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The East German Economy: Austerity and Slower Growth

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An Intelligence Assessment

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August 1983
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An Intelligence Assessment

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This paper was prepared by [redacted] Office of European Analysis. [redacted] 25X1
[redacted] of EURA contributed to the analysis. The paper was coordinated with the Directorate of Operations. [redacted] 25X1

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Comments and queries are welcome and may be directed to the Chief, East European Division, EURA, [redacted] 25X1

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The East German Economy: Austerity and Slower Growth

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Key Judgments

Information available as of 30 June 1983 was used in this report.

East Germany continues to experience external financial problems despite a dramatic improvement in its hard currency trade balance over the last two years and the recent approval by Bonn of a five-year $400 million loan by West German banks. East Berlin has responded to its payments difficulties by launching a harsh austerity program that has cut imports, consumption, and investment and boosted exports. Because bankers generally remain cool about lending to Eastern Europe, however, East Germany's borrowing problems will continue, and East Berlin, we believe, will almost certainly have to maintain painful and politically unpopular adjustment measures. 25X1

Thanks largely to an austerity program, we believe East Germany is likely to run another current account surplus in 1983. We project a borrowing requirement of $3.3 billion for this year, which is nearly 25 percent below that of 1982 because of a drop in scheduled debt amortization and lower interest expenses. Nevertheless, East Germany could still have a liquidity crisis, especially if Western bankers continue to extend only short-term credits or refuse to roll over more maturing debt. It cannot count on significant help from its CEMA allies or most Western governments, although Bonn might provide more assistance if East Berlin makes some political concessions. 25X1

The austerity program has exacted some social and economic costs. We estimate that real personal consumption, which fell in 1982, will decline further—a difficult situation for a country accustomed to having the highest personal consumption in the Soviet Bloc and living standards comparable with those in some West European countries. Because of the continued need for austerity, we expect that GNP growth, which dropped to only 0.5 percent in 1982—the lowest of party General Secretary Honecker's tenure—will remain slower over the next several years than in the 1970s. The reduction in investment, moreover, is likely to hurt the economy's future international competitiveness, hindering the regime's efforts to sustain growth while running a current account surplus. 25X1

The regime probably will become even more hard line in reaction to its economic troubles. Never seriously interested in Hungarian-style economic reform, Honecker is likely to push centralization further in the face of adversity. In our judgment, he would be deterred from such a path only by a significant change in Soviet attitudes toward reform and even then would change course only reluctantly. Continued economic troubles and austerity, moreover, could require the regime to intensify even more its pervasive control over East German society although a tougher domestic policy would jeopardize further financial assistance from West Germany 25X1

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[redacted]

The East German Economy: Austerity and Slower Growth [redacted] 25X1

In our opinion, East Germany's external financial problems result in large measure from the poor economic policies of the regime of Erich Honecker. After succeeding Walter Ulbricht as First (later General) Secretary of the Socialist Unity Party (SED) in May 1971, Honecker announced a 1971-75 plan directive that focused on ambitious gains in economic growth and living standards. Because East Germany faced serious manpower and raw material constraints, the regime planned to accomplish these ends by upgrading its manufacturing sectors primarily through technology purchased from nonsocialist countries, particularly the industrialized West. While hard currency imports rose sharply, the East Germans were relatively unsuccessful at expanding exports. By the end of the 1970s East Germany had run up a formidable foreign debt necessitating, in the early 1980s, considerable economic retrenchment at home. [redacted]

This paper explains the reasons for East Germany's economic difficulties, discusses its efforts to stave off financial crisis, and analyzes the present and future economic and social costs of the regime's adjustment measures. [redacted]

The Manpower and Resource Vise

The Honecker regime's decision in the early 1970s to increase trade with the West reflected the realization that manpower and raw material constraints were becoming severe impediments to continued economic expansion. In particular, Moscow was increasingly unwilling to maintain the growth in deliveries of raw materials. The regime planned to overcome its labor shortage through an industrial modernization program based on Western science and technology. [redacted]

[redacted]

Throughout the 1960s the size of the East German population stagnated because of emigration and low birth rates. Although emigration virtually stopped after the Berlin Wall was built in 1961, reduced fertility rates—births per 1,000 persons fell from 17 in 1960 to 10.6 in 1973—caused the population to decline further; by the early 1970s it was some 1.7 million smaller than in 1949. The regime was able to keep the industrial labor force growing—by some 87,000 during the decade—only by continuing to move workers out of agriculture, and encouraging the employment of women. By the end of the decade, East Berlin had achieved one of the highest labor force participation rates in the world but had virtually exhausted labor reserves. [redacted] 25X1

By the end of the 1960s the leadership also encountered increasing difficulty securing from the USSR adequate amounts of raw materials vital to continued industrial growth, given the resource-poor nature of the East German region (see figure 4). Ever since Moscow had stopped blatant exploitation of its portion of conquered Germany in the 1950s, the Soviets had been providing increasing quantities of materials on favorable terms, mostly in exchange for East German manufactured goods. This enabled East Germany to rebuild the economic base destroyed during and immediately after the war. Beginning in the late 1960s, however, the Soviets began to reduce the growth rate on deliveries of some materials and to increase the amount of manufactures it pressed East Germany to buy. The volume growth rate of imports of Soviet raw materials, by our estimate, slipped from 4.5 percent annually in 1961-65 to less than 2 percent annually in 1971-73. In 1975, after Moscow unilaterally changed the price formula for its oil and raw material prices, East Germany's terms of trade with the USSR deteriorated by over 10 percent and continued, we believe, to decline thereafter.[2] [redacted]

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[2] The Soviets base the prices they charge for commodity sales to CEMA on a five-year moving average of world prices. [redacted] 25X1

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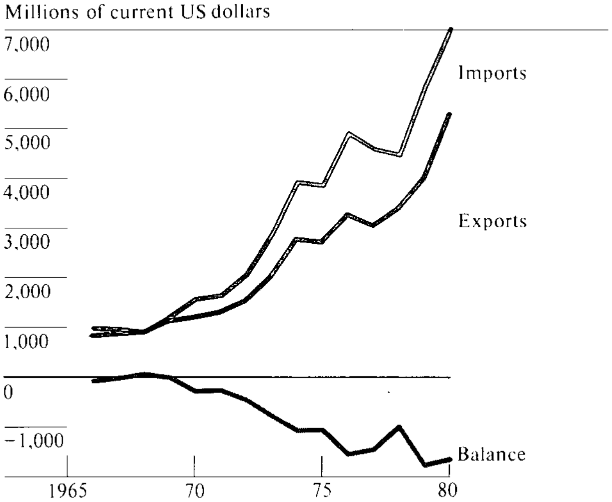
Figure 1
East Germany: Trade With Nonsocialist Countries



Source: Wharton Econometric Forecasting Associates Inc.

