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RECENT DEVELOPMENTS IN THE USSR AND EASTERN EUROPE

Report by the Chairman of the Economic Committee

I. MAIN FEATURES

In 1974 Warsaw Pact countries maintained more stable domestic prices and external balances than did the industrialised West as a whole. Their economic growth was moderately rapid, although slower than in 1973. In Eastern Europe, however, this pattern might well change considerably in the near future because of the delayed impact of the sharp rise in world prices in 1973-1974. Such a development might pose some dilemmas for the USSR. While its terms of trade have improved dramatically with developed countries - Communist as well as non-Communist - uninhibited exploitation of this economic leverage on Eastern Europe might increase their economic problems.

2. To date, East-West trade is the aspect of Eastern economic activity where world-wide inflationary forces have had their greatest impact - generally favourable for the USSR, unfavourable for Eastern Europe. Although a relatively small market, the Warsaw Pact area provided NATO countries with a favourable trade balance of about $2.5 billion in 1974 for the second successive year. Last year this surplus was earned entirely in Eastern Europe where trade deficits in convertible currencies rose considerably as a result of strong demand for Western machinery and technology (especially in Poland), price inflation of Western exports, and a recession in Western demand. The same factors limited the trade deficit incurred by NATO and other industrial Western countries with the USSR, partially offsetting the rapid increase in Soviet earnings of convertible currencies resulting from higher world prices for Soviet energy, materials and gold. According to the ECE (Geneva), the physical volume of foreign trade of Warsaw Pact countries rose more rapidly with each other than with the industrial West. The improvement in its terms of trade thus enabled the Soviet Union simultaneously to earn its first trade surplus in years in the West, and to increase its commercial dealings in real terms with its Allies.

This document includes: 1 Annex

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3. Little reflection of these external stimuli and shocks has yet appeared in Eastern domestic economies, which allocate a relatively small proportion of GNP to trade with non-Communist countries and (in the case of the USSR, Romania and Poland), have sizeable domestic energy resources. The East is also partially shielded from outside influences by price controls and subsidies, although these also tend to distort resource allocation. In 1974 moderate increases in retail prices were experienced by Poland (5.6%) and Romania and Hungary (about 2%).

4. It should be recalled that repressed or disguised inflation, caused partly by excess demand, exists in all Warsaw Pact countries. These imbalances and the rising external trade deficits of East European countries however, have been less severe in most of them than in the West. They have been alleviated by Western credits and did not have a significant effect on rates of Eastern economic growth in 1974.

5. Soviet economic growth slowed down last year to about 3% in terms of real GNP and may attain an average of the order of 4% for the years 1971-1975 - creditable by current Western standards though short of the over-5% rate implied by the Five-Year Plan. Eastern Europe on the whole in 1974 maintained a rapid expansion that seems to place major five-year plan targets within reach. In Poland, however, despite strong overall performance, local disturbances were reported because of meat shortages. The decisive factor in these developments appears to have been the critical agricultural sector. Harvests that fell short of plan constrained Polish meat supplies and handicapped overall Soviet performance while an exceptionally good crop apparently accelerated growth in East Germany.

6. The economic effects of world-wide inflation on the East should become more pronounced in the future. Economic growth will probably be affected to a greater degree by external trade balances, which promise to be more favourable than in the past for the USSR but unfavourable for Eastern Europe. In an effort to promote industrial modernisation, the USSR continued to accelerate its advance orders for Western equipment in 1974-1975. In Eastern Europe, however, the terms of trade with the USSR have recently worsened following an increase in Soviet energy and materials prices that transmits part of the earlier rise in world prices. This change has been countered but not balanced by the increased prices for East European machinery and equipment, agricultural products and consumer-good exports. The resulting pressure may lead most East European countries to divert exports from the West to the USSR, and to slow down growth of industrial and consumer programmes. The considerable economic leverage that world price movements have given the USSR over its Allies may accordingly be exercised with discretion and be aimed as much at political objectives - e.g. COMECON integration - as at commercial advantage.

