EXECUTIVE SECRETARIAT

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D/ Executive Secretary

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12 January 1982

MEMORANDUM FOR: Deputy Director for Intelligence

FROM: Director of Central Intelligence

SUBJECT: Articles on Poland and Soviet Union

1. Here is the Wall Street Journal editorial and Nagorski op-ed article on Poland. We need a study, as we discussed this morning, on how the milking of Poland squares with the cost of empire. We also need a study on how the debt can be applied to alter the prospects for the pipeline.

2. The story from Sunday's Washington Post by Dusko Doder attracted my interest by spelling out:

- -- How the Soviets cut their capital spending by $42 billion over five years.
- -- How the Soviets had to put 27% of the investment into agriculture.
- -- How the Soviets will have to make an energy investment of $170 billion over four years.
- -- How the Soviets have increasing consumer subsidies and $460 billion annual budget.
- -- Needs of Eastern European countries related to Soviet industry.

3. [redacted] has a line on the economist at Indiana University in Bloomington, Indiana, who has devoted years to studying economic relationships between the Eastern European countries and the Soviet Union. He believes that the cost of empire has been overstated because it fails to reflect the manufactured goods which the Soviets pull out of the Eastern European countries at a below market price. His perception on our $22 billion cost of empire calculation might be worth having and you might usefully illuminate the degree of dependence of the Soviet economy on getting components from other Eastern European countries. 25X1

[redacted] 25X1

4. Admiral Inman was telling me this morning how the Polish telephone system may be fouled up for a long time by the thorough job the Pols did of cutting off communication when they imposed martial law, and someone here told me today that the Soviets have been getting a large part of their telephone equipment from Poland and that this may foul up their internal communications.

William J. Casey

Attachments:
3 articles

CONFIDENTIAL

THE WALL STREET JOURNAL
8 January 1982

The Consequences of Polish-Soviet Trade

By ZYGMUNT NAGORSKI

Reports from the military junta in Warsaw indicate that trials soon will be held of former high Communist Party officials responsible for the country's economic disaster; many will be charged with corruption, others with incompetence. But the trials will almost certainly spare from public accusation the main culprit — the Soviet Union.

Among the luxury items the Solidarity period in Poland brought to that unhappy country was freedom of disclosure. There were so many disclosures of public documents revealing the manner in which previous governments had run Poland that some important information went unnoticed. One such disclosure suggested the extent to which the Soviet Union carried the principal blame for the gradual decline of Poland's economic welfare and for the dramatic growth of Polish indebtedness to the West. At a relatively minor gathering of provincial party officials last spring, a document was presented by a party member describing the economic consequences of the trade policies the Soviets imposed on Poland over the last five years.

In 1976, according to the document, Russian leaders convinced their Polish counterparts that it would be in their mutual interest to transact trade in a specially created accounting system and that the Russians should be permitted, and even encouraged, to purchase from Poland finished and semi-finished products in exchange for raw materials.

Limited-Use Ruble

The trade agreement's unit of exchange was described as a transferrable ruble, which is the term often used to describe the unit used to settle trade accounts among the Comecon partners. But this system seems to have been uniquely developed between Poland and the Soviet Union. Poland's debts to other members of the Soviet bloc could not be paid in this monetary unit, nor could it be used to accumulate monetary reserves. In short, in spite of its official label, the new unit of payment introduced as the only permissible one in 1976 was neither transferrable nor liquid.

It allowed the Soviet Union to bypass the problem of hard currency. Using hard currency received in loans from the West, Poland would purchase licenses, some raw materials, semi-finished products and food from Western suppliers. Poland was then asked to sell a wide range of finished products to the Soviet Union.

For bookkeeping purposes, the value of a dollar for these transactions was set at 67 kopecks, and later 62 kopecks, even below the official level of the regular Soviet ruble. The Poles calculated in the party meeting document that the Soviet Union was making a clear profit of about 30% on each dollar transacted. Poland, which paid in dollars to the West, was the loser.

During the party meeting at which the disclosure of this agreement was made, one speaker drew a daring conclusion: Poland's high indebtedness to the West was in direct proportion to the volume of Poland's trade with the Soviet Union.