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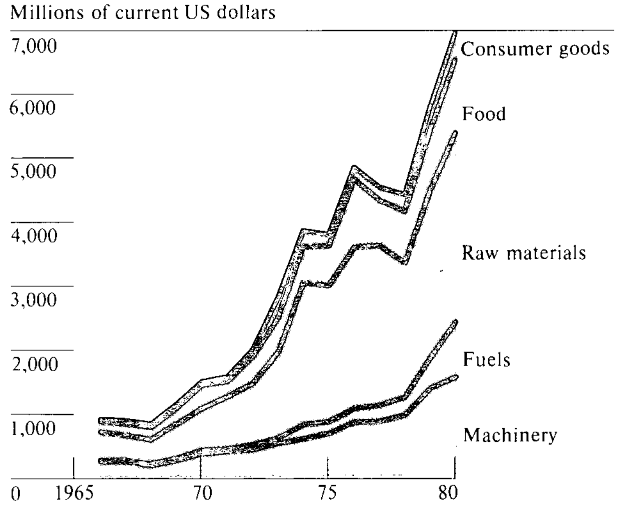
Figure 2
East Germany: Imports From Nonsocialist Countries



Source: Wharton Econometric Forecasting Associates Inc.

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New Strategy: Increased Trade With Nonsocialist Countries

To maintain the growth of consumption and upgrade the country's industrial base, the newly installed Honecker turned to nonsocialist countries for new technology, larger amounts of raw and semifinished materials, and agricultural imports. The gradual warming of East-West relations lowered trade barriers, and Western capital markets became more willing to finance East-West trade, especially after the explosion of oil prices in 1973-74 provided banks with large amounts of recycled petrodollars. Partly because of this increased trade with nonsocialist countries, the regime attained, by our calculation, higher GNP growth in 1971-75 than in Ulbricht's last years, and managed to keep GNP growth in 1976-80 from slowing as much as it did in most other East European countries. We estimate GNP growth averaged 3 percent annually and personal consumption about 2.5 percent annually during the 1971-80 decade (see table 1). By 1975 East Germany, in our estimate, had achieved the highest levels of per capita GNP and personal consumption in the Soviet Bloc, and, by 1980, it had a standard of living rivaling that of some West European countries.

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According to partner country trade data, the value of East German imports from nonsocialist countries rose from $1.6 billion in 1971 to $3.8 billion in 1975 and nearly doubled again by 1980. The value of exports also grew rapidly—reaching $2.7 billion in 1975 and $5.3 billion in 1980—but did not keep pace with imports (see figure 1). With the growth of trade with nonsocialist countries outpacing trade with the Communist allies, East German statistics show that the nonsocialist world's share of total trade rose 5 percentage points in the 1970s, to 33 percent in 1980 (see table 2).

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The increase in imports from nonsocialist countries—averaging 15 to 20 percent annually in 1971-80—was due almost equally to volume and price changes (see figure 2). On the volume side, using East German and

Table 1
East Germany: Estimated Annual Rates of Growth of GNP by Sector of Origin, 1966-82

	1966-70	1971-75	1976-80	1979	1980	1981	1982 [a]
Gross national product, total	**3.2**	**3.5**	**2.4**	**2.7**	**2.4**	**2.4**	**0.5**
Industry	4.1	3.3	2.9	3.0	2.9	3.7	2.2
Agriculture, forestry	0.4	3.7	1.6	5.3	0.8	2.5	−5.9
Construction	7.7	4.6	2.8	1.2	1.5	−1.8	2.9
Transportation, communication	4.4	4.9	2.0	1.7	2.1	0.8	−2.6
Trade	4.5	5.3	2.0	1.4	2.8	1.3	0.6
Housing	0.8	1.2	1.0	1.4	1.3	1.0	0.8
Government, other services	2.1	2.7	2.7	2.2	3.2	1.9	1.9

[a] Preliminary.

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Table 2
East Germany: Foreign Trade by Country Group

Percent of total trade turnover

	Socialist			Nonsocialist	
	USSR	Non-Soviet CEMA	Other Socialist	LDCs	Industrial West
1960	42.77	24.83	7.04	4.28	21.08
1970	39.10	28.22	4.25	4.04	24.39
1975	35.67	30.55	3.46	4.37	25.94
1980	35.48	27.21	3.76	6.10	27.44
1981	37.53	25.92	3.16	4.92	28.49

Source: *Statistical Pocketbook of the German Democratic Republic*, 1982.

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partner country data we estimate that imports from nonsocialist countries approximately doubled during 1971-80:

- Honecker's promise of greater meat supplies led to large increases in feedgrain imports; imports of corn rose from 650,000 tons in 1971 to 3.2 million in 1980. Overall grain imports—most from nonsocialist countries—more than doubled from the late 1960s, reaching more than 4 million tons by 1980 and comprising about one-third of annual grain consumption.

- Purchases of crude oil from nonsocialist countries rose nearly 150 percent in volume terms during the same period.

- Imports of technology from the industrial West also grew, although the exact extent of the increase is difficult to gauge. According to partner country data, the volume of annual East German machinery imports in real terms from nonsocialist countries—a rough measure of purchases of technology—also about doubled during 1971-80.

