percent since 1982. Considerable opportunities still remain for substitution of gas for oil, which could free yet another 90-110 million metric tons. It is not likely that the Soviets would force additional reductions in demand beyond current programs in response to any future economic setbacks.*
- *This view further holds that the Soviets appear to be in an excellent position to expand oil exports through 1986 (because of the current production increase) and to maintain this level over the next several years. The Soviets would most likely reduce oil exports to Eastern Europe if they needed still more oil. Such a reduction would not significantly disrupt the East European economies because they should be in a position to absorb a substantial amount of Soviet gas exports through the major "Progress" gas pipeline, which should be fully operational by the late 1980s. Furthermore, this view holds that the Soviets will not have to, nor would they want to, divert oil from hard currency exports to oil-fueled powerplants to make up for lost production from Chernobyl and the resulting shutdown of similar nuclear reactors.*

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### Assumptions Underlying Projections of Soviet Hard Currency Balance of Payments

#### Export Projections

- Oil exports fall from 1.3 million b/d in 1986 to 800,000 b/d by 1990. An alternative view holds that oil exports will probably remain at this 1986 level or be slightly higher for the remainder of the decade. <sup>a</sup>
- Gas exports rise from 33 billion cubic meters in 1985 to 48 billion cubic meters in 1990.<sup>a</sup>
- Real arms sales show no growth during the period 1986-90 after dropping an estimated 30 percent in 1985.
- Real nonenergy, nonarms exports are held constant.
- Real net earnings from invisibles (excluding interest) remain constant.

#### Price Projections

- The overall annual inflation rate applicable to exports and imports is 3 percent during the period 1986-90.
- Nominal oil prices decline from \$28 per barrel for the mix of crude and petroleum products exported to hard currency countries in 1985 to an average of \$18 per barrel in 1986-90.
- Nominal gas prices drop from the 1985 level of \$119 per thousand cubic meters to an average price of \$84 in 1986-90.
- The nominal gold price grows at the rate of inflation from its current price of about \$400 per ounce.
- Interest rates average about 9 percent.
- The average repayment period is eight years on Western government-backed credits and five years on medium- and long-term commercial credits.
- The dollar depreciates 30 percent by 1990, with much of the decline occurring in 1986.

<sup>a</sup> *The holder of this view is the Director, Defense Intelligence Agency.*

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some measures will have only long-run benefit, providing little relief within the current five-year planning period—a crucial testing period for Gorbachev's leadership and his modernization program.

5. Moscow is in an excellent position to tap Western credit markets. The USSR is in a healthy financial

Soviet Oil Production and Domestic Demand<sup>a</sup>

The substantial increase in investment in the oil industry since 1985 has increased production, but this effort can increase output only temporarily. Depletion and rising resource costs of sustaining production will outrun the capability to introduce capacity, resulting in a decline in output, probably before the end of this decade. The Barents Sea may hold considerable potential, but any sizable commercial production from this area is unlikely to occur before the 1990s. [ ]

Domestic demand for oil during the period 1986-90 is likely to remain close to 9 million b/d. Although there is room for additional substitution of gas for oil, most of the easy changes have already been made. [ ]

<sup>a</sup> See footnote 2 for an alternative view held by the Director, Defense Intelligence Agency view. [ ]

position in terms of the balances; it has about \$12 billion on deposit in Western banks, its hard currency debt was about \$26 billion at the end of 1985 (a net increase of \$4 billion from yearend 1984), and it has a very high credit rating. Moscow will become even more creative in the use of international financial instruments such as bonds and currency and interest rate swaps, which would lower borrowing costs and cut potential losses as exchange and interest rates fluctuate. Moscow will remain judicious in international financial matters, however, and will be reluctant to become overly dependent on Western banks and their governments. A large drawdown in assets would mean giving up a cushion of reserves that could be used to finance key imports such as grain in bad harvest years. [ ]

6. The Soviets also have some flexibility with regard to *gold sales*. They have an estimated 2,800 tons of gold (worth roughly \$13 million per ton at the current price of about \$400 per ounce) in reserve and annual production of 340 tons. By using the physicals market, the futures markets, and direct bilateral sales, the Soviets probably could sell as much as 450 tons in 1986 without causing a major price decline. Should they increase sales for several years at that rate, however, they would risk driving the price down substantially. Annual world supply of new gold, both for industrial use and for investment and stockpiling, is fairly constant at roughly 1,500 tons per year. If traders and gold consumers believed that the USSR intended to begin selling larger amounts on a continual basis, this would cause substantial downward pressure on the price and reduce Soviet proceeds from the sales. [ ]

7. The USSR could put pressure on Eastern Europe to reduce further its imports of Soviet oil or to increase its exports to the USSR above planned levels. However, changes of the order of magnitude required to provide substantial relief to the Soviets are not likely to occur:<sup>3</sup>

— Large cuts in oil deliveries, which force Eastern Europe to look westward for supplies and financing, would run counter to Moscow's policy to expand intra-Bloc trade.