To check on the validity of that assumption, it is necessary to look back. The new system was introduced roughly five years ago. Until 1976, Poland's indebtedness to the West amounted to $3.8 billion, in spite of the fact that the first five years of the decade saw tremendous industrial growth and a high level of investments in heavy industry. Today's debts amount to over $27 billion.

Poland's trade balance with the Soviet Union was on the positive side and on an average, Poles were able to accumulate around $3 billion annually in their hard currency reserves. They also had at that time a fairly solid credit rating in the West. Until then, all the Soviet-Polish trade was conducted through clearings. Goods sold to Russia were calculated on the current value of the dollar; the same principle was applied to Soviet goods sold to Poland and then the entire transaction was recalculated in rubles. Poles were losing a little due to the inflated value of the ruble but it was the least they could expect. Once the system was changed in 1976, the entire picture of trade with the Soviet Union changed.

"The reasons for the present crisis," the party meeting document states, "are rooted in the unjust and unfair conditions of our foreign trade, conditions which can be described as robbing Poland of its hard currency reserves." In addition to depriving Poland of its hard-won currency and forcing it into further debt to the West, the system made the Polish market an extremely attractive hunting ground for official Soviet buyers.

Scores visited Poland from 1976 onward. Inhabitants of Warsaw recalled endless television coverage about arrivals and departures of Soviet dignitaries: ministers, directors of industrial sectors from Soviet Asiatic republics and others. Shortly thereafter, a connection was observed between sudden shortages of goods and products and the direct, professional interests of the departed visitors.

After the Soviet minister of energy left, coal was not readily available on the market; power plants began receiving lower quality coal, reducing productivity by 15% to 17%. A visit by the minister of chemical industry resulted in a shortage of chemical fertilizers. Drugs were in short supply after a huge order was placed by the visiting Soviet minister of health. The most damaging of these visits was that of the man in charge of the Soviet agricultural sector. From then on, Poland became an active exporter of grains and meat to the Soviet Union.

Even without official visits, the document says, the Soviet Union increased its role as a trading partner of Poland in a number of other sectors. Moscow became the largest importer of Polish power stations and high voltage equipment; it tripled its purchases of mining machinery; it increased considerably imports of railroad cars and locomotives. Today, the USSR is the largest importer of Polish telephones and communication equipment. Five million units of telephone receivers were exported from Poland to the Soviet Union in 1978 alone. Altogether, according to the official Polish statistics in 1978, exports of industrial machines and equipment increased by over 30% from the preceding year. The list, presented at the provincial party meeting, is far from complete.

Airplane engines, computers, shipbuilding machinery and armament factories have also been listed as heavily oriented toward Soviet export markets. All these finished goods called for heavy injections of high technology, spare parts and other items obtainable in the West only for hard currency.

The document also cites the remarks of a top Polish government official on the high level of industrial activity needed to fulfill Soviet requirements: "According to the declaration of Minister Marian Krzak (currently minister of finance), published in Dziennik Baltycki (The Baltic Daily, No. 75, 1981), in order to secure the necessary production to fulfill export needs it would have been necessary in 1981 to secure an additional loan from the West of $11 billion."

An indirect reference to that state of Soviet-Polish trade appeared in a statement two days ago from Moscow and reported over Warsaw radio regarding new Soviet loans to be granted to Poland. There will be a decline in exports of capital goods from the Soviet Union and considerably lower exports from Poland to Russia due to economic conditions in Poland. The announcement also added that the USSR, due to a lack of hard currency in Poland, will assume the role of sole supplier of oil, natural gas, pig iron and saw timber. It is worth remembering that in the past the Soviet Union exported to Poland about 9 million tons of iron ore and 13 million tons of oil annually.

The attractiveness of the Polish trade to the Soviet Union under the new arrangements is clearly illustrated by the degree that Soviet-Polish trade grew over the years. The last three five-year plans between the two countries can be taken as indicative. According to statistics cited in the party meeting document during the first of these, 1966-70, the volume of trade grew by 8.2%; during the second, 1971-75, still operating on the principle of clearances, the growth amounted to 17%. In the last five-year period, 1976-80, the increase was 22%. Considering that Polish productivity increased during that last period by 5.8%, the gap between productivity and export requirements can be easily understood.

The Roots of Solidarity

That gap also explains shortages in Poland of food and industrial goods. In 1980, only 4% of industrial production was earmarked for the agricultural sector and even that meager share was not delivered. Exports to the Soviet Union drained domestic Polish markets, contributed heavily to the Polish indebtedness to the West and indirectly must have been responsible for the initial economic upheavals among Polish workers. These upheavals led eventually to the birth, success and ultimate temporary demise of the Solidarity movement.

The Polish economic crisis cannot be fully attributed to the Soviet export exploitation. But judging from the facts and figures as they emerged during the liberalization period in Poland, and never challenged by either Soviet or Polish officials, it was a considerable factor. Conventional wisdom often voiced in the West that the Soviet Union has a vested interest in seeing Poland afloat is only partly correct. Poland, as it emerged from the above analysis, has been an excellent conduit of goods and services that the Soviet Union would have had to buy outside the Eastern bloc for hard currency. Instead, Poland paid the bill. It was Poland that earned itself a poor credit rating, and it was Poland that attempted to free itself from both export requirements and other forms of Soviet direct and indirect pressures and paid the ultimate price.

It has been reported that the Soviet Union has "helped" Poland in paying part of its interest due to the West. The Soviet Union should also seriously consider contributing a major part of the principal of the Polish debt.

Mr. Nagorski is director of executive seminars at the Aspen Institute for Humanistic Studies.

THE WALL STREET JOURNAL
8 January 1982

REVIEW & OUTLOOK

The Issue in Poland

Yesterday our Seth Lipsky disclosed documents showing that in the wake of the Polish crackdown, the State Department's first instinct was to urge the banks to go easy in their negotiations on debt rescheduling. While State's economic wizards later thought better of such lunacy, it remains clear that no one in charge has picked up a clue that in Poland the debts are *the* issue.

We do not mean to denigrate the human rights implications of the Polish tragedy, nor the political lesson of yet another demonstration of the inability of communism to either tolerate or totally suppress freedom and diversity. But from the standpoint of U.S. national interests, the Polish economic crisis and its impact on Western debts has an even more portentous aspect. It is the first eruption of an issue transcending Poland and going to the heart of Soviet-American relations. To put the issue in its most dramatic form, it is this: Are we going to continue to allow and even encourage Western banks to finance the Soviet military machine?

How does this come about? For starters, it is useful to think of Poland the way Leonid Brezhnev thinks of Poland—and indeed all other members of Comecon—as a Soviet vassal state. As Mr. Nagorski reveals elsewhere on this page today, the Soviet Union in 1976 created a "transferrable ruble" to, in effect, obtain a highly favorable exchange rate from its Comecon partners and thus buy manufactured goods cheaply. To provide these goods, the satellites were encouraged to borrow heavily in the West to buy machinery, raw materials and semifinished manufactures. Western bankers and businessmen were thrilled with the new "vitality" in the East, an illusion that caused them to allow the hard currency debts of the East Europeans to rise out of all proportion to their ability to repay (see tables).

Soviet Bloc Debt
(Net hard-currency debt to the West in billion current U.S. dollars)

	1970	1980	1985-f
Bulgaria	0.7	2.7	4-5
Czechoslovakia	0.6	3.4	5-6
East Germany	1.4	11.8	18-20
Hungary	0.6	7.0	10-11
Poland	1.1	21.9	31-35
Romania	1.6	9.0	19-21
USSR	1.0	9.6	30-35
Comecon Banks	0.3	4.1	6-7
Soviet Bloc Total	7.3	69.5	123-140

Source: Wharton Econometric Forecasting Associates.
f-Wharton forecast.

In simplest terms, the Soviet Union exploited its Comecon partners as a conduit to obtain Western goods on the cuff. As the Wharton tables show, Soviet hard currency debt has itself expanded sharply and is expected to rise further in the years ahead, but it is not yet nearly as far out of line with any prudent measure of repayment ability as the debts of Poland, Hungary and East Germany. The Russians got the TV sets and Wartburgs and the Poles, East Germans and Hungarians received the bills.

