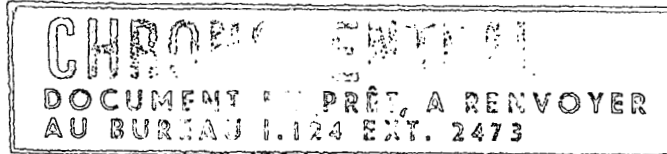


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N A T O   C O N F I D E N T I A L

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ECONOMIC COMMITTEE

RECENT ECONOMIC DEVELOPMENTS IN THE USSR AND EASTERN EUROPE

Note by the Chairman

The attached report is the latest in the series of biennial summaries of economic developments in Warsaw Pact countries. These reports have for several years been submitted to Ministerial sessions of the Council as background papers in the form of Reports by the Chairman of the Economic Committee.

It is suggested that this practice be continued. Delegations are invited to contact the Chairman if they wish to make changes or additions to the report. On the basis of all such comments received as of 4th June, 1973, it is proposed to revise the paper into a "Report by the Chairman" which would then be placed on the Agenda of the Ministerial meeting of the Council as a background paper.

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N A T O   C O N F I D E N T I A L

RECENT ECONOMIC TRENDS IN THE  
USSR AND EASTERN EUROPE

Economic growth in Warsaw Pact countries in 1972 was the slowest in 20 years, largely because of stagnation in the Soviet economy (which represents over three-quarters of the Eastern total). Unfavourable weather, and misdirection of investment, combined with the fundamental handicaps of labour shortages, resource depletion, and economic centralization, produced an agricultural crisis, construction delays, a record postwar low in growth of industrial production, and shortfalls in output of consumer goods in the USSR. The major goals of the 1971-75 plan are probably unattainable. East European countries, however, maintained their scheduled rate of growth under five-year plans because of generally more favourable performance in agriculture and investment. A need for basic economic reforms to reduce waste still exists in the East but faces possible opposition from workers as well as central planners. In Poland and Hungary, promising experiments with wage reform are apparently regarded as threats to job security.

2. Clearly, the USSR and its allies are looking increasingly to Western technology, grain, and credits on favourable terms as the main remedy for economic stagnation - and are counting on a long-term supporting framework of East-West political detente. The Soviet Union also probably calculates that mounting Western demand for energy and minerals might finally remedy its principal trading handicap - a shortage of competitive exports. In 1972, growth of Soviet commerce with industrialized Western countries accelerated as purchases of both grain and machinery in the West broke past records. Financing was facilitated partly by the rise in the price of Soviet gold sold on the free market. The most important factor, however, has probably been the conclusion of major political agreements with Western governments and the subsequent spread of industrial-cooperation arrangements that permit the USSR to pay over time for Western machinery with Soviet commodities, largely minerals.

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3. These upward trends in East-West trade and industrial cooperation have continued in early 1973. Normalization of East-West economic relations has also been promoted by increasing Eastern contact with international economic organizations and by further agreements with Western companies and governments, sometimes with Eastern concessions. Most important, a recent Soviet press campaign encourages domestic expectations for Western aid in raising Soviet living standards. These developments hold advantages for the Alliance in the framework of both trade and negotiations with the East.

A. Domestic Production and Growth

(i) The USSR

4. The Soviet economy is in the midst of its most severe slowdown since the 1940s. While average annual growth of 5% or more has been projected in the plan for 1971-75 and regularly achieved in the past, GNP is estimated to have risen about 1.5% in 1972 after an increase in the neighbourhood of 3.5% the year before. The basic, long-term problems are increasing investment costs, declining growth of employment, and high-level policies of centralization and self-sufficiency that create waste and inhibit technical advance. Additional causes of the slowdown in 1972 were (a) unusually unfavourable agricultural weather and (b) increasing mismanagement and dispersion of investment funds. Plant completions accordingly fell behind schedule and labour productivity (the main driving force of industrial output) rose considerably less than either planned for 1972 or achieved in 1971. Similar slowdowns occurred in such key production sectors as chemicals (including mineral fertilizers), tractors, and even natural gas; slow development of gas deposits in Siberia apparently prompted a visit by Premier Kosygin last January. As a result of these shocks, expansion of output in 1972 was at a record low for industry and fell almost 5% in absolute terms in agriculture. Poor harvests were reported for grain and several foodstuffs.

5. These setbacks were reflected primarily in living standards and foreign exchange reserves. In 1972 the priority assigned in recent years to consumer goods in industrial production was discontinued. Output of steel, coal, electricity and producer goods generally - traditional leading sectors prior to the 1960s - rose on or ahead of schedule. But growth of production of industrial consumer items fell below both plan and 1971 performance. The same was true of housing, consumer services, real income per capita, retail trade and output of fabrics. Substantial slowdowns from 1971 growth rates were registered for social welfare, production of certain household appliances, and output of light and food industries (which rose only 3%).