— Such cuts also risk undermining the hard-won political stability achieved by these regimes in recent years.

— The Soviets also would find it difficult to wrest substantial increases in exports from Eastern Europe because falling oil prices will bring Soviet trade deficits with the region toward the end of the decade.

— Moreover, most East European trade is complementary to, not a substitute for, hard currency purchases. [ ]

8. Most of the Soviets' other short- to mid-term options are extremely limited. The Soviets will attempt to increase arms sales, probably by offering state-of-the-art equipment, but financial difficulties in the OPEC countries will limit Moscow's ability to increase earnings in this way. Moscow will be likely to barter arms for increased deliveries of Libyan oil but even here we expect the amounts involved to be rather small. Moscow also may increase its efforts to negotiate barter arrangements, particularly with the LDCs, for desired agricultural commodities. Faced with financial problems of their own, the LDCs may become more receptive to such Soviet overtures. The Soviets will take advantage of opportunities to expand their soft currency grain purchases with countries such as India and China. [ ]

9. In a move with longer term payoff, Moscow could *alter the nature of its relationship with Western firms* in order to enhance the effectiveness of imported technology and equipment. Before the sharp downturn in oil earnings, Soviet officials had expressed interest in joint ventures entailing Western profit sharing and managerial presence. Also considered were closer engineering and production consultations with Western firms and the creation of more training facilities with Western participation. Traditional Soviet suspicion of a foreign presence and continued

<sup>3</sup> See footnote 2 for an alternative view held by the Director, Defense Intelligence Agency. [ ]

concern over US export controls will limit Soviet actions in these areas. Moreover, Western businessmen are likely to react cautiously to Soviet proposals calling for coproduction and profit sharing.

### The Soviet Strategy

10. The Soviets have not yet implemented and most likely have not yet fully developed a long-term strategy for dealing with the decline in hard currency earnings. Moscow responded at first to reduced export earnings by increased borrowing and gold sales. In 1985 it took advantage of favorable borrowing conditions to build its assets to a level about \$2 billion higher than at yearend 1984. For most of the year it continued to negotiate and sign major contracts with Western firms for projects to be constructed during the period 1986-90. Then, in late 1985 Soviet purchasing activity began to slow, and by early 1986 there were sweeping cutbacks in purchases. The major emphasis so far has been on cutting and delaying equipment orders rather than reducing purchases of other items—agricultural products and intermediate goods—needed to meet current output and consumption targets.

11. We believe that over the next year or so the Soviets will develop a longer range and relatively conservative strategy to minimize the impact of the decline in hard currency earnings. This strategy will include elements of present ad hoc measures as well as some new initiatives. The major elements of this strategy will be:

- An average annual increase in international borrowing of perhaps \$1-2 billion, which would raise the debt-service ratio from the present 19 to 20 percent to about 30 percent. This would represent a somewhat less conservative strategy than in the past but would still allow room for additional loans to cover events such as a harvest disaster.
- A drawdown in assets in Western banks by as much as \$4 billion from the current \$12 billion. A drawdown of this magnitude would not seriously jeopardize their liquidity position.
- Increases in gold sales from recent levels of 100 to 200 tons to 300 tons annually. Sales of this magnitude seem possible without a major effect on gold prices.
- Efforts to push the East Europeans to absorb a reduction in oil deliveries over the next few years, especially if world oil prices remain low. A

5-percent reduction in oil exports to its Communist allies would enable Moscow to earn an additional \$1 billion over the period 1986-90 from increased exports to the West.

- Efforts to maximize hard currency earnings from arms sales.
- Attempts to expand participation by Western firms in Soviet development projects, perhaps to include production-sharing arrangements.

Under this strategy, we estimate that annual average hard currency import capacity will fall to \$18.5 billion during 1986-90—a cut of one-third from the 1984 level. The alternative assumption<sup>4</sup> on oil exports would yield an import capacity of \$19.9 billion during 1986-90. In any case, the Soviets will need to continue selective reductions of imports.

