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ECONOMIC COMMITTEE

RECENT ECONOMIC DEVELOPMENTS IN THE USSR AND EASTERN EUROPE: IMPACT OF THE ENERGY CRISIS

Note by the Economic Directorate
(Draft report by the Chairman to the Council)

I. MAIN FEATURES

(a) Foreign Trade

The USSR has gained considerable financial strength from the world-wide increase in energy and commodity prices, which has in various ways increased Soviet buying and bargaining power with the developed West and Eastern Europe and has probably also diminished Soviet incentives for effective internal economic reform. Although the extraordinary rise in prices of oil, gold, and materials has damaged most East European and Western economies (which import these items), it has benefited the Soviet Union (which exports them). In 1973, increased hard-currency earnings, together with Western credits (which may have expanded considerably in the prevailing climate of political détente), financed record Soviet imports of Western technology for industrial modernization and of grain needed for politically important dietary improvements. Eastern Europe shared in the rapid growth of East-West trade and co-operative arrangements in 1973, but may henceforth be increasingly diverted to intra-COMECON commerce and accordingly become more vulnerable to Soviet economic pressure.

2. The USSR has thus far demonstrated some restraint and flexibility in exercising its newfound economic power, occasionally settling transactions on relatively easy terms. Generally, however, Moscow has followed sharp upward trends in world commodity prices. Western customers were and are being offered little increase in Soviet oil deliveries in 1973-1974. While Eastern Europe has received more Soviet oil, the USSR has the option to make further commitments, regarding material as well as energy supplies, conditional upon greater East European compliance with Soviet policy priorities, e.g. economic integration of COMECON countries.

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(b) Domestic Developments

3. Such improvements in Soviet economic competitiveness may have diminished the gravity, in Soviet eyes, of continuing internal economic problems and fluctuations. Economic growth accelerated in most Eastern countries in 1973 - perhaps exceeding 6% for Soviet GNP - in response to extremely favourable weather for Soviet agriculture and faster growth of labour productivity in East European industry. A deceleration is expected in 1974-1975 because of probabilities that most East European countries will be short of energy and extraordinary improvements in meteorological or other conditions for Soviet farming will not recur quickly. Eastern leaders are nevertheless adhering to time-honoured economic remedies (e.g. computerization, bureaucratic reshuffling) that are slow or limited in effect. A more serious effort to solve basic problems, the Hungarian economic reform, seems to be in difficulties. Such seeming acceptance of slower growth rates may be related in part to Soviet calculations that, in a period of world shortages and inflation, Western economic performance will also be weakened.

II. USSR

(a) External Economic Relations

4. Results. The commerce of the USSR with NATO and other industrialized Western countries broke several records in 1973, rising about 40%, contributing to a 20% boost in total Soviet foreign trade, and raising the Western share thereof above one-quarter (see Table II attached). Its proportion of the global commerce of OECD countries remained modest - less than 2% (about 3/10 of Belgium's volume and 1/10 of the FRG's) - but continued to expand. The increase in Soviet imports from the West last year was accounted for mainly by machinery, shipping, and feed-grains needed for high-priority programmes of industrial modernization and dietary improvement. The increased charges were financed with apparent ease, perhaps partly because of the background of political détente, which increased Soviet access to Western credit facilities (including self-liquidating, barter credits) but mainly because of a considerable improvement in the Soviet terms of merchandise trade. The world-wide rise in prices of basic commodities relative to manufactured goods markedly boosted the earning power of timber, chemicals, and other materials and fuels, which constitute about 2/3 of Soviet exports to the West. Similar price movements added about $500 million to the value of estimated Soviet gold sales in 1973 (over $800 million): most of the gold sold was probably from current production, causing little reduction in reserves.

5. Prospects. The outlook for Soviet trade with the West remains favourable for 1974. It seems doubtful that the record-breaking expansion of 1973 can be repeated, in view of expectations of a tapering-off of Western demand for some commodities, but Soviet-Western commerce may well continue to expand its share of world trade. While Soviet grain imports will probably rise further following the record-breaking volumes of Soviet orders placed in 1972 and 1973, largely under industrial co-operation arrangements. Soviet orders for machinery and equipment continued at a high level during January-April 1974, amounting to an estimated $1,150 million in Western Europe and $20 million in the US. The USSR has also opened a bank in Vienna, reached an understanding with the FRG on joint ventures in third countries, and concluded several technical co-operation agreements with Western companies.

