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East German Economic Management: The Quest for Efficiency

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A Research Paper

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East German Economic Management: The Quest For Efficiency [redacted] 25X1

A Research Paper

This paper was prepared by [redacted] Office of European Analysis. [redacted] Office of Leadership Analysis, provided a biographical contribution. Comments and queries are welcome and may be directed to the Chief, East European Division, EURA, [redacted] 25X1 25X1 25X1

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East German Economic Management: The Quest for Efficiency 25X1

Summary

Information available as of 5 December 1986 was used in this report.

East Germany, since the late 1970s, has made a series of changes in its economic management that have generated improvements in efficiency, have helped keep growth high by East European standards, and have prompted rare public praise from Soviet General Secretary Gorbachev. East Berlin's changes, for the most part, were administrative and organizational; tight central control remains a hallmark of the economy. The East Germans managed the improvements apparently without ever seriously considering decentralizing reforms. 25X1

Key to the effort to improve efficiency was the reorganization of industry. In 1979, after several years of study, the East Germans restructured industry in an effort to overcome the common problems of centrally planned economies: inefficient use of energy and raw materials, low capital and labor productivity, planning and coordination problems, and poor use of investment resources. The government reorganized all of the centrally controlled industrial enterprises into about 130 *Kombinate,* or combines. The directors-general of the combines were given broad authority over operations and were made personally responsible for performance. The large, streamlined entities, it was hoped, would benefit from economies of scale, leadership by managers of proven ability, better interenterprise coordination, and improved use of investment and research and development resources. 25X1

As external pressures on the economy grew more severe in the early 1980s, additional changes were made in policies and organization to promote exports, productivity gains, and the more frugal use of production inputs:

- In 1981, East Berlin reorganized the foreign trade apparatus, increasing the emphasis on exports and tightening the links between foreign trade enterprises and the industrial concerns they directly serve.

- After years of public complaints about the sluggish performance of agriculture, East Berlin in 1984 launched an agricultural price "reform," featuring sharply higher producer prices for farm products and reduced subsidies. It also made a series of organizational changes designed to improve the management of farms.

[redacted] 25X1

- East Berlin directed its limited investment resources toward the modernization of old, rather than the construction of new, plants and toward a few key projects in order to bring new capacity into operation more quickly.

- The regime boosted financial incentives for both workers and combines, offering the prospect of larger bonuses and increased resources for better work, and penalties for poor production.

- East Berlin shifted the criteria for judging enterprise performance—and determining bonuses for workers—toward profitability, net output (gross output less inputs), and exports.

- The regime moved to improve the administration of the economy by issuing directives to change specific enterprise practices and modifying the planning process to accommodate organizational changes. It also tightened oversight of the economy, in some cases. [redacted] 25X1

Data on economic performance—[redacted] 25X1 [redacted] indicate that the changes in economic management have generally paid off. Since the region's economic and financial crisis of the early 1980s, East Germany has been the most successful East European country in reviving economic growth, strengthening its hard currency financial position, improving living standards, and reducing trade deficits with the USSR. By East German measures, produced national income grew an average of 5.2 percent in 1984-85 versus 2.6 percent in 1982, while Western estimates show GNP rebounding from no growth in 1982 to an average of 2.8 percent the past two years. The regime has reported—and our analysis confirms—renewed growth in productivity and steady reductions in production costs. We calculate that while energy consumption was 1.1 percent higher in 1984 than in 1980, industrial production was 8.4 percent higher. East Berlin has run hard currency trade surpluses since 1980 of about $1 billion annually, on average, and cut net debt roughly in half, rekindling enthusiasm among Western bankers to lend to East Germany. Official statistics for the first 10 months of 1986 suggest that East Germany has begun its new five-year plan period on the right foot; growth of national income remains above 4 percent and most industrial sectors exceeded targets. [redacted] 25X1

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In sum, organizational changes have made it possible for East Germany better to take advantage of two important assets—special trade and financial links to West Germany and a well-educated, well-disciplined work force—and have brought about a notable economic turnabout since the early 1980s. 25X1

Despite the achievements, some of East Berlin's actions have probably been counterproductive, others were not as successful as hoped, and key problems endemic to centrally planned economies—such as distorted prices—have not been addressed. The combine reorganization, for example, may have reduced the initiative of factory managers to innovate. Altered performance criteria may be encouraging the inefficient production of consumer goods and the costly, extended use of obsolete capital goods. East German officials publicly admit that the planning process could be further improved. The GDR has not decided on a genuine reform that would set prices at their economic cost—a key to improving resource allocation in the economy. 25X1

Given the comparative success of current policies, the East German leadership seems unlikely to alter its economic strategy, particularly in favor of decentralizing reforms. Party leader Honecker said in 1985 that the economy is no place for "experiments" and he remains firmly in control. While problems remain, and a successor to the 74-year-old Honecker could want to make changes, we expect no significant alteration in the basic economic course before the next Communist Party Congress in 1991. Instead, the East Germans are likely to continue to tinker with aspects of the economy to redress perceived problems and improve efficiency. 25X1

Nonetheless, with tightening resource constraints at home, continuing Soviet economic pressures, and completion of many of the easy organizational fixes, East Germany will have to look to new areas to keep productivity on the rise and growth stable. The East Germans are banking on improvements in science and technology linked closely to industry to be the main motor of growth. We expect that the East Germans will be able to generate additional efficiencies through modernization and better organization, planning, and management. This should keep growth strong by East European standards even if the economy continues to lag the more advanced Western countries. 25X1 [redacted] 25X1

East Germany's comparative success in recent years has prompted some observers to wonder whether its experience offers a "model" that other socialist countries could profitably emulate. We believe that some of East Berlin's practices can be borrowed successfully. However, the government's actions were designed to correct particular East German problems, and the unique institutional characteristics of a relatively small economy suggest that most policies are not easily replicable in other CEMA countries. Even the USSR, whose leaders have been most outspokenly complimentary of East German domestic economic management, has yet to borrow significantly from East German experience. Despite Gorbachev's praise, many Soviet economists say that any eventual Soviet emulation of East German economic practice will be modified by particular Soviet needs and national institutions. [redacted] 25X1

Continued improvements in the efficiency of the its economy will keep East Germany an economic power in CEMA and help East Berlin support Moscow's domestic economic programs. East Germany should—despite recent friction over bilateral trade relations—maintain its position as the largest trading partner of the Soviet Union and as a technological leader within CEMA. Improvement in export competitiveness, despite recent losses from the decline in oil prices, probably will keep East Berlin in hard currency trade surplus and keep the GDR a favorite of Western bankers. Finally, a continued example of East German prosperity could help spur other East European regimes to redress clear economic ills, further contributing to the strength of CEMA and the power of the Warsaw Pact. [redacted] 25X1

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Contents

25X1

Appendixes

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Scope Note

This paper discusses changes in the management of the East German economy that we believe have contributed in recent years to the improved efficiency and relatively strong performance of the economy, by CEMA standards; it is not intended to be a text on the organization of the East German economy or socialist economies in general. We focus on the impact of the changes on East German performance and generally do not discuss the applicability of GDR economic management practices to other Communist countries.

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East German Economic Management: The Quest for Efficiency 25X1

Introduction

The East German economy has performed well in recent years, by Communist country standards. Following stagnation and a near financial crisis in the early 1980s, East Germany has recorded healthy rates of economic growth and sizable hard currency trade surpluses, has reduced its debt, and now enjoys a solid international reputation for creditworthiness. Senior Soviet leaders, including General Secretary Mikhail Gorbachev, have praised East German economic management, particularly the *Kombinat,* or combine system of industrial organization, despite apparent differences over bilateral trade relations.[1] East Germany's emphasis on streamlining central planning, while maintaining tight central control of industry, apparently appeals to the Soviets because it is an attempt to improve the present system without the political risks of decentralizing reforms. Some Western and Eastern observers have even speculated that the East German experience may offer examples to the Soviets and other socialist states of ways to improve their economies. 25X1

In making the East German economy the most solid among CEMA countries, the GDR leadership has benefited from two important assets: special trade and financial links to West Germany and a well-educated, well-disciplined work force.[2] Nonetheless, we believe East Berlin's efforts to improve economic management through organizational changes have not only made it possible to take better advantage of these assets but are the major reason for East Germany's recent economic turnaround and success in meeting Soviet economic demands. This paper assesses the GDR's efforts to improve the efficiency of its economy and examines the challenges of the next several years. See appendix A for a description of data on East German economic management. 25X1

Impetus for Change

The current economic management system and policies originated with Erich Honecker's replacement of Walter Ulbricht as party leader in 1971. The Eighth Congress of the Communist party *(Sozialistische Einheitspartei Deutschlands,* or SED) in June 1971 adopted two new economic "main tasks"—rapid growth and improving the living standards of the population. It rejected Ulbricht's faltering program of modest decentralization, the New Economic System (NES), and reimposed tight central control over most facets of the economy. 25X1

East Berlin generally succeeded through the early and middle 1970s in achieving the "main tasks." We estimate that real GNP growth averaged 3.5 percent annually during the 1971-75 plan period and that consumption rose steadily. Honecker's policies, however, ignored and even aggravated fundamental problems common to centrally planned economies:

- East German industry remained inefficient, and both labor and capital productivity were markedly lower than in the West.
- Official statistics showed that factories consumed much larger quantities of increasingly costly energy and raw materials per unit of output than their Western counterparts.

[1] Gorbachev's praise of the GDR was strong and clear. His comments, in May and June 1985 and again at the East German Communist Party Congress in April 1986, focused on industry including productivity gains, product quality, and the application of new technology in production. Senior economic adviser Abel Aganbegyan also has praised the GDR. Major Soviet publications, including *Pravda* and *Izvestiya,* further highlighted Soviet interest in East German industrial organization by printing lengthy articles by senior East German officials, including Honecker and economic "czar" Mittag, on GDR economic management and performance. 25X1

The New Economic System

The New Economic System of Guiding and Managing the National Economy (NES) was the GDR's only attempt at reform of central planning. Instituted in July 1963, the NES incorporated many of the ideas of the Soviet economist Evsei Liberman and was the first program of decentralizing economic reforms in the Soviet Bloc. It partially dismantled direct administrative control, such as obligatory plan production quotas, and instituted a system of direct financial controls and incentives known as economic levers. This effectively granted enterprises more decision-making autonomy, while retaining overall central control. Profit became a major success indicator. It was hoped that the use of suitable guidance and the exploitation of the self-interest of both individual and enterprise would boost efficiency and growth. [redacted]

Problems soon emerged, however, as decentralization brought coordination difficulties. The economic levers were not working as hoped—they sometimes led to wasteful use of resources, for example—and conflicts between central authorities and the more autonomous enterprises developed. The regime, we believe, was unwilling to part with the political control that was part of the decentralizing economic reform. East Berlin grew increasingly disappointed with the NES's failure to generate significant gains in economic growth and living standards. Recentralization set in after April 1968—even before the Warsaw Pact invasion of Czechoslovakia in August made economic reform still less politically attractive—and the NES gradually faded away. Honecker's assumption of power, in April 1971, helped move economic policy away from the increasingly discredited system firmly associated with his predecessor. [redacted]

- Investment resources often were poorly used and the regime's efforts to boost efficiency and productivity by scientific and technical innovation lagged.
- The rigidities of central planning discouraged innovation, inhibited export competitiveness, and contributed to a foreign trade apparatus that, according to Western businessmen, was notoriously unresponsive to changing market conditions. [redacted] 25X1

The clearest warnings of East Germany's economic weaknesses were burgeoning foreign debt and a slowdown in growth in the late 1970s. Chronic hard currency trade deficits pushed East Germany's net debt from an estimated $1 billion in 1970 to $11.6 billion in 1980. During the last half of the 1970s, the GDR also swung into chronic deficit with its largest trade partner, the USSR, as Soviet oil and natural resource prices gradually reflected rapidly rising Western prices. Nevertheless, [redacted] 25X1 East German leaders showed little concern 25X1 about the GDR's lack of efficiency and international competitiveness so long as growth remained strong, living standards rose, the Soviets kept increasing deliveries of raw materials, and Western banks were willing to lend to cover trade deficits. By the late 1970s, however, economic performance fell below plan as GNP growth averaged 2.4 percent annually in the period 1976-80. The senior political leadership 25X1 came to realize that lagging productivity, rising costs, and mounting debt could not continue indefinitely, and the regime began to address the economy's inadequacies. [redacted] 25X1