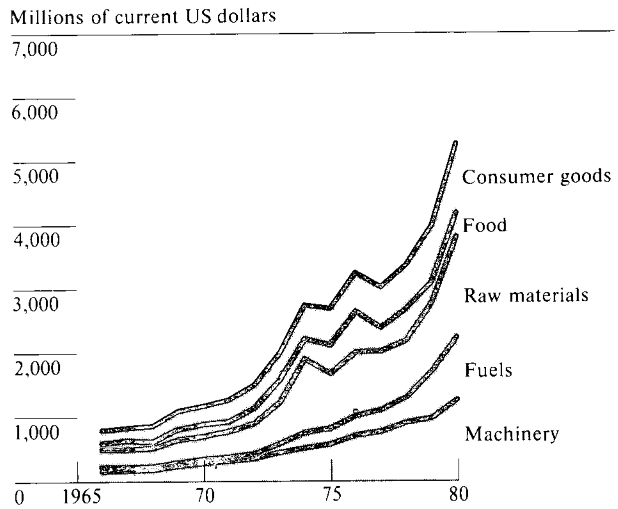
Meanwhile, commodity and oil price booms of the early and mid-1970s boosted import prices. Partner country data indicate that prices for East Germany's raw material imports from nonsocialist countries more than doubled in 1972-74, while machinery prices rose only about 42 percent. [redacted] 25X1

During the 1970s the value of East Germany's export gains to nonsocialist countries averaged roughly 15 percent annually, but the country consistently failed to reach balanced trade (see figure 3). Partner country data show that the value of fuel exports grew most rapidly—on average over 30 percent annually—but from a small base. Most of the increase was the result of shipments of refined oil products. Exports to the developed West of consumer goods—many of them simple, moderately priced products such as furniture—grew an average of about 14 percent annually during the decade. Exports of machinery grew less than 14 percent, and less than overall exports. Much of this gain, moreover, was with LDCs; by 1978 shipments to LDCs actually exceeded those to the developed West even as machinery imports from the West were burgeoning. [redacted] 25X1

The growth of overall trade with nonsocialist countries was paced by increased commerce with LDCs and nontraditional developed Western trading partners, such as the United States. Trade with LDCs climbed over 18 percent annually, on average, during 1971-80, reflecting the increase in energy imports. A similar rise in trade with the United States during the same period was almost exclusively the result of East German grain purchases. The value of trade with West Germany grew more slowly, in part because economic relations at the beginning of the 1970s were already well developed (see table 3). Additionally, [redacted] a conscious effort by the East German leadership to curb economic reliance on West Germany (including West Berlin); the regime wanted to project the image of an independent German state and wanted to enhance political ties with other countries through increased trade. Nevertheless, according to West German and OECD data, West Germany still accounted for nearly half of East Germany's trade with nonsocialist countries in 1980. 25X1

[redacted] 25X1

Figure 3
East Germany: Exports to Nonsocialist Countries



This figure depicts estimates prepared by Wharton Econometric Forecasting Associates Inc., using official East German, Soviet, and CEMA Statistics, and partner country trade data. The five categories used here are from the CEMA Trade Nomenclature (CTN), which is CEMA's equivalent to the United Nations' Standard International Trade Classification (SITC). The machinery and equipment category (CTN 1), roughly equivalent to SITC 7, includes a broad variety of capital goods such as electrical equipment, motor vehicles, boats and some appliances; the category excludes such consumer goods as radios. The fuels category (CTN 20, 21, 22 and 23) is the same as SITC 3, which includes oil, gas, coal and lubricants. The non-food raw materials category (CTN 2, 3, 4 and 5 minus fuels) comprises SITC categories 2 through 5 and 67 through 69 and includes raw and semifinished materials, animal fat and oils, raw chemicals and related intermediate products, iron, steel, and nonferrous metal products. Food and raw materials for food (CTN 4, 6, 7 and 8) is roughly comparable to SITC categories 0 and 1; it includes human food and animal feeds, beverages and tobacco products. Industrial consumer goods (CTN 9) encompasses SITC categories 6 (less categories 67 through 69) and comprises manufactured consumer goods, including textiles and clothing. 25X1

[redacted] 25X1

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Table 3
Intra-German Trade

Million current West German marks

Year	East German		Balance
	Exports	Imports	
1970	1,996.0	2,415.5	−419.5
1971	2,318.7	2,498.6	−179.9
1972	2,380.9	2,927.4	−546.5
1973	2,659.6	2,998.5	−338.9
1974	3,252.5	3,670.8	−418.3
1975	3,342.3	3,921.6	−579.3
1976	3,876.7	4,268.7	−392.0
1977	3,961.0	4,409.4	−448.4
1978	3,899.9	4,574.9	−675.0
1979	4,588.9	4,719.6	−130.7
1980	5,579.6	5,293.2	286.4
1981	6,050.6	5,575.6	475.0
1982	6,639.3	6,382.3	257.0

Sources: West German trade statistics.

[redacted]

But Trade Deficits and Debts Mount

As trade with nonsocialist countries grew, so did hard currency trade deficits. The top leadership failed to take effective corrective measures even though some East German economic planners began to argue by the mid-1970s that growth targets should be reduced, [redacted] The regime also did not adopt systemic reforms to solve longstanding structural problems. Instead it chose to intensify centralization of the economy, partly, we believe, for ideological reasons and partly out of a mistaken belief that this would bring enough new efficiencies to help solve the debt problems. [redacted]

We estimate that the annual hard currency trade deficits soared from $300 million in 1971 to $1.1 billion in 1975 and to $2 billion in 1979 before beginning to fall. Meanwhile, according to our calculations, total hard currency debt climbed from $1.2 billion in 1971 to $3.5 billion in 1975 and to $13.1 billion at yearend 1981 (see table 4). The country's debt service ratio (the ratio of annual principal and interest obligations to export earnings) rose during the same period from 15 percent to 56 percent, second only to Poland's in Eastern Europe. [redacted] 25X1

A number of factors contributed to the rising tide of deficits in the 1970s; most important, in our view, was East Berlin's inability to develop adequately its export industries. We believe that East German industry failed to:

- Assimilate new technology quickly. Despite regime efforts, many East German export goods remained dated and energy inefficient.

