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NSPG re EASTERN EUROPE

Tuesday, 25 October 1988, 2:00 p.m.

w/Dick Kerr

Situation Room

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Attached are talking points and background information for tomorrow's ~~NSPG meeting on Eastern Europe~~. You will be expected to provide a ten-minute presentation on recent developments and long-term prospects in Eastern Europe, as well as on Soviet attitudes toward the region. I have set up a pre-brief for you on these subjects for 3:00 today.

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24 October 1988

Date

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Eastern Europe



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NATIONAL SECURITY PLANNING GROUP MEETING
Tuesday, October 25, 1988
White House Situation Room
2:00 p.m. - 3:00 p.m.

EASTERN EUROPE

Agenda

- I. Introductory Remarks.....President
(5 minutes)
- II. Recent Developments, Long-Term Prospects
and Soviet Attitudes.....Director Webster
(10 minutes)
- III. Trip Report and Overview of U.S.-
East European Relations.....Deputy Secretary Whitehead
(5 minutes)
- IV. U.S.-East European Economic Relations.....Secretaries Brady
and Verity
(15 minutes)
- V. General Discussion.....All Participants
(5 minutes)
- VI. Summary of Discussion.....General Powell
(5 minutes)
- VII. Concluding Remarks.....President
(5 minutes)

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Talking Points for DCI

Background on this NSPG Meeting and Concerns You May Wish to Express

This meeting is an outcome of a recent discussion between the President and NSC staff on subjects that should be given greater consideration in the near future. The need for an NSPG at this time on Eastern Europe is the result of two thoughts:

- o Eastern Europe, especially Yugoslavia, has been much in the news
- o Deputy Secretary of State Whitehead will have just returned from a visit to the six Bloc countries (Poland, Hungary, East Germany, Czechoslovakia, Romania, and Bulgaria).

The NSC staff probably does not intend for key decisions to be made.

Your talk is expected to focus on **three topics** (see Tab C)

- o Recent Developments
- o Long-Term Prospects
- o Soviet Attitudes

Deputy Secretary Whitehead, in the course of his assessment, may propose increased US economic support for one or several countries--perhaps Poland--in the form of US actions in the IMF, GATT or other international institutions as well as bilateral actions to promote trade, credits, and US investment in Eastern Europe. He has made such proposals previously. **Secretary of Commerce Verity** may support a position urging more flexibility on export controls to reduce the US trade deficit with Eastern Europe. **Secretary of the Treasury Brady** has previously expressed doubts about the wisdom of IMF support for Poland. He also may voice concern over the IMF standby agreement with Yugoslavia because the current instability there is related to the IMF-mandated austerity program. Secretary Brady probably believes further that on purely economic grounds the East European countries should get no additional support until they demonstrate effective action to reform their economies.

Advocacy of greater US activism may also include the argument that West European countries, particularly West Germany, and possibly Japan, have become more economically supportive of the East European countries in the last several years and are making commercial gains because of this. The US position has generally been that the Bloc countries should not be assisted until they liberalize their political systems and institute real market reforms in their economies, and that Yugoslavia should be given economic aid commensurate with the economic reforms that it makes. The key word used to describe which countries have done what we would like the most and consequently deserve better treatment is "differentiation."

You may wish to take issue with the view that other East European countries besides

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Yugoslavia have made enough recent reforms to warrant increased US assistance (See Tab E). While many changes have occurred in the region,

- o The fundamental elements of a Marxist-Leninist political system and socialist command economy remain intact in all six Bloc countries--including Poland, where the regime continues to try to confuse consultation with powersharing.
- o The pressures for change in Eastern Europe are coming from below, and not from above as in the USSR. In Poland, Jaruzelski has sought continuously to resist political change and has taken positive steps only in response to opposition pressures.
- o Increased US assistance to countries like Poland (and Hungary) might modestly alleviate some of the hardships of austerity and make it easier for their governments to implement some economic adjustments; **but** the regimes will probably try to use any breathing room they can get to avoid making the major economic changes that are needed. Increased Western aid is also likely to undermine pressures from below for political change and powersharing.

There are **other things the United States can do** to show its support for the changes that are occurring and to move them further forward, always recognizing that any US actions will only modestly influence these internal developments. These actions include:

- o Public comments by senior officials applauding the direction of specific actions but which also make clear what political and economic steps would cross the line in our minds to warrant noteworthy US support.
- o Making the point that the US will not help these regimes paper over their troubles and maintain their current systems, but it is prepared to approve IMF support and greater integration of Eastern Europe into international trade as well as facilitate activities of US firms interested in Eastern Europe if these regimes undertake real powersharing and key market-oriented reforms--for example, the termination of government control over prices, a significant role for private enterprise, fair treatment for foreign investors, and liberalization of foreign trade. We would also expect these regimes to avoid engaging in illicit technology transfer to the benefit of the USSR.
- o Clearly informing the regimes that the political opposition's views of its actions are an important factor in our decisions.
- o Continuing to press the importance of Soviet conventional force reductions in and around the region because such reductions could increase the pressures for change in the region.

You may further wish to note the importance of considering other issues in determining the wisdom of new US assistance, including technology transfer and support for terrorism. For your further information, we have included background information on a number of subjects relevant to a general discussion on Eastern Europe.

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Talking Points for DCI**Recent Developments in Eastern Europe**

Strikes and demonstrations, leadership shakeups, and talk of reform have created the most intense climate of change and instability in Eastern Europe in 30 years.

- o Unlike in the USSR, where the push for change has come from above, in Eastern Europe demands for renewal are coming from more assertive populations, illegal opposition groups, and even a few lower-level party officials attracted to Gorbachev's ideas.
- o While noteworthy political and economic changes are occurring in the region, all six Bloc countries retain the fundamental features of communist-run political systems and command economies.

Poland and Hungary have been pushed furthest in the direction of political powersharing and economic decentralization.

- o In Poland, the recent worker outbursts in May and August have forced Warsaw into agreeing to roundtable discussions with the opposition. The government talks of market incentives, entrepreneurship, independent unions in factories, and parliamentary seats for the opposition, but this rhetoric conceals a desperate effort by the regime to maintain its monopoly-on-power.
- o Last May's overhaul of Hungary's party leadership has unleashed a momentum for political reform that has caught the new leaders off guard. The regime is consequently allowing more independent political activity and is formulating measures that could introduce considerable market influence into the economy. Orthodox party leaders, however, speak ominously of "pre-counterrevolutionary" trends, and all are wary about the impact of real economic change.

Events over the weekend illustrate the point that the pressures are coming from below and that the regimes are resisting change:

- o In Hungary, on Sunday, the government deployed a large number of well-armed police to discourage crowds and dispersed modest gatherings of several hundred people who defied an official ban to commemorate the 23 October anniversary of the beginning of the 1956 revolution.
- o And in a speech made public on Sunday, Polish leader Jaruzelski warned that authorities will not hesitate to use force if needed to protect the Communist system.

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Bulgaria and Czechoslovakia are now using the lexicon of reform, but these fundamentally hardline regimes are more concerned with staying in Gorbachev's good graces than inaugurating real change.

- o Despite talk of glasnost and restructuring, Bulgaria's Zhivkov retains near total power over political life, and sweeping proposals for reform have produced little more than confusion and disruption in the economy.
- o While Czechoslovak leader Jakes recently brought some new faces into the top leadership, his regime remains adamantly opposed to independent political activity and is only considering bureaucratic streamlining to address economic problems.

East Germany and Romania remain convinced that their highly centralized systems are on the right track and wholly reject glasnost, perestroika, and democratization.

Ethnic rivalries and worker unhappiness over deepening austerity have sparked the most serious challenge to Yugoslav stability and unity since the death of Tito.

- o Although far short of a democratic, market-oriented society, Yugoslavia's turmoil stems from pressures released by more fundamental political democratization and economic reform than that which exists elsewhere in Eastern Europe.

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Talking Points for DCI**Long-Term Prospects for Eastern Europe**

The outlook over the next several years is for:

- o Growing internal diversity as well as greater diversity in relations with the Soviet Union and the West;
- o Economic changes of note in only a few countries, slow growth, and considerable austerity; and
- o Much political turmoil and probably larger outbursts than we have seen so far because of varying combinations of economic difficulties, the contempt in which these regimes are held, regime resistance to change and the challenge of managing it, the pressures for change from Moscow, and, in Yugoslavia, nationalism.

The candidates for the greatest political instability are Poland and Yugoslavia. Upheavals are also possible in Hungary and Romania.

- o Major turmoil is much less likely in Czechoslovakia, East Germany and Bulgaria as well as Albania because these regimes are maintaining a relatively tight lid, are unlikely to introduce major political or economic experiments, and their populations are relatively cowed.
- o Significant leadership changes and a strong push from Moscow will almost certainly be necessary before Prague, East Berlin, or Sofia will undertake real political or economic reforms.

Further noteworthy economic changes are most likely in Yugoslavia, Hungary, and Poland. Despite their rhetoric, however all countries will shy away in the next several years from actually allowing market forces to determine prices, wages, exchange rates, investments, and bankruptcies of enterprises. Each will likely nibble some more at the edges, but the risks of dramatic action on these fronts will remain enormous.

Five variables will likely determine the broad course of events:

- o The course of political and economic reform in the USSR.
- o The specificity of and substantive demands that Gorbachev makes.
- o Actual national and regional economic conditions.
- o Leadership willingness to take major risks and cross the lines of powersharing; and their ability to orchestrate events.
- o International economic trends and the political and economic support that the West

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gives them.

Our interests and goals will continue to be to separate these countries from the USSR, decrease the power that communist parties exercise over them, integrate them into the international economy, and improve the political and economic conditions of living in these societies.

The dangers to US interests will probably be:

- o The danger that East European regimes will gain credence for arguments that the West, particularly the US, is the source of its economic problems and is blocking the cure to them.
- o Any East European regime receiving increased aid will try to gain political legitimacy from it and will likely use it as best it can to avoid making changes that undermine party control.
- o Poland and Yugoslavia will continue to have enormous problems paying their debts.
- o Disunity between the US and Western Europe, particularly the West Germans, over the extent of political and economic change that has occurred and consequent differences in our policies toward the Soviet bloc.
- o The possibility that a major upheaval will lead to new Soviet military intervention, notwithstanding Moscow's reluctance to do this.

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Talking Points for DCI

Soviet Attitudes

Gorbachev's fundamental challenge in Eastern Europe is to balance the need for economic and political reforms against the destabilizing effects of these changes and, at the same time, insure continued party control.

- o Gorbachev believes the evolving economic crisis in Eastern Europe poses the greatest threat to communist regimes in the area.
- o His "hands off" approach to East European domestic experimentation acknowledges different paths to socialism under unique national conditions and is placing the burden of managing change on the region's leaders. [REDACTED] ILLEGIB
- o Gorbachev is, however, pushing for greater CEMA integration and increased East European support for the Soviet economy.

Despite Gorbachev's looser rein, Moscow is watching events in Eastern Europe closely:

- o The Soviets attribute Polish unrest chiefly to the loss of popular confidence in Warsaw's economic policies and regard the Polish government's dialogue with the opposition--but not powersharing-- as the most promising avenue for restoring political stability and the economy.
- o The Soviets have apparently given up trying to rein in Romanian leader Ceausescu whose erratic leadership and refusal to initiate reforms have led his country to near economic ruin. Moscow, however, will continue to press both Bucharest and Budapest to calm if not settle their dispute over Romanian treatment of the Hungarian minority in Transylvania, but is unlikely to intervene directly.
- o Since Yugoslav leader Tito's death in 1980, the Soviets have been uneasy over the communist party's failure to contain ethnic unrest and implement economic reform. Moscow believes its interests in this non-Bloc nation are best served by a stable, unified Yugoslavia, but is unlikely to meddle for fear of arousing an anti-Soviet backlash.

The remaining East European countries are giving Moscow little immediate concern.

- o The Soviets have given Hungary the green light for economic and political experimentation provided communist party control is maintained. Moscow's tolerance probably would diminish if reforms led to major political unrest or further drops in economic performance.
- o Gorbachev seemingly accepts the use by conservative leaders in Bulgaria, Czechoslovakia and East Germany of his tolerance for diversity to resist Soviet-style

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reforms, but Moscow is still pushing for improved economic performance and more integration under the CEMA economic umbrella.

While broadening the limits of the permissible, Moscow remains leery of any signs of the erosion of communist party control and would not allow any of its allies to leave the Warsaw Treaty Organization or CEMA.

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Deputy Secretary Whitehead's Agenda for Recent Visit

Deputy Secretary Whitehead reemphasized continuing US interest in the region and assured leaders that our expanded contacts are a firm cornerstone on which a new US Administration can build. He reminded his hosts that the strong US interest in expanding relations depends on their meeting US concerns halfway. In particular, he expressed support for economic reform (decentralization and expanded room for private initiative) and political reforms (better treatment of dissidents, minorities and religious groups). On foreign policy issues, he reviewed US positions on a variety of issues from arms control to regional disputes to ensure that his hosts were not just working from a Soviet script.

Mr. Whitehead clearly considered **Poland** his most important stop because of the fluid and fragile domestic situation. He strongly supported President Jaruzelski's decision to initiate contacts with Solidarity's Lech Walesa and said that as reforms progress, the US is prepared to help in Poland's economic recovery.

He urged **Hungarian** party leader Grosz to move forward aggressively on economic reform, saying others in the region will follow, and offered additional, largely unspecified, US help as Hungary moves toward a market economy. In seeking to encourage a more independent foreign policy, Mr. Whitehead questioned how the Hungarians decide to vote in the UN and warned of the harmful effects of Hungarian espionage [redacted]

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Discussions with **Romanian** President Ceausescu were, predictably, the chilliest. Mr. Whitehead said relations had deteriorated over the past several years and reviewed US concerns about human and religious rights. Ceausescu blamed the admitted downturn on the US.

The visits to East Berlin, Prague and Sofia were more perfunctory largely because these countries are further behind the curve of change and less responsive to US interests.

Mr. Whitehead told **East German** leader Honecker that further progress in relations depends on settling US and Jewish claims and a more aggressive stance against terrorists.

In **Czechoslovakia**, Mr. Whitehead expressed support for expanded trade and said the US would be willing to train some Czechoslovak managers. He encouraged party leader Jakes to consider expanded room for private initiative in his reform program and allow greater toleration of Church activities.

In **Bulgaria**, Mr. Whitehead encouraged party leader Zhivkov to pursue his reform plans but said the US could support Bulgarian membership in GATT only if Bulgaria creates a more market-oriented economy. He raised US concerns about treatment of the Turkish minority and a recently created dissident organization.

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Talking Points for DCI**State of Reform in Eastern Europe**

Numerous political and economic changes have occurred in the region, some of which are indeed noteworthy; and the ongoing ferment and developments in the USSR suggest that more is yet to come in Eastern Europe. Nevertheless, unlike Yugoslavia where real democratization of the political process and more farreaching economic changes have occurred, all of the six Bloc countries retain the fundamental elements of their Marxist-Leninist systems and Stalinist command economies:

- o Communist parties retain a monopoly of political power, the regimes retain and use their security forces arbitrarily, and the populace have no ability to change things without resorting to illegal activities or civil resistance.
- o The regimes, not markets, set prices, make investment decisions, set exchange rates, determine wage levels, and retain ownership of the vast proportion of their economies.