6. Policy Considerations: Economic Leverage. The shift last year to a seller's market for key commodities that the USSR sells abroad has been maintained thus far in 1974, increasing Soviet freedom of manoeuvre in economic negotiations as well as strengthening trade prospects. Soviet terms on sales of timber and coal seem to have followed sharp upward trends in market prices. In the case of oil, little increase in Soviet exports materialized in 1973 nor is anticipated this year (see Table III attached). Recent Soviet oil deliveries and negotiations with some Western partners have been dilatory. The main reasons are probably production shortfall at home, rising demand from Eastern Europe (see below), and incentives to speculative hoarding stemming from the rapid rise in prices. Moreover, price increases alone may double or triple the value of Soviet oil sales for hard-currency (adding $500-1,000 million) even without an increase in volume. A recent agreement specifies oil prices that will reportedly triple the cost of Finland's imports from the USSR this year and will finance Finnish construction of a copper-nickel smelter in the Soviet Union. The rise in oil prices may also be contributing to increased Soviet hard-currency earnings in some Arab countries, which are reportedly no longer obtaining Soviet arms under long-term credits but purchasing them for cash out of their burgeoning oil revenues.

7. Soviet terms have stiffened somewhat in regard to some long-term Siberian development projects under discussion. Japan is now being asked to provide credits at only 6.4% interest in regard to co-operative, coal, timber and natural gas schemes and to contribute to an expensive and politically risky rail transport project in return for oil shipments.

8. On occasion, the USSR has used its new-found market power to soften its commercial terms. In late March, Soviet officials who were also negotiating for West German nuclear power facilities suddenly agreed to pay cash for a $1 milliard steel plant, which they had for two years been attempting to obtain under relatively low interest rates and long-term credits.

(b) Domestic Developments

9. Results. In 1973 the Soviet economy grew at its most rapid rate since 1970 - 6.8% in terms of net material product (see Table I). The main factor in recovery from the 1972 slump was agriculture, which featured a record-breaking grain harvest and a 14% increase in farming output (the fastest growth since 1964), resulting largely from favourable meterological conditions. Numbers of livestock also rose moderately, thus advancing the high-priority programme to enrich the Soviet diet by 1975 with greatly increased supplies of meat and dairy products.

10. The economic impact of the farming upswing was partly blunted by the continuation of relatively low growth rates (by past Soviet standards) in most industrial sectors and by the reported unreadiness of the Soviet economy to handle such a large harvest. Inadequacies of drying, storage, and transport facilities resulted in a high wastage of grain. In industry, output of crude oil and natural gas, respectively, was 2% and 6% behind schedule because of shortfalls in drilling efficiency and in construction of pipelines. Contrary to a major commitment of the Soviet leaders, the rate of growth of production of industrial consumer goods (5.9%) was lower than that of producer goods (8.2%). Chronic problems - under-fulfilment of the technological programme, dispersion of investment, slow growth of employment, lack of market competition - no doubt contributed to these results, but the immediate cause was again agricultural. First, the poor harvest of 1972 limited supplies of industrial raw materials. Second, the immediate impact of remedial measures is probably to depress economic growth; while concerted attempts to improve Soviet agricultural performance are long overdue and helpful from the long-term standpoint, they involve a transfer of investment resources from industry, where capital productivity is currently estimated to be about double that in agriculture.

11. Prospects. In view of these basic weaknesses, a deceleration on Soviet economic growth - to rates of 3-4% - would not be surprising in 1974-1975. For the current year, industrial performance to date is somewhat improved - probably as a result of last year's farming accomplishments, which

stimulate industries (e.g. food) that depend on agricultural raw materials. The moderate acceleration in growth of industrial output anticipated for 1974 will probably be far outweighed, however, by the 8% decrease in the harvest forecast by the Soviet Authorities. While living standards should rise appreciably this year, the improvement may well be confined largely to food items: no acceleration is planned for increases in housing construction, consumer services, or output of light industry and household appliances.

