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# RECENT ECONOMIC TRENDS IN THE SOVIET UNION AND EASTERN EUROPE

Report by the Chairman of the Economic Committee(1)

The following report has been prepared by the Chairman of the Economic Committee on his own responsibility, in the light of discussions held in the Committee. It endeavours, in a first part, to assess the recent general trends and basic problems in the USSR and Eastern Europe. The second part of the paper gives a more detailed review of economic results during the second half of 1977 and examines briefly the prospects for 1978.

## BRIEF OVERVIEW

### SOVIET UNION

1. Data so far available reflect continuing sluggish performance in the industrial sector, particularly in production of industrial materials. In agriculture, grain output fell short of expectations but harvest results were good for other major crops. Consequently, overall performance in the agricultural sector should not adversely affect the increase in Soviet National Income targeted this year to reach 4.1%.

2. According to official figures released in mid-October 1977, Soviet industry managed to meet the output growth rate for the first nine months of this year, as specified in the 1977 Plan, for most sectors; however, there are signs that some key sectors of heavy industry may be falling behind the schedule laid down in the 10th Five-Year Plan (1976-1980). Industrial production was 5.8% above that of the same period last year, slightly over the annual growth target of 5.6%. Leading branches included machine-building and metal processing, chemical and petrochemical equipment, automated systems equipment and the all-important livestock and meat production sector. Over three-quarters

(1) For previous report, see document C-M(77)31

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of the nine months' industrial upturn was attributable to a 4.3% increase in labour productivity - below the annual Plan target, however, of 4.8%. Gas output, up 8%, is a bright spot among the fuels sector with the oil production increase just slightly below target, and that of coal mediocre. Despite these generally optimistic, highly aggregated indicators for gross output and productivity, the central Soviet press listed a number of important areas where industry failed to meet targets. These include the key iron and steel sector where almost no growth was registered, rolled ferrous metals, steel pipes, freight transport, timber and, a traditional laggard, the textile industry where little improvement is noted despite official assurances that more will be done in this area for the consumer.

3. The fact that many branches are only slightly above the relatively low targets suggests continuing, apparently intractable, problems, reflecting in part such factors as ageing plant, delays in new equipment deliveries, and a chronic inability to complete new output facilities on schedule. The most serious issue in meeting growth targets of future Plans could be a possible levelling off or even decline (according to some estimates) in oil production during the 1980s, contributing to the anticipated deceleration of growth rates throughout the economy. The extra pressures associated with the Sixtieth anniversary of the Revolution in November could result in more targets being met or overfulfilled at year's end, but this will call for an even greater effort than the usual "storming" encountered in the last quarter of the year.

EASTERN EUROPE

4. In the first six months of 1977, Czechoslovakia increased its industrial output at a rate sufficient to meet its annual Plan target of 5.3%. Half-year results for the GDR economy, on the other hand, showed industrial output to be short of target (5.1%), while personal consumption, imports, and investment increased more than planned. Both economies showed signs of being unable to satisfy increasingly strong consumer demand. Czechoslovakia has already instituted limited consumer price increases and there are indications that price adjustments may occur in the GDR. Hard-hit by increased import costs, both from the USSR for needed fuels and raw materials and from the West for technology and consumer goods, both economies have been unable to increase their export volume sufficiently to reverse ever-widening total trade deficits. In the GDR, the foreign hard currency debt, already high ($4.9 billion at the end of 1976), continues to grow (with an additional $750 million in Eurocurrency borrowings in 1977). Although Czechoslovakia has taken a more cautious attitude toward borrowing in the West, it too is troubled by an increasing hard currency trade deficit.

