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DCI Remarks on Vulnerabilities of the Soviet Economy
and Possible Policy Initiatives for the US

1. The Soviet military buildup in conventional and strategic arms is frightening. Perhaps more threatening is Soviet strategy in working with Cuba, Libya, South Yemen and Vietnam to destabilize and back insurgencies in strategically located third countries. Since 1975 this kind of insurgency has been supported in over a dozen countries, five successfully. Four of those still under way are at the three most strategically critical choke points in the world -- Oman on the Straits of Hormuz, North Yemen and Somalia at the mouth of the Red Sea leading to Suez, and Morocco on the Strait of Gibraltar. To support all this, the Soviet Union gave Cuba close to \$4 billion this year and Vietnam over \$1 billion. It got half a billion in hard currency by selling arms to Libya, some of which Libya redistributed elsewhere. The Soviets earned 20 percent of their hard currency from arms sales.

2. The key to the drive for military power has been the ability of the Soviet economy to provide small but steady improvements to the standard of living. Until recently, the Russian economy provided enough additional butter to support the acquisition of more and more guns.

3. We now recognize that a key element in Moscow's ability to keep this strategy alive through the 1970s was help from the West, in the form of credits to buy equipment, technology, and food. In addition, the Russians helped themselves by acquiring Western technology through espionage, and by earning hard currency through exports of oil, arms and gold. US inertial guidance technology and precision grinders have produced the accuracy and MIRVing in Soviet missiles which have resulted in budget busting appropriations for MX and Trident.

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4. The Soviet economy is now spiraling down toward an extended period during which annual growth rates will be in the 1 percent to 1.5 percent range at best. Shortages of oil and declining rates of labor productivity are major causes of this declining performance. In the Soviet Union, most rises in productivity have come from increments to the labor force, as opposed to technological innovation. But due to low birth rates during the 1960s among ethnic Russians and other Slavs, the Soviet Union now has a shortage of workers in key regions. During this decade, the work force in the Russian Republic -- which accounts for 60 percent of the country's total industrial output and 75 percent of total military output -- will shrink by 1,300,000.

5. It is in large part to compensate for this shrinkage in the work force that the Russians have turned to Western equipment and technology. The fact is that their need for our equipment and technology is greater now than it was during the heyday of detente. But the Soviet Union's ability to import equipment and technology is declining rapidly due to a shortage of hard currency:

- a. Oil prices are dropping.
- b. Gold prices are low (due, in part, to heavy Soviet selling).
- c. The market for Soviet arms is softening.
- d. Western banks are increasingly reluctant to extend credit to the Soviet Union -- or its satellites -- at preferential rates.
- e. Three consecutive poor harvests have forced the Russians to divert billions of dollars from equipment and technology purchases to grain.

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6. All this spills over into diverse sectors of the economy. There have been major disruptions in the already seriously burdened Soviet rail system resulting from priority to harvest and food shipments, overland shipments to Iran and Afghanistan, slow freight clearances and maneuvers around Poland. This has produced embargoes of rail nets, car shortages, further disruptions to industry.

7. Monitoring the economic troubles of the Soviet Union, and its satellites, is now a top priority of the US intelligence community. We are learning just how close to the edge Moscow is now operating. Reports have recently surfaced that:

a. For economic reasons alone the Russians will reduce the number of foreign military trainees in the USSR.

b. The quality of Soviet potatoes has degenerated so badly that to reverse a decline in crop yields the Soviet Union recently imported 20,000 tons of seed potatoes from the Netherlands. That suggests the old joke about Soviet efficiency being so bad that if the Russians ever do take over Saudi Arabia, within five years they'll have to import sand. As for those seed potatoes, our source has further reported that due to "an unfortunate bureaucratic error," the entire crop from those potatoes was shipped to market and eaten.

c. We are also learning that productivity declines anywhere in the Soviet bloc trigger industrial back-ups throughout the bloc. A lack of Polish coal has closed steel mills in Russia; a lack of Polish integrated circuits has forced a decline in the output of Czech computers that use these chips.

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8. Since 1965, the growth in Soviet defense spending in ruble terms has averaged about 4 percent a year -- about the same as that for the overall economy. Over most of this period, the defense share of GNP was a relatively constant 12 to 13 percent. In 1979, the share increased by a percentage point to 13-14 percent, and has increased slightly since then because of declining growth in GNP. Given current and future economic conditions, maintaining historical rates of growth in defense spending will be economically and politically more difficult. Nevertheless, on the basis of observed military activity -- the number of weapon systems in production, weapons development programs, and trends in capital expansion in the defense industries -- we expect that Soviet defense spending will continue to grow at about its historical rate through at least 1985. In this case, the defense share of GNP would increase to at least 15 percent in 1985 and could approach 20 percent by the end of the decade. With an increase in production of less than 2 percent to continue a 4 percent annual increase in military spending, the military will have to increase its share of the increment from the present 25 percent to 50 percent by 1985 and 66 percent by 1990. It's difficult to see how Moscow can continue its arms buildup without strangling its economy without continued help from the West.