East Berlin's institutional and administrative changes in the late 1970s were intended only to modify the existing economic system and to push growth back to the levels originally planned for the period 1976-80. The perceived inadequacies of the NES and the potential political dangers of decentralization helped dissuade the Honecker regime from emulating Hungary's market-oriented reforms. Moreover, the Honecker regime chose not to follow Hungary's strategy of a deliberate slowdown in economic growth and consumption gains to adjust to its debt problem. Instead, East Germany's 1981-85 plan directive largely retained the macroeconomic goals from the 1976-80 plan and called for gains in productivity and 25X1 efficiency to provide the impetus for faster growth. [redacted] 25X1

East Germany's increased emphasis on efficiency reflected the regime's awareness of the constraints on the economy's growth potential. Limited domestic resources—including a steadily declining population

East Germany: Chronology of Significant Economic Events

11 July 1963	*Introduction of the guidelines for the "New Economic System of Planning and Management for the National Economy." Only comprehensive economic reform in East German history. NES gradually faded away in the late 1960s.*
June 1971	*Eighth Communist Party (SED) Congress. Honecker changes economic strategy, establishes growth of economy and personal consumption as "main tasks." Recentralization continues.*
1972-73	*Much of private enterprise nationalized. The rest is restricted.*
Late 1970s	*Regime slowly recognizes need for improvement in efficiency and reduction of trade deficits.*
8 November 1979	*Decree mandates conversion of Associations of People's Own Enterprises, or VVBs, to* Kombinate *(combines) effective 1 January 1980.*
1980	*Foreign trade enterprise reorganization announced.*
April 1981	*10th SED Congress adopts Economic Strategy of the 1980s.*
13 December 1981	*Martial law declared in Poland. GDR nears liquidity crisis shortly thereafter as bankers react to Western sanctions. Vigorous domestic adjustment begins.*
1982-83	*Regime imposes austerity and issues steady stream of new regulations.*
1 January 1984	*Agricultural price reform implemented.*
1 January 1984	*Seventy-percent tax on wage fund—called contribution to social funds—imposed on industrial firms.*
1 January 1985	*Seventy-percent wage tax extended to construction enterprises.*
June 1985	*Honecker announces new domestic S&T initiative, including separate five-year plan.*
January 1986	*Capital price revaluation. Exact amounts unspecified.*
April 1986	*11th SED Congress announces 1986-90 plan directive and confirms current economic strategy.*

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and comparatively few natural resources—as well as declining growth in Soviet energy and raw materials deliveries left little alternative but to abandon "extensive" growth—increased production using more inputs—in favor of "intensive" growth resulting from increases in efficiency. 25X1

Events beyond East Berlin's control added even greater impetus to regime efforts to improve efficiency and competitiveness in the early 1980s. Western bankers, already concerned by the buildup of debt of East European countries including East Germany, reacted to Poland's bankruptcy and heightened East-West tensions after the imposition of martial law in December 1981 by cutting back lending to Eastern Europe. By early 1982, East Berlin was forced to impose severe austerity measures, to increase exports at almost any cost, and to accelerate efforts to cut production costs in order to avoid financial insolvency. The regime had to subordinate, at least temporarily, growth and improvements in living standards to repayment of debt and maintenance of balanced trade—a significant change in economic priorities. At the same time, East German terms of trade with the USSR continued to deteriorate even as the Soviets cut raw materials deliveries, including oil, and demanded that the GDR reduce its trade deficits. 25X1

East Berlin's Actions

To deal with its economic problems, the government made changes in industrial organization, pricing, incentives, and regulations that guide economic decision making. The regime increased emphasis on scientific and technical progress as a motor of economic growth. The regime also made changes in the planning mechanisms to reflect the organizational changes and address perceived weaknesses. 25X1

The separate changes were not part of a single comprehensive plan such as the NES. Instead, they emerged largely in piecemeal fashion from the "economic strategy of the 1980s," a 10-point directive to "rationalize" the economy promulgated by the 10th

The Economic Strategy of the 1980s

The East German Communist Party, or SED, unveiled at its 10th Congress in 1981 and reaffirmed 5 years later a 10-point "economic strategy for the 1980s" that was designed to move the economy from "extensive" growth to "intensive" growth by improving the efficiency of the economy. The list of goals represented a series of overlapping ambitions rather than a coherent, integrated plan like the New Economic System. The individual points represent, however, constant public themes of the East German leadership and show where the regime is devoting its human and physical resources. 25X1

According to Honecker in his Central Committee report in April 1986, the strategy includes:

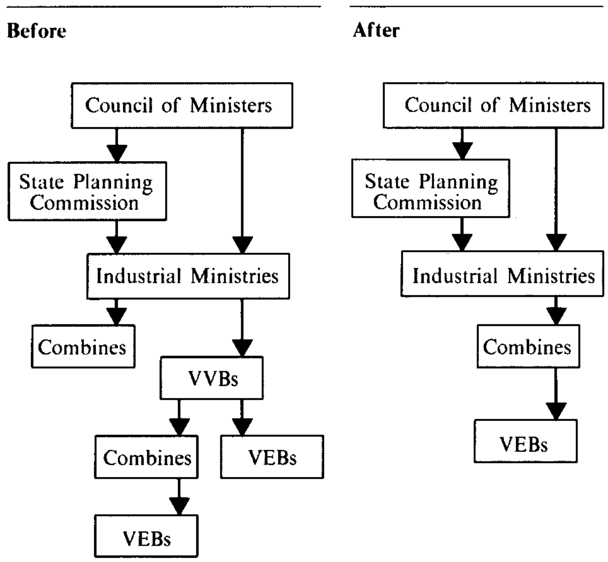
- *"Linking even more effectively the advantages of socialism with the scientific-technical revolution." He singled out microelectronics and computers as areas that "increasingly determine the performance" of the economy.*
- *Accelerating the growth of productivity and generating 90 percent of overall economic growth from productivity gains.*
- *Cutting the use of energy and materials in production.*
- *Improving the quality of output.*
- *Giving a "prominent place to socialist rationalization." The regime wants to improve the efficiency of production through better industrial organization.*
- *Increasing the "efficiency of labor." This involves using capital to increase efficiency as well as providing a variety of labor incentives to boost productivity, such as those currently in effect under the "Schwedt Initiative"—named after the oil refining and chemical combine at Schwedt.*
- *Increasing the effectiveness of investment by improving the planning and management of investment projects.*
- *"Greater . . . production of consumer goods." Quality is to improve and every combine must contribute. The directive is intended to support Honecker's consumerist policies and to meet Soviet demands for greater consumer goods deliveries.*
- *Gearing the economy toward "continuous and dynamic growth of performance." A relatively nebulous directive, the regime means to improve its human capital by boosting education and encouraging creativity.*
- *Pushing the application of science and technology to all segments of society.* 25X1

SED Congress in April 1981. Almost all of East Berlin's actions have amounted to administrative changes, which do not constitute reform in the sense of changing the mechanisms by which resources are allocated in the economy. Central authorities—the government and party leaderships—have continued to make the key decisions on how economic resources are used, and market forces play only a small role in determining the production and distribution of goods. In some cases, moreover, individual economic decision-makers, such as the enterprise directors, have lost freedom of action. 25X1

The Combine Reorganization

The most important changes have occurred in industry. In November 1979, after several years of experimentation, the parliament *(Volkskammer)* issued a decree reorganizing all centrally controlled industrial

Figure 1
East Germany: Industrial Organization
Before and After the Combine Reorganization



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enterprises into *Kombinate* or combines.[3] The reorganization created large, generally vertically integrated monopolies that control all phases of production for a given type of output from resource extraction to final assembly. This involved putting several "People Owned Enterprises" *(Volkseigene Betriebe*, or VEBs) that generally were engaged in different operations and research organizations under the control of a single combine director-general (see figure 1). [redacted]

[3] In this paper, we use the English term combine—an association of groups united for the furtherance of commercial interests. Under this definition, East German combines resemble somewhat the combines, or trusts, of the 19th-century capitalist West. The decree in 1979 accelerated the use of the combine organization and modified command relationships, but did not create the institution; the combine was mandated under a decree in February 1967 as part of the NES. Some industries were organized as combines throughout the 1970s. [redacted]

Carl Zeiss Jena:
A Model Combine

East German leaders tend to single out the Kombinat VEB Carl Zeiss Jena (CZJ) *as the model industrial combine. Looted and completely destroyed by the Red Army immediately after World War II, CZJ reassembled those employees who did not flee to the West and became one of the GDR's most technologically advanced combines. It is widely regarded as a world leader in some technologies, particularly optics. The combine sells extensively in the West and acquires Western technology. The combine also assists the USSR in a variety of areas, including supplying photo reconnaissance cameras and military optics such as night vision devices and laser rangefinders. In recent years, CZJ has moved into the microelectronics field.* [redacted] 25X1

CZJ had 24 subordinate enterprises and 69,000 employees in mid-1986, making it one of the largest enterprises in the country. CZJ in early 1986 had two research organizations with 7,500 employees, a close working relationship with the Friederich Schiller University of Jena, and a wholly subordinate foreign-trade enterprise (with a branch office in New York City.) The combine is one of only a handful authorized its own hard currency account—a reward for its superior export performance. 25X1 *CZJ has another major advantage: Director-General Wolfgang Biermann is a son-in-law of Premier Willi Stoph and a full SED Central Committee member. This presumably gives him extra clout when party decisions are made on resource allocations.* [redacted] 25X1

CZJ displays many of the characteristics the party leadership is trying to foster throughout the economy, and it often is used as a standard of comparison. In January 1986 the combine received lengthy, front-page praise in the Communist party newspaper Neues 25X1 Deutschland. *Honecker had glowing words during a visit to one of its plants in May 1986. Praise typically centers on CZJ's:*

- *Technologically advanced, high-quality output.*
- *Success at exporting to the West and socialist countries.*
- *Steady growth and rapid increases in productivity.*
- *Close working ties between researchers and the* 25X1 *factory floor.* [redacted] 25X1

Table 1
East Germany: Centrally Controlled Industrial Combines

Year	Number of Combines	The Combines' Share (*percent*)			
		Industrial Commodities	Work Force	Output of Finished Consumer Products	Exports
1970	35	33	33	6	38
1975	45	43	36	7	45
1978	54	49	36	14	59
1979	101	85	45	78	96
1980	130	99	98	97	99
1981	133	100	98	100	99
1982	133	100	98	100	99
1983	132	100	98	100	99
1984	133	100	98	100	100
1985	129	100	98	100	100

Source: *Statistisches Taschenbuch der Deutschen Demokratischen Republik*, 1986.

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Once mandated, the combine organization spread quickly. According to official statistics, the number of combines in centrally controlled industry rose from 54 in 1978 to 133 in 1981, when all such industry—including 4,332 VEBs and nearly 3.2 million workers—was reorganized (see table 1).[4] The regime then began to reorganize centrally controlled construction, transportation, and communications industries and district (*Bezirk*) controlled industry, which includes much smaller enterprises.[5] By yearend 1985, the total number of centrally controlled combines stood at 156, while districts managed 93 combines in late 1985. Centrally controlled industrial combines typically have 20 to 40 VEBs and have, on average, about 25,000 employees; the largest has about 70,000 personnel. 25X1

The East Germans believed the large groups would increase efficiency by generating economies of scale, pooling managerial talent, focusing investment on specific production tasks, reducing administrative redundancies, and streamlining decisionmaking. The combine structure would foster risktaking and innovation because a large, wealthy entity could afford occasional losses resulting from single mistakes. The

[4] By the early 1980s, combines had been created or reorganized in five ways:
- VVBs—or Associations of People's Enterprises—were renamed combines, with or without adding enterprises.
- Two or more existing combines merged.
- An existing combine absorbed more VEBs.
- An existing combine was resubordinated to another ministry as a nucleus of a new combine.
- Existing single-enterprise combines were left alone. 25X1

The new combines varied considerably in structure, including:
- Vertical monopolies—single producers of products controlling their own supplier enterprises such as the optics maker Carl Zeiss Jena.
- Horizontal monopolies producing all of some products but without control of their suppliers.
- Oligopolies of several combines in an industry—chemicals, for example—specializing in somewhat different products. 25X1

[5] East Germany is subdivided into 15 *Bezirke*, or districts, which contain 228 *Kreise*, or counties. The district is the smallest political unit controlling economically important institutions, though the counties offer some economic services such as employment offices. 25X1

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concentration of human and material resources under leaders of proven management ability would give constituent enterprises access to larger investments and better management services than they could secure on their own. It also would improve interenterprise coordination and facilitate planning through better information management. Whereas VEBs performing different functions had been previously subject to the planning, resource allocation, administrative and marketing prerogatives and procedures of several ministries, reorganization into a single combine made them responsible to only one ministry. This concentration of enterprises would reduce the need for interministerial coordination, speeding the flow of information toward the center and horizontally among enterprises and combines. [redacted]

The regime expected that the subordination of research and development organizations to combine management would link these capabilities more directly to the needs of production enterprises. The GDR particularly hoped that the combine directors-general could bring about a more direct involvement of research talent in production in order to develop new technologies that would boost labor productivity. This is a key concern in an economy with a falling population and an already high labor force participation rate. Accelerated product development is also essential for a country that must compete on the demanding, rapidly changing world market for manufactured goods and respond to Soviet demands for higher quality exports. [redacted]

Altered Command Links

The reorganization markedly changed command relationships within industry and modified the mix of centralized and decentralized management in the East German economy:

- Central authorities—including the Council of Ministers and State Planning Commission—retained the authority to set plan targets and control resources.