5. Half-yearly results for Hungary as of July 1977, indicate that industrial production rose by 6.1% thus meeting most Plan targets; general Plan fulfilment was the keynote of other major sectors of the economy. For 1978-1980, the Hungarian FYP targets reflect increased uncertainty about world market developments and the strength of Hungarian exports. The usual aggregate goals are set for the whole period, but investment plans are much less extensive than has been customary in the past. No new "central development programmes" are proposed; rather, the Plan stresses proper completion of those projects currently underway (aluminium petrochemicals, vehicles, computerisation, natural gas, industrialised building techniques). Housing will also receive special priority. For Poland, the 1977 half-year results show much the same picture - Plan targets have been met despite a drop in investment outlay growth and a failure to complete important investment projects on time. Severe flooding in Poland last Summer will prevent agriculture from rebounding from the 1976 poor harvest, and grain output may fall below last year's levels. Labour productivity and industrial output were deemed satisfactory by planners. Both in Poland and Hungary, consumers experienced gains in availability of goods although the Polish meat shortage continued. One major problem common to both Poland and Hungary is the possible sluggish growth over 1978-1980 of their hard currency export trade which will invariably hamper their ability to repay the large foreign loans amassed over the past few years.

6. Both Bulgaria and Romania continued to sustain high rates of growth, with expansion fueled by high capital investment and technological modernisation. None the less, their impetus is being hampered by a series of increasing difficulties which were reflected in a slow-down of key indicators. Both nations still record high absolute levels, e.g. industrial production: +7.7% for Bulgaria (below target however) and +11.5% for Romania in the first half of 1977. The régimes still insist on heavy industrialisation, and consumer welfare has so far this year registered only moderate improvements. The two countries are still the least developed within COMECON and prospects are dimmed by such factors as low labour productivity, scarcity of labour (especially skilled), a traditional agricultural bottleneck, energy problems and foreign indebtedness. After the results of 1976 and the first half of 1977, it is less likely that all the ambitious 1976-1980 objectives will be attained, although substantial growth will probably continue in the short run.

7. As regards East-West trade, with the exception of Hungary and Romania, the East European countries reduced their trade deficit in 1977 by a policy of restricting imports from the West and of attempting to boost exports. This development was especially clear in the case of the USSR which, following good harvest results in 1976, was able to reduce substantially its grain procurement in the West. Extrapolating the trends observed in the first half of this year, the trade deficit of the COMECON member countries could reach some \$4.5-\$5 billion compared with \$6.6 billion in 1976 and \$8.2 billion in 1975(1).

8. 1978 is likely to witness a continued trend by the Communist countries of limiting imports and increasing exports; nevertheless, large trade deficits will remain. That of the USSR is likely to stay high as it will have to procure large amounts of grain following the modest harvest results of 1977. As a result, the indebtedness of the East European countries will continue to increase together with their debt service ratio. This situation will probably oblige the Eastern countries, including the Soviet Union, to intensify their efforts to export manufactured goods to hard currency countries. The success of this trade policy, however, will depend on the economic situation of the non-Communist industrialised nations and on the extent to which goods available from the COMECON countries can be adapted to meet demand in the West.

(1) Including intra-German trade

## COUNTRY REVIEW

### USSR

9. By the end of September 1977, industrial output was up by 5.8% over the same period for last year, which roughly corresponds to the projected rate of growth of 5.6% in 1977. However, accurate forecasts cannot yet be made for the full year. The presently observed rate is low by past standards and an indication that the target of 36% growth between 1976 and 1980 (6.3% yearly as an average) may not be attained. The results known so far range from very good to fair in the salient fuels sector. A leader appears to be gas output: at 254 million cubic metres, it is up 8% and likely to overfulfil the annual Plan without difficulty (6.5%). Oil (including gas condensate) reached 406 mmt., up 5%: projected at this growth rate, the oil target of 550 mmt. may not be achieved, although only by some 4 million tons. Coal output is up only 2%, and the sector could be as much as 10 mmt. short for the year which requires that output rise just under 3% over 1976. Electricity is up 4% and may just meet the annual target of 4½%. Sluggish growth in this sector may well reflect the problems the industry is encountering in coping with peak demand each Winter whilst having to use all its older generating equipment.

10. Otherwise, September industrial output statistics show in many branches good if not spectacular growth over the corresponding period for 1976. Chemicals were up 5%, but if they repeat the first half growth rate performance of 1977, only mineral fertilizers, up 5%, would probably overfulfil the end of the year Plan: sulphuric acid is up 6% (but below target), chemical fibres, 6.1% and the petroleum refining and petrochemical industry output increased by 4% over the same period for last year. The basis for future growth is seemingly being laid by a generally strong performance in machine-building and related sectors: in the light and food industry, machine-building output was up 7.5%, for livestock and fodder it was 7%, and for the chemical and oil industry, 6%. Food statistics reflect an increase in meat of 13% corresponding to an output still below 1975 levels, but only a 1.4% upturn in canned food output, suggesting perhaps a lack of food inputs as a result of a higher percentage of food going into current consumption.