9. For Kremlin leaders, the trick will be to keep the old strategy going for a while longer by somehow finding enough additional money to support current levels of defense spending while fending off disaster in the civilian sectors. One option would be to order a tightening of belts, using more police power if necessary to keep the lid from blowing. A second option would be to "starve" the satellites to feed the Motherland, for instance by reducing subsidies the Soviet Union now provides to Eastern Europe by selling oil at roughly half the world market price. Another option would be to find

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alternate sources of hard currency, and thus to continue imports of Western technology, equipment, and food. Alternate sources of hard currency could include:

- a. Credits from new lenders, such as Mideast governments.
- b. Increased exports of raw materials including natural gas, minerals, and increased exports of chemicals.
- c. Access to wealth without spending hard currency through a Soviet drive politically, economically or militarily toward the Persian Gulf is a source of worry. At least so far, all these activities have a strong ad hoc flavor. Kremlin leaders seem to be winging it, so to speak, rather than confronting the issue squarely and adopting a coherent, comprehensive response. It is probable that no major decisions will be made until Brezhnev leaves the scene. Indeed, the pressing need to start making decisions may speed his departure. The ouster of Khrushchev in October 1964 was hastened in part by the perceived failure of his economic policies, as well as his international setbacks and domestic political struggles. The man who succeeds Brezhnev will be the first Soviet leader to take power at a time when his country is, arguably, the world's number one military power. If US will is perceived as so weak, the ability of Moscow to intimidate is enhanced. Mideast governments may respond to Soviet threats by extending credits at low rates of interest--or by selling oil to the Soviet Union and its satellites at sweetheart prices. A variant of this option would be for the Russians to get what they need without actually spending hard currency, for example by bartering or by intimidating Mideast governments into selling oil at sweetheart prices--or taking control of the Persian Gulf outright. All we can say is that the pressures are intense.

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10. To some extent, the Russians are pursuing all these options:
 - a. As for belt-tightening, we know that food is being withheld from shops, and transferred instead to key industrial enterprises such as the Kama River truck plant for distribution to workers. This keeps discontent among workers down--and places the burden of the cut-backs on those least likely to cause trouble, such as pensioners.
 - b. As for starving the satellites, the Russians are raising their oil prices from 50 percent of the world price to 90 percent.
 - c. A push is on for new sources of hard currency; the Yamal pipeline will provide the Russians with about \$9 billion a year, starting in 1987 or 1988.

11. What can we do:

We can work to deny credits to the Soviet Union. As you know, we are exploring this path now. But perhaps we can look beyond the usual financial centers and find ways of blocking new sources of credit, such as Mideast governments and multi-national lending organizations.

We can work to limit the Soviet Union's ability to earn hard currency. Developing alternate sources of energy for Europe--for instance by developing Norwegian natural gas fields or boosting US coal exports--is one promising way.

We can and are strengthening our efforts to deny the Soviet Union access to Western technology and equipment.

We can work to use food to influence Soviet policy. The US, Canada, Australia, and Argentina control 78 percent of all wheat in world trade, 87 percent of all corn, and 90 percent of all soybeans. By way of comparison, the 13 OPEC nations control just 71 percent of world oil. At current prices, for about \$20 billion--less than one-tenth of the defense budget--the US could purchase every bushel of grain on the world market.

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It should take only a fraction of that to hold farmers in the food growing countries harmless from the consequences of scaling down wheat for the Soviet Union. That would be very powerful leverage indeed but it would be an extraordinary measure which cannot be taken lightly. It would be difficult to justify in world opinion unless taken for a very specific and important purpose. We are likely to face a gravely intensified anti-nuclear campaign during the spring and summer. The use of economic inducements to achieve arms limitations has been discussed before and always foundered on the difficulty of measuring and verifying budget reductions and other general measures of arms limitations. A better result may follow if negotiations are confined to very specific measures, continued credits and grain in return for the mutual, verifiable destruction and renunciation of specific weapons.

12. Finally, we can seek to develop a concerted strategy and policy with our allies to apply our combined preponderance of economic power with a combination of major leverage points - energy, technology, food and credits - to offer a phased package of carrots and sticks to induce Soviet restraint in its international behavior. An effort should be made to have the Versailles Summit product a declaration avowing a coordinated policy for economic relationships with the Soviet Union utilizing options like these.

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