While Poland and Hungary have evolved the most and some leaders in both countries would like to go much further, the pace of change is likely to remain terribly slow. The regimes in both countries still want to retain their current character and want to obtain Western economic support to help them do this.

- o Unlike in the USSR, where the push for change has come from above, in Eastern Europe the pressures for change are coming from illegal opposition groups and otherwise from below.
- o ✓ Warsaw has been pushed into virtually every positive step it has taken and now is desperately trying to resist crossing the line of powersharing. Only Hungary has shown some leadership willingness to make changes in the absence of massive public defiance and civil strife.
- o < Bulgaria and Czechoslovakia are now using the lexicon of "reform," but we see no serious likelihood that these fundamentally hardline and relatively united regimes intend notable changes in the next several years.
- o The GDR and Romania remain self-satisfied and wholly reject glasnost, perestroika, and democratization.

More specifically, though, on:

Poland

The Jaruzelski regime, like others in the region, has been stripped of its argument that it cannot go forward because of Soviet opposition to reform. After the two recent worker outbursts in May and August, it has no credibility with the populace, yet it continues to try to cut the salami of consultation ever thinner to avoid the opposition's demands for real

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powersharing.

- o It wants to coopt Walesa without making serious concessions and to focus attention on meeting the demands of the dinner table rather than the Roundtable.
- o As with the opposition, it wants to make the West, and particularly the US a "partner" in sharing the responsibility for the nation's destitution.
- o Its talk about adding a second chamber to the Sejm and allowing up to 49 percent of the seats to be held by non-Party members would be just more symbolic steps as long as the Party and its designated government retain power.

The opposition would want the regime to make real major political concessions before it would support increased Western assistance.

As to economic change, Poland has the largest private agricultural sector in the Bloc and has modestly decentralized economic decisionmaking. The regime's economic plan calls for:

- o Price and wage reforms, and greater incentives for factory and worker productivity.
- o Forcing inefficient firms into bankruptcy and encouraging entrepreneurship.
- o Loosening foreign investment controls.

Hungary

The regime now appears to be more tolerant of independent political activity and is **talking** about big political changes, but the Party still tightly controls the government, has not sanctioned any organized political opposition, and what pluralism exists is the result of regime indecisiveness rather than legal guarantees.

- o It is noteworthy that regime leaders now talk about the introduction of a multiparty system and non-Party controlled elections to the National Assembly.
- o In recent weeks a number of non-Party political groups (for example, the Hungarian Democratic Forum) and several independent unions (scientific and technical workers, journalists) also have come into the open--with the regime seemingly deadlocked about how to respond.

Hungary since the 1960s has selectively introduced more market reforms and allowed the largest private and cooperative sectors in the Bloc. It has similarly been the leader in reducing the role of central planning and decentralizing management.

- o Its current plans call for making the economy broadly more sensitive to market forces, phasing out grossly inefficient firms, adopting a more Western-like banking system, and expanding the scope for private and foreign capital.

Bulgaria

Despite frequent talk of "reforms" and glasnost, Zhivkov continues to tightly control the Party and the Party tenaciously retains all of its controls over the government and economy. Independent organizations are not permitted to exist and recently, when some Party members

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took part in an environmental protest, they were quickly expelled.

- o The media are now criticizing government handling of some environmental problems and selected individuals for economic failures.
- o But **articles from Moscow Pravda** are frequently censored because they question the kind of system the Zhivkov regime practices.

Sweeping proposals for economic reform were announced in July 1987, but since then implementation has lagged and many have been watered down as Sofia tries to show support for Gorbachev's goals without making any difficult adjustments.

- o The only steps of note are that wages in many industries are now determined by the quantity and quality of goods produced, new foreign investment laws have been promulgated, some banking reform has occurred, and some wholesale prices now better reflect world prices.
- o Sofia is also talking about "shareholding" in companies, guarantees against bankruptcy to Western investors in Bulgarian enterprises, and US training of enterprise managers.

Czechoslovakia

The Czechoslovak regime, faced with the winds of change from Moscow and its own stagnating economy, is searching for a way to avoid any economic changes that would endanger Party rule. It remains adamantly opposed to the formation of organized political opposition, allows no free public expression as best as it is able, and uses its security apparatus vigorously to maintain control.

- o Its only political concessions have been to allow some modest cultural liberalization and periodically falter in its decisiveness in dealing with demonstrations.
- o In the economic arena, there have been cutbacks in the size of government staffs and several ministries have been merged, but discussions and plans for the use of "market tools" face stiff opposition and will be implemented extremely slowly, at best, by the current leadership.

East Germany

o The Honecker leadership remains adamantly opposed to significant political and economic change, which will likely occur only after it has been replaced. Although some internal regime criticism is surfacing over the leadership's handling of the weakening economy and dissidence, it is of very low volume and noticeable mainly because of its total absence previously. Rather than showing a positive direction of change, East Berlin's actions in the past year are most notable for their backsliding: ?

- o Following last year's amnesty, the number of political arrests, detentions and imprisonments is now increasing.
- o Censorship of church publications is up.
- o Emigration and travel restrictions seem to have been tightened again after showing some progress previously.

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- o The Berlin Wall shoot-to-kill order seems to have been reinstated as there have been several shooting incidents in recent weeks.

No significant economic reforms are on the horizon.

- o Lesser actions possibly will be slowly taken to allow some private consumer services and agriculture to develop, reduce some subsidies, and give enterprises greater leeway in foreign trade and joint ventures.

Romania

Ceausescu maintains a strict Stalinist political and economic system, is convinced this is the right course, and rejects all proposals for change. His security apparatus enforces his brutal oppression, the country's Hungarian minority is especially abused, no open criticism of the regime is tolerated, and Ceausecu himself gives all the orders that count, sometimes down to the enterprise level.

- o The only attractive feature of his rule is his general rejection of Moscow's dictates and relatively independent foreign policy.
- o Ceausescu has rejected all calls for economic reform and is using his brutal austerity program to pay off the country's international debt--and not permitting any noteworthy modernization of the economy.

Yugoslavia

Yugoslavia has evolved to a point that it is fundamentally different from the the East European Bloc six, although it still remains far short of a democratic, market oriented nation. Politically and economically it may be two decades ahead of Hungary and Poland. Its current political troubles are in part the result of the democratization that has occurred.

- o The national and regional Party organizations play only modest roles in policy for ILLEGIB and do not exercise practical control over the actions of the federal or six republic governments. The Federal Presidency and not the Party controls the military and other security organs.
- o Federal powers are generally weak and the ethnically diverse regions exert strong control over their own future.
- o The use of secret ballots and multi-candidate elections is growing.
- o Freedoms of assembly and speech are generally taken for granted, although some regional media are strictly controlled.
- o Yugoslavia boasts the most decentralized economic system in the Communist world, although the economy is still guided by inefficient "social compacts" between firms, banks and local governments.
- o The current agreement with the IMF calls for freeing up prices and foreign exchange rates, broadening the private sector, permitting bankruptcies, and further expanding

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private and foreign investment rights.

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CZECHOSLOVAKIA: ECONOMIC PROFILE

Population (1987): 15.9 Million GNP/Capita (1987 US \$): \$9,522
 Percent of US per capita GNP: 51.8

	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
GNP (Purchase Parity - Billion 1987 US \$)	145.2	146.3	149.4	151.4
GNP (Constant Prices - % Change by Year)	2.4	0.8	2.1	1.3
Consumer Price Index (1980 = 100)	106	109	109	110

Industrial growth, which powers the Czechoslovak economy, fell last year to little more than half that of 1986 and growth in agricultural production slowed to less than half the 1986 rate. Inventories of shoddy, unsold goods -- particularly those of engineering products and machinery -- reached levels in 1987 roughly equivalent in value to the total net material product of 1986. Although favorable weather spurred above plan growth in overall output during the first half of 1988, the pace of growth slowed in the second quarter and unwanted stocks continued to accumulate. The Czechoslovak leadership -- aiming to improve domestic supplies and work discipline -- announced in mid-May a comprehensive plan to increase the variety and quality of consumer goods in 1989 and 1990. Retail sales already jumped 6 percent in the first half of 1988.

Last year, Czechoslovakia, long Eastern Europe's most financially conservative country, ran its first hard currency trade deficit of the decade. Prague boosted hard currency imports by 18 percent as it stepped up purchases of Western machinery to support its ambitious modernization drive. The 7-percent rise in exports was composed primarily of increased sales of food, chemicals and machinery. The regime has admitted early problems in meeting its hard currency targets in 1988 and has attributed the lack of success on foreign markets to the low quality of Czechoslovak industrial production.

Prague moved from a deficit in 1986 to a surplus trade balance with the USSR in 1987 by reducing imports almost 2.5 percent and increasing exports by more than 5 percent. The reduction in the value of imports primarily reflects declining Soviet energy prices. Regime officials admit that despite meeting export volume targets for machinery on the whole, there were still problems in the selection and quality of Czechoslovak engineering exports to the USSR.

<u>Hard Currency Trade and Payments</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
Exports (Million US \$)	4122	4059	4472	4801
Imports (Million US \$)	3328	3422	4182	4945
Balance of Trade (Million US \$)	794	637	290	-144
Current Account Balance (Million US \$)	640	510	170	-340
Gross Debt (Billion US \$)	3.58	3.83	4.48	5.81
Reserves (Billion US \$)	1.01	1.01	1.22	1.59
<u>Trade with the USSR</u>				
Exports (Million Rubles)	6017	6587	6556	6907
Imports (Million Rubles)	6591	6813	6947	6777
Balance of Trade (Million Rubles)	-574	-226	-391	130

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EAST GERMANY: ECONOMIC PROFILE

Population (1987): 16.6 Million GNP/Capita (1987 US \$): \$11,870
 Percent of US per capita GNP: 64.5

	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
GNP (Purchase Parity - Billion 1987 US \$)	184.7	190.0	192.9	197.1
GNP (Constant Prices - % Change by Year)	3.5	2.8	1.5	2.2
Consumer Price Index (1980 = 100)	106	109	111	112

East Germany's GNP growth accelerated moderately in 1987. By significantly increasing its hard currency imports, East Germany achieved the region's highest industrial growth rate of 3 percent, half a percentage point higher than 1986. East Germany, which is not a major agricultural producer, was the only country in Eastern Europe to manage modest growth (about 1 percent) in agricultural output last year; this followed a 1.5 percent decline in 1986. Improved weather conditions spurred near plan fulfillment in the first half of 1988; however, industrial growth has slowed during the third quarter and sectors producing consumer goods have been running behind plan. The regime has called for increases in consumer supplies this year to appease a population increasingly envious of life styles in the West.

To support its ambitious modernization drive, East Germany -- one of Eastern Europe's strongest countries financially -- boosted hard currency imports nearly 15 percent in 1987. East Berlin managed the second highest rise in hard currency exports in the region last year (nearly a 15 percent increase in US dollar terms). Much of this growth in dollar value occurred in inner-German trade and was due to the devaluation of the dollar against the West German mark. East German officials have complained that unsatisfactory industrial performance will probably hurt export performance this year.

Berlin's trade deficit of a half billion rubles with the USSR was the largest in Eastern Europe last year. Although still the region's foremost exporter of machinery and equipment to the Soviet Union, East German exports fell largely because of a sharp decline in deliveries of ships and other marine equipment. Conflicting reports blame the falloff in East German deliveries on tougher Soviet quality standards, problems in the East German economy, and a planned slowdown to accommodate new investment and retooling in East German industry. While its trade deficit declined in the first six months of 1988, East Germany is now the only East European country continuing to record a shortfall with the Soviet Union.

<u>Hard Currency Trade and Payments</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
Exports (Million US \$)	8402	8177	9225	10601
Imports (Million US \$)	7321	7436	8757	10065
Balance of Trade (Million US \$)	1081	741	468	536
Current Account Balance (Million US \$)	1110	1230	540	940
Gross Debt (Billion US \$)	12.37	14.05	17.04	20.42
Reserves (Billion US \$)	4.54	6.49	7.46	9.01
<u>Trade with the USSR</u>				
Exports (Million Rubles)	7367	7553	7128	7093
Imports (Million Rubles)	7481	7652	7880	7636
Balance of Trade (Million Rubles)	-114	-99	-752	-543

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HUNGARY: ECONOMIC PROFILE

Population (1987): 10.6 Million GNP/Capita (1987 US \$): \$8,260
 Percent of US per capita GNP: 44.9

	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
GNP (Purchase Parity - Billion 1987 US \$)	87.0	84.8	86.6	87.6
GNP (Constant Prices - % Change by Year)	2.6	-2.6	2.1	1.2
Consumer Price Index (1980 = 100)	133	144	152	167

Hungary's GNP grew slowly in 1987 as a 1-percent decline in agricultural output offset much of the 2.5-percent growth in industry. Although government subsidies, higher domestic demand, and investment growth buoyed overall industrial output, sectors important to modernizing industry and expanding exports continued to lag. In an effort to balance the budget and generate a hard currency current account surplus by 1990, Budapest introduced a three-year austerity program in January, which calls for a drop of 6 to 8 percent in consumption and GNP growth of less than 1 percent. In the first eight months of 1988, industrial production grew only 0.3 percent, consumer prices rose 16 percent, and retail trade declined about 5 percent in real terms.

Hungary labors under the highest per capita hard currency debt in Eastern Europe. Even if the austerity program reduces the current account deficit, Budapest will probably need to borrow more than \$2 billion annually until 1990 and increasing amounts thereafter, exceeding \$3 billion by 1992. Without these funds, Hungary faces the prospect of a debt rescheduling and even more severe austerity measures. Hungary was Eastern Europe's largest borrower from Western commercial lenders in 1987 and probably will remain the largest borrower in 1988. An IMF standby agreement has helped Budapest secure the commercial loans it needs this year, and it intends to negotiate a new Fund program for next year. Hungary ran a \$177 million trade surplus in the first six months of 1988 compared to a \$337 million deficit in the same period last year. In the first eight months of 1988 Budapest expanded exports by over 20 percent, surpassing IMF mandates, but did not reduce imports as required.

Hungary ran the region's largest surplus with the Soviet Union in 1987. Exports rose by more than 4 percent, and imports slipped by nearly 2 percent. The reduction in the value of imports primarily reflects declining Soviet energy prices. Exports of machinery and equipment to the USSR rose by 2 percent, including a 13 percent increase in buses. Meat and poultry exports rose 29 percent.

<u>Hard Currency Trade and Payments</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
Exports (Million US \$)	3974	3508	4136	4324
Imports (Million US \$)	3811	3732	4676	4712
Balance of Trade (Million US \$)	163	-224	-540	-388
Current Account Balance (Million US \$)	330	-460	-1420	-850
Gross Debt (Billion US \$)	8.84	11.76	15.09	17.74
Reserves (Billion US \$)	2.11	3.12	3.06	2.27
<u>Trade with the USSR</u>				
Exports (Million Rubles)	4434	4850	4873	5080
Imports (Million Rubles)	4321	4560	4678	4600
Balance of Trade (Million Rubles)	113	290	195	480

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Talking Points for DCI**US Economic Relations with Eastern Europe**

Obtaining economic support is Eastern Europe's overriding priority in its relations with the United States. The regimes want Washington to lower barriers to their exports, liberalize controls on technology transfer, provide credits, encourage US firms to enter joint ventures, and advance their interests in international economic organizations. The East Europeans believe such concessions are valuable not only as direct assistance but also as a lever to unlock even more benefits from Western Europe and Japan.