11. Disappointing performances were given by the steel sector which rose by 0.9% only, with rolled ferrous metals up by 0.4% and steel pipes, essential for the country's oil and gas projects, up a mere 0.9%. Despite the emphasis

on modernising and wastage reduction in this sector, there seems little chance that the 1977 target of a 5% increase in crude steel will be met. Reasons given officially include delays in technology absorption, shortages of raw materials and breakdown of vital equipment. Textiles were up only 1% and timber 0.1%; whilst metallurgical equipment showed a slight growth of 1%, coal-washing combines were down four percentage points, a fact that bodes ill for improving labour productivity in the already sluggish coal industry.

12. Overall agricultural information is not available as the harvest is still not complete. Nevertheless, Brezhnev has announced that the grain harvest is expected to reach 194 million metric tons (i.e. 19 mmt. below target) and grain imports totalling 20-25 mmt. during the coming 12 months are anticipated according to US sources. The 9% drop in targeted grain output, which could mean about a one percentage point decline for agriculture as a whole, seems likely to be offset by better results in other parts of the sector. The amount of excess moisture and foreign matter in the 1977 crop will probably be above average and is currently put at about 15% or some 33 million tons. An estimated 32 mmt. of wheat will be fed to livestock this year, an increase of some 7 million over the 1976 figure. The drive to produce more meat accounts for much of this increase and will probably affect future Soviet grain purchases from the United States.

## Implications

13. While the list of industrial ministries, whose enterprises have overfulfilled their production plans is not unimpressive, there is a serious debit side: in addition to ongoing problems which appear to be having a significant and more permanently decelerating effect on, for example, the energy and steel sectors (see paragraph 3 above), it is clear that part of the responsibility lies in the slow completion of capital projects. Such completion, in turn, depends largely on the performance of the construction and equipment industries which, themselves, depend on supply deliveries from GOSSNAB (State Supply Agency). This agency itself looks to the industrial enterprises for these supplies, the total result being a vicious circle which cannot be broken in the shorter-term, since the reorganization and modernisation of the construction industry is a long-term goal.

14. On the energy side, the current Plan requires that electricity output increases 5-6% on average per annum - a downgraded figure compared with the 9th Five-Year Plan. If this target is not reached, there could be serious repercussions on the planned mechanisation of industry and modernisation

of the farm sector, both of which depend greatly on the increasing availability of electricity. In the even more critical oil sector, to meet Plan targets, oil output must increase by 5.6% this year and by an average of 5.1% thereafter until 1980. To keep in line with the increase in output, the growth rate of domestic oil utilisation has already been reduced from an average of over 7% in the period 1970-1973 to only 4.2% in 1974-1976. Indeed, in 1976 consumption rose by only 2.85% - an all-time post-war low. Any further cutback might well have a generally adverse effect on growth rates in all key industrial sectors.

15. First indications of the 1978 Soviet Plan point to areas where the Soviet leadership realises it has continuing problems, including the lag in application of new technology. The reference to the need for conservation of energy is another reminder that the leadership is aware that new production alone is unlikely to assure an adequate supply in terms of the growing needs of the domestic economy. The planners believe that the current reorganization of industry, in which individual enterprises are merged into larger-scale industrial associations, will improve aggregate economic performance, and first results are said to be encouraging. In any case, there seems little sign that the Soviet leadership will move in 1978 towards decentralisation which many Western specialists see as the best solution for higher Soviet productivity. Targets in industry are still geared largely to gross output as priority and this discourages innovation and/or the introduction of new machinery and technology. The level of mechanisation and automation in Soviet industry remains well behind that of most advanced Western nations with over one half of industrial workers engaged in manual labour. The need to base industrial growth until the end of the current Plan period (1980) increasingly on higher labour productivity will presumably keep the USSR interest in inputs of Western technology.