12. We do not believe that, within the 1986-90 time frame, the Soviets will see major economic reform designed to improve economic efficiency as a viable option for eventually reducing the need for imports. In the short run, decentralizing reforms that give factory managers the power to make decisions on imports would be likely to increase the demand for imports. Moreover, the political and economic ramifications of serious, systemic reform—alienation of the bureaucracy, economic dislocations, reduced control over resources for military production—would seriously circumscribe Gorbachev's initiatives in this area.

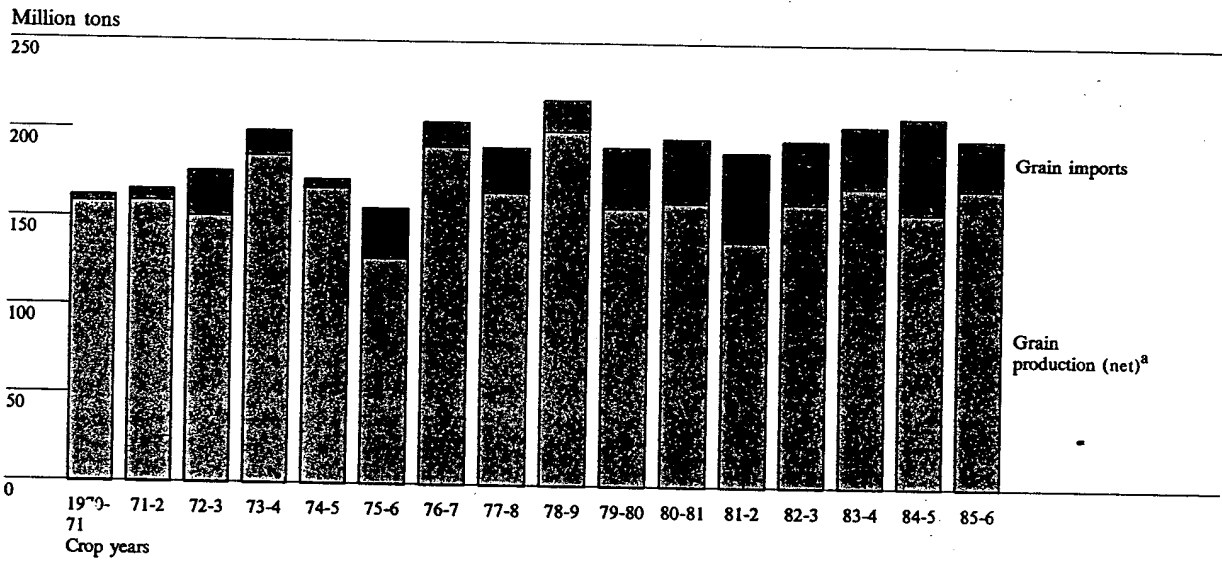
### Gauging the Import Cuts

13. Consumer-related purchases are likely to be cut back the most. A Soviet official recently remarked that consumer goods imports from the West would be practically eliminated this year. Spending for agricultural imports could absorb a major part of the reduction relatively easily, given a scenario of average weather, improved agricultural practices, and a continued world grain glut, which depresses agricultural prices. Each 1 million ton reduction in wheat imports saves the Soviet Union \$100 million at current prices. Assuming the value of total hard currency agricultural imports is cut by roughly 50 percent from the 1981-85 level, some growth in farm products per capita would still be possible, although at rates below the 1986-90 goals.

14. Moscow will be extremely selective in reducing imports of machinery. Although hard currency imports of machinery supply only about 10 percent of