- o **Hungary, Poland, and Yugoslavia** already receive reduced US tariffs under Most Favored Nation trade status while Romania lost this status earlier this year when it refused to comply with human rights conditions. The other countries are seeking MFN.
- o **Hungary** wants continued US support for IMF and World Bank credits, assistance in changing US banks' negative attitudes on lending to Hungary, encouragement of joint ventures through insurance from the Overseas Private Investment Corporation (OPIC), and a trade office on the West Coast. A privately funded US management training school is about to open in Budapest.
- o **Poland** is seeking US support in applying for an IMF adjustment program, new official and commercial credits, and lower interest rates on its government debt rescheduling accords.
- o **Bulgaria** is lobbying the US to support its bid for membership in the General Agreement on Tariffs and Trade (GATT) and reductions in Western barriers to its exports. The US is opposed because of inadequate market reforms in Bulgaria and the poor performance of other Soviet bloc GATT members (Romania, Poland, Czechoslovakia, Hungary). Sofia also wants help in attracting joint ventures.
- o **Romania** wants the US to restore MFN status without human rights conditions; meanwhile, it is trying to cut deals with US firms to reduce the cost of higher tariffs.
- o **East Germany** wants reduced US tariffs on its exports, but is stalling on settlement of US and Jewish claims arising from World War II and postwar nationalization, the precondition for a trade accord.
- o **Czechoslovakia** wants MFN status and US government support for participation of US firms in Czechoslovak investment projects.
- o **Yugoslavia** seeks US support for financial assistance from the IMF, commercial banks and Western governments as well as an easing of US quotas and tariffs on some exports.

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Eastern Europe accounts for less than 1 percent of US world trade and foreign lending. Easing of East-West tensions and talk of reforms in Eastern Europe have sparked more interest in the US business community, but firms remain wary of the region's economic weaknesses and highly bureaucratized systems.

- o The US ran a trade deficit of \$1.3 billion with the region in 1987, and a fall in exports to several countries will probably widen the shortfall this year.
- o US banks hold \$1.3 billion in claims on the six Soviet-bloc countries of Eastern Europe and \$2.0 billion in claims on Yugoslavia. These totals are down from a peak of \$5.0 billion and \$3.0 billion respectively in 1981.
- o Liberalized joint venture laws have attracted a few US firms to invest in Hungary, Yugoslavia, and Poland, but questions about security of investment, control of operations, and access to profits continue to dampen Western enthusiasm for joint ventures in Eastern Europe.

UNITED STATES
1987 TRADE IN TOTAL COMMODITIES
(MILLION US \$)

Partner:	Exports Value	Percent	Imports Value	Percent	Balance Value
WORLD	252496	100.0	422407	100.0	-169912
EAST EUROPE	1180	0.5	2493	0.6	-1313
ALBANIA	3	0.0	2	0.0	1
BULGARIA	89	0.0	47	0.0	42
CZECHOSLOVAKIA	47	0.0	86	0.0	-39
EAST GERMANY	54	0.0	96	0.0	-42
HUNGARY	95	0.0	306	0.1	-210
POLAND	239	0.1	330	0.1	-91
ROMANIA	193	0.1	782	0.2	-589
YUGOSLAVIA	460	0.2	845	0.2	-384

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Talking Points for DCI**East European Record on Technology Transfer**

The Warsaw Pact countries are working aggressively to close the technology gap with the West through legal and illegal acquisitions of Western science and technology, particularly in computers, industrial automation, nuclear power, advanced materials, biotechnology, telecommunications, electronics, and chemicals. The East Europeans acquire technology through two different programs.

- o The Bloc targets militarily significant Western technology for the USSR as part of an acquisition program managed by the Military Industrial Commission (VPK) of the Presidium of the Council of Ministers. This program--designed to improve Soviet weapons and military equipment--seeks to acquire one-of-a-kind military and dual-use hardware, blueprints, product samples and test equipment primarily through intelligence channels.
- o The East Europeans also target dual-use Western technology through a trade diversion program using Western businessmen as middlemen. Although equipment acquired through the VPK Program is almost exclusively for the Soviets, the East-Europeans usually acquire dual-use technology to improve their own industries.

Some countries seemingly are more active than others in providing Western technology to the USSR; the **apparent** smaller degree of activity by some may reflect limited access to desired technologies, greater success in covering their tracks, or their lesser cooperation with the Soviets.

- o **Bulgaria and Hungary** are active illegal technology diverters. For example, the Bulgarians gave Moscow access to Japanese technology for controllers, disk drives, and microelectronics; and the Hungarians have diverted a large portion of the integrated circuits that they have acquired from the West.
- o **East Germany** legally and illegally acquires large quantities of dual-use Western technology for its own high technology industries but often balks at sharing technology in CEMA to preserve a competitive edge for its industries.
- o **Poland** has occasionally exported Western technology indirectly, such as by embodying Western integrated circuits in their computer exports to the USSR, but we do not know if technology has been illegally diverted.
- o We lack conclusive evidence that **Czechoslovakia** regularly acquires Western technology for diversion to the USSR.
- o **Romania** clandestinely acquires COCOM-controlled technology, but probably seldom shares the technology with the USSR; Bucharest has passed a decree to exclude foreigners, including Soviets, from Romanian factories.

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Non-Pact member **Yugoslavia** is not a proscribed country under COCOM rules.

- o Although the Yugoslav government attempts to prevent diversion of controlled technologies to the Bloc, some individual officials and enterprises have made illicit transfers. For example, a Floating Point Computer System was diverted within the past two years .
- o US negotiations with Belgrade to upgrade the 1976 Memorandum of Understanding on observance of export controls to comply with current COCOM procedures are underway.

All except East Germany and Romania have liberalized their policies on joint ventures since 1986 in an effort to acquire more Western technology, but so far these initiatives have attracted few Western partners.

In the political sphere the Bloc countries will use their new political ties to the European Community (EC) to lobby for weakening of COCOM controls and access to EUREKA, the West European advanced technology program.

- o Although the EC has endorsed the current COCOM rules and has refused to include science and technology in new cooperation pacts with the Bloc, various West European political parties and business interest groups are pressing for relaxation of controls.

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Talking Points for DCI**East European Record on Terrorism**

Eastern Europe continues to provide direct and indirect assistance to terrorist groups, usually under the pretext of aiding "national liberation movements". Assistance ranges from allowing transits of known terrorists to providing arms, training, funding, and political encouragement. However, increased US and Western pressure has recently forced some countries to curtail their support.

Yugoslavia: Reacting to US pressure, Yugoslavia recently has taken limited steps to distance itself from terrorists and better control its porous borders. Belgrade expelled Fatah security official Colonel Hawari in June and has promised to step up surveillance of its large Middle Eastern student populace. Terrorists, however, reportedly continue to transit and reside in the country, and Belgrade did not publicly condemn North Korea's abuse of its territory following the bombing of a South Korean airliner last fall.

Poland: Following considerable US pressure, Warsaw in 1988 reluctantly closed down an Abu Nidal organization (ANO) trade office operating on its territory. There is no current evidence that Poland trains terrorists or provides them direct support.

Hungary: Increased Western pressure and publicity have prompted Budapest to distance itself from terrorists and step up efforts to control their transits. Hungary also reportedly expelled one of Colonel Hawari's lieutenants last year and has allowed US officials to inspect its antiterrorist unit. Budapest, however, has a long way to go in ending terrorist misuse of its territory.

Bulgaria: Sofia engages in gray arms sales -- using Western factory markings to disguise their Bulgarian origin -- and conducts training for various "national liberation" groups. Recently, Sofia has been somewhat more open to dialogue with the US on terrorism, probably hoping to win some economic benefits, but so far talks have produced only evasive and tardy responses.

Czechoslovakia: Evidence of Prague's current involvement in terrorism is limited to reports of Czechoslovak-produced explosives finding their way into the hands of terrorists. Prague denies any responsibility, but has said it would consider tagging its explosives with chemicals to make them more detectable. Although Czechoslovak officials continue to deny US charges of involvement with terrorists, past evidence suggests Prague has conducted terrorist training and may still be doing so.

East Germany: East Germany continues to rebuff all US overtures to move forward on counterterrorism and probably still conducts terrorist training. Since 1986, evidence of East German support for terrorism has diminished somewhat, probably due to better concealment. Past indications of East German assistance to terrorists include extensive diplomatic safehaven, transit rights, and training activities.

Romania: Reports of Romanian involvement with terrorism are scant and dated, mostly involving sporadic transits, arms sales to Middle Eastern sponsors of terrorism, and military

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training for Palestinians. During bilateral talks in 1987, Bucharest seemed interested in getting US help to stop terrorists from entering Romania, but prospects for reciprocity and broader cooperation are probably limited.

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24 October 1988

Talking Points for DCI**Yugoslavia: The State of The Crisis**

Serbian party chief Milosevic (pronounced Mee-LOH-sheh-veech) suffered a major setback in his bid to overturn the post-Tito system of collective, ethnically balanced decisionmaking in favor of strong Serbian rule at a national party plenum last week. In the coming weeks, he is most likely to moderate his tactics in response to federal pressure. New provocations and confrontations with federal leaders, however, are still possible. Enduring stability is unlikely until the country's underlying ethnic and economic problems are dealt with more effectively.

Milosevic failed to achieve his main goals at the plenum:

- o He was not able to oust most of his opponents from the national leadership
- o National and regional leaders have sent Milosevic a clear signal that they will not tolerate his use of Serbian nationalism to undermine the political system.
- o Senior military officers at the plenum indicated to Milosevic that they remain solidly behind the federal leadership, and that they will not allow him to try to gain influence among the Serb-dominated officer corps. [redacted]

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We believe two scenarios are possible in the coming days or weeks:

- o **Most likely is that Milosevic's actions will be constrained by federal and regional leadership stands.** Serb demonstrations would gradually taper off or remain at a low level. Federal leaders would grant Serbia some increased control over its two autonomous provinces to assuage Serb public opinion. This would give Serbia only a modestly greater voice in national policymaking.
- o **Milosevic makes a greater attempt to destabilize the political system and overturn the federal leadership.** He would encourage larger and frequent demonstrations of Serbs in other republics and in Belgrade. But such an attempt would most likely lead to Milosevic's ouster. Federal leaders are now more likely to use federal security forces--or the Army if necessary--to quell new waves of Serb demonstrations.

Even if Belgrade reins in Milosevic, the prospects for greater instability will increase as long as the weak national leadership fails to take tough steps to dampen ethnic nationalism--especially among his Serb supporters--and improve economic performance. [redacted] 25X1

- o The national party and government officials probably will be no more effective in solving key problems.
- o Dissatisfaction with Premier Branko Mikulic's (MEE-koo-leech) handling of the economy is so great that he and his cabinet could face a vote of confidence within six months.

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- o No new government is likely to be able to implement the kind of economic reforms needed to promote recovery and stop inflation, now running at more than 200 percent.

The current developments in Yugoslavia threaten US interests for several reasons:

- o While the current political turmoil is indicative of the partial democracy that has evolved in Yugoslavia, Milosevic's goals and the escalation of ethnic antagonisms are a danger to previously developing democratic processes and pluralist institutions.
- o Military intervention in Serbia provoked by future Milosevic provocations would likely be accompanied by significant human rights violations.
- o Yugoslav economic objectives and the likelihood of Belgrade's meeting commitments to the IMF have been further threatened, and new demands for Western economic aid are likely to become more vociferous.

The US has limited options--with the exception of expressing general concerns over Yugoslav stability--to influence the course of the political fight or Milosevic's actions. The US could encourage the IMF to relax stringent performance criteria associated with a standby agreement negotiated last May. Short of providing massive economic aid, more liberal US policies on imports, export financing, and technology transfer agreements could help, in small part, to relieve austere economic conditions.

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Talking Points for DCI**Poland: Political State of Play****Current Political Situation**

The situation is extremely fluid; both sides want to appear flexible while portraying the other as uncompromising. The Roundtable talks, reportedly now set to begin this Wednesday, were delayed, apparently as part of a government propaganda campaign designed to drive wedges in the opposition.

- o Several of Walesa's close advisers have been branded by the regime as "unacceptable" members of Solidarity's delegation. They are depicted as confrontational intellectuals, led Solidarity astray in 1981.
- o The government wants to divert attention from its **stonewalling on Solidarity's relegalization**; however, the regime remains ambiguous on the issue and is leaving room in its public statements for the rebirth of independent factory level unions. The government has not specified what powers such truncated unions might have, or what price it would expect Walesa to pay for the concession.
- o Premier Rakowski is touting his plans for unilateral economic and political reforms, apparently hoping to strengthen his hand going into the talks. These plans include conceptually sound intentions to decentralize the economy and plans to offer independents seats in the parliament, but not a genuine share of power in the government. Rakowski believes that if he can turn the economy around, his government can minimize political concessions to Walesa.

Solidarity continues to insist that relegalization is the necessary precondition for its support of economic reform and austerity. **Walesa might accept a compromise** granting Solidarity immediate factory level recognition, with a firm timetable for acquiring specified regional and national organizational rights. Even he is probably unsure if he can sell such a compromise to union militants. A variety of sources indicate he is having difficulty in imposing discipline on his diverse and hastily assembled union delegation.

Alternate Futures

If the regime is using the roundtable as an elaborate ploy, it will have no intentions even of offering a "factory-level" compromise. Walesa will probe early on to test this intent. If he concludes this is the regime's intention, the talks will break down acrimoniously. We can then expect new large-scale demonstration and strikes; whether they become violent and widespread will depend on the authorities' initial reaction, the organizational base Solidarity has recreated since last May, and the public mood.

- o If the regime's approach to the talks is sincere, it is still possible that after hard bargaining on both sides, no acceptable formula will be found on the key issue of

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Solidarity's legalization. In this case, the regime will probably offer concessions on some other issues, perhaps on associations, hoping for a "face-saving" solution of allowing Walesa to register Solidarity as a national association, not a union. If the associations policy is liberal enough, the church may see something in it for itself, and the regime will hope Walesa feels the heat. It is unlikely, however, that such a "half-way" solution will be acceptable, but it might buy Rakowski time until the spring.

- o Regardless of what may happen at the Roundtable talks, external "provocations" could occur--perhaps wide-scale student strikes, new labor strikes as coal price hikes begin to hurt, or hardline party thugs create an incident. These external events will increase the pressure on the negotiators; how they would react is uncertain but such events would be more likely to sabotage than strengthen the talks.

US Goals and Options

US policy is to seek the legal existence of an opposition in Poland and genuine powersharing in decisionmaking.