II. USSR

(a) External Economic Relations(1)

7. Industrial Western countries(2) continue to lead other areas in regard to rate of growth of trade with the Soviet Union in value terms although Eastern Europe is still the principal trading partner of the USSR. These trends are reflected in Soviet data recently released on the foreign commerce of the USSR in 1974. Soviet-Western exchanges rose 50% in current prices, faster than world trade, reaching $16.5 billion. This value is still small in comparison with the scale of intra-Western commerce, but it represents 31% of Soviet global trade in money terms, while Eastern Europe accounts for 44%. The two shares had been converging since 1972, when the Western portion was only 23%, the East European 55%. Much of this trend, at least in 1974, stemmed from an inflation in Western prices that was not yet reflected in COMECON exchanges.

8. Most of the increment in Soviet commerce with the industrial West last year was directed at NATO countries, Japan and Finland. A decrease of about $600 million in trade with the United States was outweighed by a $4 billion increase in exchanges with other members. The dynamism of this commerce was the major factor in a further acceleration of growth of Soviet global trade, which rose 20% in 1973 and 26% last year. (See table annexed.)

9. This expansion in Soviet-Western commercial exchanges has resulted from (i) long-standing needs for advanced technology in the USSR and for basic materials in the West, (ii) the expansion of Western credits in a period of détente and, most recently, (iii) the shift in the terms of trade. In 1974 the chronic deficit in Soviet merchandise trade was converted to a moderate surplus(3). The considerable increase in world prices of energy and raw materials (e.g. timber and non-ferrous metals), has correspondingly boosted Soviet export earnings; this in turn has enabled the USSR to import a much

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(1) Soviet trade figures reflect a less favourable balance of Soviet commerce with the "industrial West" than do OECD data because of differences in countries included, methods of valuation, types of transactions, etc.

(2) In the Soviet definition the "industrial West" appears to consist of Common Market countries, Canada, Norway, the United States, Australia, New Zealand, Austria, Finland, Japan, Sweden, Switzerland, Iceland, Greece, Spain and Malta

(3) About $250 million according to Soviet data, considerably more according to OECD data

higher volume of the Western machinery, technology and foodstuffs needed for economic modernisation and consumer satisfaction. In regard to oil exports, for instance, the USSR apparently emulated OPEC countries (though it is not an OPEC member), reducing its deliveries to non-Communist markets by six million tons. Nevertheless, Soviet earnings in the industrial West increased about 100%, or $1.5 billion, as a result of the sharp rise in world prices. Adverse effects on the Western trade balance with the USSR in 1974 were mitigated by (i) the small amount of oil, compared with Middle Eastern exporters, supplied by the USSR, and (ii) the pronounced Western surplus - more than $1 billion - that had resulted from increased exports of grain and machinery in 1973. With its relatively advanced technical level, the USSR has a correspondingly high absorptive capacity for Western technology and equipment. Last year Soviet imports continued to rise strongly, with a decline in the grain sector outweighed by an increase of about 50% ($1 billion) in imports of Western machinery.

10. Strength was also evident in 1974 in other components of the Soviet balance of payments including "invisibles". Soviet competitiveness in international transport has reportedly increased with surprising rapidity. Almost 10% of the total volume of shipments between Japan and Western Europe has been captured by a joint Soviet-Japanese-Swiss venture, started in 1971, that transports cargoes East and West on the Trans-Siberian railway(1). With regard to new orders for Western equipment, Soviet contracts and agreements on future deliveries appear to bave doubled in 1974, exceeding $5 billion(2) and approaching the level of total Soviet imports from the industrial West in 1973. Soviet financing continues to be eased by "product-payback" arrangements where Western credits are ultimately repaid with products of the Western machinery delivered - e.g. wide-diameter pipelines, aluminium and timber equipment. Soviet gold sales were reportedly of the order of $600 million - only one-half of potential proceeds from sales at current prices of the annual Soviet gold production capacity - estimated at about 250 tons in 1974.