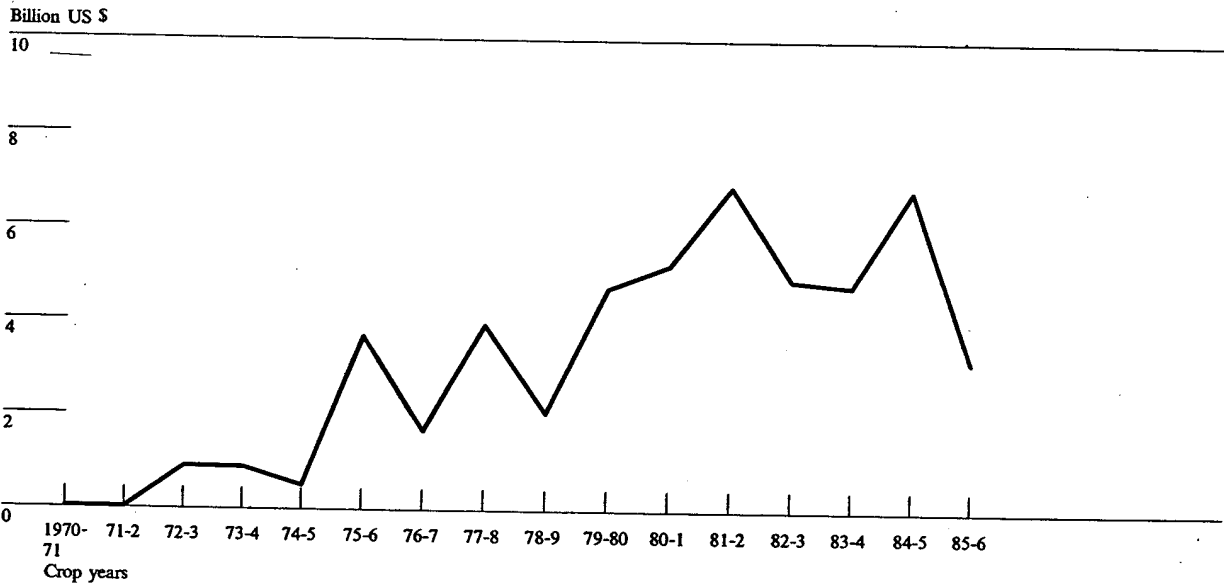
<sup>4</sup> The holder of this view is the Director, Defense Intelligence Agency.

**Figure 2**  
**USSR: Grain Production and Imports**



<sup>a</sup> Gross grain production minus deduction for excess moisture, and extraneous matter.

**Hard Currency Grain Imports**



Soviet Dependence on Western Machinery

Although imports of Western machinery and equipment account for only about 10 percent of total Soviet investment in machinery and equipment, these imports have been carefully selected to meet the needs of priority sectors of the economy. Since 1980, purchases for the chemical, energy, and metallurgical sectors have accounted for almost 70 percent of total Soviet orders of machinery and equipment. [ ]

The Soviets often complain that they have been disappointed with the results of Western machinery, but the degree of success in using such imports often depends on whether they must be interfaced with Soviet-built machines or can be used in a stand-alone manner (for example, turnkey plants). The latter have contributed substantially to growth in output and enhancement of technology in selected industries, notably chemicals, automotive and truck, pulp and paper, and several defense-oriented machine-building industries. [ ]

Imports of Western technology have helped the Soviets overcome some shortcomings in their technology:

- In the steel sector, purchases of Western technology for rolling operations and pipe production have been particularly important.
- In the chemical sector, Western imports have provided key technologies for the production, handling, and storage of fertilizers and for production of plastics and synthetic fibers.
- In the oil and gas sectors, recent imports of such items as Western pipe, pipelayers, offshore drilling equipment and technology, and well-completion equipment have provided substantial aid to Soviet oil and gas development. Looking a few years ahead, the Soviets will be in the market for corrosion-resistant pipe and other production and processing equipment for Astrakhan, Karachaganak, and Tengiz.
- The acquisition of a Japanese drydock gave an added capability to Soviet ship-repair facilities. [ ]

total investment, they are important to key sectors critical to the modernization program (see box). We believe top priority will be given to imports of energy-related equipment<sup>5</sup> and advanced machine tools. Without Western imports, development of the Pre-Caspian oil basin would be further delayed, as would exploration and development of the Arctic offshore areas. [ ]

<sup>5</sup> See footnote 2 for an alternative view held by the Director, Defense Intelligence Agency. [ ]

15. We believe Moscow will cut some machinery imports as long as the cuts do not seriously jeopardize Gorbachev's industrial modernization program. The Soviets have recently canceled or reduced five contracts for large chemical complexes. Import cuts for the pulp and paper and cement industries also might be made. The Soviets could take a variety of actions that would minimize the cuts in machinery imports. For example, they will continue to push for more buyback and barter arrangements. Expensive, turnkey projects will likely be scaled back, with the Soviets providing more of the civil engineering work and plant infrastructure themselves. The Soviets could save additional foreign exchange by selectively cutting imports of industrial materials without causing serious bottlenecks. [ ]