- Redress chronic quality problems. [redacted] 25X1
  [redacted] observers regularly rated quality as uneven, and the regime itself gave only 24 percent of its products a "Q" rating for achieving world quality standards in 1980. 25X1

- Adequately market and service the products it could sell in the West. Customers regularly reported inadequate responses to sales and service requests. 25X1
  [redacted] 25X1

In addition, some of the government's centralization efforts proved counterproductive. In agriculture, for instance, the regime increased the size of farms and created highly specialized "industrialized" farms that, by its subsequent admission in the 1980s, had management problems and used large amounts of costly energy. Agricultural output grew slowly, and yields per hectare of cereals, according to official statistics, actually fell over 1 percent in 1976-80 from the 1971-75 level. [redacted] 25X1 25X1 25X1

The deficits also were exacerbated by factors beyond East Berlin's control. Most serious was the overall worsening terms of trade [3] with the nonsocialist world 25X1

[3] "Terms of trade" refers to the relative prices of traded goods of given countries. East Germany's terms of trade deteriorated in the 1970s because the unit prices of its imports grew faster than the unit prices of its exports. As a result, the country had to export relatively larger physical quantities of goods to maintain a constant level of imports. [redacted] 25X1

Table 4
East Germany: Hard Currency Balance of Payments and Debt

Million US $
(except where noted)

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981 [a]	1982 [a]
Current account balance	−293	−197	−383	−689	−1,019	−1,067	−1,446	−1,336	−1,094	−1,858	−1,600	−489	1,246
Trade balance	−299	−268	−483	−774	−1,068	−1,125	−1,591	−1,510	−1,137	−1,810	−1,590	60	1,509
Exports	1,261	1,368	1,642	2,230	3,014	3,062	3,643	3,578	4,158	5,098	6,555	6,714	7,172
Imports	1,560	1,636	2,125	3,004	4,082	4,187	5,234	5,088	5,295	6,908	8,145	6,654	5,663
Net invisibles, excluding interest	56	132	175	220	260	250	450	550	650	800	900	985	950
Net interest	−50	−61	−75	−135	−211	−192	−305	−376	−607	−848	−910	−1,534	−1,213
Capital account balance	298	198	24	647	716	956	1,499	1,112	1,389	2,228	1,974	765	−1,279
Drawings	418	352	354	858	1,367	2,520	1,376	2,156	2,862	4,179	4,168	3,050	1,650
Repayments	120	141	208	276	367	468	708	867	1,113	1,400	1,941	2,250	3,150
Changes in reserves [b]	0	−13	−122	65	−284	−1,096	831	−177	−360	−551	−253	−35	221
Statistical discrepancy [c]	−5	−1	359	42	303	111	−53	224	−295	−370	−374	−276	33
Gross debt	1,197	1,408	1,554	2,136	3,136	5,188	6,118	7,145	8,894	11,673	13,900	14,700	13,400
Commercial	700	855	945	1,510	2,495	4,485	5,043	6,140	7,729	9,672	11,400	11,500	9,965
Official	497	553	609	626	641	703	1,075	1,005	1,165	2,001	2,500	3,200	3,435
Reserves	190	203	325	260	544	1,640	809	986	1,346	1,897	2,150	2,185	1,964
Net debt	1,007	1,205	1,229	1,876	2,592	3,548	5,309	6,159	7,548	9,776	11,750	13,115	11,436
Of which:													
West Germany	460	500	550	675	790	920	1,100	1,420	1,700	1,850	2,000	1,650	1,555
Total debt service	170	202	283	411	578	660	1,013	1,243	1,720	2,248	2,851	3,784	4,363
Debt service ratio [d] *(percent)*	13	15	17	18	19	22	28	35	41	44	43	56	61
Gross annual financing (repayments to medium- and long- term debt plus current account deficit)	413	338	591	965	1,386	1,535	2,154	2,203	2,207	3,258	3,541	2,739	1,904
Net resource transfer [e]	248	150	71	447	789	1,860	363	913	1,142	1,931	1,317	−734	−2,713

[a] 1981 East German trade data are especially inconsistent with partner country data. For this reason, the 1981-82 trade and current account estimates should be regarded as very tentative.
[b] − means increase in reserves and + means decrease.
[c] Adjustment needed to ensure that the capital account balance offsets the current account balance.
[d] Repayments of medium- and long-term debt plus net interest as a share of exports.
[e] Difference between drawings and debt service.

Source: official East German, partner country trade, and BIS data.

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after the 1973-74 oil price explosion. Western experts estimate that East German terms of trade with the industrial West deteriorated by about 10 percent during 1973-75 before stabilizing in the late 1970s and that the terms of trade with LDCs—heavily dependent on commodity prices—deteriorated by nearly 40 percent in 1973-75. [redacted]

Indirectly adding to the hard currency deficits were continued problems with socialist suppliers. To maintain needed imports from the Soviets, who [redacted] toughened trade, credit, and debt negotiations as their economic growth slowed, East Germany apparently was forced to export to the USSR better quality goods, some of which could have been sold to the West. By our count, East Germany spent at least $200 million in hard currency in 1980 and 1981 to replace goods Poland failed to deliver during the height of Warsaw's economic crisis. According to East German statistics, Polish shipments of coal and coke to East Germany fell 59 percent from 1979 to 1981.[4] The cuts were partly to blame for some temporary factory closings in the winter of 1980-81 and prompted East Berlin to seek alternative sources of supply, mainly in the West. [redacted]

The Regime Acts

The deteriorating debt situation and increasing unwillingness of bankers to lend to East Germany finally forced the regime to take effective remedial action in 1981. Although the regime for years had urged increased exports and maintained control over imports, we believe it more seriously pushed its program after the party congress in April 1981. The government upgraded meeting export goals as a criterion for judging enterprise performance and imposed still tighter controls on hard currency imports. As a result, partner country data show that the dollar value of imports dropped 18 percent, exports rose 8 percent,[5] and the regime achieved a $60 million surplus in trade with nonsocialist countries—the first of the Honecker era—and a marked improvement over what we estimate to have been a $1.6 billion deficit in 1980. [redacted] 25X1

The regime took further measures in early 1982. Despite the improvement in the trade account, Western bankers became more concerned about East Germany's large debt and much less willing to extend new credits. To a large extent, their shift in attitude stemmed from further problems with Polish and Romanian loans and the deterioration in East-West relations following declaration of martial law in Poland in December 1981. As a result, in mid-February 1982, Honecker told a group of district party functionaries that the world economic situation had worsened noticeably since December and that further remedial measures were necessary—his first significant public admission of real difficulty. The regime subsequently gave even higher priority to improving its hard currency trade balance and moved, [redacted] to cut imports further and boost exports. [redacted]

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In a series of confidential directives to combines and enterprises, the party ordered:

- Reduced imports of capital goods, industrial raw materials and semifinished goods, feedgrains, and foodstuffs.
- Higher domestic prices for goods imported from the West.
- Emergency sales of hard goods, such as steel, to the West at bargain prices without regard to production costs.