11. Growth of Soviet-Western trade seems likely to remain rapid in the coming years. In 1975 the increase may again reach 20% or more in value terms. Recession will no doubt take some toll of prospective earnings of convertible currency; Soviet timber exporters offered a 20% reduction in price from previous levels in the British market last March. On the other hand, Soviet export capabilities are being diversified, e.g. with the completion of natural gas pipelines to Western Europe

(1) Financial Times, 16th July, 1974 and 1st March, 1975
(2) $4 billion (still a 50% rise over the 1973 level) if agreements in principle regarding the Kursk steel plant and Siberian coal and timber projects are excluded

and also have favourable long-term prospects. For example, the USSR agreed in principle last April to ship about ten billion cubic metres of natural gas yearly from Iran to the Federal Republic of Germany via pipelines to be constructed across the USSR. Soviet orders for Western equipment have continued at a high rate in 1975, paced by a $180 million purchase of a hotel system. To strengthen its trade capabilities, the USSR also recently borrowed a total of $350 million on five-year terms in the Euro-currency market; some Western experts expect further Soviet borrowings of this type, although gold reserves of the USSR could allow cash payments.

(b) Domestic Developments

12. Economic growth in 1974 is estimated at about 3% in terms of real GNP (see Annex). For 1971-1975, it is expected to average about 4% per year. While such an expansion would be creditable by present Western standards, it would fall far short of the rates implied by the Five-Year Plan and achieved in 1973.

13. The 1975 economic plan published last December tacitly revised downward most of the principal growth targets of the original Five-Year Plan announced in 1971. Performance this year is now scheduled to exceed the 1970 level by 15% in the case of agricultural production (compared with an original target of 21% in the Five-Year Plan), by 42% (formerly 47%) for industrial production, and by 33% (previously 39%) for industrial labour productivity. Reductions of original goals in the revised plan are especially large in the case of production of natural gas, chemicals, lumber and paper. Only the latter two sectors, however, are to grow less than 40% over the five-year period.

14. Over-ambitious planning and erratic weather appear to be the major factors in these projected shortfalls. The agricultural programme was set back by meteorological conditions that caused a poor harvest in 1972. Although the 195 million ton grain harvest of 1974 was the second largest in history, it fell considerably short of the bumper crop of the year before. Total agricultural output declined 3.7%, completions of investment projects were 10% behind schedule in 1974 and the volume of unfinished construction was increasing. Such difficulties in capital formation and agriculture both reflected, and contributed to, productivity problems which have been the major handicap in recent performances.

15. The Five-Year Plan has also been less than accurate in its indications of resource reallocations to the consumer though living standards have continued to rise. The revised

1975 plan which is based on actual achievements through 1974, indicates that output of heavy industry is scheduled to increase 44% during 1971-1975 - much more rapidly than that of consumer goods, although the latter had been accorded a slight advantage in growth rate in the original plan. Achievement of the politically important "high-protein diet" promised by the Soviet leadership depends on fulfilment of ambitious targets for agricultural production this year. Disguised inflation continues to exist in the form of a displacement of lower-priced consumer goods with nearly identical ones with higher prices. The improvement in the consumer's lot planned for 1975 is nevertheless noteworthy; if it is fulfilled, real income per capita and output of light industry would be 21-24% greater than in 1970 - representing average annual growth of 4-4.5%. Such results, however, would represent shortfalls of 5-10% from original objectives.

III. EASTERN EUROPE

(a) External Economic Relations

16. Although Soviet foreign trade continued to grow more rapidly with the industrial West than with Warsaw Pact countries in money terms, last year growth trends in regard to volume of commerce favoured Eastern Europe (see Annex). The ECE in Geneva reports that, in real terms, the growth of East European commerce with the developed West was both slower than in 1973 and less rapid than the increase in intra-COMECON trade in 1974. The slowdown, mainly in exports, was presumably caused in part by the recession in Western demand and was accompanied by imbalances amounting to an estimated $300 million in convertible currencies for Hungary and $2 billion for Poland. In the latter case, the principal factor was probably a substantial increase in volume of machinery imports prompted by the large Polish domestic development programme. On the other hand, deterioration in the terms of trade was probably the main problem for Czechoslovakia, East Germany, Hungary and Bulgaria, which import most of the articles whose world prices have recently risen.