## EASTERN EUROPE

16. In many cases, data on economic development are only available for the first six months of 1977. Nevertheless, the overall picture for the six smaller East European countries reflects an improvement over 1976, both in terms of general industrial output and agricultural production. However, the problem of rising indebtedness to the West is reflected in an attempt by all six East European countries to reduce their imports from the West to meet only their more vital technology requirements in order to satisfy growth targets, and a greater effort to boost exports to the West. A disquieting note in some cases would appear to be the drop in capital investment compared with previous years and the large number of unfinished capital construction projects.

Czechoslovakia

17. In the first six months of 1977, Czechoslovak industry gave a slightly above-Plan performance, with a 5.9% increase (1976: 6% for the corresponding period) in total output, but with a perceptible fall in labour productivity (six percentage points behind the same period in 1976 in contributing to output growth). The key sectors of engineering products and chemicals were the growth leaders, with output increases of above 7%. Plan targets were not fulfilled in capital construction, where the number of new production facilities put into operation dropped severely. In the energy sector, Czechoslovakia continues to grapple with a growing shortage. During the first half of 1977, hard coal production, on which Czechoslovakia depends substantially for energy needs, fell 3.2% because of two mine disasters. In addition, the rate of expansion of electrical energy output did not keep pace with growth in domestic demand.

18. Hindered by rains, the 1977 Czechoslovak harvest appears to have been moderately good, but the economy is still feeling the pervasive effects of the two bad harvests of 1975-1976. Output of consumer goods, two-fifths of which is represented by the food industry, increased by only 4% in the first six months of 1977. Personal savings continued to grow faster than consumption. A retail price reform which took effect in July 1977 has increased prices for products consisting of expensive imported materials (e.g. wool, cotton and coffee), items which are readily saleable as exports (e.g. glass) and products wasteful of energy (e.g. electric oil heaters); this price upturn has generated disgruntlement, but not widespread consumer unrest.

19. Czechoslovakia's trade deficit of the previous two years (1974-1975) with the other Communist countries became a 1.1 billion Kcs. (officially $196 million) surplus in the first half of 1977 but the traditional deficit with developed Western industrial countries continued to deepen from its 1976 level of 3.4 billion Kcs. ($611 million). Czechoslovakia's policy of modest borrowing on Western money markets continued with the raising of a Eurodollar loan in June 1977 for $150 million.

GDR

20. Although Produced National Income (net material product), the GDR's basic measure of growth, increased by a below-Plan 4.5% in the first six months of 1977 (as opposed to 5% in the corresponding period in 1976 and 5.5% in 1975), the apparently near-normal harvest should help boost the national income results for 1977 as a whole. The six-month

increase in industrial output (4.8%), however, was also short of the Plan target (5.1%) and represented a continuing decline from previous years. There were notably lower rates of growth in fuels and energy, metallurgy, and food production, and chemical output increased at only about half the rate of the corresponding period in 1976. Strongest growth increases (of 5-6%) occurred in machine-building and electronic equipment. Construction growth continued to subside: it grew 5.4% in the first half of 1977, as opposed to 6.6% in the first half of 1976, and 7.5% in 1975. On balance, GDR industrial output is suffering from declining capital productivity and rapidly rising raw materials prices.

21. Paradoxically, industrial investment grew vigorously (8%) and well above-Plan (6.5% overall) in the first six months of 1977. Such heavy expenditures reflect continuing imports of Western technology and rising costs. Net personal incomes and spending continued a rising trend in the GDR during the first six months of 1977, stimulated partially by a 14% pension boost in December 1976. Increasingly, however, supplies of consumer goods have been withdrawn from the domestic market to provide more exports, with resulting consumer discontent.

22. In 1977, the GDR continued to incur increasing trade deficits both to the West and to the Soviet Union. In the first six months, imports from the USSR grew by 26%, while exports increased only 6%. Concurrently, the GDR trade balance with the West does not appear to be improving. In the first ten months of 1977, the GDR took on an additional $500 million in Eurodollar borrowings - signifying substantial current or anticipated hard currency shortfalls in foreign trade. By contrast, one hopeful sign was the GDR's declining deficit with the FRG in the first six months of this year: amounting to only DM. 78.3 million, it compared favourably to the total 1976 deficit of DM. 391 million and the 1975 deficit of DM. 580 million.