12. Five-year plan objectives will probably be underfulfilled in 1975 in many major Soviet industries. For oil and natural gas, growth of production has been revised downward in the 1974 plan and is not expected to satisfy the five-year plan objectives for 1975 on the basis of anticipated supplies of pipe and rates of pipeline construction. As a result of slow progress made during 1971-1973 or planned for 1974, shortfalls from 1975 targets are also likely for net material product, project completions, investment, industrial output and labour productivity, engineering and chemical production, and most consumer-oriented categories.

13. Prospects are brighter in agriculture and certain other sectors. Production of mineral fertilizers and agricultrual equipment are on or ahead of their five-year plan schedules, as is application of computer technology, coal production (which is being speeded as other types of energy fall short of long-term goals), and agricultural investment (whose share of total Soviet investment has expanded to 26%). Realization of the politically important livestock and dietary programme by 1975 nevertheless appears difficult because of its costly requirements in terms of feed-grains - about 10 million tons in excess of expected annual domestic production.

(c) Policy Considerations: Reform vs. Status Quo

14. There is no indication that the Soviet Authorities plan any radical or far-reaching reforms or innovations in economic policy. They have recently administered traditional palliatives that have had little visible effect in the past - holding slack managers up to public criticism and tinkering half-heartedly with the structure of the economic hierarchy. Boundaries of major economic regions have also been changed. Farms are scheduled to be merged into larger administrative units, like the factory reorganization that was announced a year ago and is still reportedly meeting

resistance. Greater impact in the long run can be expected from the policies of acquisition of Western technology, spread of computerization and strengthened agricultural investment. The high priority for agriculture that has occasioned short-term sacrifices in economic growth was reasserted by General Secretary Brezhnev in his recent announcement of a 15-year, land-improvement programme that would absorb much of the expected increment in agricultural investment during the next five-year plan (1976-1980).

15. The explanation for this seeming acquiescence in economic mediocrity in the short run is probably that the Soviet leadership now considers such problems relatively limited and tolerable, taking into account the current Western economic situation. A growth rate of 3-4% is slow in comparison with the 5-7% pace of Soviet expansion achieved during 1950-1970, but may appear relatively satisfactory to Moscow at a time when the press is predicting short-term recessions and long-term energy constraints in the West. The Soviet flirtation with economic reform over the past 10 years coincided with increasing economic competition from the developed West - e.g. a Japanese growth rate that threatened to overtake Soviet GNP in the 1980s.

III. EASTERN EUROPE

16. Results. Developed countries considerably expanded their share of the commerce of Eastern Europe (excepting Bulgaria) last year, accounting for almost one-half of Polish foreign trade. Rapid growth of industrial co-operation remained a contributing factor. Co-operative agreements are said to account for 10% of Polish commerce with the West and 20% of Hungarian machinery exports. The East European share of Soviet foreign commerce correspondingly reached a new low of 49% (down from 55% in 1972). East European trade with Moscow grew only 7.6% last year, compared with a 40% rise for Soviet trading partners in the third world (including considerable Soviet arms deals) and in the West. The USSR nevertheless maintained its economic leverage with Eastern Europe by increasing oil exports thereto about 5 million tons (10%) over the 1972 level.

17. Economic growth likewise accelerated last year in most East European countries, surpassing the pace of the late 1960s and attaining principal five-year plan objectives (see Table I). The speed-up seems attributable mainly to faster growth of labour productivity in industry, Poland and Rumania remained the most dynamic economies, with investment, labour productivity, and net material product, growing 9-10% or more. Polish economic progress, far ahead of schedule, was stimulated by the fastest growth of labour supply in Eastern Europe, and included a 10% rise in real wages. In Bulgaria, growth of net material product accelerated but

not sufficiently to satisfy ambitious objectives of the five-year plan; strong industrial performance was offset by a mediocre harvest and by anti-inflation measures that halted the rise in investment. Hungary had generally similar policies and results, though with better luck in agriculture. Czechoslovakia and East Germany, the most mature economies of the area, continued to expand slightly faster than the planned rate of 5%.