- The VVBs *(Vereinigungen Volkseigener Betriebe* or Associations of People's Enterprises) that had loosely linked similar enterprises and combines but had limited operational authority were abolished. Primarily an administrative body, the VVB did not have the legal standing to direct the activities of associated enterprises and thus could not deal with the coordination and supply problems endemic to centrally planned economies.

- The combine directors-general were given markedly greater authority over enterprise operations at the expense of both the ministries and VEB managers. The removal of central authorities from day-to-day operations reduced their ability to micromanage while the role of enterprise managers in policymaking was reduced to that of providing information.

- Although they have lost influence in setting economic priorities, enterprise managers retained major operating authority at the shop level that is 25X1
beyond the day-to-day control of the ministries and combine directors-general.

- The subordination of research and development assets to the combines reduced the role of the ministries and the Academy of Sciences in financing and directing industrial S&T development.

The abolition of the VVBs and the strengthening of combine management's powers over VEBs have effectively reduced the number of major bureaucratic levels within economic management from five to three: the Council of Ministers, industrial ministries, and combines. The East Germans see this structure as a way to secure the benefits of partially decentralized operational management without relinquishing cen- 25X1
tral control over basic policy and resource allocations.
[redacted] 25X1

The Role of Combine Management

The reorganization made the combine directors-general the crucial actors in the management of East German industry. They received significant new authority over resources and commensurate responsibility for their combines' performance. The directors-general were given considerable freedom to direct, change, or reorganize combine operations and move human, physical, and financial assets within their combines. This includes the authority to assign tasks to VEBs, create new VEBs, and transfer tasks between these enterprises. They were charged with fostering innovation and the introduction of new products within general guidelines set by planning authorities. They authorize bonuses and have de facto authority to lay off workers deemed redundant despite the constitutional guarantee of a job for all. The changes made the directors-general, in essence, both limited entrepreneurs and agents of their industrial ministers responsible for plan fulfillment. [redacted]

The VEB directors became operating managers subordinate to the directors-general. In this respect, VEBs came to resemble somewhat the operating divisions of large Western corporations—with investment, personnel transfers, and product lines subject to the authority of "headquarters management"—even though they retained legal status as independent firms. To solidify the control by the directors-general the regime gave many of them a second hat as director of the *Stammbetrieb,* or main enterprise, of a combine. These large VEBs often account for a large share of the employees and much of the production of heavy industrial combines.[6] [redacted]

Changes in the planning process in the early 1980s explicitly made the directors-general focal points in the flow of information and planning, including the determination of goals and allocation of investment, capital, labor, and financial resources within the combines. The directors-general are expected to take the initiative during the planning process to broker the interests of subordinate enterprises, the supervising ministries, and themselves. Enterprise wants and needs are communicated to planning authorities and the Council of Ministers through the combines, while orders and resources flow back down. To improve its chances of plan fulfillment, combine management must ensure, during plan negotiations with its ministry and the planning commission, that its goals are realistic and that it has the resources to accomplish tasks set by the central authorities. [redacted]

[6] These large enterprises exist mainly in industries that require great capital investments and can achieve economies of scale in single large plants. The *Stammbetrieb* of VEB *Gaskombinat Schwarze Pumpe,* the lignite processing and gasification combine, employs over half of the combine's workers. The other VEBs transport gas and operate smaller plants that have a narrower range of functions—production of lignite coke, for example. [redacted]

The increased power of combine directors-general, often buttressed by membership in the SED Central Committee, comes close, in some Western observers' views, to rivaling the authority of the industrial ministers. These observers speculate that this enhanced authority harbors the potential for disruptive power struggles and ultimately may lead to the abandonment of the combine as an industrial structure. The ministries, however, have retained the means to control the activities of combine management, and we do not have any evidence of ministry-combine conflict. Moreover, we believe that the party would move quickly to nip in the bud any such conflict. [redacted] 25X1 25X1

Although the combine directors-general have considerable freedom to change operations at the factory level, they function within some tight institutional bounds in formulating broader strategies. Major investment projects and hard currency allocations are controlled by the Council of Ministers, State Planning Commission, and party; wages and prices generally are fixed by central regulation; broad production-mix objectives are centrally determined (albeit with the combine management's input); and the state commits large amounts of output to export to socialist countries under long-term contracts. [redacted] 25X1 25X1

The regime clearly hoped that the reduction in levels of bureaucracy and greater centralization of power in the hands of combine directors-general would produce advantages that would outweigh the disruptions from change. The new organizational structure allows greater flexibility to respond to perceived weaknesses, new needs, and changing resource availabilities. Combine directors-general regularly merge enterprises and create new VEBs within their combines to meet demands. Official statistics show a net loss of 679 VEBs between 1981 and 1984, to 3,653, as industry continued to consolidate. By early 1986, according to the GDR press, the regime also reduced by six—to 127—the number of combines via the merger route. For example: 25X1

- *Kombinat VEB Pentacon* of Dresden, a maker of cameras, was dissolved and its assets resubordinated in January 1985 to optics maker *Carl Zeiss Jena,*

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the country's major camera maker. [redacted] the move was designed to boost CZJ's capacity for military-related production. It was also apparently intended to eliminate redundant R&D efforts.

- The East Germans on 1 January 1985 deactivated *VEB Kombinat Elektroanlagen Leipzig* (an electrical equipment maker) and combined its assets with VEBs from other combines including *VEB Transformation* and *VEB Kombinat Automatisierungsanlagenbau,* headquartered in East Berlin. The move apparently was a part of the government's push to develop higher technology goods by combining the firms' research departments.

The GDR's continuing emphasis on centralizing research and production operations in large monopolies argues that the Honecker regime is generally satisfied with the combine form of industrial organization. [redacted]

The Foreign Trade Reorganization

To complement the combine reorganization and address the problem of burgeoning debt to the West, East Germany instituted major changes in the structure of foreign trade enterprises (FTEs).[7] Although deteriorating terms of trade and domestic economic inefficiencies contributed to poor hard currency trade performance, the FTEs—all subordinate to the Ministry of Foreign Trade and not accountable to the industrial concerns they served—were widely regarded as out of touch with domestic industry and foreign markets. [redacted] the FTEs were slow to respond to changing Western market conditions and were notoriously poor in providing customer service. [redacted]

At the beginning of 1981, the regime moved to improve links between producers and foreign markets by:

- Creating 24 new foreign trade enterprises and subordinating them to combines. These enterprises became marketing arms and purchasing agents directly responsible to combine directors-general. Combine management received greater supervisory authority over foreign trade officials with the goals of securing more timely and complete information about trends in Western markets and exercising better control over combine resources to meet customer service requests.

- Resubordinating some 20 other FTEs (subdivided into 61 foreign trade sections with each supporting one combine) to both the Ministry of Foreign Trade and one of the 11 industrial ministries.[8]

As a result of these changes, the FTEs now provide Westerners with explicit single points of contact for individual industrial sectors. [redacted] 25X1

Despite the increased authority in foreign trade activities given combine managers, the operational prerogatives of the FTEs and hence of the combines remain circumscribed. The State Planning Commission and the Council of Ministers continue to exercise the traditional state monopoly over foreign trade by controlling hard currency authorizations and receipts. The FTEs generally lack the authority to trade on their own account.[9] [redacted] 25X1

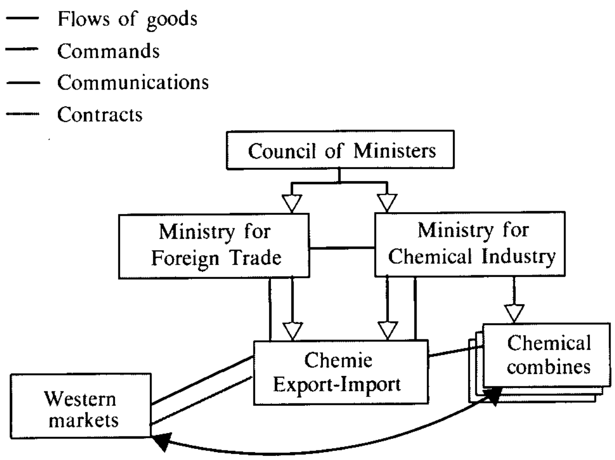
Although the dual subordination of many FTEs violates the managerial principle of unity of command, the East Germans implemented the change to facilitate communications. Contact with the trade ministry ensures compliance with overall national foreign trade objectives, while subordination to an industrial ministry ensures the FTE supports the ministry's combines. 25X1

[7] The FTEs are primarily involved in trade with the West. Agreements and contracts with socialist countries often are handled at the government-to-government and ministry-to-ministry levels and arranged by joint economic commissions. [redacted] 25X1

[8] The GDR left in place a few non-industry-specific FTEs, such as the general trading firm Intrac, and service enterprises directly responsible to the Ministry of Foreign Trade. Intrac is a special case in other ways: it has wide latitude to use foreign exchange and borrowing authority, can operate worldwide and trade in all commodities, [redacted] The East Germans did not change the status of four FTEs responsible for coal, lumber, and electrical energy trade. A final foreign trade variant involves combines without subordinate FTEs that were allowed to conduct some business on their own. [redacted] 25X1 25X1 25X1 25X1

[9] Special hard currency accounts, funded by a part of their own earnings, are authorized for only a few combines as rewards for particularly large exports to the West. [redacted] 25X1

Figure 2
East Germany: Command and Commercial Links of a Typical Foreign Trade Enterprise



This schematic represents the relationships between the foreign trade enterprise Chemie Export-Import and its Western customers, two superior ministeries, and the chemical combines it serves. The Foreign Trade Enterprise (FTE) receives commands and funding from its ministries. It procures in the West for its combines and markets their products abroad. If service is required by a Western costumer, the FTE gets technical expertise,which it may not have,from a combine. The combines themselves do not contract directly with Western firms.

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Access to ministerial authority allows the FTE director to requisition combine resources —service representatives, for example—not otherwise automatically available. The command links of a typical foreign trade enterprise, *Chemie Export-Import,* are shown in figure 2.