- o Since only the regime can resolve the political impasse, the US is pushing for specific legal guarantees to allow associations to form, to allow open elections, and to set specific time tables for reestablishing an independent union structure. Once these guarantees are in place, we probably would encourage the moderate opposition to test and use them to shape policy in appropriate areas such as worker benefits and economic planning.
- o The US generally seeks to strengthen Walesa's hand because of his centrist tendencies to support change within the system rather than through violence.

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Talking Points for DCI**Poland: Economic Crisis and the IMF**

Poland's economic crises this year--with two major outbreaks of labor strikes and reform policy failures triggering 60 percent inflation--have hit hard an economy already struggling with falling output, a massive foreign debt, and worsening living standards:

- o Poland's GNP fell 2.5 per cent last year, with an 11.5 percent decline in agricultural output.
- o Poland's \$39 billion hard currency debt is the largest in Eastern Europe--almost twice that of Yugoslavia or East Germany.
- o Per capita income is ten percent less than it was in 1980, and urban couples must wait 10-25 years for an apartment.

The May and August strikes convinced Warsaw to reshuffle both the the government and its economic reform policies. The new government has repudiated earlier wage and price policies, and a new package of economic reforms is being prepared hastily for November.

- o Prime Minister Rakowski has pledged to increase consumer goods supplies and to attack Poland's severe housing shortage. The regime will try to show quick results, but importing goods in short supply is expensive and cannot continue indefinitely.
- o The government claims it will give priority to revitalizing agriculture, pressing financial discipline on enterprises, encouraging growth of the private sector, strengthening the currency, and dealing with Poland's severe pollution problems.

Poland's prospects for an economic recovery without fundamental reforms and Western financial assistance are bleak. Current foreign exchange earnings are not enough to meet industrial import needs and maintain even interest payments on Poland's \$39 billion debt.

- o Poland's obsolete, inefficient, smokestack industries are incapable of producing new, competitive exports without substantial inflows of Western technology and equipment.
- o Even traditional foreign-exchange earners are in jeopardy. Poland's coal industry has depleted most of the more accessible coal; maintaining production will prove increasingly costly.
- o Curbs on imports in the 1980s have kept many Polish enterprises producing below capacity because of inadequate supplies of spare and replacement parts for Western plants and equipment imported in the 1970s.

Renewed access to foreign hard currency credits is insufficient to solve Poland's problems. Also required is a sound import and investment strategy--virtually impossible in Poland without

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significant progress in financial reform, tough IMF supervision, and project evaluation assistance from the World Bank.

- o An IMF standby agreement would give Poland access to perhaps \$2-3 billion in IMF loans over the next few years.
- o More importantly, the IMF would work with Poland in formulating its macroeconomic policy, cited by many of Poland's Western creditors as a key condition for resuming their own loans to Poland--which could total many times what the IMF agrees to.

However, with the wage concessions won by strikers, the current overall inflation, and the government decision to import consumer goods, Poland by any objective criteria is less able than last year to meet normal IMF criteria for a standby agreement.

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Talking Points for DCI

Hungary: Can the Party Manage Political Change?

Recent developments in Hungarian society show a **momentum for political reform that has caught the party's leadership off guard** and left it confused and divided over its next steps. Reform-oriented intellectuals, emboldened by the removal from the Politburo last May of long-time party leader Kadar and his do-nothing "old guard," have taken the initiative in proposing fundamental changes to the system.

- o Their main tactic has been to organize independent political organizations and unions that, at a minimum, hope to serve as pressure groups to influence regime policies, and, over the long run, could form the basis of new political parties.
- o They also have organized a series of public demonstrations to protest regime policies on such issues as the environment, conscientious objection, and Romanian repression of ethnic Hungarians in Transylvania.

The regime has done little to control or direct these developments because the leadership is divided over their desirability.

- o The most reform-oriented members believe that political reforms are needed before the populace will accept austerity and economic restructuring; they are encouraging the formation of the independent groups, and some are proposing even broader reforms in widely-publicized speeches.
- o More orthodox leaders worry that such political changes will further undermine Communist party power; they are trying both to muzzle the reformers in public and to force the new groups to accept the primacy of the party before allowing them to exist.

The party is now more tolerant of independent political activity, but the regime is still not clear whether it intends to legalize the new groups and unions. Reburial of Imre Nagy, the leader of the 1956 revolution, and a neutral reevaluation of the events leading to the revolution would be the clearest signal that Budapest is prepared to legalize independent groups and take other steps in the direction of political liberalization.

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Talking Points for DCI**East Germany: Jewish Material Claims**

East Germany is showing greater interest in a settlement of Jewish material claims for losses suffered in prewar and wartime Nazi Germany in hopes of getting Western economic support to help it overcome lagging economic growth and growing industrial obsolescence.

- o The East German leadership earlier this year termed the claims for \$100 million for Jewish-owned property losses understandable but did not go beyond a longstanding offer of \$1 million for Jewish suffering while standing firm on its demand for US trade concessions to enable payment.
- o The leadership handled the visit last week of Edgar Bronfman, head of an important Jewish organization, with unusual protocol made it seem that final agreement on a \$100 million settlement had been reached and that a public announcement was just around the corner.
- o Honecker and company undoubtedly hope that demonstrations of flexibility or even a settlement of Jewish claims, which might be announced in conjunction with the Kristallnacht commemorations set for November 8-9, together with hints of movement toward a resumption of diplomatic relations with Israel, will win a favorable hearing in Washington for East German demands for trade concessions.

Meanwhile, the regime shows no signs of budging from its position that it cannot pay US material claims pegged at \$300 million without tariff concessions and an easing of technology transfer restrictions to stimulate increased bilateral trade, an argument we calculate has no basis in view of East German hard currency reserves of some \$8 billion.

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Talking Points for DCI**Romania: Outlook For Relations with the US**

Bilateral relations are at a standstill in the wake of Romania's renunciation of its Most-Favored Nation (MFN) trading status last February, due to Bucharest's unrealistic expectation that the next US Administration will want to upgrade the relationship again.

- o Ceausescu, who has never understood the importance of human rights in the formulation of US foreign policy, apparently believes his loss of MFN was an election year ploy by Washington and that the next Administration -- regardless of which party wins -- will eventually offer to renew MFN on his terms -- without Jackson-Vanik human rights restrictions.
- o In the meantime, Ceausescu wants to maintain the appearance of good bilateral relations through a series of high-level visits and discussions on trade and general international issues. He has been disappointed by Washington's refusal to agree to largely ceremonial exchanges, but he may rationalize this as more election year maneuvering.

With MFN gone, Ceausescu no longer feels constrained to make human rights concessions to the US.

- o Emigration to the US is down by 40% in the first 9 months of this year, compared to the same period in 1987. In contrast, emigration to West Germany -- covered by a separate agreement under which Bonn makes cash payments for emigres -- has not been affected, and emigration to Israel is down only slightly, apparently due to the shrinking pool of potential emigres.
- o Bucharest refuses to honor its previous commitment to print Baptist Bibles and is stonewalling discussions with various Protestant denominations on replacing recently destroyed churches or constructing new ones.
- o Romania has stepped up its harassment of visiting Western journalists, including Americans, and all but eliminated bilateral cultural exchanges.
- o Romania rejects any international discussion of its mistreatment of Transylvania's 2 million-strong Hungarian minority or of Ceausescu's "systematization" plan (which calls for the destruction of half the nation's villages in order to make more land available for agriculture.)

While Bucharest also reacted to the loss of MFN by further restricting our embassy's access to Romanian officials, such restrictions may be selectively eased in coming months in an effort to restart flagging relations.

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- o Party Secretary for International Affairs Stoian followed up Ceausescu's conversation with Deputy Secretary Whitehead almost immediately by agreeing to see Ambassador Kirk for the first time in nearly 3 years.
- o Romanian agreement to move ahead with the purchase of three Boeing 767 aircraft after protracted negotiations is also intended to signal renewed interest in improved relations.
- o Even these limited concessions are likely to disappear once the new Administration indicates the continued linkage of human rights concerns to other aspects of bilateral relations.

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Attached is additional background on Gorbachev and Eastern Europe provided by the NIO for Europe. Most importantly, you should know that in May of 1988 we produced the NIE, "Soviet Policy Towards Eastern Europe Under Gorbachev." You might want to take a quick look at the Key Judgments of this NIE.



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NIO/EUR; 10/21/88

GORBACHEV AND EASTERN EUROPE

Our National Estimate (NIE 11/12-9-88) in May concluded that:

- "Gorbachev's policies have increased the potential for instability in Eastern Europe."
- They have also "expanded the scope for diversity and experimentation."
- These trends present "new opportunities for US and Western policies" to encourage greater liberalization and independence from Moscow.

These judgments have been confirmed. If anything, changes have come faster than forecast.

- In Poland, the Jaruzelski regime has opened a long overdue dialogue with Lech Walesa and other opposition leaders. If the dialogue succeeds, the Polish government may finally implement economic and political reforms. If it fails, Poland faces renewed labor unrest and perhaps much greater instability.
- Hungary's new leadership under Grosz includes radical reformers whose proposals go well beyond Gorbachev's in the USSR. While the Hungarian leadership has been debating, Hungarian society has begun to organize itself as if Hungary were already a pluralist system.

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- Outside the Soviet sphere, Yugoslavia faces its greatest threat to stability since the 1940s. New attempts by Serbia (the largest republic) to dominate the federal system, coming on top of a severe economic crisis, raise major concerns about Yugoslavia's ability to hold together.

- Elsewhere, events have been much less dramatic. Czechoslovakia's new leadership under Jakes has only begun to move toward cautious economic change; Bulgaria and East Germany have done even less. Romania's severe economic problems could lead to instability, but regime policy will not change so long as Party leader Ceausescu remains in power.

Eastern Europe is entering a period of profound change that will have important implications for US interests. An upheaval there could threaten Gorbachev's position in the USSR and upset positive trends in East-West relations. A successful move toward liberalization and national autonomy, on the other hand, could help break down some of the barriers that have divided Europe since 1945.

But our ability to influence developments in Eastern Europe is limited. All these countries look to the United States for political and especially economic support. But our limited ability to provide economic help -- improved trade, new credits, and permanent Most Favored Nation treatment -- is dwarfed by the magnitude of their economic problems. High-level visits are useful in demonstrating our commitment to human rights and democratic values. But the broader questions of internal change in the region are beyond our control.

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Soviet Policy Toward Eastern Europe Under Gorbachev

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National Intelligence Estimate

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*NIE 11/12-9-88
May 1988*

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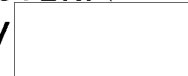
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SOVIET POLICY TOWARD EASTERN
EUROPE UNDER GORBACHEV



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Thus, at best, Gorbachev's approach can achieve only evolutionary progress toward political rejuvenation and improved economic performance in Eastern Europe. Continued, and probably heightened, Soviet pressure will lead to sharper conflicts, both within East European societies and between Moscow and its allies.

Potential Challenges to Soviet Control

Cross-pressures emanating from Moscow, coupled with severe economic and political dilemmas in Eastern Europe, could yield more serious challenges to Soviet interests. Three extreme scenarios are possible:

- *Popular upheaval* in Poland, Romania, or Hungary, involving a broad-based challenge to party supremacy and ultimately to Soviet control.
- *Sweeping reform* in Hungary or Poland, going well beyond Gorbachev's agenda and eventually threatening to erode party control.
- *Conservative backlash*, involving open repudiation of Soviet policies by orthodox leaders in East Germany, Romania, or elsewhere.

Of these, popular upheaval is the most likely contingency. Gorbachev will expect his allies to act decisively to end any political violence or major unrest. Indeed, East European leaders are at least as aware of the need for vigilance as Gorbachev is, and they have at their disposal powerful security forces that have proved effective in containing unrest. Should events spin out of their control and beyond the limits of Soviet tolerance, the ultimate controlling factor on change in Eastern Europe will be Soviet force:

- Gorbachev faces greater constraints than did his predecessors against intervening militarily in Eastern Europe; his foreign policy and arms control agenda, and much of his domestic program as well, would be threatened.
- A Dubcek-like regime would have much greater latitude to pursue reforms now than in 1968, and Soviet intervention to stop it would be more problematic.
- In extremis, however, there is no reason to doubt his willingness to intervene to preserve party rule and decisive Soviet influence in the region.

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Implications for the United States

Gorbachev's sanctioning of diversity and experimentation have expanded the limits of the thinkable in Eastern Europe, presenting new opportunities for US and Western policies:

- Economic dilemmas and high-technology requirements will lend strength to US calls for internal reforms of the kind already legitimized by Moscow.
- Gorbachev's active European policy and the generally more dynamic period of East-West relations will offer new opportunities for the West to engage even the more conservative East European regimes.

At the same time, Gorbachev's policies will complicate the coordination of Western policies toward European security. Differing Western approaches will make it harder for Western governments to reach a political consensus on dealing with Moscow and its allies, and harder for NATO to maintain a security consensus.

Gorbachev's policies also call into question some of the assumptions upon which the US policy of differentiation is based, in that the twin US goals of diversity and liberalization increasingly collide. Those regimes most at odds with Gorbachev's approach also tend to be the most orthodox and repressive, and the reform-minded Hungarians and Poles are now closely attuned to the Soviet line. In practice, however, our ability to influence the grand alternatives—reform or retrenchment, crisis or stability—will remain limited; we can at best encourage evolutionary movement toward internal liberalization and greater independence from Soviet tutelage.