[4] East Germany also receives Polish coal on Soviet account under a longstanding, complicated trilateral trade agreement. Most of the drop in "Soviet" deliveries in 1980-81 probably was due to Polish production cuts. [redacted]

[5] While the dollar costing of imports and exports is necessary for balance-of-payments assessments, changes in trade volume provide the best indication of economic adjustments to the regime's trade controls. Since most East German trade is conducted in currencies that depreciated against the dollar in 1981, the year-to-year trade performance when measured in dollars overstates the degree of import cuts and understates export expansion. Allowing for dollar appreciation and assuming minimal price inflation in 1981, we estimate a fall in import volume of under 5 percent and a rise in export volume of about 15 percent. Similarly we estimate that imports fell about 8 percent in 1982 while exports declined slightly. [redacted] 25X1 25X1

At the same time, [redacted] the regime sought quicker payment for its deliveries, bargained for delays in payment for imports, and accelerated its efforts to secure barter deals in lieu of cash purchases [redacted] East Berlin also diverted to the industrial West goods originally scheduled for delivery to East European countries, and that it undertook some unconventional trade and financing arrangements in order to secure hard currency credits for even very short periods.[6] [redacted] 25X1

The tough new orders were effective in improving significantly the hard currency trade balance. Signaling its satisfaction, the regime released in mid-1982 normally secret trade data that indicated that East Germany had run a trade surplus with the developed West and LDCs of "over" 1 billion Valuta Marks (more than $300 million) in first-half 1982. In March 1983, in another unusual move, the East German foreign trade bank announced a $1.5 billion trade surplus with nonsocialist countries for the year generated by a 17.3 percent rise in exports and a 4.3 percent cut in imports. We accept the East Germans' trade balance figure but believe that the officially reported export and import growth rates are inflated. As a result of the trade turnaround, we estimate a $1.2 billion hard currency current account surplus for the year and conclude that the East Germans began to reduce their hard currency debt for the first time under Honecker. [redacted]

In large part because of the improving current account, East Germany's financial situation stabilized in the second and third quarters of 1982.[7] By the fourth quarter, Bank for International Settlements data, reflecting the growing trade surplus, show a noticeable improvement. Assets rose nearly $700 million during the quarter—to only $120 million below levels a year earlier—while liabilities declined $9 million. [redacted] 25X1

Table 5
East Germany: Officially Reported Performance

Percent growth over previous period 25X1

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	1981 Plan	1981 Actual	1982 Plan	1982 Actual
National income	5.0	5.0	4.8	3.0
Industrial production	5.0	5.1	4.6	3.2
Productivity	5.0	5.4	4.5	3.6
Retail trade	4.0	2.5	4.0	1.0
Construction	2.8	4.1	2.5	4.2
Foreign trade	16	10.1	15	NA

Source: *Neues Deutschland.*

[redacted] 25X1

The Domestic Economy Slows

East Berlin reported achievement of most major domestic goals for 1981 but admitted a significant slowing in 1982 as the import cuts hit home (see table 5). Investment spending declined, and real personal consumption probably dropped for the first time under the Honecker regime. [redacted] 25X1

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For 1981 we estimate that GNP grew 2.4 percent, the same as in 1980, and that industrial production rose 3.7 percent, slightly higher than in 1980. Increased monitoring of imports, reported gains in the efficient use of energy and raw materials, much of which are imported, and probable drawdowns of "reserves" all helped prevent an industrial slowdown. Import cuts were concentrated in areas that would have less immediate impact on overall growth rates. We calculate that as much as 30 percent of the 5-percent cut in imports—after adjusting partner country data to reflect the appreciation of the dollar—can be accounted for by a 1.3-million-ton reduction in feed corn imports, a decline of 42 percent from the 1980 level. The regime held the growth rate of investment to 1.2 per-

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[redacted] on several occasions the East Germans purchased commodities in world markets with 210-day trade financing provided by Western banks, but immediately resold the goods to third parties, mainly LDCs, on 120-day terms. The result was that East Germany got 90-day credit it otherwise would not have been able to acquire. [redacted]

[7] Banks in West Germany do not report their assets and liabilities with East Germany to the Bank for International Settlements, and Bonn refuses to divulge the information. East Berlin may have drawn down deposits in West Germany in order to pay off maturing obligations in other countries and to avoid the appearance of a continuing decline in reserves. [redacted]

[redacted] Although Bonn's Intra-German Affairs Ministry regularly reports the net accumulated debt arising out of intra-German trade, we believe that this total excludes credits from West German banks that are not related to West German–East German trade. Because West German banks have been providing non-trade-related financing since at least the mid-1970s, East Germany's debt to West Germany is almost certainly greater than the announced totals. [redacted]

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The Numbers Game

We tentatively accept the regime's recent trade claims despite considerable inconsistencies between East German and Western trade data. East German trade statistics for 1980-81 (the first such statistics released by East Berlin since 1975) show that East Germany's trade balance with non-socialist countries moved from a $1.6 billion deficit in 1980 to the reported $60 million surplus in 1981 because of a 4-percent drop in imports and a 29-percent gain in exports. But statistics from the OECD and West Germany show the deficit declining from $430 million in 1980 to $240 million in 1981, with a 5-percent decline in exports and an 8-percent fall in imports.

We can nearly replicate East Berlin's reported hard currency trade surplus in 1982 from partner country data. But we believe that because of valuation problems, and possibly deliberate exaggeration, both import and export growth figures are seriously overstated. By our calculations, using OECD and West German figures, exports grew 6.8 percent and imports fell 14.9 percent. Reported imports from OECD countries other than West Germany fell over 32 percent for the year compared with the East German claim of a roughly 20-percent cut. The data show a particularly sharp import retrenchment in the third quarter, which tends to confirm our anecdotal evidence. 25X1

We cannot explain the discrepancy between the March 1983 East German foreign trade bank report and partner country data in 1982. The East Germans were characteristically cryptic, providing scant information about their accounting practices. Despite its financial troubles last year, East Berlin steadfastly refused to release additional information 25X1 *and in early 1983 ceased publication of a* 25X1 *monthly journal that was a significant source of* 25X1 *economic information. We believe the regime probably released aggregate trade figures this year mainly because they were favorable and would impress bankers.* 25X1

Such contradictions between East German and Western partner trade data, the lack of basic information on West German–East German credit flows, and limited East German statistics make us very cautious in our analysis of East Germany's trade and financial situation. 25X1

cent, while concentrating investment resources in export, energy, and high-technology areas; it reduced spending absolutely in the construction, agriculture, and retail sales sectors, according to official statistics. We calculate that the growth of personal consumption slowed slightly to 1.3 percent.