East German officials maintain that the dual subordination does not cause managerial conflict. *Chemie Export-Import* officials have told US Embassy Berlin officers that the FTE's thousand or so employees are not buffeted by opposing commands from combines, the Ministry of Foreign Trade, and the Ministry for Chemical Industry. Indeed, the East Germans maintain that the structure ensures harmony by making both relevant ministries responsible for fulfilling the foreign trade plan and eliminating the possibility that one could blame problems on the other. 25X1

The government has taken other steps to improve the performance of the FTEs. 25X1
FTE employees are receiving better training in Western marketing and customer service techniques and getting more foreign travel opportunities. The regime is also encouraging expansion of the semiannual Leipzig Trade Fairs. 25X1 25X1

Changes in Policies and Controls

In addition to the industrial reorganization, the Honecker regime in the early 1980s instituted a number of changes in investment management, worker incentives, planning and performance criteria, and administrative regulations. Some of these changes were to accommodate the combine reorganization and to take advantage of its perceived advantages. Other changes responded to the heightened external economic pressures on East Germany caused by the East European financial crisis and toughening Soviet trade requirements. 25X1

Investment Policy and Management

East Berlin modified its investment strategy in order to reflect its hard currency constraints and its shift toward "intensive" growth by seeking to "rationalize," or increase, the effectiveness of investment. The government cut back new investment, focusing more on earlier completion of continuing projects and modernization of existing plant and equipment. The result was a reported 9.9-percent decline in investment (in constant prices) from 1981 to 1984 before a 3.7- percent rise in 1985. As the volume of investment fell, the regime reallocated investment's diminishing share of national income. Energy—particularly lignite development—and key manufacturing sectors, like machine building and electronics, got the largest portion. Domestic trade, transport, and communications received declining amounts. Agriculture's take fell 23 percent between 1980 and 1984, 10.6 percent between 1983 and 1984 alone—a decline we attribute largely to the reduction in subsidies associated with the agricultural price reform (see inset). In addition, official statistics show that the construction share of overall investment is dropping as the regime concentrates on purchases of equipment. 25X1 25X1 25X1

The Unusual Agricultural Price Reform

The unprecedented agricultural price reform and organizational changes implemented in East Germany on 1 January 1984 reflected the regime's longstanding unhappiness with the performance of agriculture. Output of key commodities had stagnated and grain imports of roughly 3 million metric tons annually had become a major drain on hard currency reserves. Reported productivity was low, the government acknowledged wasteful use of fertilizers, and repeated regime exhortations for increased worker effort failed to evoke a significant response. [redacted]

The "price reform," as it is widely known, introduced major pecuniary incentives into agriculture. The regime sharply boosted procurement prices for a broad variety of agricultural products, typically by 60 to 80 percent, [redacted] *It promised that increased output would be rewarded by higher farm profits and higher bonuses for managers and workers. The reform also rewarded small private producers—those farming in small, state-provided garden plots—with extra large increases in state procurement prices for fruits, vegetables, and even rabbits, which are especially prized by consumers. The government further encouraged small farmers by granting preferential access to supplies of seed and fertilizer from state stocks. The decree did not, however, give much room for market forces to determine prices, although some latitude to set prices is granted small producers who run their own shops.* [redacted]

The regime boosted the farms' costs even as it offered positive incentives. The reform imposed differential rents on farmland, which for the first time were assessed on the basis of the land's fertility. It sharply reduced subsidies for agricultural machinery and fertilizer and set prices of many inputs at cost, forcing farms to come up with their own investment resources; official budget figures show that subsidy payments fell 39.1 percent from 1983 to 1984. The clear message was that only strong producers and efficient users of inputs would be profitable, and the regime would not permit customary bonuses to workers or managers in subpar state farms (VEGs) or cooperative farms (LPGs). [redacted] 25X1

At the same time, the regime recognized administrative problems and made organizational and procedural changes. It implicitly recognized that its policy of creating extremely large farms—up to 15,000 hectares—had been mistaken. The government publicly admitted the inefficiency of trucking "cooperative peasants" many kilometers per day to distant parts of farms when they could work in the vicinity of their homes. To improve the management of the farms, the government also subdivided the LPGs, for administrative purposes, into as many as four subsections and strengthened the operating authority of the subunits' managers, who could better manage the smaller plots. The reform changed performance criteria to emphasize self-sufficiency, net production, cost reductions, and profits. In June 1985 the regime moved to improve efficiency further by reuniting previously separate and overspecialized crop and livestock producing farms—a carryover from when the GDR thought that extreme specialization was beneficial—reducing the need to transport fodder long distances from farms to feedlots. [redacted] 25X1

25X1

25X1

The changes in agriculture marked major modification in two longstanding SED tenets—that strong pecuniary incentive in agriculture should take second place to political motivation, and that agriculture can and should be treated as a variant of large scale industry. They reflect recognition by the regime that the unique problems of agriculture required greater devolution of authority and incentives at the producer level. The organizational changes in agriculture, however, have no rough equivalent in any other sector of the GDR economy. Moreover, the measures did not introduce real reform in terms of freedom of action of individual LPG and VEGs, real market forces, or markedly increased scope of freedom for private agriculture. [redacted] 25X1

25X1

The government moved to increase the effectiveness of investment by shifting financial and supervisory responsibility to the individual economic entities, notably the combines. Combine management and employees would have a greater incentive to see that investment resources were well used because poorly executed projects would be unproductive, cutting the combines' profits and the employees' bonuses. New regulations also increased financial penalties for poorly conceived projects. [redacted] 25X1

The shift in responsibility for managing investment emerges from official data on investment financing. Funding by central authorities fell more than 6 percent in 1985 after a drop of nearly 13 percent in 1984 and a smaller decline in 1983. At the same time, the combines are carrying out more so-called rationalization investments in which they draw on existing resources to set up new or improved production capacities. Official statistics show a 21-percent increase in combine-managed investment in 1985 over 1984. While this reflects a judgment that the production unit knows best how to utilize investment goods, it could lead to some duplication of capacities across combines and, more likely, ineffective construction by technically deficient combine crews. Even though a greater share of investments is being funded from enterprise-retained earnings and bank credits, central authorities continue to make basic decisions on major projects. [redacted] 25X1

More Incentives for Workers

East Germany has made increasing use of material incentives to encourage greater worker productivity. Probably most important, the regime has generally kept its promise that the higher wages earned by harder work can be used to buy better quality goods. With the exception of the lean years of 1982 and 1983, [redacted] 25X1 the regime has consistently been able to deliver more and higher quality goods to retail stores—both low-priced outlets providing subsidized "basic" goods and *Intershops* that sell luxury Western goods much prized by East Germans.[10] The government also is expanding its chain of *Delikat* and *Exquisit* specialty stores that sell luxury goods at higher prices in domestic East German currency. By a variety of measures, East Germans enjoy the highest level of personal consumption in the Communist world. [redacted] 25X1

To improve their system of incentives the East Germans have developed a complex system of wage differentiation. Official statistics show average monthly earned income of 1,130 East German marks in 1985.[11] Education and qualifications are major criteria for wages, with apprentices (at 100 to 200 marks per month) and unskilled labor (300 to 500 marks) at the bottom of the economic ladder. Farm workers make 500 to 700 marks per month. Factory workers receive 1,000 to 2,000 marks per month before deductions of roughly 20 percent of wages, about the same as university-trained specialists; service workers earn somewhat less. Midlevel managers may make up to 1,500 marks. [redacted] 25X1 [redacted] 25X1 combine directors-general may earn up to 3,000 marks monthly. The regime also uses piece wages in some industries, and offers special or hazardous duty pay to entice workers to unattractive jobs, including those on joint Soviet–East German projects in the USSR. [redacted] 25X1

The government is boosting financial incentives for high-quality work, and is making it increasingly clear to workers that they cannot expect automatic bonuses for substandard performance. Bonuses are periodically awarded for fulfillment of group objectives—such as those of a labor brigade—which are paid out of funds generated by enterprise profits. These bonuses, [redacted] 25X1 vary considerably across industry; the potentially large size of these bonuses—perhaps as much as several months pay—are intended to be a strong incentive to high productivity. Our Embassy in East Berlin reports that these bonuses

[10] The regime has another motive. Most of the hard currency spent in the *Intershops* are West German marks that East Germans receive as gifts from friends and relatives in the West. The stores have become a significant hard currency earner for East Berlin while satisfying some consumer demand. [redacted] 25X1

[11] The domestic East German mark is inconvertible into Western currency and an approximation of its value is obscured by changing rates of exchange between the domestic and foreign trade (Valuta) mark. East Berlin claims that its domestic currency is equivalent to the West German mark, which in late 1986 was worth about 50 cents. However, on West German spot markets, the East German mark is worth only about one-fifth of a West German mark. [redacted] 25X1

occasionally create friction in the work-place, with more energetic workers chastising laggards. This suggests that combine managements have heeded orders not to automatically grant bonuses. [redacted]

To encourage individuals, enterprises also offer nonmonetary awards, individual bonuses of up to several months' wages, and special access to consumer goods in short supply; they also impose penalties. In 1984, for example, the regime sold a special shipment of 10,000 Soviet-made Lada automobiles to outstanding workers nominated by their enterprises; the normal wait for a car is over a decade. The Zwickau motor transport enterprise in 1984 offered its truck drivers clear incentives for efficient driving. It authorized each a fixed amount of fuel per 100 kilometers of travel, and, if the driver used less than his allotment, he would receive an extra 9 pfennigs per hour worked for every liter saved. If he used more, his pay was to be cut at the same rate. [redacted] employee errors in the workplace can result in penalties of up to several months' salary. [redacted]

New Planning and Performance Criteria

East Germany, like other centrally planned economies, employs a host of "norms," "balances," and "indicators" to ensure that materials are used in accordance with the plan and to measure enterprise performance against plan goals. In 1982 the regime formulated more stringent planning norms that increased the share of economic inputs controlled by the plan and placed specific limits on the use of key materials down to the enterprise level. At the same time, the regime revamped the process of balancing uses against resources to ensure the primacy of its key economic goals and to enhance the combines' role in material balancing. The regime focused material balancing on controlling the allocation of the most essential energy resources and raw materials to achieve maximum output, on using capital equipment to support improved export performance and more effective investment, and ensuring adequate supplies of consumer goods. [redacted]

The combines were given a greater role in this process in order to diminish bottlenecks and improve coordination. Given the regime's objective of operating at maximum capacity despite constraints on imports, raw materials, and energy, the combine directors-general needed greater authority to make and implement timely decisions on the use of inputs. In 1985 the 25X1
central authorities—the Council of Ministers and the State Planning Commission—set the balances for 1,050 of the most essential items in the economy. The combines, in turn, set the figures for 1,086 elements, with the approval of the supervising ministry. Another 2,400 balances were set directly by the combines or subordinate enterprises, subject to the approval of the combine director-general. [redacted] 25X1

The central authorities have also toyed with the criteria used to evaluate combine and enterprise performance. Success in meeting various criteria determines the allocation of money to a series of "funds" that the enterprises use for wages, investment, and purchases of inputs. The most successful enterprises under these criteria have the greatest access to the 25X1
resources needed to maintain and expand operations. These criteria also determine the amount of money 25X1
authorized for payment of bonuses to managers and workers. [redacted] 25X1

Since 1984, East Berlin has downgraded the importance of gross measures of output in evaluating enterprise performance in favor of four criteria that put greater emphasis on conserving inputs and on meeting the demands of domestic and foreign markets:

- Net profit earned by reductions in costs but not by unauthorized price hikes or reductions in quality. These earnings can be used for worker bonuses and expansion of enterprise capacity with the permission of planning authorities or retained for future use in bank accounts.

- Net production, or output minus consumption of materials and depreciation. This measure is intended to encourage greater efficiency in the use of raw materials and energy. 25X1

Economic Planning in the GDR

The regime, in recent years, has enacted new regulations to improve planning in general and incorporate industrial combines more directly into the planning process. The Order of Planning in 1979 mandated procedures for drafting the 1981-85 Five-Year Plan while a related Basic Set of Operating Principles established regulations for the annual plans. Thereafter, a series of supplementary regulations were issued to clarify rules and procedures. [redacted] 25X1

East Germany has an elaborate central planning apparatus with the State Planning Commission (SPK) at its center. Headed by candidate East German Communist Party Politburo member Gerhard Schuerer, the SPK coordinates extensively with both the party and the Council of Ministers. The SPK is charged with the development of annual and five-year economic plans (FYPs), and it supervises implementation of the plans; the SPK also has the major responsibility for longer term plans such as the CEMA science and technology initiative through the year 2000. Many details of the planning process, which integrates all the plans, are considered state secrets by the GDR, and the SPK maintains a fairly low public profile. We know, however, that the GDR prepares elaborate, detailed plans making extensive use of econometric models and computers. [redacted]

The planning process begins early and involves nearly all significant economic institutions, but with major responsibility borne by the combines. Annual planning begins in the first half of the year before the plan period, while preparation for the FYPs begins two or three years ahead. [redacted] *planning begins relatively informally at the lower levels of the economy—including the individual enterprise and farm—and becomes increasingly rigorous. At first, the SPK asks economic institutions what they will need, what they can produce, and how they can reorganize processes and enterprises to improve production, boost exports, and save materials. Initial requests and objectives are modified in light of state need, resource constraints, or belief that enterprise goals are unrealistically high or low. After much discussion, industrial ministries, combines, VEBs, and farms finally receive explicit instructions on production goals, and investment, personnel, and hard currency allocations. The final directives, issued by the Council of Ministers, are binding and not normally subject to appeal. Combines, ministries, and even the Foreign Trade Bank then become instruments of the plan, with room for initiative left to those areas not explicitly determined by the plan.* [redacted] 25X1

Western observers generally rate East German economic planning as being comparatively good, given the inherent problems of running a centrally planned economy (CPE). The East Germans have developed sophisticated planning tools and have thoroughly integrated the process into the economic life of the country. Thorough preparation means that the major dislocations so commonly reported in other CPEs—massive hoarding by enterprises and "storming" at the end of plan periods, for example—seem relatively unusual in the GDR. [redacted] 25X1 25X1 25X1

Production problems at individual plants can quickly affect the output of customers, a situation caused by comparatively low inventories, not hoarding. Although East Berlin probably has improved the process somewhat in recent years, East German officials say publicly that further gains are needed, and there undoubtedly is room for improvement. [redacted] 25X1 25X1

- Products and services for the population. This measure is intended to increase domestic consumer supplies and exports of consumer goods and requires all combines, even those in heavy industry, to produce consumer goods.