18. Prospects. Since January, East European governments have continued to broaden the framework of economic relations with industralized Western countries. Czechoslovakia has concluded a double-tax agreement with the Netherlands. Bulgaria has taken out a $40 million, 12-year Euroloan and signed technical-co-operation agreements with US and Italian firms. It has also invited de facto joint ventures with Western companies, which in return for export credits and technical assistance may station their personnel as advisers in Bulgarian enterprises, sharing in the profits of exports for hard-currency. Hungary has placed $50 million in machinery orders in Western Europe so far in 1974.

19. It nevertheless appears doubtful that East European commerce with developed countries will continue to grow rapidly in a period of world-wide inflation and commodity shortages. While improving Soviet terms of trade, the rise in prices of materials and oil has had the opposite effect on most East European countries, which are net importers of such items and have been purchasing growing amounts of Middle Eastern oil. Trade prospects are also complicated by the possibility of slackening demand and increasing unemployment in the West. Such developments might tend not only to reduce Western commercial purchases from Eastern Europe but also to dampen the interest of Western companies in long-term economic co-operation therewith. "Joint production" originated largely in the attraction of Western firms, at a time of relatively full employment at home, to the low labour costs of manufacturing operations in Eastern Europe. If unemployment rises, it remains to be seen whether such co-operation arrangements would be criticized in the West.

20. Inflationary trends abroad and energy constraints may also slow down East European economic growth, already handicapped by labour shortages. All governments in the area have attempted to minimize import requirements by instituting energy conservation measures at some time since last November. Coming on top of a shortage of hydro power caused by dry weather, the negative effect on exports in Rumania and on industry in other areas may have been substantial. To compensate, Bulgaria in February cancelled

a reduction in the work-week to five days that had been introduced in January. External inflationary pressure has also led to considerable price rises for coffee and spices in Hungary and for oil products in Poland and Czechoslovakia.

21. Policy Considerations: Soviet Attractions and Pressures. Such constraints and doubts tend to increase the relative importance for East European countries of trade with the USSR, thus strengthening Soviet leverage. The Soviet oil, grain, and materials obtainable by Eastern Europe on barter terms are now rendered doubly attractive by the mounting costs of alternative supplies. In return, the USSR could reiterate some of its unsatisfied policy aims in Eastern Europe (e.g. economic integration) and possibly stiffen its opposition to far-reaching economic reform. In March, Mr. Nyers, a leader closely identified with the Hungarian experiment with economic decentralization - the only remaining active reform in Eastern Europe - was demoted.

22. Poland and Rumania remain at least partial exceptions to this East European picture, having faster growing labour forces, less dependence on Soviet commodities, export structures more similar to that of the USSR, and a more favourable trade outlook. Both countries placed substantial orders for Western machinery in 1973 for future delivery. Rumania is independent of Soviet oil, exports petroleum products, and has utilized $95 million (half of its IMF reserve) to balance its external payments. Poland plans 20% growth of trade this year and has placed sizeable orders for West European machinery and equipment. Although Poland imports Soviet oil in substantial quantities, its financial position had been strengthened by the increasing competitiveness of its shipbuilding and engineering industries, which received substantial orders from the West last year, and by rising world demand for coal and copper, of which Poland has exportable surpluses.

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TABLE I

ECONOMIC GROWTH OF WARSAW PACT COUNTRIES, ACTUAL AND PLANNED, 1971-1975
(% growth)

	Results		Plans	
	1973	1971-1973 average	1974	1971-1975 average
USSR				
Net material product (NMP)	6.8	5.3	6.5	6.8
Investment (a)	3.9	6.1	6.3	6.8
Agricultural production	14.0	3.3	6.4	3.9
Industrial production	7.4	7.2	6.8	8.0
Real income per capita	5.0	4.4	5.0	5.6
Foreign trade (in roubles)	20.3	12.5	10.0	6.2
EASTERN EUROPE: NMP	7.9	7.6	8.4	6.8
Industrial production	9.6	8.6	9.5	7.7-7.9
Foreign trade (in dollars)	46	25	-	-
BULGARIA: NMP	8.7	7.4	10.0	7.7-8.5
Investment	8.0	6.3	-	6.4
Agricultural production	3.0	3.3	5.0	3.2-3.7
Industrial production	0.6	9.5	11.0	9.2-9.9
Real income per capita	7.9	5.3	4.8	4.6-5.4
CZECHOSLOVAKIA: NMP	5.2	5.4	5.2	5.1
Investment	8.4	7.6	-	5.6
Agricultural output	4.2	3.8	3.8	2.7
Industrial output	6.3	6.5	5.8	6.0
Real income per capita	5-6	5.5	-	4.5
EAST GERMANY: NMP	5.5	5.3	5.4	4.9
Investment	8.5	3.9	5.3	5.2
Agricultural output	1.0	3.5	6.8	2.4
Industrial output	6.8	6.2	6.7	6.0
Money income	5.6	4.5	3.7	-
HUNGARY: NMP	6.5-7.0	6.1	5.0	5.5-6.0
Investment	1.0	3.0	6.0-7.0	5.1
Agricultural output	5.0	5.6	2.2-5	2.8-3.0
Industrial output	7.2	6.4	5.5-6.0	5.7-6.0
Real income per capita	4.5-5.0	4.3	5.0-5.5	4.6-4.9