The regime's priority on industrial production was at the expense of other sectors. Industry grew more rapidly than all but one sector—communal services—of the 10 we regularly evaluate. We calculate, for example, that GNP originating in the construction sector fell 1.8 percent while the transportation and communications sector declined 0.8 percent in 1981.

The austerity measures of 1982, however, were significantly more disruptive. GNP growth fell to an estimated 0.5 percent and growth in industrial production to 2.2 percent. The decline in growth rates would have been even greater if the regime had not further expanded its strategy of protecting industry at the expense of other sectors. Moreover, even where imports of industrial inputs were cut, the regime refused to lower enterprise production goals. While this tactic 25X1 may have backfired in some cases, we believe that the overall effect on output was positive as enterprise managers were forced to draw upon "emergency" hoards of raw and semifinished materials. The regime 25X1 kept the pressure on managers, 25X1 by firing several of them for failing to meet quotas and by sacking two industrial ministers in the fall, apparently because of the poor performance of their industries. 25X1

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More Problems With Numbers: GNP

Despite our estimate that the economy continued to grow in 1981 even with a 5-percent import cut with nonsocialist countries after adjustment for the strengthening of the dollar, we have no evidence that the East Germans falsified the economic data on which we have based our estimates. Nevertheless, domestic inflation appears to have increased in 1981—by perhaps 1 to 2 percentage points—and may have biased reported results upward somewhat. In addition, growing economic troubles and strong regime emphasis that managers were responsible for performance may have induced them to increase falsification of plan fulfillment reports submitted to the Central Statistical Administration. [redacted]

We believe that there is a strong possibility that the aggregate official data reported for 1982—including a 3-percent growth in national income—were inflated. Though it is usual for component statistical series to be somewhat inconsistent with aggregate results, the 1982 report seems especially suspect. Our GNP estimate is based on official disaggregated series and the GNP/national income ratio for 1982 is markedly below that of previous years. Moreover, some of the 1982 government's performance statements appear inconsistent. For example, the regime reported that meat consumption remained the same as in 1981 despite production cuts and apparently increased exports, and that transportation of goods declined sharply at the same time that industrial production grew. The regime's increased emphasis on plan fulfillment may have sparked increased plan falsification by enterprise management, and apparently increased inflation in 1982 may have been reflected in the reported results. Finally, the regime's intense insecurity about its political legitimacy may have induced it to alter its own accounting systems to overstate actual performance. [redacted] 25X1

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Produced national income is the Communist world's rough equivalent to GNP, but differs from GNP by excluding most services. Growth of GNP is lower than national income growth because the value of services, including housing, tends to grow more slowly than other sectors of Communist economies. Both concepts are used in this paper; our calculation of GNP necessarily lags behind regime announcements of national income results because component series are not released until after the aggregate plan fulfillment reports. [redacted] 25X1

The regime, in order to cut back sharply machinery imports from the West, reduced investment spending by about 5 percent and slowed down the rate of initiating new industrial projects. Preliminary data through September from some OECD countries and West Germany indicate that East German imports of machinery fell more than any other category, nearly 35 percent. We believe the reduced imports of capital goods contributed to a decline in initiation of new industrial projects and a roughly 5-percent decline in investment spending for the year. [redacted]

The 1982 import cuts hit the consumer hard. The drop in the officially reported growth rate of retail sales to slightly below 1 percent and numerous reports worsened meat and butter shortages, longer lines, locally imposed rationing, and higher prices for consumer goods lead us to believe that real personal consumption probably declined in 1982 for the first time under Honecker. Supplies of imported goods were especially short. The grain import cuts contributed to declines in numbers of pigs, cattle, and chickens; the swine population, for example, shrank by over 7 percent, according to official statistics. [redacted] 25X1

[redacted] 25X1
increased shortages in 1982 provoked growing unhappiness among the populace. Some workers, for example, walked off the job to 25X1

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A brave regime front ignores growing shortages and higher prices. [redacted]

Frankfurter Allgemeine Zeitung ©

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protest shortages in factory canteens and increasingly criticized party activists defending regime policy. Housewives, meanwhile, grew more sullen and increasingly compared their situation to that of the Poles. [redacted]

Despite a somewhat favorable report released by the regime in mid-June, we believe that the continued curtailment of imports increasingly hindered growth of industrial output in early 1983. [redacted] Embassy contacts report that factories throughout the country were curtailing production somewhat and that a few closed for lack of factor inputs. As a result, enterprises laid off some workers, the regime transferred others between factories, and young people entering the job market began to find work harder to come by—very unusual in traditionally labor-short East Germany. [redacted]

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Financial Outlook Improved

We believe that the regime's austerity measures have improved markedly the country's financial situation, and that the chances of avoiding a debt rescheduling

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this year are good. Threats to solvency remain, however, and the long-term adjustment process necessary to reduce its debt will be painful. We believe that East Germany will be able to run a current account surplus again in 1983 and its estimated financing requirement this year of $3.3 billion will be nearly 25 percent below last year's. It will benefit from lower interest rates and the fact that fewer loans come due in 1983.

The near-term financial outlook improved further in late June 1983, when the West German Government decided to approve a five-year 1 billion Mark (about $400 million) loan from West German banks. The loan went through because the East Germans agreed that if they fail to make scheduled principal or interest payments, they will forgo payments by Bonn for regular transportation and some postal services. Bonn would use the funds to reimburse the banks.

But East Berlin is still not immune to a financial crisis (see table 6). The major threat to financial solvency in 1983 and beyond is the possibility that East Berlin may not be able to roll over maturing Western credits. Western bankers for the most part closed their long-term loan windows despite the East Germans' improved current account outlook. Until then, numerous reports indicate that two-year trade financing was the longest term money East Berlin could secure and that it accepted one-year loans because of some bankers' unwillingness to offer longer term credit.