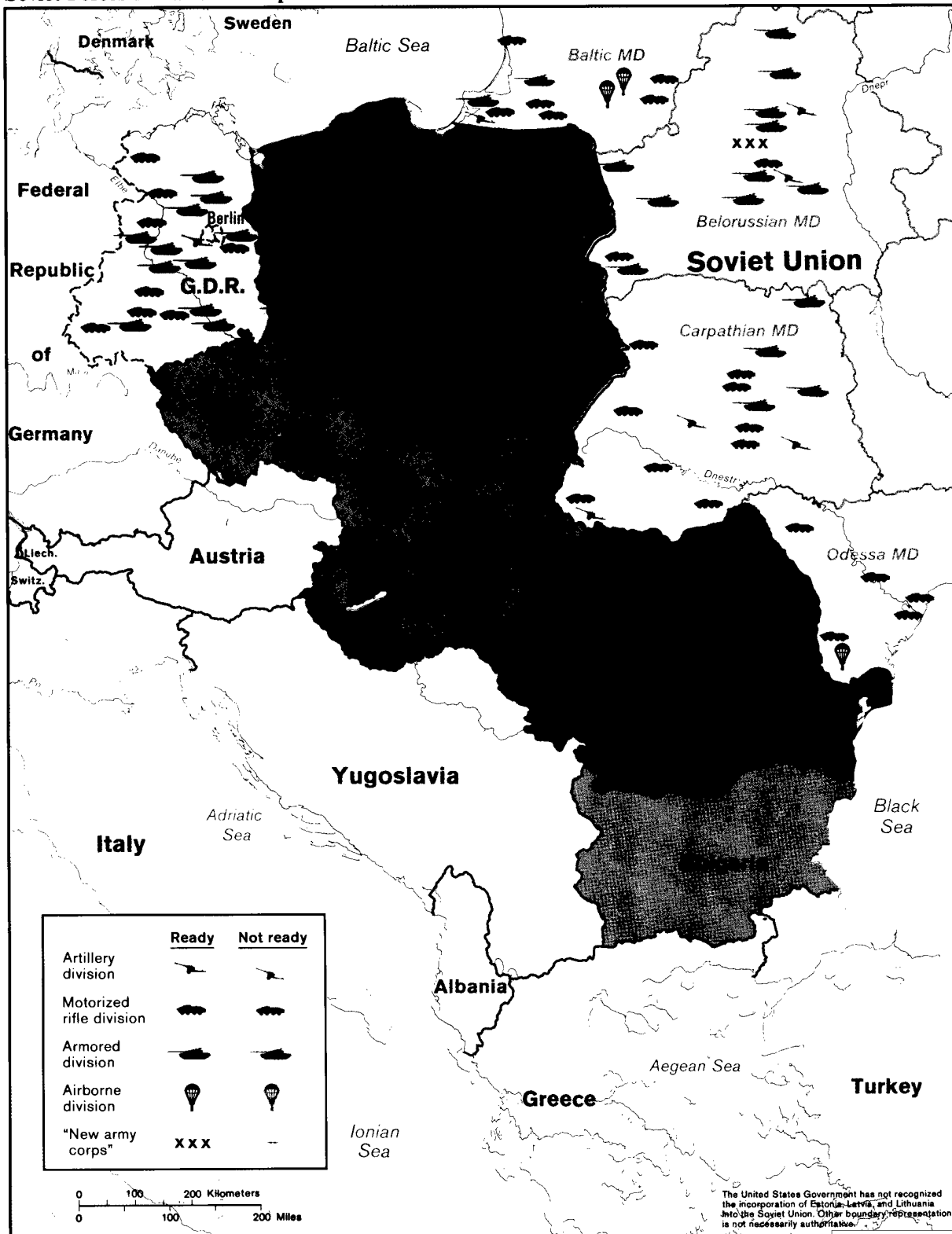
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Figure 1
Soviet Forces in Eastern Europe



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DISCUSSION

1. Not since the early Khrushchev years have policy changes in the USSR had so profound an impact on Eastern Europe as those now being pushed by General Secretary Mikhail Gorbachev. These new winds blowing from Moscow, as well as serious internal economic and political dilemmas, have ushered in an era of considerable uncertainty—and potentially of significant change—in Eastern Europe. With the impending passing of an entire generation of leaders in the region, Soviet policy over the next three to five years is likely to be decisive in determining the scope and direction of change and, ultimately, the stability of the Soviet empire. []

2. For Gorbachev as for his predecessors, the importance of Eastern Europe can hardly be exaggerated: it serves as a buffer, military and ideological, between the USSR and the West, a base for projecting Soviet power and influence throughout Europe, a conduit of Western trade and technology, and a key external pillar of the Soviet system itself. The Soviet Union continues to exercise decisive influence over the region through a complex web of political, economic, and military and security ties, and there is no reason to doubt ultimate Soviet willingness to employ armed force to maintain party rule and preserve the Soviet position in the region. []

3. At the same time, however, Eastern Europe is a region of chronic instability, recurrent crisis, and growing diversity; the tasks of Soviet alliance management have grown progressively greater. Successive Soviet leaders have sought both cohesion and viability in Eastern Europe; they have failed to achieve them simultaneously. Gorbachev, while mindful of the need for stability, has tilted the balance toward an agenda of change and reform in the interest of regime viability. Some veteran East European officials liken the current situation to Khrushchev's de-Stalinization campaign and the subsequent upheavals in Hungary and Poland in 1956; they fear that the Soviet reform

¹ This Estimate examines relations between the Soviet Union and its six Warsaw Pact allies—East Germany, Poland, Czechoslovakia, Hungary, Romania, and Bulgaria—over the next three to five years. It focuses on the impact and implications of Soviet policies in the region as a whole rather than offering detailed assessments of individual countries. []

drive will unleash potentially uncontrollable pressures for change in Eastern Europe. []

Eastern Europe in the Mid-1980s

4. The new Soviet leadership under Gorbachev inherited an Eastern Europe whose seeming quiescence was belied by serious problems just beneath the surface. To be sure, the challenge posed by Solidarity in Poland had been successfully contained with the imposition of martial law in December 1981, and the Jaruzelski regime had made some progress toward restoring party control and neutralizing its domestic opposition. Yet, throughout Eastern Europe, severe economic problems, rising social discontent, and political stagnation among the aging party leaderships created an unstable situation []

5. *Economies in Decline.* When Gorbachev assumed power in 1985, Eastern Europe had endured nearly a decade of economic decline and stagnation. Most obviously, the region-wide financial crisis of the early 1980s contributed to the end of an era of East-West economic detente: trade with the West declined sharply, new credits were scarce, and several of the East European regimes were compelled to enter into extensive refinancing negotiations with Western creditors. Trade relations with the USSR fared little better, as Soviet oil prices reached a new peak in 1982-83, belatedly reflecting the full brunt of the 1978-79 increases in the world market (as the five-year averaging mechanism for Soviet oil deliveries caught up with prevailing world rates). []

6. These reversals took a heavy toll on standards of living, as the East Europeans struggled with large foreign debts and deteriorating economic performance. In Romania and Poland, shortages of energy and basic foodstuffs raised the prospect of economically induced political instability; elsewhere, problems were less disastrous but still acute. Failure to deliver the promised improvements in living standards—the linchpin of regime strategies in the 1970s—further undermined political legitimacy and deepened societal alienation. Reduced investments and growing lags in the scientific-technological revolution had also weakened East European competitiveness on world markets further mortgaging the region's economic future. []

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7. **Aging Leaderships.** Adding to Eastern Europe's decline was the stagnation and immobility of its aging party leaderships. By 1987, the average age of the six top party leaders was well over 70, their average tenure in office more than two decades. Only Poland's General Jaruzelski, a relative youngster at 64, and East German party leader Erich Honecker, still spry at 75, seemed capable of energetic leadership; most of the others were in poor health, presiding over leaderships bereft of new ideas. These were hardly the men to grapple with the difficult policy issues of the 1980s.

8. Political malaise in Eastern Europe had been accentuated by a long period of enfeeblement in Moscow, stretching from the latter years of the Brezhnev era through the interregna of Yuri Andropov and Konstantin Chernenko. Three Soviet successions in the space of as many years, coupled with mixed policy signals, heightened uncertainties and complicated succession dilemmas in Eastern Europe. The absence of clear and decisive Soviet leadership also contributed to a period of drift in Eastern Europe, as each regime began to ad-lib its own approaches, even on some sensitive foreign policy issues.

9. **Challenges to Soviet Authority.** Ideological erosion in Eastern Europe—accelerated by the crushing of Solidarity in Poland—gave rise to new independent social groups and, above all, to a resurgence of national consciousness throughout the region. In some cases, the regimes responded by attempting to co-opt nationalist sentiments, as in the Honecker regime's appropriation of Martin Luther, Frederick the Great, and others as precursors of the East German state. In others, official policy played on exclusivist, chauvinistic nationalism: the Bulgarian regime mounted a brutal assimilation campaign against its Turkish minority, and Romania's President Ceausescu increased repression against the Hungarian minority in Transylvania.

10. More worrisome from Moscow's perspective were new signs of national self-assertiveness among its allies, particularly in the aftermath of INF (intermediate-range nuclear force) deployments in Western Europe in late 1983 and 1984. East European concern about the Soviet walkout from the Geneva disarmament talks in late 1983 betrayed deeper anxieties over the erosion of European detente. During the fall of 1984, there was an unprecedented, semipublic display of Warsaw Pact disunity—the Soviet and Czechoslovak regimes called for a tougher line and closed ranks, while the East Germans, Hungarians, and Romanians pressed for improved East-West relations and stressed

the special role of small states in promoting detente.

11. For most of the East European regimes, the preservation of European detente was no longer just desirable; it had become an essential ingredient of their economic and political strategies. It also corresponded to rising pressures from below for national self-expression and self-assertion and for affirming the "Europeanness" of the East European states. Unlike the upheavals of 1956, 1968, and 1980-81, these trends did not directly threaten Soviet primacy in the region but were aimed at achieving greater scope for diversity in the interest of economic and political stability. Together with mounting internal problems, they added up to considerable disarray in Moscow's East European empire.

Gorbachev's Policies Toward Eastern Europe

12. In Eastern Europe as elsewhere, Gorbachev's initial approaches were extensions of his broader domestic and arms control agenda:

- Domestically, Gorbachev was seeking to revitalize Soviet power and prestige through economic "restructuring" (*perestroika*) and a carefully regulated campaign of "openness" (*glasnost*), designed to strengthen a lagging economy, overcome bureaucratic resistance, and breathe new life into society at large.
- Externally, Gorbachev needed a respite from East-West tension and the debilitating arms race with the United States. He also sought to replace the rigid, ideological world view of his predecessors with a more sophisticated pursuit of Soviet regional interests, particularly in Western Europe and East Asia.

13. As for Eastern Europe, Gorbachev probably did not have a fully developed conception of its problems and, as at home, lacked a clear and detailed plan of action. Improved economic performance was a high priority—to transform Eastern Europe from a drain on Soviet resources to an asset in the Soviet modernization drive and to promote economic and political viability. Gorbachev viewed with obvious disdain the hidebound leaderships in Prague, Sofia, and Bucharest, which reflected the corruption, inefficiency, and dogmatism of Brezhnev's latter years. Given his ambitious foreign policy program, he also required renewed discipline and greater coordination among the East Europeans:

- In pursuit of these objectives, Gorbachev needed to press change on the East Europeans, particularly in economic policy. But he also needed

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stability in the region, so as not to jeopardize his more urgent priorities at home.

— Although Gorbachev was not inclined to embark on a high-risk strategy, he also saw dangers in continued stagnation and hence was more ready than any Soviet leader since Khrushchev to encourage diversity and experimentation as the keys to long-term viability in the region.

— And, of course, Soviet approaches to Eastern Europe were not Gorbachev's alone. As on domestic policy, Gorbachev also had to take into account the views of other key Soviet officials. (See annex.)

14. *Foreign and Security Policy Coordination.*

Gorbachev's first task was to reassert firm leadership over Warsaw Pact foreign policy and improve coordination to support his far-reaching arms control agenda. This he achieved through a series of Warsaw Pact summits—six in his first two years—and the adoption of something approaching a conciliar system, whereby the East Europeans were briefed before and after major Soviet foreign policy initiatives. More important, the Soviet shift from confrontation to dialogue on arms control issues helped allay East European concerns of being caught in the middle of rising tensions, facilitating a natural convergence of Soviet and East European approaches on East-West issues.

15. Gorbachev's ambitious foreign agenda also entailed a much greater role for the East Europeans. Jaruzelski and Honecker paid early visits to China aimed at restoring normal interstate and interparty ties, and several East European governments began exploring the prospects for normalizing relations with Israel. Some—notably the Poles and East Germans—floated new arms control and other security proposals. And Honecker's visit to Bonn exemplified a more active Western policy by the GDR.

16. In light of growing East European diplomatic activity, it should not be surprising that Gorbachev laid great stress on coordination and discipline in Warsaw Pact councils. The renewal of the Pact itself was instructive. With its initial term due to expire in May 1985, the Romanians and others hinted that they favored certain changes to the text—a watering down of mutual defense obligations and more precise provisions for the Pact's eventual dissolution—and that they wanted only a 10-year extension. In the event, the Pact was renewed without a single change; and Gorbachev, then only two months on the job, had achieved an

Multilateral Summit Meetings of Soviet and East European Party Leaders, 1985-87

Date	Location	Event	Agenda
March 1985	Moscow	Chernenko funeral	
May 1985	Warsaw	Warsaw Pact 30th anniversary	Renewal of Warsaw Pact
October 1985	Sofia	Warsaw Pact Political Consultative Committee (PCC) meeting	Pre-Geneva arms control proposals
November 1985	Prague	Ad hoc	Informal debriefing on US-Soviet summit at Geneva
June 1986	Budapest	PCC	"Budapest appeal" for conventional and tactical nuclear force reductions
November 1986	Moscow	Ad hoc meeting of CEMA (Council for Economic Mutual Assistance) party leaders	"CEMA 2000" program for scientific-technological cooperation
May 1987	East Berlin	PCC	Conventional force reductions; military doctrine; "new international economic order"
December 1987	East Berlin	Ad hoc	Debriefing on US-Soviet summit in Washington

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impressive show of unity. (Gorbachev reportedly hammered out this agreement at the time of Chernenko's funeral—literally his first day in office—but only at the price of offering new Soviet energy deliveries in return for Ceausescu's agreement.) Gorbachev also has moved to expand the infrastructure of the Warsaw Pact. In May 1987, two new Pact bodies were created to facilitate ongoing coordination of Soviet and East

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European arms control positions and supervision of East European foreign visits and contacts [redacted]

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17. At the same time, however, Gorbachev has used the Bloc's consultative bodies for substantive policy discussions rather than ritualistic endorsement of pre-cooked resolutions. Soviet influence remains paramount, but Gorbachev's new stress on consultation and consensus-building reflects his understanding that the East Europeans have extensive and useful foreign ties of their own and that an effective Soviet approach to the West must take these realities into account. Once a common position is reached, Gorbachev has insisted on closed ranks and alliance discipline, and even the loyal Bulgarians have been called to task for failing to endorse Soviet arms control initiatives with sufficient enthusiasm. Gorbachev also instructed the Poles to redraft the "Jaruzelski Plan" for arms reductions in Central Europe, and he played a key role in controlling the pace and timing of inter-German relations.

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18. *Economic Pressures.* The second major item on Gorbachev's agenda was to link the East European economies to the Soviet modernization drive. Both bilaterally and through CEMA (the Council for Economic Mutual Assistance), Gorbachev moved to redress the trade deficits the East Europeans ran up in the 1970s, maintaining a freeze on Soviet oil deliveries at their early 1980s level and demanding increased imports of higher quality East European goods, particularly consumer items and high-technology machinery and equipment. The heavily indebted Poles, Romanians, and Hungarians were enjoined to reduce their economic dependence on the West; the Bulgarian and Czechoslovak regimes were exhorted to revive their stagnant economies and upgrade performance. And all were pressed to join the Soviet-led "Comprehensive Program" for scientific-technical cooperation through the year 2000—"CEMA 2000," for short—through joint ventures and coordinated production in key high-technology areas:

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- To enforce these strictures, Gorbachev created new quality-control inspections and delivered blunt messages to several East European leaders.
- Gorbachev lobbied personally for the swift implementation of the CEMA 2000 program in late 1985 and, in doing so, moved CEMA toward a new agenda.

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² These are the Multilateral Group for Current Information Exchange and the Special Commission on Disarmament Questions.

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- He also pushed through new bilateral agreements on scientific-technological cooperation and secured new legislation in the East European countries to facilitate coproduction and joint ventures.

19. The actual conduct of Soviet-East European economic relations in Gorbachev's first two years revealed less change than the early rhetoric seemed to promise. Indeed, the East European trade deficit with Moscow rose sharply in 1986 to 2.6 billion rubles—the largest annual trade gap since 1981. Although trade for 1987 was nearly balanced, the favorable trends were due chiefly to a decline in the value of Soviet oil rather than increased East European deliveries. In export performance, as well as domestic "restructuring," the veteran East European leaders temporized with the familiar foot-dragging that has frustrated Soviet leaders from Khrushchev on.