Poland

23. Polish official figures from January to July of 1977 for economic performance show that Plan targets have been met, despite a drop in investment growth. Industrial production increased 9% and in particular the electrical and mechanical engineering sectors; labour productivity met planned levels although there is still considerable room for improvement as recent criticism by top leadership suggests. Grain output will be about 10% below planned

targets or about 20 million metric tonnes, necessitating imports in excess of six million metric tonnes. Supplies of meat will continue to fail to satisfy demand, and the present shortage has become more severe. A major problem that has seriously affected the Polish economy in 1977 and is likely to do so in 1978 is the overly large increase in wage fund disbursements, and the delay in completing certain key investment projects. The problem of the rising wage fund (over 8% in 1977) has to be considered on two levels: the effect of the increased purchasing power of the population on a market where demand chronically chases supply, and the equally inflationary pressure it exerts if the extra money in circulation is not earned through extra productivity. That production has been lagging well behind both demand and the money available is shown by the official returns contained in the statistical yearbooks.

24. Total foreign trade turnover in the first half of 1977 increased 9.2% over the corresponding period of last year, with exports increasing 12.7% and imports going up by 6.3% - thus widening the already serious trading gap and leading to an even more serious trade gap. Part of the reason lay in new impediments to Polish exports, such as the halt in EEC textile liberlisation quota processes, continued Western economic recession which has encouraged anti-dumping trends and moves in some Western countries directed against Polish exports in general. At the same time, as was the case with Hungary, world prices for vital Polish export commodities such as coal, fertilisers, sulphur and some agricultural items have fallen. Overall Polish indebtedness is put at about $10-11 billion for end of 1976. Debt service payments due that year were estimated at over $1.5 billion, giving a debt service ratio in 1976 of 35-40%. Although Poland still has room for additional borrowing, nevertheless, as is the case in Bulgaria, there is definite concern in the Polish Government about the size of the country's hard currency debt load, and this has resulted in a concerted effort to reduce non-essential Western purchases (and especially large capital equipment imports), to push buy-back agreements in cases where Western capital equipment purchases are made, and to reduce hard-currency expenditures for invisibles in every way possible. These policies resulted in a 5% reduction in hard-currency imports during the first half of 1977, as compared with the same period in 1976. The Government's ability, however, to sustain such cut-backs is not clear.

Hungary

25. According to the official half-year statistics, industrial production in the socialist sector increased by 6.1% over 1975 - slightly above Plan target. The increase was

greater than average in telecommunications instruments, pharmaceuticals, the meat processing industries and heavy industry (particularly ore and mineral mining sectors). Oil and gas production did well as a result of intensive efforts to limit expensive imports and expand domestic production. In the agricultural sector, early figures show that both crop output and livestock production will rise above 1976 levels and the overall output level for these sectors of 5.3%. The foreign trade sector did not fare as well due to the worsening in terms of trade by 2-3% with socialist countries and 4-5% in dollar country trade as a result of unfavourable world price movements. For the first half of 1977, hard currency imports rose 28% over 1976 corresponding period, while exports rose 18%. Important raw materials, such as cotton, became some 60% dearer while Hungary's main export items, such as wheat, fell to $90.00 a ton from $150.00 in 1975. The Hungarian net foreign debt rose to between $3-4 billion as a result of continued borrowing to finance import growth, especially Western technology. Nevertheless the debt ratio is acceptable and Hungary's bank credit remains favourable.

26. Plan targets for 1978 are not yet available. The main feature, however, will not be any systematic change, but rather an attempt to adjust to external pressures on the economy: a hard currency trade deficit, influenced by a substantial volume of indebtedness towards the West and falling terms of trade within COMECON, a situation exacerbated by ongoing commitments to invest in raw material extraction in other COMECON countries, especially the USSR. These pressures are to be met by expanding exports rather than restricting imports. The outstanding questions are whether exports can in fact be increased as rapidly as planned, and how the population will react to the necessary fall in the growth rate of consumption. The authorities seem to realise that there may be advantages, especially in these adverse circumstances, in maintaining systemic stability. But even assuming optimistic hypotheses, the pressures on the Hungarian economy in 1978-1980 will be severe, particularly if the agricultural sector is sluggish, and the uncertainties surrounding any predictions about the system, and especially its foreign economic relations, are correspondingly great.