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	Results		Plans	
	1973	1971-1973 average	1974	1971-1975 average
POLAND: NMP	10.0	9.4	9.5	7.0
Investment	23.0	17.8	11.8	8.3
Agricultural output	7.8	6.5	4.3	3.3-3.9
Industrial output	11.6	10.2	11.1	8.5
Real wages	9.9	7.5	-	-
RUMANIA: NMP	10.8	11.2	14.6	11-12
Investment	5.3	9.1	18.1	10.5
Agricultural output	0.2	9.4	21.5	6.3-8.3
Industrial output	14.7	12.7	16.7	11-12
Real income per capita	4.4	6.0	8.6	7.0-7.9

(a) Gross fixed capital formation
Primary source: UN, Economic Commission for Europe (Geneva), "l'Economie Européenne en 1973", ch. 2 (advance copy)

TABLE II

DIRECTIONS OF SOVIET FOREIGN TRADE, 1972-1973

	1972 (in billion roubles)		1973 (in billion roubles)		1973 (in $ billion) (a)	
	Value	% growth	Value	% growth	Value	% growth
TOTAL TRADE	26.0	10%	31.3	20.3%	-	-
Total Exports	12.7	2%	15.8	25.0%	-	-
Total Imports	13.3	18%	15.5	15.0%	-	-
Trade with different areas:						
- Industrial West	5.9	14%	8.3	41.0%	11.2	60%
Share of total	22.6%	-	26.5%	-	26.5%	-
- Eastern Europe	14.4	10%	15.5	7.6%	-	-
Share of total	55.4	-	49.4%	-	-	-
- Other Communist countries	1.8	0%	2.15	19.0%	-	-
Share of total	6.9%	-	6.9%	-	-	-
- Cuba	0.8	-	1.1	23.0%	-	-
- China	0.2	-	0.2	-5%	-	-
- North Korea	0.4	-	0.36	-6%	-	-
- Mongolia	0.3	-	0.34	17%	-	-
- Developing countries	3.9	8.3%	5.4	38%	-	-
Share of total	15.0%	-	17.2%	-	-	-
- Iraq	0.15	-	0.33	118%	-	-
- Algeria	0.1	-	0.1	2%	-	-
- Yugoslavia	0.6	-	0.7	18%	-	-

(a) At an exchange rate of $1.3449 per rouble

SOURCES: See Table III

TABLE III

SOVIET PRODUCTION, IMPORTS, AND EXPORTS OF OIL, 1973 (preliminary estimate) AND 1972

(Million metric tons)

	1972		1973	
	Volume	% growth	Volume	% growth
Domestic output (crude oil)	394	6%	421	7%
Imports: Total	+9	28%	15	67%
(crude)	(8)	-	(13)	-
(refined)	(1)	-	(2)	-
TOTAL SUPPLIES	403	6%	436	8%
Domestic consumption	296	8%	318	8%
Gross exports, including:	107	2%	118	10%
(Eastern Europe)	49	11%	54	10%
(Other Communist countries)(a)	11	0%	14	27%
(Non-Communist countries)	47	-4%	50	6%

(a) Includes Yugoslavia for 1972 and presumably for 1973.

SOURCE: Vneshnyaya Torgovlya (Soviet Foreign Trade statistical year-book) for 1972 data. Ekonomichesskaya Gazeta, No. 15, April 1974 for 1973 data.