6. Little hope for recovery this year is generated by the published portions of the 1973 economic plan, which represents a substantial cutback from the original targets for this year in the Five-Year Plan. In major speeches of last December and September, respectively, First Secretary Brezhnev and Premier Kosygin signalled an increasing austerity in resource allocations that is borne out by the relatively low growth rates targeted for key indices relating to consumption, investment, employment and productivity. The solution proposed for reported mismanagement of investment is a reversion to greater central control, which has in the past been generally recognized as a major cause of waste and inefficiency in the USSR. Not surprisingly, economic performance showed no improvement in the first quarter of 1973.

7. The principal basis for the 6% overall rate of expansion planned in 1973 is clearly agricultural output, which has an ambitious growth assignment of 12.6% that will be difficult to meet without unusually favourable weather. The farming sector, however, remains a highly uncertain basis for the forecast of rapid Soviet economic growth - particularly since the area of winter wheat which was seeded last autumn was 25% less than in the previous year.

8. The consumer is again evidently scheduled to absorb much of the resulting economic slowdown. The 1973 plan consolidates the reversal of relative priorities as between growth rates: while output of producer goods is projected to rise 6.3%, that of consumer goods is cut back to a 4.5% pace. Slower expansion than attained last year is also projected for money wages, retail trade, social welfare, and food production. In March, Soviet officials admitted that butter and potatoes were being rationed in some areas. At the same time, a press campaign was being developed on the uncharacteristic themes of the relatively high living standards in industrialized Western countries and the possibility of increasing Western economic assistance to the USSR.

(ii) Eastern Europe

9. During 1972 economic expansion in Eastern Europe as a whole continued on schedule, nearly equalling the moderately rapid average annual rate (6.8% in terms of Net Material Product) projected in Five-Year Plans. Even higher rates than planned were registered by Poland, East Germany and Czechoslovakia, where growth of investment and agricultural output accelerated. In Rumania, the pace of expansion slowed somewhat from the 12.5% growth of Net Material Product attained in 1971 but - at 10% - remained the fastest in the Warsaw Pact. Indices of living standards also rose substantially in these countries. Only Bulgaria, with two successive years of mediocre agricultural results, has fallen far short of its Five-Year objectives. Growth of Net Material Product was lowest (5%) in Hungary, where investment, imports, and real income were held back by policies of constraint and recentralization that had been applied to curb inflationary demand and to limit the experiment with economic reforms that accompanied it.

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10. Plans for 1973 appear generally consumer-orientated. Increases of 6.5% or more in real income are projected for Rumania, Poland, and Bulgaria. In the GDR, production of consumer goods, which face considerable demand from foreign as well as domestic markets, is scheduled to grow at accelerated rates, surpassing that of producer goods, and to receive a massive increase in investment.

B. Problems: Reform and Inflation

11. No firm indication has appeared of a genuine economic reform along the lines of a decentralization of economic power and unleashing of market forces. While Hungary has been re-establishing central controls, new experiments of dubious value have been commenced by Poland in January and the USSR in April. In both cases, associations of industrial enterprises have been granted nominal decision-making authority (as in the initial Hungarian reform of 1968). It remains unclear, however, whether (as in the Hungarian case) their activities would be cramped or subsidized by the centre.

12. The process of economic reform in the East is apparently subject to opposition from workers as well as central planners. A new Polish wage scheme would make wages dependent on sales, whereas a Hungarian experiment with "bloc-payments" involves payment of a lump sum to the smallest group of workers capable of performing a given task. Both ideas are designed to spur productivity and thus offset labour shortages. Both, however, are apparently regarded by workers as threats to job security and may therefore not be widely applied.

13. The sensitivity of East European consumers to rising prices of basic necessities has also inhibited moves to curb excess demand and inflationary pressures. Retail prices of Hungarian dairy products were raised 14-28% in January in response to excess market demand; wages of certain industrial workers in turn were boosted 8% in March. Polish food prices are currently frozen through November, but inflationary pressures are considerable: in March, central controls were re-applied to slow down a boom in investment, which had risen 21% in 1972. Such constraints were reportedly also administered in Czechoslovakia but without much success. Latent inflationary pressure continued to build-up last year in the USSR; personal savings rose 14% as consumers refused to spend these funds on the goods available.