20. The East Europeans were particularly wary of being drawn into Soviet-sponsored (and Soviet-dominated) joint ventures in high-technology areas, and resistance was evident in the elaboration of the CEMA 2000 program. Owing to its industrial power and unique access to Western technology via "inner-German" trade, the GDR was the key East European participant; but the East Germans, like the Hungarians and Romanians, were reluctant to jeopardize their own carefully cultivated trade relations with the West in support of Gorbachev's domestic agenda. Soviet-East European differences were evident at the hastily convened November 1986 Moscow summit on CEMA integration, which yielded only minimal consensus on the next stage of scientific-technological cooperation. Even Soviet planners now concede CEMA 2000 goals are too optimistic.

21. *Succession Dilemmas.* These frustrations pointed to Gorbachev's more basic dilemma: how to impart some of his own dynamism to Eastern Europe without a wholesale shakeup of the ossified party leaderships in Prague, Sofia, and elsewhere. Gorbachev evidently recognized, however, that any direct attempt to instigate an East European succession would entail great risks. Consequently, Soviet efforts have been largely indirect, aimed at shaking up the ruling establishments by projecting reformist ideas and the example of Moscow's own domestic innovations. These efforts also aimed at shifting the internal party debates in those countries toward the preferred Gorbachev agenda, and in so doing altering the context and accelerating the pace of presuccession maneuvering.

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Outlook: Growing Diversity, Sharper Conflict

26. Soviet policy toward Eastern Europe is likely to continue along the lines already established under Gorbachev. Its key elements will be:

- Within the framework of firm party control, *sanctioning of diversity and experimentation* as the keys to economic and political viability.
- Continued *pressure for reform* without dictating specific measures or demanding slavish emulation of Soviet practices.
- Insistence on *foreign policy coordination*, whereby the East Europeans are afforded greater room for tactical maneuver but are expected to hew closely to the broad lines set in Moscow.
- Mounting pressure for *improved East European economic performance* and increased cooperation in high-technology areas.
- Longer term efforts toward *strengthened institutional ties*, coupled with alliance management techniques that facilitate Soviet control and influence through a more participatory system of give-and-take [redacted]

27. These broad contours of Soviet policy will remain in place so long as Gorbachev's domestic position is secure and Eastern Europe remains quiescent. A major change in Moscow would obviously alter the equation:

- *Gorbachev's ouster* would curtail the Soviet reform drive and heighten uncertainties in Eastern Europe as the new regime sorted itself out. His removal on political grounds would send another new signal to the divided East European regimes—this time a sharply antireformist one—and undercut Soviet authority, at least temporarily.
- *Retrenchment in Moscow* (with Gorbachev still in office) would strengthen the existing orthodox leaders in Eastern Europe without fully arresting the pressures for change. Perceived lack of unity in the Kremlin would further polarize Eastern Europe, with conservatives seeking to restore the status quo ante and reformists continuing to push for change.
- *More daring Soviet reforms*—a result, perhaps, of Gorbachev's need to overcome bureaucratic resistance through radical policy and personnel

changes—would further destabilize Eastern Europe and strain relations with Moscow. Rising pressures within the East European regimes might prompt some of them to implement sweeping reforms or force out existing leaders.

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28. Gorbachev has played a skillful political game so far, pulling back when necessary while gathering support for the next push forward. Although the chances of a domestic showdown have increased, Gorbachev seems to have the upper hand and appears inclined to push his reform agenda further and more forcefully [redacted]

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29. ***Growing Diversity.*** For the next three to five years, the outlook in Eastern Europe is for growing diversity—in responding to reform pressures, crafting approaches to the West, and managing relations with Moscow. Diverse East European arms control proposals and economic approaches to the West will facilitate some Soviet objectives, but they will also complicate the tasks of alliance management and run counter to the joint action needed for scientific-technological cooperation. In Gorbachev's broader view, moreover, diversity is no end in itself but rather a vehicle for economic and political regeneration. These goals are nowhere in sight in Eastern Europe. Except perhaps in Hungary, they are not likely even to be seriously pursued [redacted]

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30. *Glasnost* and *perestroika* will continue to yield mixed results. Barring leadership changes, Romania and East Germany will continue to resist reform pressures; Bulgaria will continue to experiment at the margins but will proceed only haltingly toward real "restructuring." The new Czechoslovak leadership under Jakes will push more forcefully for economic change, but serious movement toward economic and political reform remains a distant prospect. Hungary and Poland could be more interesting:

- The appointment of Karoly Grosz—a tough, self-confident risk taker in the Gorbachev mold—as General Secretary of the Hungarian party and the promotion into the leadership of outspoken reform advocates marks an important turning point. The new leadership is likely to be much more aggressive in pressing economic and political reforms, but it faces severe problems—including workers unhappy with austerity, intellectuals demanding more freedom, and an economy that is stagnating and burdened with a heavy foreign debt. Failure to develop a more radical

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and effective reform program would further contribute to a rise in tensions.

— Evidently with Soviet blessings, General Jaruzelski has already consolidated a rather unorthodox pattern of party-military rule, moved toward granting the Catholic Church new legal status, and proposed economic reforms that, on paper at least, go well beyond Moscow's. The disastrous economic situation and social discontent—as shown by the recent wave of strikes—make successful realization of the reforms unlikely, but the urgency of domestic problems may also push the regime toward the social dialogue it has rejected up to now [redacted]

31. In foreign policy, the East European regimes have reason to be satisfied with Gorbachev's skillful engagement of the West and their own increased room for maneuver. So long as Moscow maintains a conciliatory approach to the West, Soviet and East European policies will remain generally congruent. At the same time, Gorbachev's encouragement of a more active role for the East Europeans will increase the chances for open conflicts of interest at CSCE (Conference on Security and Cooperation in Europe) talks and in other Pan-European forums. There will also be increased risk of further embarrassments to Moscow arising from Hungarian-Romanian polemics or public airing of East European human rights violations. Hence, foreign policy coordination will require more skillful management, and Gorbachev will need to prod the Czechoslovak and Bulgarian regimes toward more active diplomacy while restraining the occasional independent-mindedness of the Romanians, Hungarians, Poles, and East Germans [redacted]

32. At the same time, East European realities will limit the parameters of possible Soviet initiatives. Not only must Gorbachev weigh the consequences of Soviet policies on political stability in Eastern Europe, but he must also take into account the perceptions and likely reactions of East European leaders. Their views are not likely to deter him from policies he considers vital to Soviet interests; but, on matters as potentially destabilizing as inter-German relations, his options are limited. Indeed, Gorbachev's campaign for a common "European house" of growing intra-European cooperation implies a degree of national autonomy in Eastern Europe far beyond what he or any other Soviet leader would countenance. Moscow will find it increasingly difficult to promote this line in the West without introducing new divisions into Eastern Europe as well. (The Berlin Wall will stay, whatever tactical advantages Gorbachev might see in its removal. [redacted])

Table 1 *Million US \$*
Eastern Europe: Projected
Debt Figures, 1987-90^a

	1987	1988	1989	1990
Bulgaria				
Gross debt	4,954	5,121	5,375	5,730
Net debt ^b	3,531	3,598	3,745	3,986
Debt service ratio ^c (percent)	36.7	36.4	37.1	38.4
Czechoslovakia				
Gross debt	4,714	4,940	5,150	5,335
Net debt	3,497	3,723	3,933	4,118
Debt service ratio (percent)	15.3	15.8	16.4	16.7
East Germany				
Gross debt	16,775	16,573	16,447	16,423
Net debt	8,862	8,660	8,534	8,510
Debt service ratio (percent)	41.0	38.7	36.1	33.8
Hungary				
Gross debt	15,314	16,684	18,084	19,502
Net debt	13,414	14,784	16,184	17,602
Debt service ratio (percent)	54.1	53.4	54.9	57.1
Poland				
Gross debt	34,570	35,937	37,417	38,908
Net debt	32,850	34,117	35,497	36,888
Debt service ratio (percent)	73.9	74.0	64.2	74.5
Romania				
Gross debt	4,214	3,324	2,679	2,053
Net debt	3,632	2,490	1,593	967
Debt service ratio (percent)	34.5	21.5	16.3	14.5

^a Last updated: 14 January 1988.

^b Reserve figures used in calculating net debt exclude gold reserves.

^c The debt service ratio is calculated using the following formula:
Interest payments + medium- and long-term principal repayments/total exports + invisible receipts. The debt service ratio for Poland is calculated using the amount of interest owed, not the amount paid.

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Table 2

Percent

Eastern Europe's Economic Outlook: Average Annual Growth by Five-Year Plan Period ^a

	1971-75	1976-80	1981-85	1986-90 ^b
Bulgaria				
Total GNP	4.7	1.0	0.8	1.0
Gross fixed investment	6.4	-9.1	-1.1	2.5
Personal consumption	3.9	1.6	2.1	1.0
Czechoslovakia				
Total GNP	3.4	2.2	1.1	1.0
Gross fixed investment	6.5	-0.3	-1.2	1.0
Personal consumption	2.7	1.5	1.1	1.0
East Germany				
Total GNP	3.5	2.3	1.7	2.0
Gross fixed investment	1.5	1.7	-10.0	2.0
Personal consumption	3.8	2.0	1.2	1.5
Hungary				
Total GNP	3.3	2.0	0.7	1.0
Gross fixed investment	2.3	0.3	-5.2	1.0
Personal consumption	3.2	2.2	0.4	0.5
Poland				
Total GNP	6.5	0.7	0.6	2.0
Gross fixed investment	14.4	-2.9	-4.9	1.5
Personal consumption	5.6	2.4	-0.2	1.5
Romania				
Total GNP	6.7	3.9	1.8	2.0
Gross fixed investment	10.4	6.9	-2.2	2.0
Personal consumption	5.1	4.7	0.2	1.0

^a Last updated: 12 January 1988.^b Projections for 1986-90 were based on analysis of current trends, results of econometric models, and consultations with country experts.

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33. **Strained Economic Relations.** Eastern Europe cannot deliver what Gorbachev wants: significant improvements in trade performance, particularly in high-technology areas. Poland and Hungary will remain saddled with enormous debts for the foreseeable future, with East Germany and Bulgaria also facing debt problems. The Romanian economy, drained to repay Western creditors, will remain devastated for years to come, and Czechoslovakia's industrial and technological base has been rendered obsolete by years of neglect. Throughout the region, projected growth rates and shares devoted to investment will remain suppressed, leaving the East European economies with only limited capacity to assist in the Soviet modernization drive. Nor are the East Europeans likely to

jeopardize economic relations with the West or risk further reductions in domestic living standards for the sake of Gorbachev's economic agenda []

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34. So far, Gorbachev's economic pressures—like those of Soviet leaders before him—have yielded few tangible results aside from improved deliveries in some areas like machine tools. Foreign trade plans for 1986-90 are inconsistent with Gorbachev's main goals, calling for an average annual growth of only 5 percent in Soviet-East European trade—the slowest growth in planned trade in the last 15 years. Similarly, most of the CEMA 2000 technical goals appear unattainable—only a handful of joint ventures have been created, and the push for “direct links” between enterprises remains hamstrung by economic and bureaucratic

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impediments that have frustrated Soviet planners from the beginning. Moreover, Soviet-East European terms of trade have begun to shift against Moscow, as the five-year averaging mechanism for Soviet oil prices has caught up with declining prices on the world market. If world oil prices hold roughly steady for the next few years—or even if they increase somewhat—the East European ruble debt will begin to disappear, further weakening Moscow's economic bargaining power. [redacted]

35. Gorbachev will face a growing gap between his economic goals and results over the next three to five years, at the very time that his domestic modernization plans call for a significant increase in East European inputs and tangible progress in the CEMA 2000 program. Following the pattern of his domestic policies, Gorbachev has come to realize that his goals in Soviet-East European economic relations cannot be met without systemic economic and institutional reform. At the October 1987 meeting of the CEMA prime ministers, the Soviets reopened some of the fundamental problems raised earlier by the East Europeans themselves: lack of convertible currency, inadequacy of direct links among firms, and absence of a rational pricing mechanism. And Gorbachev will soon learn, if he has not learned already, that reforming intra-CEMA trading procedures is futile without deep structural reforms in the domestic economic systems. [redacted]

36. Thus, the dilemma of promoting change without provoking instability in Eastern Europe will grow more acute. Faced with an almost certain need to increase the pace of reform at home, Gorbachev is likely to step up pressure on the East Europeans to introduce *perestroika* and economic reform, albeit not with the same intensity or impact as in the USSR. [redacted]

37. **Succession Scenarios.** Leadership changes in Eastern Europe present both risks and opportunities for Gorbachev. On the one hand, it is increasingly clear that change of the kind Gorbachev wants will not take place under the current crop of leaders. The prospective departure of several veteran leaders gives Gorbachev an unparalleled opportunity to influence the selection of more energetic and innovative party leaderships. On the other hand, several East European successions—some already under way—pose risks for political stability and hence for Gorbachev's broader agenda. [redacted]

38. The Hungarian succession of May 1988 dramatically altered the top leadership and raised popular expectations for reform, but the attendant austerity

measures are likely to heighten domestic tensions. Nor is the succession process complete: further leadership changes, including the naming of a new prime minister, are still ahead. In Czechoslovakia as well, Husak's replacement by Jakes is just the beginning of a turnover of the entire post-1968 leadership, with the need for Czech-Slovak proportionality adding to the disruption. Elsewhere, impending successions promise to be similarly unsettling:

- Zhivkov has been in power for more than three decades; his departure will reverberate throughout the Bulgarian apparat.
- With seven Politburo members over 70, the East German party faces a major turnover of the remaining leaders of the wartime generation.
- The post-Ceausescu succession in Romania will introduce considerable uncertainties into that highly personalized leadership and may invite East-West rivalry as Moscow attempts to reassert influence with a successor regime. [redacted]

39. Gorbachev's task will be to manage several leadership transitions, perhaps simultaneously, to assure that preferred, or at least acceptable, successors are named and that regime authority is preserved in the process. His ability to do so will depend on his success in defeating conservative forces in his own leadership. The options and constraints confronting him in Eastern Europe are fairly clear:

- He will need to work with the existing top leaderships; Soviet preferences will be important but not decisive.
- There will be a short list of three to five figures in each party whose seniority gives them some claim to the job.
- Excluding the Ceausescu clan, nearly all these figures meet the minimum qualifications of experience and reliability.
- Except in Hungary, none has demonstrated the kind of dynamism Gorbachev wants, though a few have reformist credentials.

While the Hungarian succession probably comes close to Gorbachev's preferences for Eastern Europe, prospective leadership changes elsewhere are not likely to yield the dynamic, innovative leaders Gorbachev needs to achieve his more ambitious goals in the region as a whole. He will probably have to settle for a series of transitional leaderships and then work to ensure that a new generation of reform-minded leaders is groomed. [redacted]

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40. This cautious and gradualist approach has the advantage of minimizing the disruption inherent in East European successions. If carefully managed, it may also facilitate the eventual transfer of power to a new and more forward-looking generation of leaders. But it will not soon yield the dynamic, innovative leaderships Gorbachev needs to achieve his more ambitious economic and political goals in Eastern Europe. It also means that Gorbachev's reform pressures will continue to be aimed at leaderships ill equipped and, in some cases, unwilling to respond.