16. Soviet weapons producers will be relatively unaffected directly by the decline in import capacity, whatever its size. Soviet imports of Western equipment to help modernize their defense industrial base probably peaked in the mid-1970s to early 1980s, and now established weapons plants will support the great majority of planned Soviet military procurement over the next decade. Moreover, weapons producers in most cases do not depend on Western production equipment or components. Most Soviet weapons industry acquisitions of such items from the West have been one-time, relatively small purchases rather than continual or plant-scale purchases. Moreover, the priority the Soviets traditionally accord this sector will most likely protect defense-related imports. [ ]

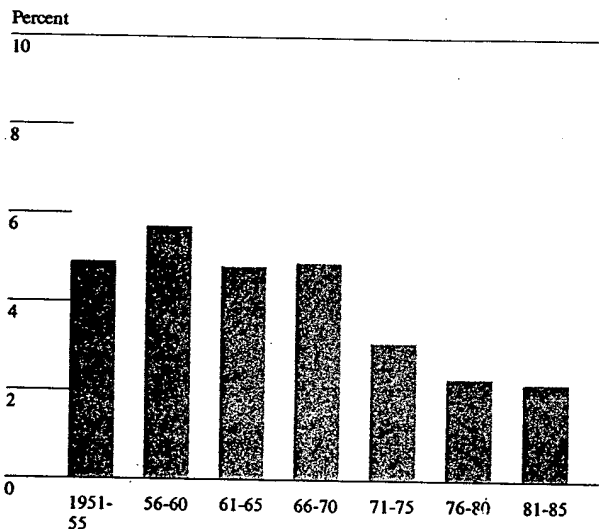
17. Because trade is a small component of Soviet GNP and critical imports will not be sacrificed, we estimate that average annual GNP growth in the 1986-90 plan would be reduced by about one-tenth of a percentage point out of our total projected growth rate of about 2 to 3 percent per year if the Soviets follow this scenario. Even so, the cutbacks will be a significant problem for Gorbachev because they limit severely the flexibility of Moscow to respond to shortfalls in key sectors. Increased inputs of Western automated equipment, for example, would be useful in meeting Gorbachev's goals of improving efficiency in machinery use and boosting productivity in the Soviet economy. Also, unlike Brezhnev, Gorbachev will not be able to use grain imports to increase the availability of meat if his program to improve the efficiency of livestock feeding falls short of goals. [ ]

Alternative Scenarios

18. Lower oil prices and/or adverse weather would change this picture dramatically, forcing the regime to make tough choices about the relative priorities of its



**Figure 3**  
**USSR: Average Annual GNP Growth**  
**by Five-Year Period<sup>a</sup>**



<sup>a</sup>GNP is measured in factor cost 1982 prices.

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modernization and consumer goals. Crude oil prices of around \$10 per barrel for the rest of the decade could reduce Moscow's annual hard currency import capacity to \$10-12 billion versus our projection of \$18.5 billion. Weather approximating the unfavorable conditions that existed during the period 1961-65 would slow growth in farm output and raise agriculture import costs considerably. In this case, hard currency cutbacks could not fall largely on agricultural imports from the West without jeopardizing per capita availability of several quality foods such as meat, vegetable oil, and sugar. Moscow could only partially compensate for this shortfall by importing more meat from such soft currency suppliers as Eastern Europe and Mongolia.

19. Increased expenditures on grain could force deep cuts in machinery imports from the West and have serious consequences for Gorbachev's modernization program. The program's lofty goals—when matched against a realistic assessment of the capabilities of domestic industries—imply that some highly specialized imports from the West for such sectors as energy, microelectronics, and telecommunications must be continued, if not increased. Similar cuts in other industry-related imports could exacerbate already taut production schedules, threatening other

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

20. On the other hand, a substantial rise in world raw material prices could bolster Moscow's hard currency position. For example, if world oil prices quickly recover to \$20 per barrel, Moscow's annual import capacity would be almost \$2 billion higher than the \$18.5 billion projection. Similarly, the Soviet trade position could be changed by effective sanctions on South Africa or internal disruptions there that would reduce the supply of gold, diamonds, and platinum-group metals on international markets. We estimate that the combined effect of higher prices and larger Soviet exports of these commodities, particularly gold, could boost Soviet import capacity substantially over the projection.

#### Foreign Policy Implications

21. The hard currency dilemma is only one of many pressing economic problems faced by the leadership. We believe that, at present, the Soviet leadership does not view it as sufficiently important by itself nor intractable enough to effect major changes in foreign policy areas, nor does the situation provide the West with large opportunities for leverage.