17. With the exception of Poland, however, Eastern Europe has probably suffered less damage from such external imbalances than have most Western countries. Eastern economies are relatively shielded from outside events. As a large scale energy producer, Romania has some extra protection against world-wide inflationary pressures. The price rises in the West have been partly beneficial to Eastern Europe, notably as regards prices of their meat exports. A large share of their imports of machinery from the West are covered by credits that defer their impact on East European external payments. In any

case, the bulk of the foreign commerce of Eastern Europe (excepting Romania and Poland) is directed to other Communist countries - principally the Soviet Union - at fixed prices which in 1974 were not chargeable in convertible currency and had been little affected by increases in world prices of major commodities.

(b) Domestic Developments

18. While causing some external problems, the continuing import boom last year enabled Eastern Europe to maintain a rapid pace of economic expansion. Growth slowed down slightly in Bulgaria and Hungary but 1973 rates were maintained or increased in the other East European countries(1) (see Annex). All these countries seem to be within reach of targets in respective 1971-1975 plans as regards average annual rate of growth of Net Material Product (NMP) - 11.5% for Romania and 5-5.5% for Hungary, East Germany and Czechoslovakia. Polish NMP in particular will probably attain an average well over the planned rate of 7%.

19. The rise in world commodity prices and associated shortages have contributed to moderate single-digit inflation of some retail prices, particularly in Hungary (where an experiment with economic reform has increased price flexibility) and in Poland and Romania (see Annex). Even there, however, price levels have risen much less than in the West because they are administratively controlled in most domestic transactions and in at least half of their external trade - i.e. the portion that is directed to other Communist countries. Such controls tend to shield the domestic economy from outside influences although they also distort resource allocation and only repress inflationary forces instead of eliminating them.

20. Agriculture, chronically a critical sector, appears to have been a more important influence than external price movements in recent East European performance and problems. Much of the acceleration of economic expansion last year was attributable to growth of agricultural output, which apparently speeded up considerably in East Germany while slowing down in Poland. The uneven Polish harvest, which was rich in grain but yielded less hay and root crops than expected, led to public disturbances that represent the major recent instance of economically-rooted malaise in Eastern Europe. Popular dissatisfaction reportedly stemmed from shortages of meat and dairy products and, more fundamentally from the sensitivity of meat consumption in terms of Polish Z

(1) Growth of Net Material Product, which excludes most services, is usually 1-2% higher than Western estimates of growth of GNP of Eastern countries.

social values. Although total agricultural production rose last year, output of beef, pork and milk declined. Poland has, since 1970, registered by far the beast East European performance in expansion of real wages (at double the planned rate) and in consumer-oriented production. However, popular expectations - at least in regard to meat supply - seem to have risen even more rapidly. In 1970, a similar shock to dietary hopes - a rise in meat prices - led to public rioting and a change of government.

(c) Prospects

21. Growth-oriented expectations and policies still seem to have priority, tending to increase East European economic dependence on the USSR and consequently to strengthen Soviet leverage. In quest of continued growth, Poland quadrupled its advance machinery purchases in the industrial West in 1974 and has placed substantial new orders in the current year. East Germany recently ordered a $100 million meat-packing combine from West Berlin. East European régimes borrowed a total of $900 million in the Euro-currency market in 1974. Kuwait loaned $40 million to Hungary and has agreed to finance one-third (about $100 million) of the Adria pipeline which is to carry Middle Eastern oil through Yugoslavia to Hungary and Czechoslovakia. Such assistance has not, however, been sufficient to compensate for the deterioration in East European terms of trade.