C. East-West Economic Relations

(i) Trade

14. The foreign trade of Warsaw Pact countries last year recovered somewhat from the retrenchment of 1971, rising 10%. The same pace was achieved by the USSR and the GDR and even faster rates by Poland and Rumania. Much of the Soviet import boom

apparently originated in commerce with industrialized Western countries, which rose a record 14% in 1972. The principal Western trading partner of the USSR last year was the FRG, closely followed by Japan. Soviet imports of grain and other consumer goods grew about \$1 billion while imports of Western machinery increased by 25% (\$250 million) over the 1971 level. The main factors responsible were probably poor economic performance at home and easier financing in the West, where gold prices rose and where credit terms eased as demand for exportable Soviet minerals mounted. Probably at least \$300 million of the Soviet trade deficit last year was financed by sales of gold out of current Soviet production. While Soviet machinery orders for future delivery spurted to a record in 1972, at least half of this total (which included \$400 million in gas-pipeline equipment) was covered by industrial-cooperation agreements involving Western credits repayable in goods instead of hard currency. According to a recent ECE report, such East-West agreements now number about 600 and account for 15% of the exports of certain East European countries.

15. East-West trade prospects for 1973 and beyond appear favourable, particularly as regards the USSR. Commerce will probably continue to benefit indirectly from scheduled high-level East-West visits, from the discussions in the framework of a CSCE, and from the attendant atmosphere of detente or agreements on cooperation. In the purely commercial sphere, Soviet exports are benefitting from the continuing sellers' market for fuels, platinum, diamonds, and gold. Soviet earnings in Western Europe will be augmented by a recently completed natural-gas pipeline from Western Siberia. The USSR has also recently sold its first enriched uranium in the West.

16. Indications are considerably more dramatic as regards Soviet imports. To fulfil its ambitious livestock and dietary programmes, the Soviet Union will probably import \$2 billion of grain this year, partly under expected orders for an additional 10 million tons of cereals or more from the West. The Soviet press build-up on the theme of increasing Soviet-Western economic cooperation has been validated by events. In April, a record \$4 billion industrial-cooperation agreement with the Occidental Corporation of the US was announced: Fertilizer plants and pipe are reportedly to be provided under credits repayable with Soviet chemical fertilizers over 20 years starting in 1978. The USSR has also been offered about \$600 million in new lines of credit by Western banks so far this year. In March, Premier Tanaka reportedly promised favourable consideration of a Soviet request for about \$1 billion in Japanese equipment and long-term credits for a Siberian pipeline that would eventually provide oil in repayment.

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17. In Eastern Europe, Poland has been the beneficiary of about \$65 million in bank credit lines since January and has continued to order Western machinery at the \$300-million annual rate achieved in 1972. A Polish government statement of March, however, hinted at possible restrictions on imports as part of the anti-inflationary programme. In the GDR, imports from the West are expected to rise strongly this year in support of a planned 9% increase in investment. On the export side, Poland, Hungary, Rumania and Bulgaria have benefitted from the recent rise in world prices of meat.

(ii) Contacts and Agreements

18. Progress towards normalization of East-West economic relations continues. The first Euro-loan (\$50 million for 7 years) was made to the COMECON Investment Bank in March. In Rumania and Hungary, new legislation permits Western firms to purchase up to a 49% share of joint ventures, though Hungarian spokesmen claim that such foreign investment will be only marginal and exceptional. A US-Hungarian claims settlement for nationalized property was signed in March. To facilitate industrial cooperation, West Germany and Poland concluded the first East-West double-tax agreement last December. Following Rumania's admission to the IMF, the next East European approach is expected to come from Hungary.

19. In May the Soviet Union reportedly agreed to open Siberian air space to West German flights to East Asia and to acknowledge the FRG's right to represent West Berlin in cooperation with the USSR. These Soviet concessions are said to be included in the economic cooperation agreement - the latest in a series concluded with Western governments - signed during First Secretary Brezhnev's visit to Bonn. Since January, additional Western companies have opened offices in Moscow and signed technical cooperation agreements with Soviet organizations, which have extended shipping service to New York and slightly widened Western access to Soviet economic information (e.g. output of individual factories).

20. In multilateral dealings, Soviet readiness in practice to conduct commercial transactions with the Common Market was demonstrated in a recent butter purchase amounting to \$85 million and in the muting of Soviet criticism of the EEC at an East-West trade conference. In March, the USSR adhered to the Universal Copyright Convention, which may hinder publication abroad by dissident Soviet writers, but also obligates the Soviet authorities to pay royalties on Western writings published in the USSR.

D. Conclusions

21. The implications of these developments are clearly favourable for the Alliance in the framework of both trade and negotiations with the East. Economic stagnation has increased the Soviet need for cooperation with industrialized Western countries,

is helping to consolidate the Soviet policy of detente, and is pushing Moscow in the direction of economic interdependence with the West. The importance attached by the USSR to improving economic relations with the industrial West is reflected in (i) a press campaign that tends to increase domestic expectations for Western aid in raising Soviet living standards; (ii) a recent spurt of Soviet orders for Western grain and for Western machinery under long-term industrial-cooperation arrangements; and (iii) an increase in Eastern economic contacts and agreements with the West.