Bulgaria and Romania

27. While they rank among the fastest growing economies within COMECON, both Bulgaria and Romania are experiencing a deceleration in many important sectors. Their Net Material Product (NMP) and industrial production growth rates are flattening, although they remain at high

absolute values. This trend has not been reversed on the basis of the first six months' results of 1977. On the contrary, Bulgarian industrial production (+7.7%) and retail sales (+3.5%), show a marked decline over previous years. The Bulgarian economy shows a clearly decelerating trend, although the second quarter of this year helped to reduce somewhat the lags registered in the first quarter. Nevertheless, there is little probability that the annual Plan targets will be met. This means that 1977 will not be a catch-up year for the comparatively disappointing results of 1976, and the Five-Year Plan will be unequivocally jeopardised. The only positive result so far seems to be the above-Plan growth of foreign trade and the favourable development of exports, which will probably bring down the growth of the hard currency debt to more manageable levels. This is badly needed, as Bulgaria had the worst debt-service ratio in the bloc in 1976, estimated at around half of its export earnings to the West.

28. Romania's problems were also translated into decelerating rates of growth this year. In particular, industrial production reflects a slow-down, although its growth rate is still very high and was above the Plan in the first six months of 1977 (11.5% compared with 10.5% planned). Reportedly, investment, industrial production and export plans were overfulfilled by mid-1977 and the economy seems to have recovered basically from the March earthquake damage. The Plan provisions were also exceeded (by 2.4%) both in light industry and engineering. On the other hand, some delays have been registered, especially in the chemical industry. Major shortcomings were also registered in capital investment, which fell substantially short of targets. In 1976, the investment growth rate was also sharply down 8.2%, as against 19.4% planned. Therefore, 1977 will probably be the second year in a row when investment plans go seriously underfulfilled, thus jeopardising Five-Year Plan implementation and the overall growth of an economy, whose main driving force has so far been massive capital expenditure.

EAST-WEST TRADE

29. In the first six months of this year, according to the trade statistics of OECD member countries, there was a continuing improvement of the imbalance existing hitherto. This was particularly clear in the case of the USSR, whose first half-year imports from the OECD area ($6.8 billion) declined compared with the same period for 1976 by 4%, whereas Soviet exports to this area (some $5.5 billion) rose substantially (+11%). The drop in Soviet purchases was due to the sharp decline in grain imports and only a modest upturn in value terms in procurement of non-farm products. In 1977, the Soviet trade deficit with the OECD zone will probably be below $2 billion, a considerable improvement compared with last year ($3 billion).

30. Between January and June 1977, a greater range of development was recorded in the trade pattern between Western countries and the smaller East European nations. Poland, Bulgaria and Czechoslovakia managed to reduce their negative trade balance with the West compared with the corresponding period for 1976: this was due to a stagnation in purchasing, or a sharp decline in the case of Bulgaria, and a substantial increase in exports. By contrast, Hungary and Romania reflected a deterioration due to a sharp increase in imports, whilst that of the GDR remained almost static, with imports and exports showing equal growth. Overall, the trade imbalance of Eastern Europe in 1977 will probably be between \$2.5 and \$3 billion, compared with \$3.4 billion in 1976. In general terms, the main obstacle to an expansion of East-West trade in 1978 will remain the European COMECON hard currency debt towards the West: at the beginning of 1977, this net indebtedness was around \$40 billion; it will have grown during 1977 with the debt service reaching very high levels in some cases - representing, for example, about half of Bulgaria's hard currency export earnings and between 35-40% in the case of Poland. Additionally, the East European countries could well be faced with higher repayments as certain of their medium and long-term loans contracted in recent years reach maturity.

31. In September 1977, for the first time since the creation of the EEC and COMECON, high-level contacts were made between these two organizations, with further talks to be held in the Spring of 1978. In contrast to the COMECON approach which is to seek a general agreement including trade clauses, the EEC wishes to handle trade matters with the East European countries on a bilateral basis and restricting relations with COMECON as an organization to areas such as the reciprocal exchange of information.

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