22. The economic effects of world-wide inflation on the East should become more pronounced in the future however. The terms of East European foreign trade recently suffered a further deterioration - this time with the USSR. The relatively low prices stipulated in COMECON agreements covering 1971-1975 for Soviet energy and materials have been revised a year ahead of schedule. According to new agreements that base intra-COMECON trade on a moving average of past Western prices, charges for Soviet energy and materials are boosted considerably more than the prices of East European exports. The Soviet oil price, for instance, has been raised more than 100% and is now pegged for 1975 at about $7.50 per barrel. It is generally estimated, for instance, that the average price of Hungarian imports of Soviet energy and materials has been driven up 50%; part of this increase should be transmitted to domestic prices or subsidies unless the current economic reform is modified. The new COMECON agreement would, according to one Western estimate, raise the East European oil bill by more than one billion roubles in 1975, despite only a negligible increase in the volume of Soviet deliveries. Moreover, Soviet oil export volume would reportedly not be raised further unless some payment is made in convertible currencies.

23. Such pressures will probably induce most East European countries gradually to divert further trade from the West to the USSR, to slow down their industrialisation and consumer-welfare programmes - and to run the consequent domestic political risks. Even energy-independent Romania has indicated its concern by cutting its new orders for Western machinery - appreciable in past years - to nearly zero in 1974. Elsewhere in Eastern Europe, the reduction in GNP caused by deteriorating terms of trade is estimated to range from 0.5% (for Poland) up to 1% (Czechoslovakia). In Hungary, a reduction of $50 million in imports from non-Communist countries has been announced for this year and First Secretary Kadar has publicly prescribed more emphasis on central planning and less on higher living standards. In the case of Poland, however, recent experience suggests that even a modest cutback in personal consumption - particularly dietary - might be socially and politically delicate.

24. In view of the existence of such risks, the USSR may exercise its economic leverage with a certain care. Little Soviet interest would appear to be served if Soviet economic pressures were pushed to the point of causing social upheaval or economic stagnation in Eastern Europe; the USSR might even favour maintenance of substantial economic relations with the West by its allies as a means of stimulating and strengthening their economies. A Soviet readiness to "pull punches" to some extent has already been demonstrated in the COMECON price revision. Ten-year credits have been extended to Hungary to ease the rise in the oil price. This is still reportedly payable in soft currencies within designated quotas and is considerably less than the $11 per barrel charged NATO countries in the Middle East since 1973. This Soviet discount may, of course, be compensated by East European political concessions - e.g. greater compliance with Soviet priorities for economic centralisation and COMECON integration. Indeed, East European countries are of necessity becoming increasingly involved in the development of Soviet raw material resources, providing equipment, (some of it bought in the West for convertible currency), infrastructure and labour. The USSR might regard such measures as one of the most satisfactory means of payment by East European countries that constitute not only important trading partners but also a sensitive security area.

25. The Council is invited to take note of this report which has been discussed by the Economic Committee but is presented by its Chairman on his own responsibility.

(Signed) J. BILLY

NATO,
1110 Brussels.

SOVIET AND EAST EUROPEAN RATES OF ECONOMIC GROWTH, PRICE INFLATION AND EXPANSION OF FOREIGN TRADE 1974(a)

(% increase)

	Economic Growth		Rise in Retail Prices	Increase in Foreign Trade	
	GNP	NMP(b)		Value	Volume
USSR	3 (est.) (c)	5.0	-	26	-
Bulgaria	-	7.5	-	24(d)	-
Czechoslovakia	-	5.2	0.5(e)	24	-
East Germany	-	6.3	-	20(est.)	-
Hungary	-	7.0	1.9	25	-
Poland	-	10.0	5.6	32	-
Romania	-	12.5	1.8(f)	38	-
Total Warsaw Pact countries	-	5.9	-	23	7(est.)
East-West	-	-	-	44	1
World	-	-	-	45(g)	5(g)

(a) Principal source: "The European Economy in 1974", Chapter 2, (Advance copy), European Economic Commission, Geneva, April 1975
(b) Net Material Product: see page 7, footnote, above
(c) By International Staff and other Western sources
(d) For nine months of 1974
(e) For 11 months of 1974
(f) Based on rise in real and money incomes
(g) See AC/127-WP/420, Corrigendum 2, 1st April, 1975