- Exports to meet the goal of reduced debt to the West and the USSR and to fund needed imports, especially from the West. [redacted]

With greater emphasis on net profit, enterprise managers are now supposed to respond, at least in theory, to considerations of costs and revenues rather than to physical output quotas in determining what and how to produce. But net profit is still less important to an East German manager than to his counterpart in a market economy. In part, this is because the other indicators—production of export goods and consumer goods, net production, and the many other less important criteria—enter into the evaluation of East German enterprise performance, but may not necessarily be consistent with maximizing net profit. [redacted]

Although profits may not have assumed the same importance as in a Western economy, they seem to have introduced some financial discipline into East German economic management. While the government does not allow Western-style bankruptcies, [redacted] the authorities take action to deal with chronic money-losing firms in lieu of extending operating subsidies. The government may extend short-term assistance to firms with temporary problems by providing (high-cost) credits or, on rare occasions, authorize wage cuts to tide over a troubled enterprise. But if management is unable to turn the situation around, the authorities will replace the managers or reallocate assets to more successful enterprises in intra-combine reorganizations. Even marginal combines have been broken up. [redacted]

Financial Levers

Consistent with the greater emphasis on profits, the regime is making somewhat greater use of financial levers—such as prices, taxes, and interest rates—to influence enterprise decisionmaking. As a result of new price formation procedures adopted in 1983, planning authorities have been adjusting prices for production inputs more frequently to reflect world market prices and domestic costs. This policy is intended to spur greater efficiency in the use of energy and materials, because prices presumably come closer to reflecting real economic costs. [redacted] 25X1

East German authorities have also made greater use of price differentials to spur exports and innovation. The regime authorizes the combines higher domestic East German prices for goods that are exported to the West. It grants 2-percent higher prices for goods awarded the "Q" symbolizing world-level quality and offers higher prices for new or improved products. The authorities, however, lower prices on goods judged to be obsolete or of poor quality. [redacted] 25X1 25X1

These more active pricing policies do not, however, constitute a basic price reform. Prices, wages, and foreign exchange rates remain under tight central control. The absence of market forces in determining prices—even some private handicraft prices are controlled—means that, at best, central authorities are only minimizing the distortions between prices and true economic costs. Moreover, regime policies have continued to deliberately subsidize many prices, particularly for basic consumer goods, and to undervalue capital. Profit maximizing decisions by enterprise managers in response to these centrally fixed prices continue to reflect planner preferences and not necessarily the most efficient allocation of resources. [redacted] 25X1 25X1 25X1

The regime is making greater use of its taxing power to encourage savings in the use of capital and labor. On 1 January 1984, the government imposed a 70-percent tax on the wage funds of industrial enterprises that was designed to discourage "hoarding" of labor and to boost productivity. In order to reduce their tax bill and protect profits and bonuses, enterprises cut hiring, contributing to a rise in unemployment despite a constitutional ban on joblessness. The regime allowed some transition to the steeply higher wage tax by providing a new subsidy to enterprises in 1984, but it forced the enterprises to shoulder more of the burden in 1985 by cutting subsidy payments by 71.3 percent. [redacted] 25X1 25X1 25X1

As part of its effort to "rationalize" investment, the government, since 1982, has imposed a 6-percent tax on investment not completed on time and a 12-percent surcharge on inventories deemed excessive. The regulations waived payment of asset taxes on projects completed ahead of schedule until their originally scheduled completion date. The government also imposed taxes on little-used productive assets in an effort to boost capital utilization rates. [redacted]

The authorities use the state banking system to pressure poorly performing enterprises and to reward good ones. The banking system has been given a greater role, in conjunction with planning authorities, in assessing the viability of investment projects. It limits loans to problem firms—much like Western banks—and, after specified intervals, imposes higher interest rates on loans. The banks charge differential interest rates for different kinds of projects. They grant lower rates to profitable enterprises and to firms producing high-quality output and goods intended for export. The regime in recent years also has encouraged private enterprise by increasing the availability of inexpensive credit, a move that we believe has encouraged the modest recovery of that sector (see inset on page 17). [redacted]

Regulatory Changes

Although central authorities have given greater attention to financial levers, they have resorted to tighter administrative measures to deal with certain problems. Some of these controls have come in areas where planners judged that changing prices would not have produced the quick response needed or would have been highly disruptive to carefully calculated balances. Many others fine-tuned existing procedures and provided specific guidance in the wake of larger decrees like the one for the combine reorganization. [redacted]

The most prominent area for new regulations has been the transportation sector. A large number of decrees issued in the period 1982-83 were primarily aimed at reducing liquid fuel consumption in the face of oil shortages.[12] The regime slashed monthly fuel allocations for trucking companies, idling many at the end of each month. Other published government orders restricted usage of trucks and ordered greater reliance on railroads and inland waterways for freight transport. The result has been a major change in the structure of transportation in the GDR. [redacted] 25X1

25X1

Government economic regulations run the risk of producing bottlenecks, evasion, and other counterproductive behavior. This undoubtedly has occurred in some instances but, on balance, we believe these regulations have been modestly effective. [redacted] 25X1

25X1 [redacted]

25X1 [redacted] The authorities evidently have allowed few appeals, a practice that could quickly ruin a regulation if appeals are granted too liberally. Nonetheless, the regime demonstrates some flexibility by repealing or amending regulations shown to be ineffective or outdated. [redacted] 25X1

Stability Amidst the Change 25X1

Despite the organizational and policy changes, the Honecker regime has left much of the fundamental economic structure in place. The combine reorganization has never threatened the primacy of the party and government central planning authorities in determining macroeconomic policy, setting general goals for combines, controlling prices, and allocating investment and hard currency. Although some power of the industrial ministries has been devolved to combine managers, central control may have grown even stronger with the reduced authority of VEBs, increased

[12] Effective in 1982, the USSR reduced oil deliveries on soft currency account from 19 million metric tons to 17.1 million. The hard currency shortage prevented East Berlin from buying replacement oil in the West and necessitated imposition of significant conservation measures. Despite the severe rationing of East German businesses, consumer supplies and prices were not affected—a clear reflection of Honecker's consumer policies. [redacted] 25X1

25X1

Private Enterprise in East Germany

The private sector is a small but important part of the East German economy, especially in crafts and services; it accounted for 2.8 percent of produced national income in 1985, according to official statistics. According to the official news agency ADN, some 82,000 private enterprises and 2,800 production cooperatives—semiprivate associations of private firms—employed 420,000 people in 1985 or some five percent of the work force. According to official statistics, roughly half of these work as artisans, while about 10 percent work in both the construction and domestic trade sectors. Essentially none are in industrial jobs.

Private enterprise contributes significantly in some areas of the economy. According to the party newspaper Neues Deutschland, *private firms and semiprivate construction cooperatives in 1984 provided 70 percent of general service and repair work done in the country and 52 percent of housing repair. Individuals and concessionaires ran 40 percent of restaurants and taverns in 1984; by all accounts they are a welcome improvement over state-operated restaurants. Private firms also carried 20 percent of cargo hauled by truck in 1984.*

Entrepreneurs operate under strict rules. The regime limits the scope of activities and strictly controls the size of private enterprises. It sets prices at which the private sector sells its goods and services and imposes special taxes on private firms. The regime also requires that entrepreneurs obtain operating licenses before doing business—15,000 were granted in 1985, according to the East German press—and comply with a host of regulations. The regime both encourages and controls the private sector by providing needed supplies at government-established prices and offering credit from the state bank. The result is an extremely stable stock of private enterprises that are both modestly profitable and unlikely to fail. 25X1

The private second economy works very differently in East Germany than in other East European countries. The regime encourages second jobs and encourages payment in West German marks—which circulate as a second semiofficial currency—because it knows that it will eventually acquire most through its hard currency Intershop *system of retail outlets. The government strongly discourages, however, a true black market; economic criminals are dealt with harshly.* 25X1 25X1 25X1

East German Government policy on private enterprise has shifted over the years. The Honecker regime slapped sharp new regulations and disincentives on the sector in the early 1970s, and the number of workers in private small business fell to 250,000 in the mid-1970s, compared with 860,000 in 1950. Since the mid-1970s the regime has modestly encouraged private enterprise, and the sector has experienced steady, if unspectacular, growth. Repeated public praise by Honecker in the mid-1980s is but the most obvious sign that the SED appreciates a modest, petit bourgeois presence in the first "workers' and peasants' state on German soil." The regime apparently believes it can adequately control entrepreneurs and shows no fear of possible development of reactionary economic elements. 25X1 25X1

regulation of parts of the economy, and more stringent planning norms and performance evaluation criteria.

The basic institutions of senior economic decision making have remained the same. The major organizational casualty of the combine decree—the VVB—had no fundamental policy role. The key actors have remained: the Politburo, the Central Committee and its departments on the party side; and the Council of Ministers, State Planning Commission, and ministries on the government side (see appendix B). The regime maintained the status of most implementing organizations—those without independent decision making authority—such as the Foreign Trade Bank. It has, however, created in recent years a few new regulatory bodies to monitor combine performance. 25X1 25X1

East Germany's Senior Economic Decision Makers

Guenter Mittag . . . chief economic policy maker in the GDR . . . party secretary for economic affairs since 1962 except for stint as a first deputy premier during 1973-76 . . . full Politburo member since 1966 . . . tough, pragmatic in approach to issues . . [redacted] 25X1 25X1

Gerhard Beil . . . his appointment as Minister for Foreign Trade in May 1986 reflects growing influence and status as a longtime top foreign trade official . . . previously responsible for trade with Western nations . . . deeply involved in efforts to improve US-GDR economic ties . . . respected, influential, a key player in implementing trade policies of economic "czar" Mittag and a possible successor to him should Mittag's health worsen . . . former Nazi Party member, joined SED in 1953 . . . shrewd, aggressive negotiator . . . 60. [redacted] 25X1

Gerhard Schuerer . . . deputy chairman, Council of Ministers, and head of the State Planning Commission . . . also has party status as a candidate member of Politburo . . . primarily a party functionary in economic management positions, not a trained economist . . . [redacted] 25X1 *. . . spent three years at CPSU Higher Party School in Moscow, presumably speaks Russian . . . cautious, competent, knows his subject thoroughly . . . 65.* [redacted] 25X1 25X1

Guenther Kleiber . . . became full member of Politburo in 1984, after 17 years as a candidate member . . . deputy chairman, Council of Ministers, and Permanent Representative to CEMA, responsible for overall GDR technological cooperation within CEMA . . . electrical engineer, experienced in machine tools, electronics, and data processing development . . . has been the GDR's top economic troubleshooter to the Arab world . . . a protege of Mittag and close to Honecker . . . 55. 25X1

Werner Felfe . . . member, SED Politburo (since 1976) and secretary for agriculture (since 1981) . . . party careerist with no agricultural training but extensive experience as a party overseer . . . spent 10 years as first secretary in Halle District, the GDR's top industrial producer and polluter . . . has ties to Honecker dating back to Free German Youth work in the 1950s . . . competent administrator . . . 58. 25X1

Werner Jarowinsky . . . SED secretary responsible for domestic trade and supply matters since 1963 . . . became a full Politburo member in 1984, after 21 years as a candidate member . . . well educated, has studied and taught economics, holds a doctorate . . . his long tenure as a party secretary presumably indicates leadership satisfaction with his job performance . . . 59. 25X1

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Mittag's Meetings With the Managers

Party secretary for economics Mittag meets with the country's party and industrial economic management twice annually, just before the Leipzig Trade Fairs. Managers in attendance include:

- *All the combine directors-general.*
- *Central Committee economic department personnel.*
- *Party organizers.*

Government representation, by contrast, is small even though the combines are directly subordinate to the ministries. [redacted]

The 2-day seminars organized by the SED Central Committee feature Mittag's comments on policy and a review of economic successes and failures. The managers compare notes on problems. Mittag, [redacted] *is candid in his remarks and has been pointedly critical of some combine directors-general. Some of the critiques show up in the East German press. Sessions like these—combining the most senior SED economic leadership short of Honecker and the significant industrial managers in the same room—illustrate the ease of communication of economic policy in a country of under 16.7 million people occupying an area the size of the state of Ohio.* [redacted]

The key decision making cadre remained intact through the changes of the last several years. Honecker's economic team implemented the policies of rapid growth and increases in consumption of the 1970s, as well as the recent efforts designed to correct problems caused by these policies and a more difficult external environment. We judge that the stability of the senior economic leadership reflects the competence of the individuals and their consistent adherence to evolving party objectives. [redacted]

The Results

Data on economic performance [redacted] suggest that the changes in East German economic management have generally paid off. Since the region's economic and financial crisis of the early 1980s, East Germany has been the most successful East European country in reviving economic growth, strengthening its hard currency financial position, improving living standards, and reducing trade deficits with the USSR. While we cannot prove, for methodological reasons, a direct link between East Berlin's actions and these gains, the correlation appears strong. Nonetheless, some measures have been counterproductive, and significant problems and challenges remain. [redacted] 25X1

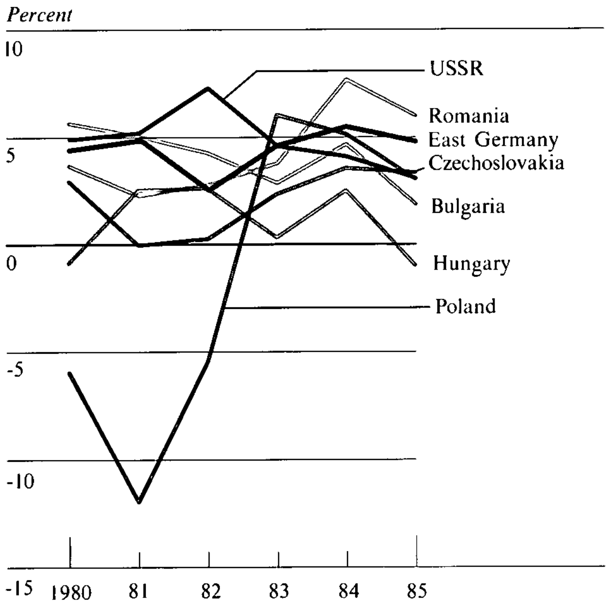
The Successes

Aggregate measures of economic performance show that the East German economy rebounded strongly in the period 1984-85 from stagnation and recession. By East Berlin's measures, national income grew an average of 5.2 percent over the past two years, compared with 2.6 percent in 1982. Our calculations of gross national product show a similar pattern of economic recovery. After declining in 1982 to zero, East German GNP growth in 1984-85 reached a level somewhat above that of 1976-80. [redacted] 25X1 25X1 25X1 25X1

East Germany's performance compares well with that of the other CEMA countries. By 1985, East German economic growth—as measured by officially reported national income figures—was leading all CEMA countries except Romania, whose statistics almost certainly are much exaggerated. This comparison—combined with East German success in fostering greater efficiency and technical innovation—presumably prompted Gorbachev's praise of East German economic management as well as East Berlin's apparent self-satisfaction with its accomplishments. [redacted] 25X1 25X1

Major gains in agricultural performance—following the agricultural price reform and associated organizational changes—contributed much to the rise in East German growth. The GDR recorded two consecutive record grain harvests. Production reached 11.6 million metric tons in 1985, according to East German statistics, a sharp jump from the roughly 10-million-ton level of the previous several years. Preliminary figures point to another good harvest in 1986. Production of other major agricultural goods also has risen 25X1 25X1 25X1

Figure 3
Eastern Europe-USSR: Growth of National Income, 1980-85



Although all East European economic statistics are suspect, Romanian figures appear particularly unreliable. We believe actual growth, using socialist accounting methods, was considerably below reported levels.

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markedly. Although favorable weather, more irrigation, and better farming techniques contributed to agriculture's good performance, the US agricultural attache in East Berlin believes the stimulus of the price reform also helped boost output.

The recovery in industrial performance seemingly is less impressive. After slowing to about 1 percent growth in 1982, the increase in industrial output—measured by Western accounting practices—has averaged 2.0 percent over the past three years (see table 2 and figure 4). While still below levels of the 1970s, this performance stacks up well against that of the other East European countries. Only Polish industry, which was rebounding from the depression of 1981-82, can claim somewhat better numbers. More important, East Germany has been able to bring industrial growth back up to levels near that of the late 1970s despite severe cutbacks in imports from the West, reduced oil supplies from the USSR, and pressures to boost exports to both hard currency and Soviet markets. 25X1

Because of the need to adjust to more costly inputs and reduced resources from East and West, the critical measure for East German economic management is its success in improving efficiency and productivity. East German official data and our own calculations indicate that such improvements have played a key role in keeping industrial output and the overall economy growing. The regime has regularly reported reductions in costs per unit of industrial output of about 2 percent annually in the last several years as well as savings in the use of energy and raw materials:

- The most striking improvement has come in reducing the consumption of energy per unit of output. We calculate that East German energy consumption was only 1.1 percent higher in 1984 than in 1980 while GNP and industrial production were 7.0 percent and 8.4 percent higher respectively (see figure 5). Official statistics show a marked shift in the transportation mix; truck usage declined 31.1 percent between 1980 and 1984, while the use of more efficient railroads and inland waterways rose 0.5 percent and 22.4 percent, respectively. 25X1

- The regime claims that labor productivity rose over 6 percent on average in 1981-85, including an 8.4 percent increase. Although our measures of combined factor productivity show less improvement, the trend has been upward over the past 2 years, following stagnation in the late 1970s and sharp decline in the early 1980s. Much of this gain, in our judgment, reflects tighter management of labor and capital. Legal travelers and emigres report that managers reacted to the stiff labor tax by reducing overmanning through layoffs and reduced hiring. Enterprises also appear to be responding to the prods of bank credit policies in order to economize on investment and direct much of it to exports. 25X1

25X1

Table 2
East Germany: Annual Rates of Growth by Sector of Origin

Percent

	1966-70	1971-75	1976-80	1980	1981	1982	1983	1984	1985
Total GNP	**3.2**	**3.5**	**2.4**	**2.4**	**2.0**	**0.0**	**1.6**	**3.2**	**2.4**
Industry	4.1	3.3	2.9	2.9	3.2	1.1	1.9	2.0	2.2
Agriculture and forestry	0.4	3.7	1.6	0.8	2.7	−1.3	2.9	8.0	3.8
Construction	7.7	4.6	2.7	1.5	−2.1	−1.1	0.8	1.0	1.8
Transport and communications	4.4	4.9	2.1	2.1	−0.8	−6.8	−0.7	2.6	1.2
Trade	4.5	5.3	2.1	2.8	1.3	−1.4	−0.3	4.3	4.2
Housing	0.8	1.2	0.8	1.3	1.0	0.9	0.8	0.9	0.8
Government and other services	2.1	2.7	2.7	3.2	2.7	2.1	2.1	2.8	2.7

Source: L. W. International Financial Research, Inc.

[redacted] 25X1

The GDR managed these gains even as it generated a large net outflow of resources to foreign creditors. Import controls and better export performance helped generate the largest hard currency trade surpluses in GDR history in the early 1980s, despite sharply deteriorating terms of trade. We calculate that a $1.8 billion deficit in 1979 was replaced by a $1.5 billion surplus in 1982. This $3.3 billion increase in net exports was a major drain on the domestically available resources of a country whose GNP, we estimate, was $145 billion in 1982. Reported nominal exports rose 41 percent while imports fell 18 percent in that period. We calculate that during 1981-84, the period of adjustment to financial pressures, East Germany boosted real exports to the West by 19 percent per annum—more than any other East European country.[13] At the same time, the GDR markedly closed its trade gap with its largest trade partner, the USSR, putting further pressure on the domestic economy. [redacted]

[13] This calculation is based on other East European, particularly Hungarian, prices. The estimate could be misleading to the extent that East German products and prices are not exactly the same as in other East European countries. [redacted]

We believe the improvement in exports to the West resulted in part from a combination of better quality goods and more effective marketing. The GDR during the early 1980s, for example, began to export microelectronic components on the basis of good quality and low price. East Berlin claims that the value of production meeting world quality standards was 109 percent higher in 1984 than in 1980 and amounted to 21 percent of production versus 13 percent in 1980. Western businessmen generally confirm improvements in the quality of export goods, although the GDR still falls short of many Western quality standards. [redacted] changes in the foreign trade enterprises have made them more responsive to customer requests, improved service of export goods, and facilitated communications with production combines. [redacted]

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The hard currency trade surpluses led to repayment of much of the GDR's foreign debt. We estimate that the GDR's net hard currency debt fell from $12.3 billion in 1981 to about $6.8 billion at yearend 1985.

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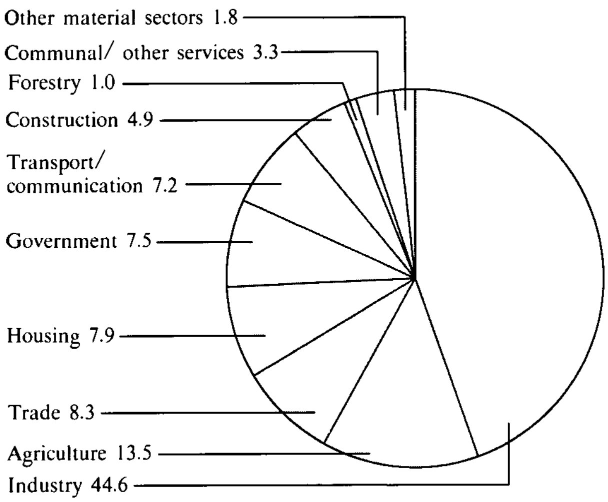
Figure 4
East Germany: GNP by Sector of Origin, 1984

Percent



Source: L.W. International Financial Research, Inc.

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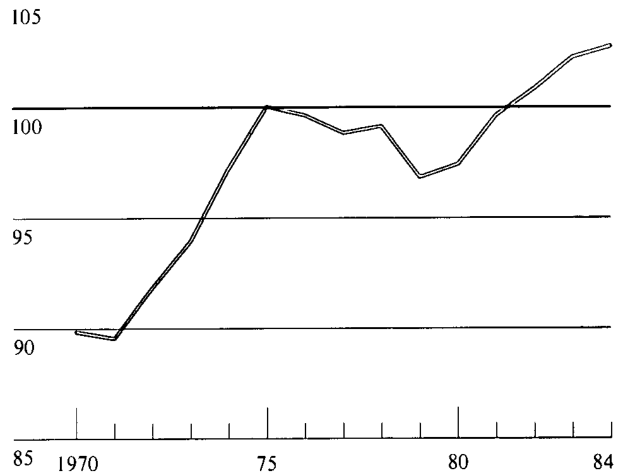
Figure 5
East Germany: GNP Produced per Unit of Energy, 1970-84

Index: 1975=100



Source: C.I.A. estimate.

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In addition, East German assets at Western banks reporting to the Bank for International Settlements reached $6.5 billion at yearend 1985, by far the highest reserves among East European countries. As a result, the Western banking community again was eager to lend; East Berlin regularly declined loan offers and managed to secure more favorable terms on some existing credits.