East Berlin's chances of avoiding rescheduling depend heavily upon its maintaining and improving the confidence of international bankers. With the international banking system under increased strain from LDC borrowers, any further deterioration in East-West relations or in the economic or political situation in East Germany or the rest of Eastern Europe might discourage more bankers from rolling over even short-term loans. To bolster its standing with Western bankers, the regime has been punctual in making its debt payments. We believe that it is consciously putting the best face on the situation despite the reduction in lending by some banks and that it hopes for a break in the chilly banking climate before it has to require even harsher sacrifices of the populace or ask for rescheduling. Such a break may depend on the significance bankers place on Bonn's role in arranging the recent loan and the extent to which they believe it represents a West German financial "umbrella."

Table 6 *Million US $*
East Germany: Estimated Financing Requirement 1981-83

	1981	1982	1983
Financing requirement	**5,239**	**4,254**	**3,275**
Current account balance	−489	1,246	1,400
Trade balance	60	1,509	1,500
Exports	6,714	7,172	7,675
Imports	6,654	5,663	6,175
Net invisibles, excluding interest	985	950	850
Net interest	−1,534	−1,213	−950
Repayments of short-term debt	−2,500	−2,350	−1,475
Repayments of medium- and long-term debt	−2,250	−3,150	−3,200
Borrowing sources	**5,550**	**4,000**	NA
Medium- and long-term credits	3,200	2,525	NA
Short-term credits	2,350	1,475	NA
Error and omissions	**−276**	**33**	NA
Changes in reserves (+ = decrease − = increase)	−35	221	NA
Memorandum item:			
Reserves in BIS reporting banks (end of the period)	2,185	1,964	NA

Help To Avoid a Rescheduling?

We believe Bonn's backing was crucial for the success of the recent West German bank loan, and that West Germany may find other ways to help East Germany out of a financial bind.

[redacted]

A failure by East Berlin to respond in some fashion to Bonn's assistance in arranging the recent loan could induce the West Germans to insist on political concessions before they would agree to extend further help. Bonn especially wants the regime to lower the minimum amount of hard currency that Western visitors are required to exchange daily for East German marks because such restrictions reduce much valued travel of West Germans, particularly pensioners, to East Germany. West Germany believes it is important to keep the level of contacts as high as possible for humanitarian reasons and to keep alive hopes for eventual reunification. East Berlin in the past has emphatically refused to link the issues, maintaining that the exchange requirement is an internal East German matter. [redacted]

If a deal to reduce the currency exchange requirement is struck, further West German assistance could be substantial. East Germany long has received West German marks via a variety of noncommercial and semicommercial channels that now provide, in our estimate, at least $1 billion in hard currency annually. The two sides could agree on new construction projects in and around West Berlin—such as efforts to improve rail links—or water pollution control projects that have long been under discussion. Bonn could provide East Berlin a cash grant to compensate for the financial loss East Berlin would suffer by reducing the exchange requirement [redacted]

East Berlin will have difficulty obtaining significant new loans from West German private banks unless they are pressed by Bonn or receive guarantees. Although our knowledge of West German commercial bank activity is limited because of Bonn's refusal to release most intra-German financial data, West German banks, in our judgment, are not inclined to do much more than roll over maturing obligations. They hold large amounts of Polish debt, have lent considerable sums to other East European countries, and are under pressure at home from the recession and related problems such as the bankruptcy of AEG-Telefunken. [redacted] 25X1 25X1

Other Western governments might help out if they believed East Germany's problems threatened their financial or commercial interests. They could for domestic employment reasons agree to extend export credits [redacted] or guarantee the loans of banks granting East Germany credits. But such assistance probably would be relatively small. East Germany does not belong to the IMF and cannot expect Western support such as the BIS loans to Hungary in 1982. [redacted] 25X1 25X1 25X1

The Soviet Union is unlikely to provide enough assistance to avert any financial crisis. As it did to assist Poland, Moscow could provide hard currency grants, accelerate deliveries of goods, exempt East Berlin from price increases, or allow reduced shipments of East German products to the USSR. Moscow, however, has its own serious economic problems, including a hard currency shortage, and seems increasingly to be pursuing its own interests at the expense of its East European allies. Indicative of this is Moscow's roughly 10-percent cutback in oil deliveries to East Germany, which we believe took effect on 1 January 1982. As Soviet raw material prices approach world levels, East Berlin probably will pay more for imports from the USSR. We believe that East Germany will again experience deterioration in its terms of trade with the USSR—the decline for 1982-83 has been estimated [redacted] at about 16 percent. [redacted] 25X1 25X1 25X1 25X1 25X1 25X1 25X1

Industry Trails West in Technology

The East German economy is the most industrialized in Eastern Europe—we estimate that industry produces over 40 percent of GNP—but has made only limited progress toward achieving technological development on a par with Western Europe and the United States. East German statistics show that about 70 percent of industrial output is concentrated in manufacturing, particularly machinery, up from less than 65 percent in 1970. Electronics and machine-building sectors grew most rapidly during the 1970s. But official statistics also show that exports to the West, while including some technologically advanced goods, are largely intermediate goods and relatively unsophisticated manufactured items—a product mix not greatly different from that which prevailed in the early 1970s. These include relatively simple machine tools and machinery; electrical equipment such as cables; relatively simple chemicals and chemical products like dyes and photographic film; refined oil; and consumer goods such as textiles, clothing, and furniture. Many industrial goods, furthermore, are below world standards of quality and technology and find ready buyers only in less demanding markets, particularly the USSR, Eastern Europe, and the LDCs. [redacted] *observers at the semiannual Leipzig Trade Fairs—East Germany's premier marketing events—regularly rate many East German goods as lagging several years behind comparable Western products.* [redacted]

The regime long has been committed to improving its industrial performance. At its party congress in April 1981, it reemphasized that policy in adopting a 10-point "economic strategy" for the 1980s that called for significant gains in productivity and product quality through further use of "scientific-technical progress," particularly in microelectronics and robotics. Output of the industrial ministries that grew most in the 1970s—such as electrical engineering and electronics and mechanical engineering—was scheduled to grow rapidly in 1981-85. The plan also called for sharp reductions in the usage of energy and raw material inputs, but the party did not order major structural changes in the economy, despite the higher prices for and reduced availability of some Soviet raw materials and chronic deficits in trade with the West. [redacted] 25X1

We believe that East Germany's program to improve the quality and efficiency of its products will produce gains. The more technically advanced industrial sectors that East Berlin has been pushing in recent years, such as electronics, probably will continue to outperform the economy as a whole. This development should help keep the East German economy growing faster than most other East European economies, albeit below the rates of the early 1970s. But East Berlin's decision to cut imports of capital will slow the modernization program, delay the introduction of new products, and inhibit needed structural changes. As a result, East German industry will continue to trail its competitors in the West. [redacted]

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East Germany probably will not get any help from its other allies. Poland and Romania remain in financial crises, Hungary is trying to avert one, and Czechoslovakia and Bulgaria, although maintaining current account surpluses, have little to offer the East Germans. [redacted]

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Economic Implications of Continued Austerity

We believe that slower growth will continue in 1983 and for at least the next several years. East Berlin seems determined to reduce its hard currency debt and will closely control the growth of imports from nonsocialist countries that helped fuel growth in the 1970s. Even a resurgence in East Germany's traditional export markets as a consequence of a Western economic recovery will not, we believe, induce East Berlin to dramatically increase imports. Recovery in the West would increase export earnings only slowly and East Berlin would, we believe, use such proceeds to reduce its debt more quickly. [redacted] 25X1

The government probably will maintain its tight rein on investment outlays and imports of capital goods. But such a short-term expedient will retard long-term modernization plans and efforts to develop new internationally competitive industries. The regime has expressed a particular interest in expanding production of high-technology goods such as electronics. The limited East German investment resources probably will be dedicated largely to maintaining production of current export goods, developing substitutes for imports—especially energy—and meeting politically sensitive housing construction goals. We believe that investment in other sectors—probably including retail trade—may be cut back sharply. [redacted]

We regard the call in the 1983 Plan for 4.2-percent growth in national income as overly optimistic and think that the regime's continued unwillingness to reduce production quotas despite reductions in factor inputs will increasingly strain an already taut economy. We believe that managers have few inventories of raw materials and parts left to draw upon. [redacted]

As the import reduction program continues, we believe the quantity and variety of foodstuffs and consumer goods probably will decline further. A senior West German official told a US diplomat in August 1982, that Bonn has firm evidence that East Berlin has completed plans for rationing meats. [redacted] We expect that the population may react with scattered protests, but the regime is closely monitoring consumer attitudes and will doubtless move to head off or crush any serious unrest. As in the past, it will try to blame its troubles on external factors, particularly the alleged US "crusade" against Eastern Europe. [redacted]

Such shortages could significantly reduce the growth of worker productivity. [redacted] Embassy sources already report that workers are leaving their jobs to stand in lines for scarce goods. Official statistics for 1982 show that productivity grew only 3.6 percent versus 5.4 percent in 1981, a trend that may reflect the decline in investment and other negative developments as well as reduced worker effort. [redacted] 25X1

Political Implications

We believe the worsening economic situation is likely to make the regime even more conservative. Honecker has never shown any interest in market-oriented economic reform and seems more likely to push for greater centralization in the face of adversity. Party and government leaders and economic experts consistently reject any abandonment of tight central controls, and their antireform rhetoric has grown more strident as problems have mounted. A commitment to reform by the new Soviet leadership could, however, require Honecker to reassess his position and to endorse some changes. But decentralization would require a major industrial reorganization and could impede economic growth in the short run. [redacted] 25X1

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In any case, continuing economic problems will heighten tensions over resource allocation and other aspects of economic policy. Reports of increasing complaints by party functionaries suggest there already has been a growing debate over economic options within the SED leadership. [redacted] 25X1 25X1 25X1

[redacted] As economic troubles continue, friction between competing constituencies within the party and government seems likely to grow. [redacted] 25X1 25X1

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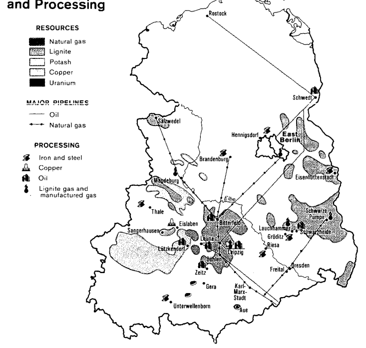
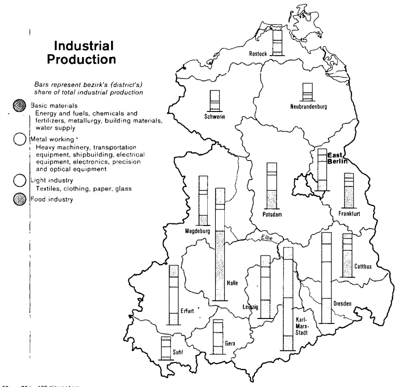
The regime, still insecure because of its lack of popular support, is likely to try to intensify its control over society. Party hardliners may argue for tighter security and a crackdown on domestic dissent. Church-state relations could worsen if the regime becomes less tolerant of such church-sponsored activities as peace workshops. Such actions would chill relations with the West German Government, however, and the regime would, in our judgment, be reluctant to jeopardize possibly crucial financial aid from Bonn. [redacted] 25X1 25X1 25X1 25X1

Figure 4
East Germany

Basic Resources and Processing

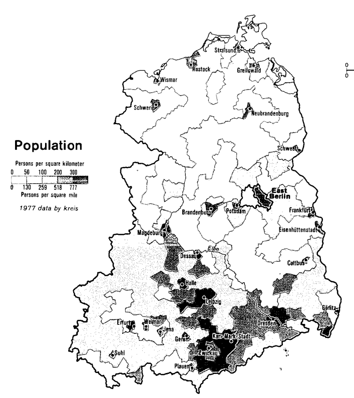


Industrial Production

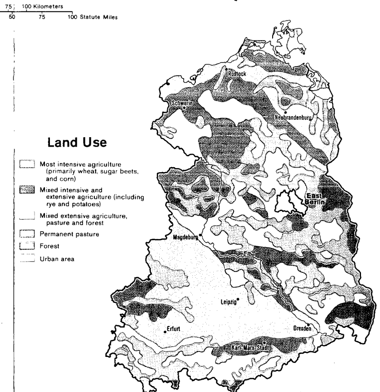


0 25 50 75 100 Kilometers
0 25 50 75 100 Statute Miles

Population



Land Use



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