The Soviets got by with this by literally holding guns to the heads of satellite party leaders; Soviet troops and tanks ring Prague and Budapest, heavily occupy East Germany and surround Poland. What the Russians didn't foresee was that East European workers, first of all the Poles, would grow tired of having the fruits of their labors purloined. Without doubt, the absence of goods to buy with zlotys contributed to the Polish uprising.

The Soviet exploitation of Western credit markets and East European workers has had the primary purpose of enabling the Soviets to build and maintain a vast military establishment. The primary role of that establishment is to intimidate the Western European suppliers of goods and credit and absolutely control the Eastern European suppliers of labor. To this end the Soviets spend some 15% of their total GNP for military purposes, more than twice the percentage for the U.S. They have some 3.7 million troops in uniform, 3,300 combat aircraft, 55,000 tanks and a grand array of other lethal equipment. The officers of this force are part of the Soviet elite, highly pampered in a society where ordinary people suffer severe deprivation.

In short, the economies of Eastern Europe are organized to support the economy of the Soviet Union, and the economy of the Soviet Union is organized to support its military machine. Into this process the Western banks have pumped some $60 billion in the last decade. If the forecasts by Wharton Econometrics prove true, they will pump almost this amount again into the same process over the years of the Reagan administration.

Indeed, with the breakdown of the Comecon credit pipeline and another big failure down on the collective farms, the Soviet Union has had to go directly to the West for money. The Bank for International Settlements estimates that the Soviets borrowed over $15 billion in hard currency last year. Reports from Europe yesterday suggest this borrowing is continuing (see page 2 of the Journal). And Soviet gold sales in the West more than tripled to 250 metric tons in 1981, according to London market estimates.

Despite all these circumstances, Western politicians are in their usual dither, insisting that there is nothing much they can do about the Russians' ham-fisted crackdown on the Polish workers. Quite clearly there is a great deal to do, and it is in the interest of the West to do it.

Ironically, the simplest thing the U.S. government could do would be to ask the banks to face the real risks of these loans. A significant, modest and entirely justified step would be for the Comptroller of the Currency to suggest banks take a 50% write-down on loans to Poland, and perhaps Hungary and East Germany. Bank regulatory officials in other Western countries could be encouraged to take parallel action. This would immediately raise the cost of credit to the whole Soviet bloc.

The credit-worthiness of the Soviet Union itself is endangered by the Comecon debts, for its own economy is dependent on theirs in many ways. If it undertakes to provide the umbrella the banks have hoped for, its own resources will be stretched. Wharton Econometrics has not calculated a debt service ratio for the bloc as a whole; an analyst there captures the attitude of the banks by saying they would find such a figure "meaningless." But the OECD, which uses a more stringent debt-ratio calculation, puts the bloc at 0.4, including the Soviet Union. Some umbrella.

Beyond that, there is the definite risk that over the next few years the Soviet workforce itself will go Polish. The Soviet Union's resources are becoming ever more strained. Its inefficient use of manpower, a product of central planning and regimentation, coupled with a low birth rate, has severely stretched the manpower supply. Productivity and morale are low, owing in part to the fact that Soviet workers fare no better than the Poles at the hands of the Communist elite. Alcoholism is epidemic. The Red Army's inability to subdue Afghanistan is requiring larger infusions of troops.

Debt Service Ratios
(0.2 or higher regarded as a danger signal in international lending)

	1970	1975	1981-f
Bulgaria	0.30	0.44	0.29
Czechoslovakia	0.09	0.11	0.25
East Germany	0.14	0.26	0.43
Hungary	0.16	0.24	0.57
Poland	0.19	0.32	0.87
Romania	0.36	0.21	0.32
USSR	0.07	0.13	0.07

Source: Wharton Econometric Forecasting Associates.
Debt Service ratio is the ratio of debt service (interest plus repayments) to sum of hard currency export balance and net balance in invisibles.
f-Wharton Forecast.