22. Moscow's economic problems are unlikely to cause the Soviets to act more aggressively abroad or, on the other hand, to be conciliatory enough to achieve major breakthroughs in East-West negotiations, or to significantly pullback from commitments to client states. Soviet foreign policy will continue to be determined largely by strategic and geopolitical considerations, with economic factors playing a complementary role. Nevertheless, the initiatives the Soviets are likely to take in response to the hard currency shortage could have some impact on US foreign policy interests. The USSR's continued need for Western goods—particularly in the high-tech areas that are most subject to COCOM restrictions—their interest in

Gorbachev's Initiatives		
Indicator	Measure of Success	Potential Hard Currency Input
Efficiency in the use of automated machinery	Goal of 5-percent increase in amount of capital in relationship to production	Machinery for production lines, technology
Consumer welfare	Production of new housing, availability of meat, collective farm prices	Agricultural imports
Productivity of the Soviet economy	Renewal of capital stock and improvement in "human factors" (reduced absenteeism, alcohol consumption, accidents at the workplace)	Machinery and technology imports and continued imports of key consumer goods
Growth of GNP	Goal of 4-percent output growth with emphasis on key sectors such as energy, machinery	Equipment to aid production in key sectors

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obtaining concessionary trade terms to save foreign exchange, and the need for credits will encourage Moscow to consider Western attitudes and reactions, particularly those of Western Europe and Japan, when formulating policy. This might result in greater cooperation by Moscow in some areas of arms limitation, commercial exchange, and social interchange but not at the cost of abandoning major foreign policy objectives.

23. At the same time, Moscow will continue to exploit opportunities to split the Western alliance in an attempt to encourage greater opposition to the more hardline policies of the United States toward East-West trade. West Germany and Japan seem likely to be targets for Moscow's efforts. The expectation that lower hard currency earnings might force Moscow to reduce the scope and nature of its trade with the West could make many Western governments and businesses more amenable to granting preferential trade terms in an attempt to beat out the competition. Unemployment remains high in Western Europe, where the job-creation benefits of East-West trade are an important political issue, and some West European plants rely almost exclusively on trade with the East.

24. Soviet attempts to maximize hard currency earnings, particularly from arms sales, will result in a more aggressive search for markets in the Third World. This sales campaign will be concentrated on OPEC members and others that have had large hard currency surpluses with the USSR such as Malaysia. Despite declining oil revenues, a few opportunities for expansion still exist, and Moscow could decide to offer state-of-the-art arms as an incentive. Libya, for one, apparently intends to give high priority to procurement of Soviet arms. Moscow also may increase its

efforts to negotiate barter arrangements, particularly with the LDCs, for desired agricultural commodities. Faced with financial problems of their own, the LDCs may become more receptive to such Soviet overtures. Moscow's search for alternatives to hard currency trade will be a factor behind its continued efforts to renew trade ties to China, particularly in light of the latter's recent successes in raising agricultural and consumer goods production.

25. Moscow's interest in developing an export market for manufactured goods, combined with the need to use international financial markets to cover its hard currency shortfalls, probably will result in new, more aggressive, demarches to participate in the international economic arena, as exemplified by Moscow's recent bid to join in the forthcoming GATT negotiations. Although Moscow's stated objective is economic gain, it probably would exploit opportunities to create dissension within the West and between the developed West and Third World.

26. Increased pressure by Moscow on Eastern Europe to supply goods that will serve as substitutes for imports from the West, particularly machinery and equipment, and to reduce their use of raw materials traditionally supplied by Moscow such as oil, run the risk of overburdening their already tautly stretched economies. Economic stringencies could lead to declining living standards and popular discontent, which could undermine existing popular support for current regimes. Moscow's attempts to transfer some of its hard currency problems to Eastern Europe will also make the East Europeans even more reluctant to shoulder the burden of upgrading Warsaw Pact forces.

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27. The hard currency shortage will raise the opportunity cost of Soviet aid to its client states in the Third World. Evidence indicates that Moscow will be even more insistent that these countries increase their exports to the USSR, pay their debts, and use Soviet aid more wisely. Some countries' difficulties in making debt repayments to Moscow already have become an important irritant in relations (Libya, for example).

Moscow probably will focus new economic assistance to non-Communist LDCs only on projects with large economic or political payoffs. Moscow has long incurred criticism in the Third World for its meager economic assistance, and its increased scrutiny of potential projects will reinforce this judgment, further tarnishing Moscow's image as a role model for development in the eyes of the Third World.

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