41. *Sharper Conflict.* Thus, at best, Gorbachev can achieve only evolutionary progress toward political rejuvenation and improved economic performance in Eastern Europe. And currently contemplated reforms will not solve deep-seated political and economic problems. As the gap between objectives and results becomes more evident, Gorbachev will be inclined to push more aggressively for deeper changes as the necessary precondition to economic and political revitalization. To do so will require a careful calibration of Soviet policy: he will need to push hard enough to achieve tangible results but not so hard as to provoke system-threatening instability. The danger of miscalculation will increase

42. Already Gorbachev has introduced new destabilizing tendencies into Eastern Europe through his open critique of past failures of socialism, heightened economic pressure on his allies, and, above all, the demonstration effect of his domestic reform program. Sharper conflict is likely even if Gorbachev does not increase the pressure on his allies. The longer the Soviet reform dynamic continues, the stronger will be the internal pressures for change on the East European regimes.

43. These cross-pressures, coupled with severe economic problems and leadership uncertainties, will heighten popular unrest in Eastern Europe. In Poland, newly implemented austerity measures have led already to widespread strikes, protests, and demonstrations; Hungary and Romania also face growing unrest. There will be a general increase of antiregime activism, owing to the climate of "openness" and greater willingness to test the limits of regime tolerance. Human rights, religious, pacifist, environmentalist, and other groups—already active in most of Eastern

Europe—will grow more assertive. The pattern of cooperation among Hungarian, Czech, and Polish dissidents is also likely to expand.

44. These developments alone will not threaten party rule, but collectively they will:

- Weaken regime authority.
- Undermine economic recovery prospects.
- Lay the groundwork for more serious challenges.

Potential Challenges to Soviet Control

45. There are at least three more extreme scenarios that could lead to serious challenges to Soviet control over Eastern Europe.

46. The Hungarian Revolution of 1956, the 1968 Prague Spring, and the Polish social revolution of 1980-81 (along with numerous lesser upheavals) provide ample evidence of the inherent instability of Moscow's East European empire. Each of these had its own dynamic, but each led ultimately to a broad-based challenge to party supremacy and Soviet control in the region. And each led to crisis—meaning in the East European context the actuality or imminent likelihood of Soviet military intervention.

47. However, Gorbachev's sanctioning of reform and experimentation implies a more liberal Soviet definition of "crisis." Liberalizing reform (of the kind espoused by the 1968 Czechoslovak leadership) may no longer lead so swiftly and automatically to a "crisis situation" in Moscow's eyes.

48. *Popular Upheaval.* Several of the usual instability indicators—discontent over living standards, weak and divided leadership, social unrest—are evident in several countries, and all face pressures emanating from Moscow. New shocks—severe austerity measures, the death or ouster of a top party leader, or the emergence of an organized and emboldened opposition—could bring about serious instability almost anywhere, with Poland, Romania, and Hungary the most likely candidates for trouble:

- The likelihood of multiple, simultaneous upheavals is higher than it has been in more than 30 years. In the late 1980s and into the early 1990s, virtually all the East European countries face

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Romania: Impending Crisis?

The potential for regime-threatening crisis is growing in Romania, the country least affected by Gorbachev's policies and most defiant of Soviet strictures. Romania's problems are homegrown, owing to the Ceausescu regime's severe austerity measures and draconian domestic policies.

A major riot involving an estimated 5,000 to 10,000 protesters in Brasov in November 1987 was the most visible manifestation of growing public unrest, which has given rise to scattered strikes, demonstrations, and acts of sabotage. So far, unrest has remained isolated and localized: there is no organized opposition, and security forces are well equipped to quell protests—with stocks of foodstuffs as well as truncheons.

Evidence is also growing of ferment within the party hierarchy itself. Disenchantment within the rank and file, fueled by popular protests and Ceausescu's scapegoating of the party for his economic failures, has left him isolated. Gorbachev's public criticism of Ceausescu's ruling style and widespread knowledge of Ceausescu's medical problems are accelerating this trend, as officials throughout the system try to distance themselves from him to avoid being caught up in a post-Ceausescu housecleaning. Discontent within the party has been diffuse up to now, and Ceausescu's reshuffling of key leaders has precluded the emergence of an oppositionist faction.

These economic and political pressures add up to an increasingly volatile internal situation, however, and several possible scenarios could bring about a full-scale upheaval:

- *Ceausescu's death or incapacitation.* Ceausescu suffers from prostate cancer and has visibly weakened in the past year (although he maintains a vigorous schedule). If he were to die in office, he would probably be replaced by a collective including his wife Elena and other loyalists; such a regime would probably be embroiled quickly in a broader succession struggle.
- *A palace coup.* The most likely crisis scenario would have growing popular unrest, stimulating still more dissatisfaction within the party and setting the stage for Ceausescu's ouster. He would

probably be succeeded by a collective of figures currently within the party leadership; Elena and the rest of the clan would be swept away along with Ceausescu himself.

- *A brushfire of popular unrest.* Simultaneous outbreaks of protest could spark a more widespread uprising, overwhelming Securitate resources and leading to a breakdown of public order. The resulting near-anarchy could lead to a seizure of power by the military.

Soviet Attitudes

So long as Romania did not descend into complete disorder, Moscow would probably have more to gain than lose in a crisis scenario. A post-Ceausescu leadership would offer opportunities for restoring lost influence; and Romania's geopolitical and economic realities would remain severe constraints on any successor regime in Bucharest.

Military intervention would not even be a plausible contingency unless there were incipient anarchy in Romania or the advent of a successor leadership that threatened to remove Romania from the Warsaw Pact. Neither is likely.

Spillover in Eastern Europe

Short of a Soviet invasion, events in Romania would not have wide repercussions elsewhere. Nor would they impinge on Gorbachev's broader agenda, in that a Romanian crisis would not be linked to Soviet policies or pressure tactics; indeed, a crisis provoked by Ceausescu's misrule would strengthen Gorbachev's argument that stability demands economic and political rejuvenation. However:

- Hungarian-Romanian relations would be severely strained if domestic violence in Romania were to turn into ethnic violence directed at the Hungarian minority in Transylvania.
- And Yugoslavia would be involved if bloodshed or chaos in Romania precipitated an exodus of Romanians seeking refuge abroad via Yugoslavia.

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analogous sets of problems: stagnant economies, leadership successions, and reformist pressures from Moscow.

- As in the past, however, possible scenarios would be highly country-specific. Only in Romania is there a significant possibility of widespread violence; elsewhere, the greater likelihood would be

a broad-based, organized challenge to regime authority. (In Poland, however, this latter scenario could also lead to a cycle of repression and violence.)

- 49. For Gorbachev, a possible upheaval in Eastern Europe constitutes the greatest external threat to the Soviet reform program and his own continued tenure.

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Despite the greater tolerance he has shown for experimentation, he will expect his allies to take swift, decisive action to end any political violence or major unrest. Indeed, the East European leaderships are at least as aware as Gorbachev is of the need for vigilance, and they have at their disposal large security forces that have been effective thus far in containing disturbances. Should events overwhelm the capacity of local leaders, there is no reason to doubt that he would take whatever action was required, including military intervention, to preserve party rule and Soviet authority in the region. Like his predecessors, Gorbachev would exhaust all other options before undertaking Soviet military intervention. Indeed, he faces even greater constraints:

- A Soviet invasion of an allied country would do irreparable damage to his image in the West and undermine the entire edifice of his foreign policy.
- An upheaval in Eastern Europe, particularly one attributable to Gorbachev's reform pressures, could also threaten his domestic standing. It would add to domestic political pressures for his removal from power and the curtailment of his reform program. [redacted]

50. **Sweeping Reform.** Gorbachev has expanded the limits of acceptable reform. In Hungary and Poland particularly, reform blueprints are being circulated that go well beyond anything now on the agenda in Moscow. And now the Hungarians have put in place a leadership team containing radical reformers, such as Imre Pozsgay, head of Hungary's Patriotic People's Front. Although Grosz has more conservative leanings than the newcomers, he is action-oriented and willing to take some chances to get the party out in front of the reform process. In light of the looming economic decline and coalescence of dissident and establishment pressures around a reform package, he could be pulled by his new Politburo toward more radical solutions to Hungary's problems. Given the fate of previous reform movements, there would be strong elite and popular inhibitions against direct challenges to party supremacy and the Soviet alliance system. If Eastern Europe's past is any guide, however, a genuine reform movement in Hungary or elsewhere would tend inevitably toward national self-determination and autonomy. [redacted]

51. Such a scenario would be the most hopeful for Eastern Europe and the most problematic for Moscow, particularly if public discipline were maintained.

There would be no incipient anarchy to facilitate Soviet suppression, few pro-Soviet collaborators to call on, and no cataclysmic event to spur Moscow to take early and decisive action. By the time Gorbachev had decided that the course of events had gone too far, he could be faced with a relatively unified reform leadership and a disciplined and determined population; the costs of intervention would be much higher than under a scenario of serious internal instability. Gorbachev would have to choose between suppressing a genuine reform movement—inspired by his own calls for *glasnost* and *perestroika*—or countenancing at least a partial erosion of Soviet control. His choice—by no means a foregone conclusion—would hinge on the scope of change and the perceived challenge to Soviet influence in the region. [redacted]

52. **Conservative Backlash.** Gorbachev's pressure for reform also could lead to stronger and more open defiance on the part of orthodox leaders in East Berlin, Bucharest, or elsewhere. Prague's chief ideologist Vasil Bilak has publicly rejected the applicability of Gorbachev's reforms to Czechoslovakia, and the East German official press regularly, if indirectly, dismisses the Soviet reform program. If further Soviet pressures create new cleavages that impinge more directly on the job security of the conservative East European leaderships, and if future Yeltsin affairs strengthen perceptions in Eastern Europe that Gorbachev is faltering, hardliners there might become much more openly confrontational. [redacted]

53. If, for example, perceived divisions in the Kremlin emboldened some East European leaders to adopt stridently antireformist platforms, the damage to Gorbachev's authority would be magnified. He would probably have the clout to silence Zhivkov and Jakes, but his capacity to ward off a conservative backlash led by Honecker or Ceausescu would be less certain, particularly if they and other recalcitrants joined forces in an informal rejectionist front (indeed, Gorbachev is already reported to have criticized Ceausescu for trying to form an "antireform alliance" with Honecker):

- Such a scenario would be interactive—it would require the tacit approval of Gorbachev's domestic opponents, who in turn would be strengthened by an East European backlash.
- While a less threatening—and less likely—contingency, it would nonetheless represent a major challenge to Gorbachev's authority and policies in the Bloc. To avert irretrievable damage to

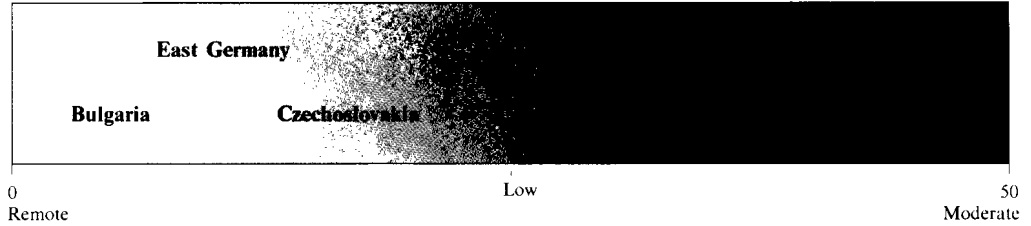
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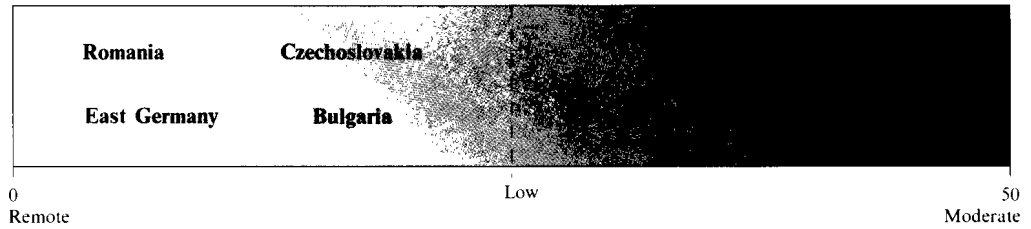
Figure 2
Potential Challenges to Soviet Control, Probabilities
Over the Next Five Years

Percent

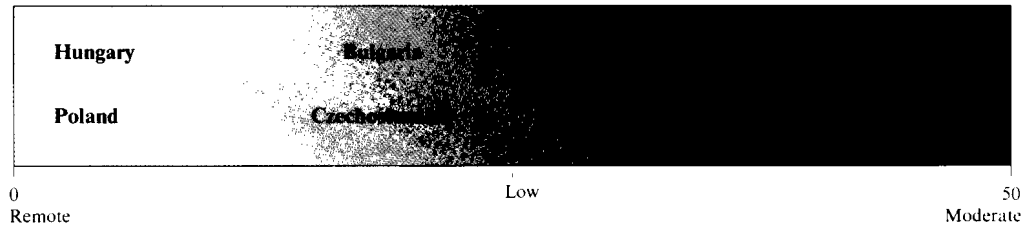
Popular Upheaval
 Internal instability leading to serious challenge to party control.



Sweeping Reform
 Regime-led economic and political reforms going well beyond anything acceptable to Moscow.



Conservative Backlash
 Strong and open repudiation of Soviet reforms and policies by East European leaders.



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both, he might have to force a showdown in Eastern Europe—perhaps by demanding the resignation of his most strident critics.

54. **Prospects and Variations.** None of these more extreme scenarios is likely to be played out in the near future, but their probability will increase over the next three to five years. Moreover, these evolutions need not be manifest in their pure forms, nor are they mutually exclusive. Short of these extreme scenarios, it

is a virtual certainty that somewhere in Eastern Europe there will be new movement toward more daring reform, a new outburst of public unrest, or more open resistance to Moscow's reform agenda. We could see all three at once

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Implications for the United States

55. Eastern Europe is entering a period of flux. Change is facing more countries—and across more

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dimensions—than at any time since the immediate post-Stalin period. Developments over the next three to five years are likely to determine the key contours of political life in the region for a generation to come:

- Within the time frame of this Estimate, these developments will not lead to the unraveling of Moscow's East European empire, nor will they by themselves diminish the military threat posed by the Warsaw Pact.
- A crisis in Eastern Europe would undermine Pact cohesion, at least temporarily, but it would almost certainly lead to a crackdown (with or without Soviet intervention), rolling back whatever concessions had been wrested from the regime.
- Short of such an extreme evolution, however, the scope of conceivable change in the region has expanded considerably. And the likelihood of growing diversity and sharper conflict will create new opportunities for Western engagement of Eastern Europe

56. Gorbachev's agenda of reform, openness, and experimentation is congruent with US goals of promoting pluralism in Eastern Europe and greater independence from Moscow. This endgame is not what Gorbachev has in mind, of course; but, in encouraging change as the key to dynamism and ultimately to greater viability, he has sanctioned diversity and expanded the limits of the thinkable in Eastern Europe.