East German statistics, Western trade data, and our calculations all point to a balanced recovery from the financial crisis of 1982-83 and a restoration of steady growth unique in Eastern Europe. East Berlin has managed to adjust its economy to internal resource constraints and external trade pressures and is again pursuing the main economic tasks of the 1970s—steady growth and rising personal consumption. Our estimates show that, after stagnating in the early 1980s, personal consumption is again rising at rates equal to or above those of the late 1970s.

Perhaps most important for East Germany's economic future, the country has continued to improve its technical base. Although knowledgeable Western observers still rate many East German products as being several years behind comparable Western goods, GDR goods remain, in many instances, technological leaders within CEMA, and some high-tech goods are very competitive in the West. We believe the East Germans are particularly advanced in optics, microelectronics, machine tools, and industrial robotics. On the downside, however, the Soviets, in addition to praising the East German economy, made clear in the 1986-90 USSR-GDR trade protocol that they want more of East Germany's technologically advanced industrial output.

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The Human Factors Contributing to Success

We believe that a number of important human variables have helped make the organizational changes effective in East Germany. The regime has sought in recent years to use its human resources more effectively by boosting its already considerable labor skills—the product of a strong basic educational system and an industrial tradition. Official statistics show continued growth in the number of university and technical school graduates employed in economic institutions; in industry, for example, the number of such graduates totaled 135.8 per thousand workers in 1984, up from 119.7 per thousand in 1980. The number of workers receiving some form of training (including apprenticeships) rose about 2 percent annually in the early 1980s (in a roughly constant labor force) and has reached about 85 percent of workers. The regime also has an active training/retraining program for workers displaced by structural change. The result is that the quality of labor is widely regarded in both East and West as fairly good, [redacted] *few complaints about untrained personnel.* [redacted]

East Germany's senior economic managers appear to be highly capable individuals. The senior half dozen economic decision makers within the party and government are well schooled, with a broad range of experience. [redacted] *they generally act decisively and are able to communicate decisions quickly via both party and government command channels. While well informed on the details of the economy,* [redacted] *they generally seem to avoid meddling in day-to-day operations, leaving those to combine and enterprise managers.* [redacted]

The combine directors-general generally seem to impress Western observers as competent industrial managers. They typically are fairly young by Western business standards, well educated, and have reputations as tough administrators who sometimes rule their combines as minifiefdoms. Some also have high party rank, including a few with SED Central Committee membership, which helps foster combine interests and facilitates planning and communication within party channels. [redacted] 25X1

The high caliber of the economic leadership appears to be at least partly the result of a growing economic meritocracy. Although the party demands compliance with basic political norms, promotions in the economic field appear to be made mainly on the basis of ability; some combine directors-general reportedly are not SED members. The growing incentives, moreover, apparently are increasing the competition among younger managers for promotion. [redacted] 25X1

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The party shows little tolerance for incompetence or corruption. Mittag, [redacted] *has* 25X1 *pointedly criticized individuals at his semiannual meetings with all directors-general. The party newspaper* Neues Deutschland *has also been more critical* 25X1 *of the performance of specific combines in recent years, increasing pressure for improvement.* [redacted] 25X1 *in 1982, Minister for* 25X1 *Agriculture Buhrig was fired for poor performance and Minister for Electronics and Electrical Engineering Steger was dismissed for failure to boost exports.* 25X1 *More recently the party, in May 1986, discovered that officials in charge of construction of the new ferry port of Mukran had failed to complete some* 25X1 *work on schedule and rescinded honors granted them* 25X1 *only a month earlier. The party has vigorously routed out corruption in other cases.* [redacted] 25X1

The Shortcomings

The macroeconomic statistics show marked improvement, but not all of East Berlin's actions have been successful; some may have even been counterproductive. Despite its leading position in CEMA, the East German economy still lags well behind advanced Western industrial countries in efficiency and innovation. Some of the fundamental elements of the East German management system could preclude a narrowing of that gap. [redacted]

Some policies tend to inhibit initiative. The loss of power of VEB management to the combine director-general probably reduces somewhat the incentive and authority for enterprise managers to introduce innovations and promote greater operating efficiency. The large combine bureaucracies probably tend to limit risktaking despite official, high-level encouragement of initiative. Moreover, the combines' tight rein on scientific organizations limits their freedom to conduct the basic research that is needed for technological breakthroughs. In addition, some knowledgeable Westerners argue that financial incentives for firms are too focused on the negative and fail to adequately encourage combine and enterprise risk taking. Continued tight central control of investment limits enterprise managements' freedom to use profits, further inhibiting entrepreneurial behavior. [redacted]

Some actions have impeded East Berlin's quest for economic efficiency. The regulatory emphasis on production of consumer goods and the requirement that all combines manufacture such items, no matter what their specialities, means that some producers are likely to be inefficient; the inefficiencies could grow as the emphasis on consumer goods continues. The reduced investment of recent years that was forced by financial stringency, even though accompanied by efforts to boost its effectiveness, may have long-term deleterious effects on industrial efficiency and international competitiveness. Tax regulations on capital assets, in conjunction with reduced investment, are encouraging extended use of old capital goods that often are inefficient and large consumers of maintenance services—a standard Communist problem. In many cases, the GDR probably would be better advised to scrap the machinery. [redacted]

The size of the combines and their dominant roles in industry can cause problems and probably have generated some. Ministerial control of industry may suffer from the monopoly status of combines. Ministers could be loathe to make desirable changes that would disrupt the operations of sole producers of key outputs in the short run and that also could affect prospects for ministry-level plan fulfillment. The large size of combines and near absence of small- to medium-size independent enterprises may limit the economy's flexibility in responding to changing conditions, particularly in Western markets. Improved FTE performance probably has only partially offset this tendency. [redacted] 25X1 25X1

Finally, the plethora of changes in recent years—reorganizations, altered supplier links, regulations, shifts in performance criteria, for example—has created adjustment problems in planning and operations, which some Western observers believe have been only partly resolved. They should tend to diminish, however, with time. [redacted] 25X1

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The Future and Its Challenges

East German leaders' public comments [redacted] suggest strongly that East Berlin will continue the "economic strategy of the 1980s" and that no major changes in economic management are in the offing. Honecker said explicitly in June 1985 that the economy is no place for "experiments," and the 11th SED Congress in April 1986 reconfirmed the existing course. The five-year plan directive released at the Congress projects a steady economic course with most macroeconomic goals in line with those of 1984-85 and offers no significant new initiatives (see table 3). [redacted] 25X1 25X1 25X1

Knowledgeable West Berlin observers of the GDR economy have told the US Embassy in East Berlin that they expect no major changes in economic direction before the 12th SED Congress in 1991. [redacted] 25X1

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Table 3
East Germany: Economic Goals for 1986-90

Percent annual growth (except where noted)

	1986-90	1985 Plan	1985 Actual [a]
Produced national income	4.4-4.7	4.4	4.8
Gross national product [b]	NA	NA	2.4
Industrial production	4.1-4.4	4.3	4.5
Productivity in industry	8.3-8.5	7.1	8.4
Unit production costs in industry	−2.2	−2.7	−2.2
Unit consumption of raw materials	−4.0	−2.8	−3.5
Personal monetary income	3.9-4.1	4.0	3.9
Retail trade turnover	3.9-4.1	4.0	4.2
Investment per year (*billion East German marks*)	69.2	56	62
Grain production per year (*million metric tons*)	11.8-12.0	10.7	11.6
New or reconstructed housing units per year (*units*)	212,800	203,125	212,222

[a] Plan and actual performance data are not exactly comparable because historical data exaggerate real economic growth by including inflation and some double-counting. Plans, by contrast, do not purposely incorporate such biases.
[b] We tentatively estimate GNP and industrial production growth in 1985 using Western accounting practices to have been 2.4 percent and 2.2 percent, respectively. Western accounts usually yield lower growth rates because they remove distortions of turnover taxes in prices and include such "nonproductive" sectors as housing and government, which generally grow more slowly than industrial output.

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Soviet Pressure for "Reform"?

We believe that the East Germans feel little pressure to make changes in their economic system in response to Gorbachev's calls for "radical reform" of the Soviet economy. The East German leadership seems to be basking in Gorbachev's praise of the combine system and the economy's apparently good results. East German officials have told the US Embassy and West Berlin economists that they have studied other socialist "models," including the Hungarian, and found them wanting. Nonetheless, East Berlin has to be wary of antagonizing Moscow by gloating over its relative success;

Serious Challenges Remain

Despite the comparative successes of recent years, East Berlin has not solved basic problems that could slow economic growth in the future. The USSR is demanding more high-quality goods, resource constraints remain, and East German industry remains inefficient by Western standards. In our judgment, the East Germans have already wrung out most of the easily attainable gains from organizational and policy change. The regime increasingly will have to find new ways to generate needed productivity improvements.

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To continue posting improvements, the East Germans face decisions that cut to the heart of a centrally planned economy. Reform of the pricing system is probably the important challenge confronting economic policymakers. Failure to set prices at their economic cost continues to distort decisionmaking and leads to the misallocation of resources.

The most readily observable pricing distortion involves retail prices. The Honecker regime, as part of its consumer policy, has subsidized "basic" goods and services so that their prices have remained at the levels of the 1930s. This has mollified consumers, but by artificially boosting some consumer demand, it risks draining away increasingly valuable resources from industrial investment. This distortion has grown dramatically since the 1984 increase in procurement prices of farm products. According to official statistics, subsidies rose 140.9 percent from the period 1980 to 1985 to 40.6 billion marks—over 17 percent of both the state budget and produced national income. While less evident in budgetary terms, the lack of a mechanism to measure the true costs of capital, labor, and industrial inputs is an even greater hindrance to overall efficiency. Without accurate measures of costs and benefits, planners cannot reliably determine the best use for constrained resources.

A number of East German economists have called for an overhaul of the economy's pricing mechanism. Indeed, beginning this year, the regime launched a revaluation of chronically undervalued capital assets that has resulted in increased capital costs and higher prices for output. The intention is that higher real costs will induce combines to use their plant and equipment more efficiently. In our judgment, however, a more thoroughgoing effort at price reform—akin to Hungary's intent to link producer and consumer prices to world market levels—is highly unlikely. The Honecker regime's commitment to low, stable prices of basic consumer goods appears unshakable. More important, the regime is unlikely to alter its administration of industrial prices because of its ideological aversion to surrendering control of economic activity to market forces and the ensuing complications to planning and coordination.

Modernization and Restructuring

The regime must also increase outlays for investment, particularly if its program for promoting scientific and technological progress is to succeed. The Honecker regime has long touted improvements in science and technology as a motor for economic growth, but its importance in East Berlin's economic strategy 25X1 appears to be increasing. Domestic resource constraints and toughening international competition have apparently convinced East Berlin that more rapid gains in technological development are essential. Soviet emphasis on modernization, including the CEMA science and technology program through the year 2000, have added impetus. In response to these pressures, the regime in 1985 announced a new five- 25X1 year plan for scientific and technological development; it has not, however, released details.

If this initiative is to be more than rhetoric, the economy must receive more investment, much of it high-tech capital goods from the West, to make up for the reductions of recent years and to modernize key industrial sectors. East Germany's much improved financial position has still not weakened the regime's caution about increasing investment and imports from the West. East Berlin must decide what and how much it can afford to buy, while maintaining the hard 25X1 currency trade surpluses and ample reserves it feels, 25X1 according to foreign trade officials, are needed to protect against another liquidity crisis.

chemicals, microelectronics, 25X1 energy, machine building, and pollution control will receive priority. Shares were not reported in the SED's 1986-90 economic directive, however, and decisions about the allocation of investment will be crucial to East Germany's effort to keep pace with international technological development. 25X1

Apart from the level of funding, East Germany must also address organizational impediments to research and development. The regime's answer seems to be still tighter links between combine R&D units, the research institutes of the Academy of Sciences, and the universities. The regime is trying to foster these links by allocating a greater share of science and

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technology funds to combine management and then letting the combines fund directly research and development in academic institutes. The regime argues that direct funding by combines and contractual arrangements will improve communication between the researcher and end user of new technology. It will also strengthen accountability, because combine managers will more diligently monitor S&T spending if their funds—and profits and bonuses—are directly at stake. A possible risk, however, is that East Berlin will limit still further the freedom of scientists to do basic research in favor of undertakings with clear, but short-term economic payoffs. In our judgment, this strategy could weaken East German scientific capabilities over the long term and reduce the scientific community's contribution to the economy. [redacted]

Outlook

Given the challenges and uncertainties facing East Germany, many Western observers question whether East Berlin's economic goals for 1986-90 are achievable. In an absolute sense, this skepticism is valid. Shortages of the most desired consumer goods will remain, product quality will remain inferior to Western standards in many areas, and the East German economy will be hard pressed to keep pace with the technological developments of the most advanced Western countries. Moreover, the conditions under which the economy operates could worsen:

- Renewed deterioration in the East-West trade and financial climate could again constrict East Berlin's access to needed Western imports.