In this lies the West's great foreign policy opportunity. The future of the Soviet economic system depends on access to the Western banking system. Instead of encouraging the banks to roll over debt in the wake of Poland, the government ought to be making clear that this access depends on a modicum of Soviet good behavior. By any realistic risk assessment, indeed, it is military spending and repression of Eastern Europe that call its credit standing into doubt. To price the Soviets out of the credit markets, what the government chiefly has to do is bring the lenders face to face with economic reality.

10 January 1981

Soviets Plagued With Shortages, Inflation

By Dusko Doder
Washington Post Foreign Service

MOSCOW—The Soviet economy, the world's largest state-run enterprise, is entering the new year amid clear signs of crisis.

Food shortages and soaring inflation have been created by three successive bad harvests, the strain of military competition with the United States, and the overall costs involved in maintaining an empire ranging from Cuba to Vietnam to Afghanistan to Poland.

But there are growing indications of basic structural weakness that the centrally planned system is imposing on the Soviet economy, which today is second in size, complexity and strength only to America's.

While the rule by decree may have been effective in previous decades in laying the infrastructure for industrialization of a young Soviet state, the system now appears in danger of choking itself in its own cumbersomeness.

There are two additional and long-term factors that are only beginning to affect the economy.

One is the harsh fact that the Soviet Union is no longer a producer of low-cost energy conveniently located in European Russia. Rather, it is becoming a high-cost producer and poorly efficient consumer of abundant resources located in distant Siberia and becoming increasingly costly.

The other is posed by an acute demographic problem. The country's rate of population growth has been falling since 1960, when it was twice the current level of 0.84 percent per year. Economic forecasts warn that acute labor shortages should be expected "in the most immediate future."

The Kremlin leaders have introduced reforms to refine the existing system. New financial incentives and modest decentralization steps have been taken in an effort to raise labor productivity. But there has been resistance to these reforms at the local level.

There was a note of near despair in recent speeches by President Leonid Brezhnev when he called for harder work, increased motivation and new improvements.

The economic system has also come under public attacks in the Soviet press. "We obviously have an abnormal situation here," the Communist Party newspaper Pravda said last week. "The planning mechanism was supposed to have been improved, yet we did not get rid of old sins." Pravda directly attacked the state planning commission for various economic setbacks.

A commentary in the daily Sovyetskaya Rosiya also minced no words about the difficulties. Criticizing low labor productivity, the paper said that new reforms were not being implemented. "The labor organization in factories is not functioning," it added, "and the second misfortune lies in the fact that the economic system itself is not working" as it should.

Despite growing frankness in the media about the nature of Soviet economic difficulties, there are no new or radical ideas on remedies to be applied.

The lack of a rational pricing system has burdened the $460 billion annual budget with the costs of ever-growing subsidies. At the same time, Moscow had to budget a 50 percent increase in its energy investment plan—to over $170 billion over the next four years—to produce marginal net increments in oil, coal and electrical energy output.

According to official figures, 27 percent of the entire investment allocations continue to be channeled into the weak agricultural sector, while well over $6 billion will have to be spent for grain and fodder imports again this year.

The exact figures for military expenditures are not disclosed here. But there are clear signs that the Russians felt compelled to divert some additional resources for defense purposes in response to President Reagan's plans to rebuild U.S. strategic strength. The Kremlin has reduced its planned capital expenditures on capital construction by $42 billion during the current five-year plan.

The Polish crisis has posed additional economic strains. Soviet raw material, energy and food shipments to Poland have been extensive. The Poles and other Soviet allies are getting Soviet oil at 50 percent of the OPEC price. Meat shipments to Poland have further reduced availability of meat in the Soviet Union.

The Polish crisis also has produced economic dislocations within the Soviet bloc economies. This is taking place at a time when the cost of supplying 10 million tons of oil to Cuba and supporting clients in Africa and Asia are steadily increasing.

The economic situation with its accumulated difficulties provide economic evidence for Moscow's sincerity in arms reduction talks with the United States.

It also provides an insight into the proverbial lethargy of Soviet bureaucracy, which has resisted changes in the economic system.

The combination of adverse long-term trends and the pressure to match America's military spending may create conditions here for radical changes in the economy. The present leadership, however, is committed to modest changes and cautious rejiggering of resources.