57. Gorbachev's policies also call into question some of the assumptions upon which the US policy of differentiation is based, in that the twin aims of liberalization and independence from Moscow increasingly collide in Eastern Europe. Those regimes most at odds with Gorbachev's approach also tend to be the most conservative and repressive. Conversely, relatively open countries like Poland and Hungary, which have received favored US treatment, are now closely attuned with Moscow

58. These contradictions in US policy will grow more acute the longer Gorbachev remains in power and the Soviet reform dynamic continues. However, our ability to influence the grand alternatives—reform or retrenchment, crisis or stability—will remain limited indeed; we can at best promote favorable change on the margins:

- Gorbachev's policies have created new opportunities for Western encouragement of liberalizing

US Policy Toward Eastern Europe

Excerpts From NSDD 54, 2 September 1982:

"The primary long-term U.S. goal in Eastern Europe is to facilitate its eventual reintegration into the European community of nations. . . . The United States . . . can have an important impact on the region, provided it continues to differentiate in its policies toward the Soviet Union and the Warsaw Pact countries of Eastern Europe, so as to encourage diversity through political and economic policies tailored to individual countries. . . ."

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"Differentiation will aim at:

- Encouraging more liberal trends in the region.
- Furthering human and civil rights in East European countries.
- Reinforcing the pro-Western orientation of their peoples.
- Lessening their economic and political dependence on the USSR and facilitating their association with the free nations of Western Europe.

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- Encouraging more private market-oriented development of their economies, free trade union activity, etc. . . .

"In implementing its policy, the U.S. will calibrate its policies to discriminate carefully in favor of governments which:

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- Show relative independence from the Soviet Union in the conduct of foreign policy as manifested by the degree to which they resist associating themselves with Soviet foreign policy objectives and support or refrain from obstructing Western objectives; or
- Show relatively greater internal liberalization as manifested in a willingness to observe internationally recognized human rights and to pursue a degree of pluralism and decentralization, including a more market-oriented economy. . . ."

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reform on the part of regimes so inclined, like the Hungarian and the Polish. For the others, the United States also may have new leverage to promote diversity, even if reform prospects are remote.

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— US policy faces the dilemma that large segments of the East European societies are not willing to accept the austerity that implementation of economic reforms would entail. And the regimes are loath to risk the political reforms needed to win public acceptance of painful economic measures.

59. Gorbachev's policies will complicate the coordination of Western approaches to European security. For Bonn, the prospect of closer relations with its eastern neighbors has revived old ambitions for a greater central European role. The French, worried about Bonn's eastward drift and suspicious of Gorbachev's ultimate aims, have taken the lead in resisting a new wave of European detente:

- These differences will make it harder for Western governments to reach a political consensus on dealing with Moscow and its allies, and harder for NATO to maintain a security consensus.
- However, differing Western policies toward Eastern Europe create cross-pressures that promote diversity, inhibit CEMA integration, and erode Warsaw Pact foreign policy discipline.

60. *Influencing Eastern Europe.* The United States has always pursued a two-track policy in Eastern Europe, communicating directly with East European populaces as well as with their governments. These direct channels of communication will be particularly important as new ideas circulate and new opportunities emerge:

- International broadcasting—particularly via Radio Free Europe, but also from other Western radios—will be an important vehicle for informing East European publics on Soviet reforms and exerting indirect pressure on the East European regimes.
- There will be greater opportunity for developing East-West contacts: those regimes that already pursue relatively open policies will have greater latitude to expand them; the others will come under pressure from both Moscow and their own populaces to do likewise. Such contacts—ranging from scientific exchanges to scholarly dialogues and people-to-people programs—will serve to push forward the limits of diversity, strengthen public and elite pressure for internal reform, and help cultivate second-level officials who may play key roles in successor regimes.

61. There also will be new opportunities for Western engagement of the East European regimes, owing to:

- Economic dilemmas that virtually compel several East European governments to accept previously unpalatable conditions in exchange for Western credits.
- High-technology requirements, pushing the East Europeans to facilitate direct contacts with Western firms and international economic organizations.
- Gorbachev's campaign for a "European house," which impels the East Europeans toward more active diplomacy and also heightens their sensitivity to charges of human rights violations.
- The general climate of reform and "openness," which offers opportunities for engaging Eastern Europe on formerly taboo subjects and pressing more directly for internal reforms of the kind already legitimized by Moscow.

62. The East European regimes will continue to be wary of any Western proposals that impinge on regime control or Soviet prerogatives on foreign and security policy. They are likely, however, to be more receptive than in the past to US proposals for counterterrorism and counternarcotics cooperation, expanded East-West contacts, and even improvements in the area of human rights:

- The CSCE process offers new forums for separate, if not fully independent, East European diplomatic activity—as in Hungary's cosponsorship with Canada of a proposal on national minorities. Such developments suggest there is greater scope for Western engagement of Eastern Europe on key East-West issues, and in so doing for promoting greater diversity and independence in the region.
- A prospective umbrella agreement between the European Community and CEMA, along with a possible CSCE follow-on conference on East-West economic relations, would complicate US efforts to control technology transfer, but they would also offer new venues for engaging Eastern Europe on foreign trade policy and domestic reform.
- New opportunities also may develop for a more genuine security dialogue, particularly if a new round of talks on conventional force reductions affords greater scope for East European diplomacy.

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— On matters of internal liberalization, the ironic convergence of US and Soviet calls for economic and political reform will lend strength to the conditions the United States attaches to expanded economic cooperation. [redacted]

63. *Influencing Soviet Behavior.* Should the trends Gorbachev himself has set in motion lead to upheaval or sweeping reform in Eastern Europe, the ultimate controlling factor will be the limits of Soviet tolerance. Gorbachev has strong disincentives to inter-

vening in Eastern Europe, particularly for the purpose of suppressing a genuine reform movement. He and his Politburo are not likely to be deterred from actions they deem vital to Soviet interests, but the United States and its allies may be able to alter at the margin the Soviet risk calculus by maximizing the price Moscow would have to pay. The extent of direct, heavyhanded Soviet interference would be influenced marginally by the ability of the United States to convey clearly how such Soviet behavior would affect the broader US-Soviet agenda [redacted]

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24 October 1988

**Situation in Eastern Europe
Fall 1988**

Unlike the USSR, the **major impetus for change** in Eastern Europe is **coming from below**.

All six bloc countries are resisting real political and economic reform, but most, and especially Poland and Hungary, have had to tolerate greater diversity for the sake of an uneven modus vivendi.

The prospects are for still greater instability as economic stagnation, lack of regime credibility, change in the USSR, and better informed populations continue to undermine the viability of Marxist-Leninist dictatorial systems.

The **Soviet Union** seems to be **encouraging** rather than **directing evolutionary change**, but is simultaneously **contributing to instability by demanding greater economic support**.

While the **US favors East European evolution toward independence and liberalization**, it faces the dilemma of not letting **regimes exploit US expressions of interest and economic support for preserving the status quo**.

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**Issue No. 6
1 October 1988**

East European Regional Economic Wrap-up



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EAST EUROPEAN REGIONAL ECONOMIC WRAPUP [Redacted]

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1 October 1988

Page

Regional Problems

Economic Ills Spark Unrest, Leadership Change in Eastern Europe [Redacted]

1

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Economic problems have given the leaders of several East European countries severe headaches this year. [Redacted]

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Good 1988 Start Fizzles [Redacted]

5

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Most East European countries increased their economic growth in the first half of 1988 due to the mild winter, but further improvements depend on the regimes' ability to improve consumer satisfaction and work discipline. [Redacted]

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Economic Relations Between East and West

Foreign Borrowing Increases [Redacted]

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Eastern Europe increased its borrowing through syndicated loans and bonds by over 50 percent in 1987, and probably will borrow a larger amount this year to finance capital imports and cover debt payments. [Redacted]

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East European Financial Outlook [Redacted]

9

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Projections of the region's balance of payments, generated by seven East European financial models, show that the region will continue to need new credits and refinancings through at least 1990. [Redacted]

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Improved Hard Currency Trade Performance [Redacted]

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The region ran a hard currency trade surplus of over \$1.5 billion last year, but production and trade problems in some countries may lead to a deterioration of trade this year. [Redacted]

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[Redacted] 25X1

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[Redacted]

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Eastern Europe: A Major Arms Exporter [Redacted] 13

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Eastern Europe has become an important source of arms on the international market in recent years by branching out beyond traditional Warsaw Pact markets. [Redacted]

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Continued Interest in Western Aircraft [Redacted] 15

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The East European CEMA countries have shown considerable interest in purchasing Western aircraft in the past two years, mainly due to tighter EC noise restrictions on aircraft and creative financing being offered. [Redacted]

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EC-CEMA Open Official Relations [Redacted] 17

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The EC-CEMA agreement signed in June creates a political framework for future cooperation, but current economic conditions make an immediate upturn in trade unlikely. [Redacted]

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Economic Ills Spark Unrest, Leadership Change in Eastern Europe [Redacted]

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Economic problems have given the leaders of several East European countries severe headaches this year. In Poland large price increases instituted as part of a package of economic reforms and austerity measures intended to deal with the country's debt problems caused workers in several plants to strike. Meanwhile, the difficult economic problems in Hungary were key factors contributing to Kadar's ouster and the rejuvenation of the Hungarian Politburo with reformist members. The activation of an IMF-directed austerity program in Yugoslavia has provoked labor unrest; by contrast, only scattered outbreaks of worker unrest have occurred in Romania despite the worst economic conditions in Eastern Europe. [Redacted]

investment and the issuance of bonds went to the legislature, implying the new team is trying to move ahead with economic change. More such moves are expected in the next six months, but the public will remain skeptical of the regime's program, especially of measures that lower the standard of living. [Redacted]

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The regime has no quick fix for its economic problems. Inflation is certain to accelerate this year, industrial output may fall, and the trade surplus is likely to shrink. The strikes in the coal mines will likely decrease coal production and exports and could even lead to loss of hard currency markets, as during the 1980-81 crisis, due to nonfulfillment of contracts. Warsaw also faces greater problems than ever in managing its debt. Plans to increase imports of consumer goods in order to placate the population will soak up funds available for debt servicing. More imports and reduced exports--as potential foreign exchange earners are diverted to domestic markets--are likely to erode Poland's trade surplus. The result may be missed debt repayments and new requests for Western debt relief. [Redacted]

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Workers Go Out in Poland

Polish workers staged work stoppages in May and August to push for increased wages and relegalization of Solidarity. Jaruzelski managed to get the Polish workers back to work in May by a combination of wage concessions and strong arm tactics, but in the process seriously undermined his economic reform program. The moves diminished Jaruzelski's public credibility and his ability to sell a program that will entail some economic pain before positive results are achieved. Further strikes in August caused more damage to the economy than the May stoppages and created a tense stalemate between the regime and the people. The strike ended when Solidarity leader Walesa persuaded workers to return to work after reaching agreement with the regime to open talks that would include discussions to relegalize Solidarity. [Redacted]

Kadar Out in Hungary

Premier Karoly Grosz's stunning rise to General Secretary in May and the replacement of conservative Old Guard Politburo members by six new members, most of them strong advocates of further reform, leaves Hungary with a leadership that has a mandate to push harder for economic change. The new leadership was united by its opposition to Janos Kadar's continued rule and agrees that things must be changed: foreign debt must be reduced, productivity must be increased, government and economic administration must be improved, and "democratization" must be extended. [Redacted]

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Jaruzelski signalled his continued commitment to reform by appointing several economic reformers to the leadership following the May strikes. Soon after these appointments were made, new measures liberalizing private enterprise, foreign

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Grosz's government does not have a concrete program for achieving these objectives, however, and its members disagree over the scope and pace of reform. Although Hungary's Central Committee in July 1988 endorsed broader reforms and harsher austerity, Grosz does not yet appear to have an unconditional green light. He has proposed measures to expand private-sector activities, cut subsidies, and allow more bankruptcies, which Budapest expects could push unemployment to 100,000 next year--about 2 percent of the labor force. The Central Committee requested more details on these measures and on a gradual adjustment option for reconsideration in October; it is undoubtedly sensitive to the potential for unrest if unemployment or inflation rises too high too quickly.



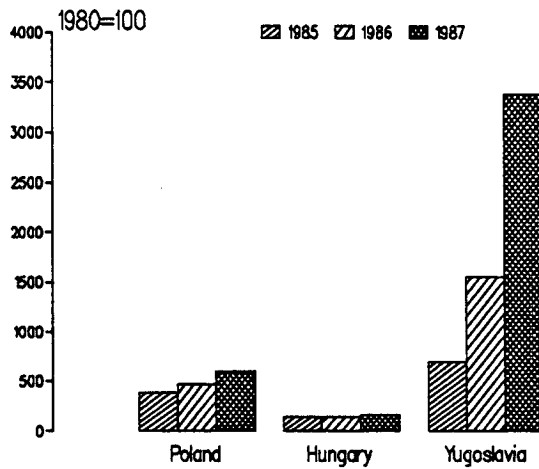
Workers Protest Austerity Policies in Yugoslavia

Labor unrest with antigovernment overtones intensified in June as Belgrade began implementing new IMF-imposed austerity measures. Yugoslavia had to implement a stringent economic package to receive credits under its new, one-year IMF standby program and clear the way for other financing from commercial and official creditors. The standby returns the Yugoslav economy to tight IMF supervision and marks a major policy reversal for Premier Branko Mikulic, who pledged two years ago never to submit Yugoslavia to IMF interference again. The initial measures of the IMF-directed reform package have provoked widespread, unprecedented labor unrest, which may increase when the reforms take full effect. The package is Yugoslavia's strongest attempt yet to strengthen the role of market forces, lessen government interference, revitalize the economy, and combat triple-digit inflation, but it will entail some further erosion in the standard of living in order to reduce the country's debt and enhance its growth potential.



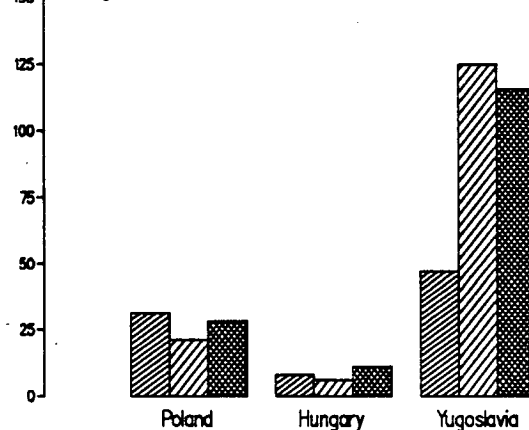
The work force is in no mood for more sacrifices. Real wages have already sunk to a level 20 percent below that of 1980, and unemployment remains at 14 percent. In mid-June more than

Consumer Prices in Three Financially Troubled Countries



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Average Annual Growth Rates



10,000 demonstrators marched on the Federal Assembly in Belgrade to protest austerity measures, corruption, and government incompetence. A week later nearly 5,000 strikers in Slovenia demanding higher wages disrupted traffic, attacked a government building, and called for the resignation of the Federal government. