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Central Intelligence Agency

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Washington, D.C. 20505

19 November 1986

MEMORANDUM FOR:

[Redacted]  
Chief, Intelligence Division  
Verification and Intelligence Bureau  
United States Arms Control and Disarmament Agency

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SUBJECT:

Response to Your 12 November Request [Redacted]

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1. Attached is our response to your 12 November request for an assessment of Soviet economic problems and their relation to arms control.

[Redacted]

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[Redacted]

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3. Finally, we would be happy to meet with you to discuss any of these issues informally, or to present more formal briefings if you would like. If I can be of any further assistance, please let me know.

[Redacted]

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Acting Director  
Soviet Analysis

Attachment:  
as stated

SOVA M 86-20109

[Redacted]

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19 November 1986

## MEMORANDUM

SUBJECT: The Impact of Soviet Economic Problems  
on Soviet Arms Control Positions

Summary

Soviet economic problems and priorities have created strong incentives for Gorbachev to reduce the growth of defense spending below the relatively low levels of recent years, but we are fairly confident that he does not believe that it is imperative that he do so. This judgment is based on our assessment of the performance of the Soviet economy since Gorbachev took over, the nature of the resource allocation decisions that will have to be made over the next few years, and the benefits to be gained from an arms control agreement. [redacted]

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Since Gorbachev assumed power, economic performance has picked up. GNP growth is headed for 3 to 3 1/2 percent in 1986, substantially better than in recent years. Gorbachev's human factors campaign has had a positive impact on productivity, while agricultural output will apparently match or exceed the previous record achieved in 1983. At the same time, our estimates show that defense spending, already at a very high level, continues to grow, albeit slowly. [redacted]

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We also believe that the shifts in machinery demand implied by Gorbachev's industrial modernization program will not have an immediate impact on the level of weapons production. Our analysis indicates that almost all of the weapons we expect to be produced through 1990 will be manufactured in plants already operating. Competition for some basic materials and intermediate goods used in the production process such as high quality steel and microprocessors will be intense and could well cause some delays in the production of certain weapons, but overall these changes are likely to be marginal. [redacted]

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While we do not believe Gorbachev feels compelled for economic reasons to sign an arms agreement or cut defense spending sharply in the immediate future, important decisions involving resource allocation will have to be made over the next two to three years. In 1988-89, the Soviets

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[redacted]  
will have to decide on production rates for major weapons systems in the 1990s, if planning for the 1991-95 Plan is to proceed on schedule. At about the same time, Gorbachev will be in a much better position to assess how his modernization program is faring. We believe the planned gains in productivity and product quality will not be achieved. Gorbachev will then have to deal with military leaders--who now appear to be backing his modernization program--asking for more money, even as pressures for more civilian investment increase. [redacted]

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We do not know what Gorbachev will do, but the state of the economy, Moscow's perceptions of the military threat, and Gorbachev's domestic political standing would all come into play. Even if the economy is doing poorly, however, there is no guarantee that Gorbachev will feel compelled to cut defense spending sharply, although it would certainly make an arms agreement more attractive. [redacted]

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There is another view of how Soviet economic problems influence defense policy. A few experts outside of government [redacted] argue that that USSR's economic stringencies are so severe that Moscow will have to conclude a strategic arms-control agreement to lessen the defense burden. We believe, however, that the near-term economic benefits to be gained from an arms control agreement are often exaggerated by proponents of this view. Certainly, there are major economic benefits to be gained from an arms control agreement, particularly one limiting SDI, but they are mainly in the area of cost avoidance and would be reaped over the longer term. The immediate benefit to Gorbachev's modernization program from reducing or even eliminating particular strategic systems would be small. Production facilities take time to convert, and spending on strategic offensive systems represents only about 10 percent of total defense spending. [redacted]

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Measuring Soviet Economic Performance

When Gorbachev took over, the economy was mired in a decade long slump. Overall GNP growth during the 1981-85 Plan was headed for its smallest increase in any Five-Year Plan period. Moreover, GNP had increased by less than 1.5 percent in 1984, and during the first quarter of 1985, just before Gorbachev took over, production was essentially flat. [redacted]

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The USSR's economic performance should not be judged primarily in terms of growth rates, however. Soviet economic growth since 1980 has been as good or better than that of other major industrial countries except for the United States and Japan (see table 1). What is more important in analyzing Moscow's willingness to increase rates of military spending is the size and the technological level of the Soviet economy. Soviet GNP in 1960 was roughly half that of US. After closing the gap during the 1960s and 1970s, Soviet GNP as a percent of US GNP fell from a high of about 58 percent in 1982 to about 55 percent last year (see figure 1 for a comparison on Soviet GNP with the United States and other developed countries). [redacted]

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Moreover, although the Soviet economy is the second largest overall, its relative technological standing is better captured by per-capita GNP comparisons. According to this indicator, both the USSR and its East European allies lag far behind the major Western countries (see figure 2). The USSR's failure to modernize its industrial sector is partly responsible for the USSR's relatively weak technological base. [redacted]

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[redacted] equipment in the early 1980 was 20 years old on average. In contrast to the West where the rapid introduction of advanced manufacturing technologies has sparked large efficiency gains, the combined productivity of labor and fixed capital in the USSR has declined in absolute terms over the past decade. [redacted]

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Soviet leaders have been especially worried about the implications of these trends for military competition. They recognize that in most advanced manufacturing technologies--technologies critical to future weapons development--the USSR remains years behind the United States (see figure 3). Indeed, even before SDI, Soviet military authorities had expressed concern about the level of technology embedded in such US programs as the D-5 SLBM, the Stealth Bomber, "smart" conventional weapons, and cruise missiles. SDI, by concentrating competition in those high tech areas where Moscow is weakest, has been viewed as a new and even greater threat. Although they claim they can counter the US SDI, the Soviets are clearly worried by the technological challenge posed by SDI and the possible spin-off of new technologies in other areas. [redacted]

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Table 1

Real Average Annual Growth Rates of GNP  
(percent)

	<u>1961-65</u>	<u>1966-70</u>	<u>1971-75</u>	<u>1976-80</u>	<u>1981-85</u>
USSR	5.0	5.3	3.4	2.3	1.9
US	4.7	3.0	2.5	3.4	2.4
Japan	10.0	11.0	4.3	5.0	3.9
France	5.8	5.4	4.0	3.3	1.2 <sup>1</sup>
West Germany	4.8	4.2	2.1	3.3	1.2
Italy	5.2	6.2	2.4	3.8	0.8 <sup>1</sup>
UK	3.2	2.5	2.1	1.6	1.7 <sup>1</sup>

<sup>1</sup>Data are for gross domestic product (GDP). The difference between GNP and GDP, net factor income from abroad, is small.

Note: Growth rates are measured in national currencies.

Sources: 1961-80, OECD, National Accounts  
1981-85, IMF, International Financial Statistics

FIGURE 1

## Gross National Product, 1985

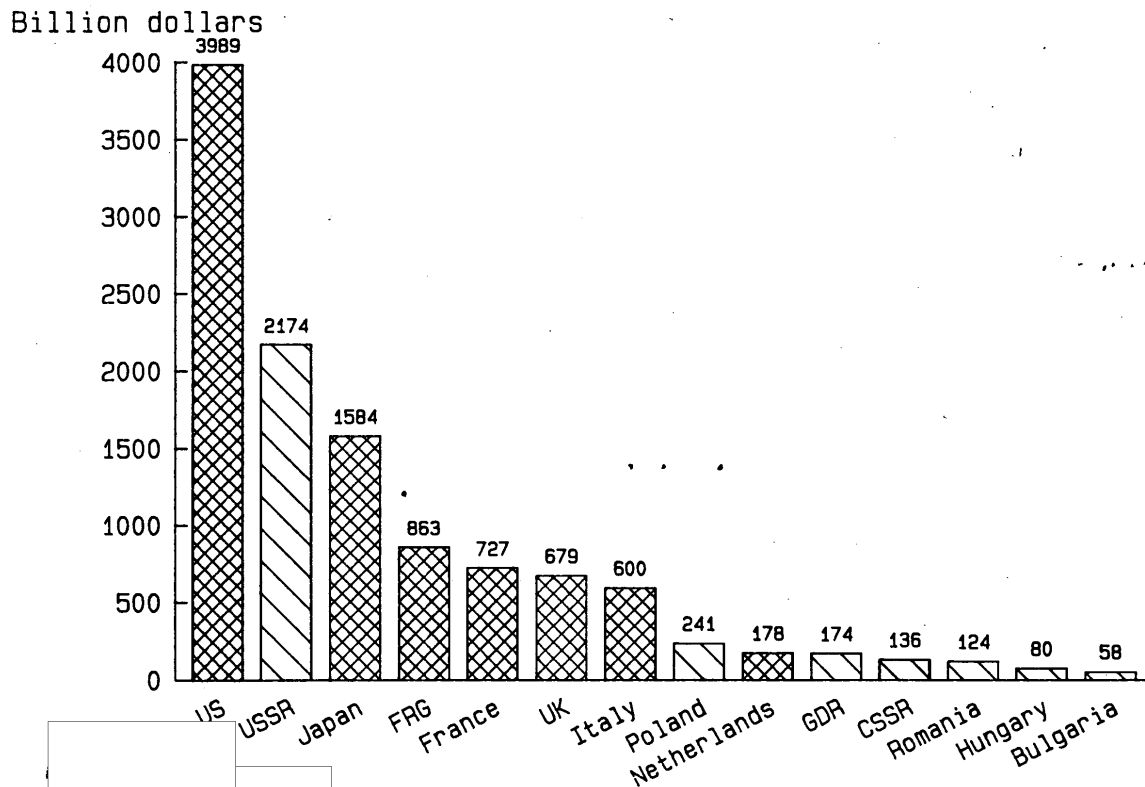
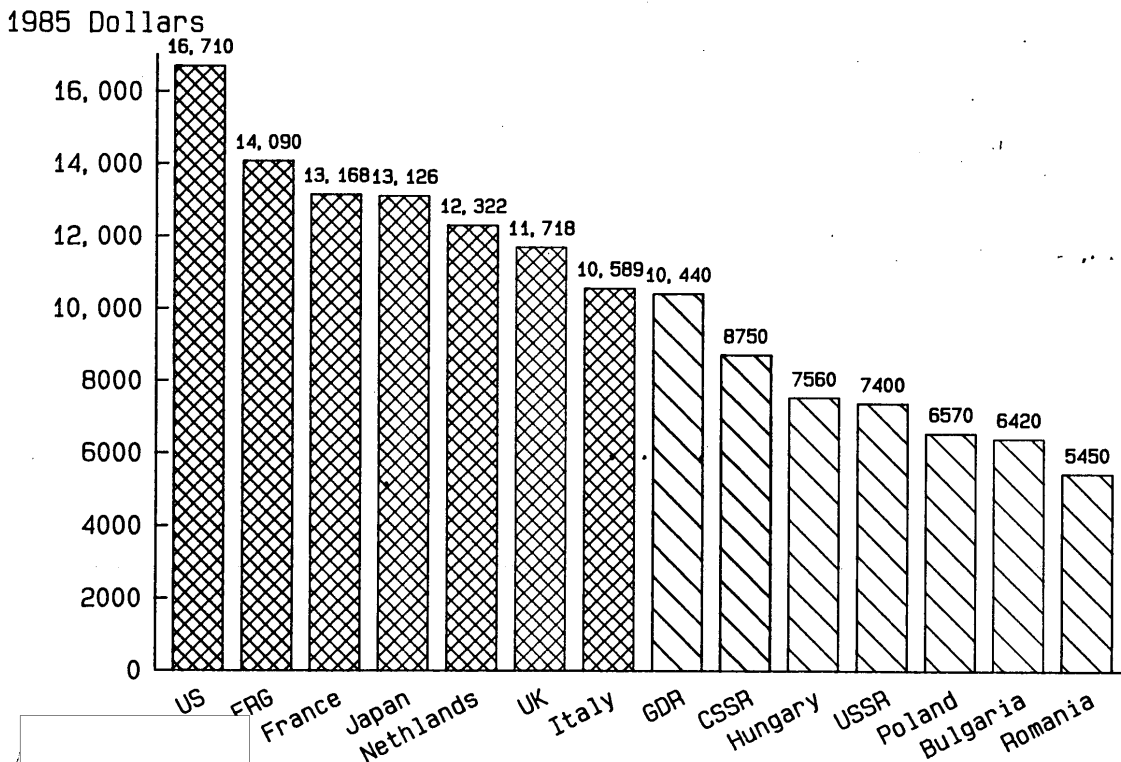


FIGURE 2

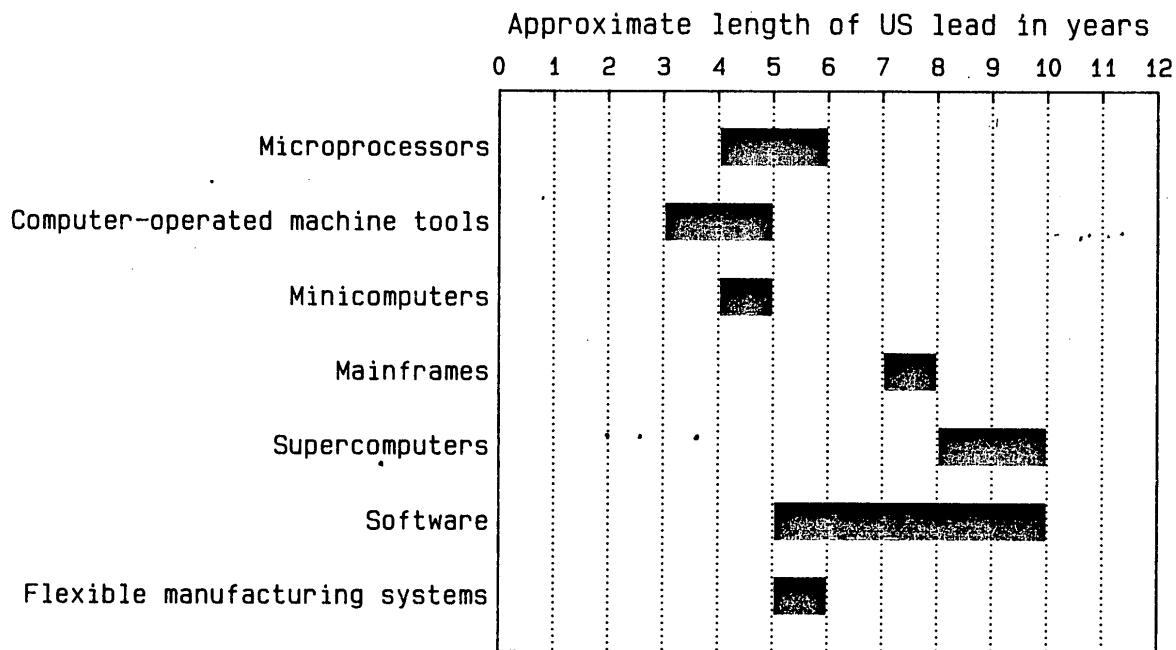
### Per Capita GNP, 1985



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Figure 3  
Selected Advanced Manufacturing Technologies:  
The United States Versus the USSR





[REDACTED]

### Gorbachev's Economic Agenda and the Competition for Resources

Gorbachev's commitment to revitalizing the country's economic base--and hence future military modernization--has been evident since before he became General Secretary. Essentially, he has adopted a two-step approach. Initially, Gorbachev is relying on a combination of measures to strengthen party discipline, improve worker attitudes and weed out incompetents--what he refers to as the "human factor." Over the longer term, Gorbachev is counting on achieving major productivity gains as a result of organizational changes, reform initiatives, and, most importantly, an extremely ambitious campaign to modernize the country's stock of plant and equipment. [REDACTED]

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#### Addressing the Human Factor

Gorbachev's first and most accessible target in his program to boost productivity has been his campaigns for discipline and against corruption and alcoholism. These efforts--like those pushed less vigorously by Andropov before him--have received widespread public support and yielded positive results. At the same time, Gorbachev has removed an unprecedented number of senior economic managers, including the Chairman of the Council of Ministers, the Central Committee Department Chiefs responsible for the machinebuilding, construction, and trade and services sectors, and over two dozen of the country's economic ministers and heads of state committees. [REDACTED]

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Gorbachev has moved only somewhat more slowly on the organizational front. During the past year, he has established new bureaus to oversee the machinebuilding and energy industries and embarked upon major reorganizations of the agro-industrial and trade bureaucracies. Gorbachev also has overseen the enactment of a series of measures designed to increase the autonomy of Soviet enterprises and improve workers' incentives. He has openly complained about the bureaucracy's resistance to his efforts, however, and the decrees that have emerged thus far appear to be the products of political compromise and not the "radical" reforms he has said are needed. [REDACTED]

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#### Industrial Modernization

But the heart and soul of Gorbachev's drive to accelerate productivity is his industrial modernization program or, in his words, "the structural transformation of the economy." In laying out his program, Gorbachev has proposed:

- Doubling retirement rates of capital stock to accelerate the replacement of obsolete capital by more efficient, largely state-of-the art machinery.

- [redacted]
- Modernizing the nation's capital stock so that by 1990 more than a third of the machinery portion will have been installed within the preceding five years.
  - Increasing capital investment in the civilian machine building sector in 1986-90 by 80 percent compared with investment in 1981-85. [redacted]

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Achievement of these goals would require extremely rapid growth in the machinery allocated for Soviet plant and equipment. Because the machinery needed for industrial modernization is produced in the machinery and metalworking sector--which is also the primary source of military hardware and consumer durables--the competition for resources will, of necessity, increase. [redacted]

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#### Leadership Attitudes Towards Defense Spending and Arms Control

The competition for resources for plant modernization certainly creates incentives for Gorbachev to hold down current military spending and to reduce the need for future programs through an arms control agreement, but we do not believe that Gorbachev feels that it is essential that he do so. Recent improvements in the economy's performance and the momentum of ongoing military programs weigh heavily in this judgment. [redacted]

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Since Gorbachev assumed power, economic performance has picked up. GNP growth is likely to be about 3 to 3 1/2 percent in 1986, substantially better than in recent years. Gorbachev's human factors campaign has had a positive impact on productivity, and agricultural output this year apparently will match or exceed the previous record level achieved in 1983. [redacted]

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At the same time, our estimates show that defense spending--already at a very high level--continues to grow, albeit slowly. In this connection, we believe the shifts in machinery demand implied by the industrial modernization program will not have an immediate impact on the level of weapons production. Our analysis indicates that almost all of the weapons we expect to be produced through 1990 will be manufactured in plants already operating. Competition for some basic materials and intermediate goods used in the production process, such as high quality steel and microprocessors, will be intense and could well delay production of certain weapons, but these adjustments are likely to be marginal. [redacted]

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In short, we believe Gorbachev's commitment to industrial modernization will not significantly impede the major deployments of strategic weapons that the Soviets have programmed for the next decade. In the absence of a major arms reduction agreement that limited the deployment of new systems by the early 1990s, we expect that a

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comprehensive modernization of the USSR's strategic forces will have been completed with the widespread deployment of new generations of land- and sea-based ballistic and cruise missiles. Strategic defensive force improvements, although less substantial, also will permit sustained improvements in capabilities with the fielding of the SA-10 and SA-X-12 strategic defense missiles. [redacted]

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### Longer Term Pressures

While we do not believe Gorbachev feels compelled for economic reasons to sign an arms agreement or cut defense spending sharply in the immediate future, important decisions involving resource allocation will have to be made over the next two to three years. In 1988-89, the Soviets will have to decide on production rates for major weapons systems in the 1990s, if planning for the 1991-95 Plan is to proceed on schedule. Based in part on these decisions, the Soviets will also have to accelerate renovation of their defense industries, as they start preparing to produce the next generation of weapons. [redacted]

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Meanwhile, Moscow will be trying to gain a better understanding of the outlook for US military programs and the potential for derailing these programs politically. It has already launched a massive active measures campaign against SDI aimed at influencing public opinion in the United States and Western Europe. Interestingly, Foreign Minister Shevardnadze commented after the recent US Senate elections that the loss of control by the Republicans could be viewed as a public referendum on the President's SDI policy. While his remarks are obviously self-serving, the Soviets may, in fact, believe--though they cannot be sure--that budgetary pressures, as well as mounting public opposition, will force the next President to go more slowly on SDI. [redacted]

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Equally important, in a few years Gorbachev will be in a much better position to assess how his modernization program is faring. Despite the economy's better performance this year, in our judgment the improvements in productivity needed to accelerate growth during the 1990s will not be forthcoming without some major economic reforms and even greater investment in technology and civilian industry. If, in fact, the planned gains in productivity and product quality have not been achieved, Gorbachev will have to deal with military leaders--who now appear to be backing his modernization program--asking for more money, even as pressures for more civilian investment increase. [redacted]

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We do not know what Gorbachev will do, but the state of the economy, Moscow's perceptions of the military threat, and Gorbachev's domestic political standing would all come into play. Even if the economy is doing poorly, however, there is no guarantee that Gorbachev will feel compelled to cut defense spending sharply, although it would certainly make an arms agreement more attractive. [redacted]

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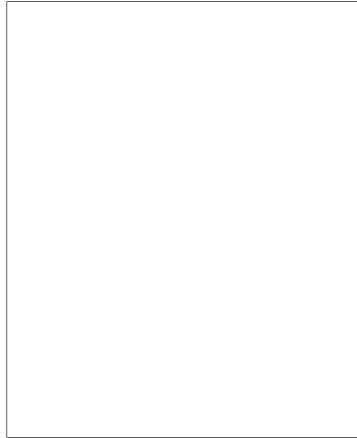
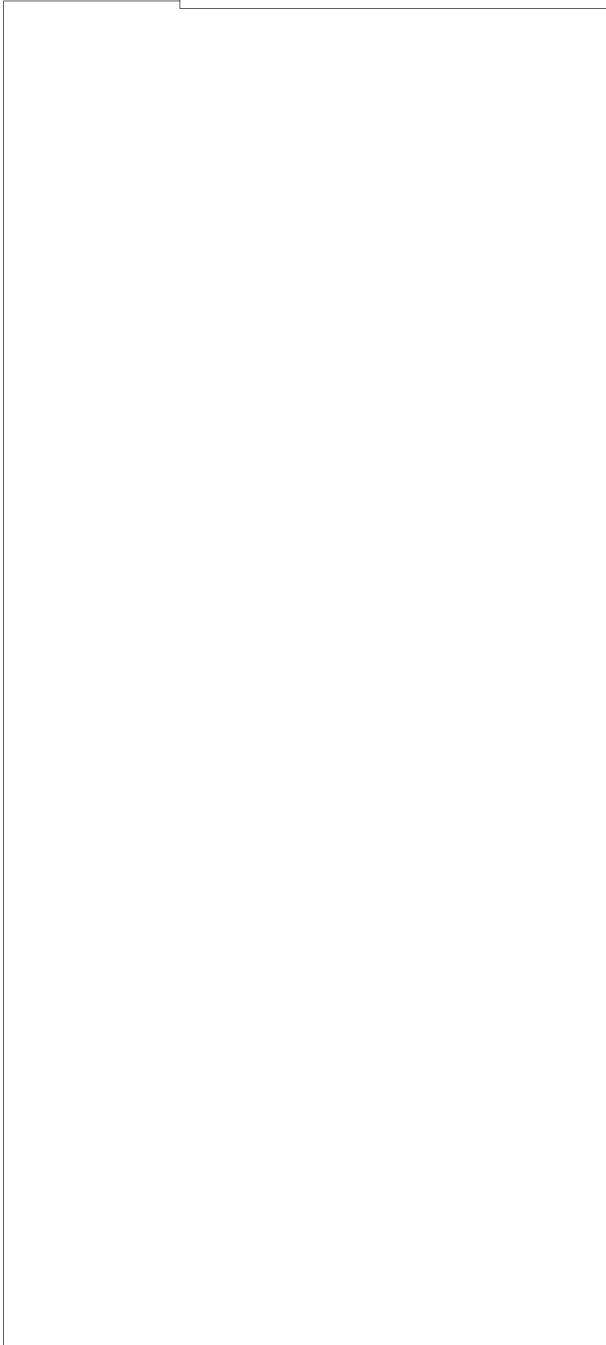
SUBJECT: Memo to Raymond B. Firehock, US Arms Control Agency, Responding to ACDA's 12 November Request dated 19 Nov 1986, SOV M 86-20109

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