- Severe economic deterioration in the USSR could lead Moscow to impose even stiffer demands, draining resources needed for consumption and investment and orienting East German technological capabilities even more to Soviet needs.

- Uncertainties resulting from an eventual succession to Honecker could complicate economic management. [redacted]

Nevertheless, we judge that a severe deterioration in East Germany's economic environment is unlikely. East Berlin's hard currency financial position is much more secure than 5 years ago, and its options for exploiting East-West economic ties consequently greater. [redacted] 25X1
25X1
the Soviets presumably recognize 25X1
that excessive pressures risk political instability in their key East European ally and a diminished economic contribution to their development strategy for CEMA. Finally, a new East German leader seems unlikely to make major changes in economic management. Although a new SED general secretary could redirect policy just as Honecker did after Ulbricht, we have no evidence of major differences over economic 25X1
policy in the leadership. In contrast to the latter years of Ulbricht's rule, the possible successors to Honecker seem generally satisified with economic management and performance. [redacted] 25X1

On balance, therefore, we judge that the East German economy will remain strong, by East European standards. East Germany's economic performance in the first half of the 1980s indicates that East Berlin has forged managerial institutions and skills capable of coping with changing and difficult circumstances. East Berlin's technological superiority within CEMA and its new initiatives should ensure that scientific and technological developments will prove a stronger economic motor than similar efforts in other Bloc countries. The East Germans seemingly have been more successful than the other CEMA countries in streamlining the centrally planned system and adapting it to the demands for more "intensive" growth. Not only has East Berlin generated economic growth, but it has been able to do so through cost reductions, productivity gains, and scientific and technological progress. Although forecasting growth rates is subject to many pitfalls, we judge that real GNP growth may average about 2 percent annually in 1986-90 barring a serious deterioration in external conditions. This

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would be in line with recent performance and sufficient to maintain the GDR as a major economic power in CEMA and to support its role in the Warsaw Pact.

Is There An East German Economic "Model"?

The series of East German actions in recent years may offer some ways of improving other socialist economies, but we believe they represent more of an example of how a socialist economy can be improved without market-oriented reforms rather than a "model" for others to emulate. The main reasons lie in the difficulty of transferring to other societies culture-specific institutions and methods designed to address specific problems.

East Berlin's actions have evolved piecemeal to correct East German problems within the context of a small economy composed of well-educated, reasonably well-disciplined workers, and experienced managers. The policies were designed to improve perceived weaknesses in industry, energy, investments, foreign trade, and agriculture within the basic operating procedures of this corporate culture. We believe that identical measures tried elsewhere in CEMA would be less successful and that only some aspects—the reorganization of foreign trade enterprises and the agricultural price reform, for example—could be readily transplanted. 25X1

The Soviet Union—by far the most enthusiastic admirer of East German economic management within CEMA—has concentrated its praise of the GDR on the changes in industry but as yet has emulated little. We believe Moscow is particularly attracted by improved efficiency in the use of energy and raw materials, continued tight central control, and minimization of the political risks that real decentralizing reform could entail—a concern apparent in Soviet attitudes toward reforms in Hungary and China. Yet some Soviet economists have expressed skepticism that East Germans methods can be successfully borrowed. Most of the pessimism has focused on the perceived lower levels of skill, dedication, and initiative of the individual Soviet worker and manager compared with their GDR counterparts. We suspect that the Soviets might eventually adapt aspects of East German practice as part of a "smorgasbord" approach to reform—selective borrowing of practices from other socialist states modified by Soviet conditions, needs, and experience. 25X1 25X1

Continued improvements in the efficiency of the East German economy will keep East Germany an economic power in CEMA and help East Berlin support Moscow's domestic economic programs. It should—despite recent friction over bilateral trade relations—keep the GDR the largest trading partner of the Soviet Union and maintain East Germany's position as a technological leader within CEMA. Improvement in export competitiveness, despite recent losses from the decline in oil prices, probably will keep East Berlin in hard currency trade surplus and keep the GDR a 25X1 favorite of Western bankers. Finally, a continued example of East German prosperity could help spur other East European regimes to redress clear economic ills, further contributing to the strength of CEMA and the power of the Warsaw Pact. 25X1

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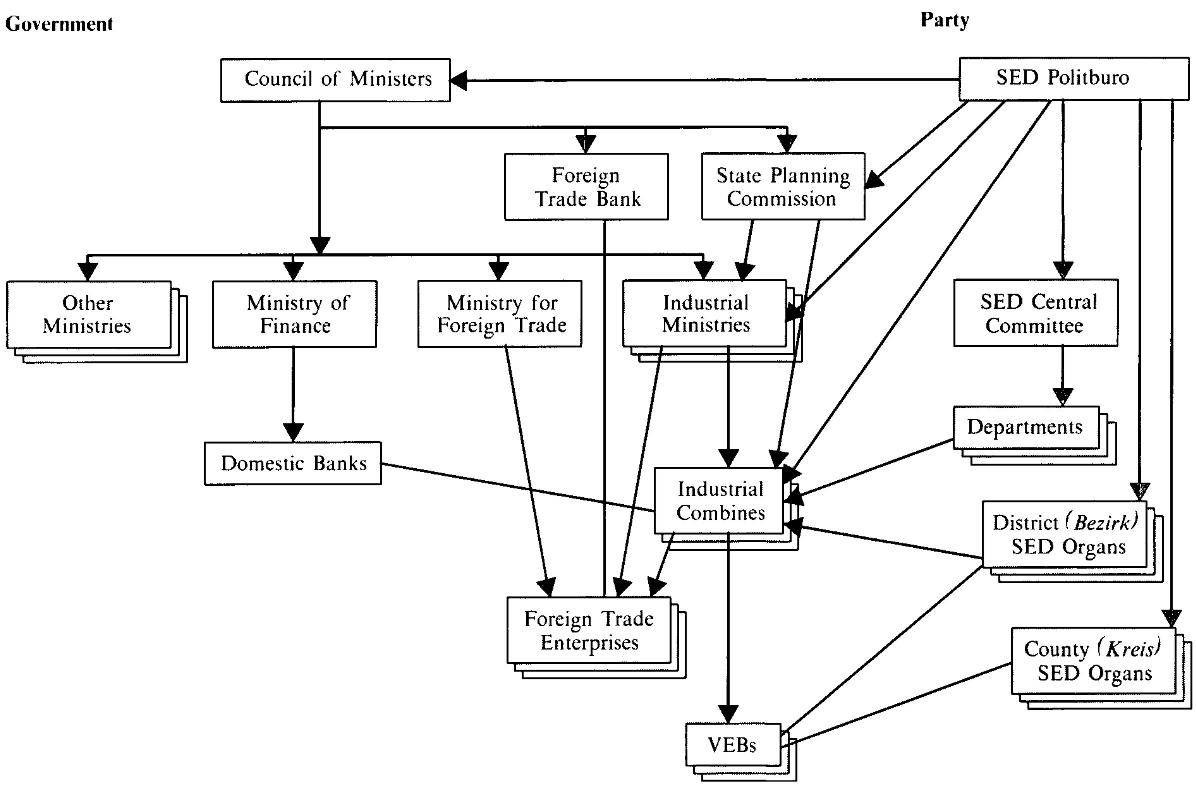
Figure 6
East Germany: Government Party Economic Decision Links

— Formal command
— De facto command
— Communications



This diagram shows lines of formal institutional command, de facto command, and communications between the industrial combines, key government bodies, and SED organs.

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Appendix B

Party/Government Economic Management Links

The *Sozialistische Einheitspartei Deutschlands* (SED) and the government play major and often overlapping roles in East German economic management. Each issues directives and receives feedback through its channels. Complaints about each are conveyed through the other. In addition, many senior economic decision makers hold both party and government positions. [redacted]

The party clearly retains ultimate power over economic management, as it does over the entire GDR. The Politburo of the SED Central Committee is the primary decisionmaking body, deciding major policy questions and, in some cases, micromanaging the economy. The chief economic policymaker on the Politburo is Party Secretary for Economics Guenter Mittag; although but one of 22 members, he apparently is given comparatively free rein by his colleagues. Other economic figures on the Politburo are Werner Jarowinsky, Party Secretary for Trade and Supply; Werner Felfe, Party Secretary for Agriculture; and Guenther Kleiber, formerly an industrial minister and now the GDR representative to CEMA. State Planning Commission Chairman Gerhard Schuerer is a candidate member. [redacted]

Politburo members direct the actions of the Council of Ministers, the highest government body; Chairman of the Council of Ministers Willi Stoph also is a Politburo member. The Council of Ministers, in turn, supervises the State Planning Commission, the ministries, and through them, the factories and farms. Mittag, who holds government rank only as a deputy chairman of the Council of State, sometimes intervenes at all levels of the government economic hierarchy. [redacted]

If a problem is serious or the importance of a project great, a Politburo member personally supervises the issue. In early 1982, for example, Politburo member Horst Dohlus directed the repair of a coal gasification unit at Schwarze Pumpe, which had been destroyed by an explosion, and had threatened the entire domestic gas distribution system. Politburo members regularly check on the progress of "national defense" projects. [redacted] 25X1

The senior party leadership also operates through economic departments of the Central Committee and the districts (*Bezirke*). A department watches each 25X1 government ministry, its actions, and the activities of its subordinate organizations, and communicates regularly with its charges at all levels. The district party organizations have sections that follow the activities of the economic entities operating within their borders. 25X1 The district party organizations touch base regularly with the party organs within combines and 25X1 *Volkseigene Betriebe* (VEBs); the Politburo uses these contacts to direct combine activities. [redacted] district party officials discuss 25X1 policy issues with combine directors-general to ensure that operations are in accordance with SED policy 25X1 and are in the interests of the workers and the district. County (*Kreis*) parties are too small to exercise significant continuing supervision over combines that spread beyond their jurisdiction, but party officials regularly 25X1 weigh in on more local issues, like plant working conditions. [redacted]

25X1

The party organizations within combines are minor economic decision making bodies. They apparently do not contribute to policymaking or overall operational 25X1 management. Instead, they concentrate on party organizational matters and ensurance of worker rights, such as safety and the adequacy of combine-provided worker housing. During the austerity period of 1982-83, for example, the local party apparatuses (*Bezirk* and below) actively sought to ameliorate discontent over shortages in factory canteens by quickly promising improvements and requisitioning supplies. In these ways, the party performs some of the functions that otherwise might be handled by the toothless official labor union (*Freier Deutscher Gewerks chaftsbund*) (FDGB). Combine party organs apparently complain to district party authorities about combine management only occasionally, and then over comparatively minor issues. [redacted] 25X1

Communication up the chain seems confused organizationally, but apparently is fast and reasonably efficient. Combines and enterprises often use both government and party channels to complain about problems, and the party often intervenes to correct ministerial problems. For example, combine managements complain to the party when failure of another combine to provide needed parts threatens interruptions in production. Party authorities typically act quickly—communication from bottom to top may take a few hours—to uncover the cause of a problem and correct it, apparently with only perfunctory coordination with industrial ministries. Similarly, though apparently to a lesser extent, economic managers complain through government channels when local party officials become too heavyhanded. Party and government bodies collaborate in, for example, investigating falsification of enterprise performance reports or crimes such as embezzlement. [redacted] 25X1

The distinction between party and government authority is blurred further in practice by the dual roles that many officials play. Final decisions on major economic policies, made by the party, are in fact influenced by all aspects of economic management because many senior government officials—including combine directors-general and industrial ministers—hold senior party positions, including seats on the Central Committee. Combine directors-general often use their party positions to help procure more resources for their combines, according to East German contacts of the US Embassy; these officials saw this practice as a way for successful directors-general to acquire means to increase further their successes.
[redacted] 25X1

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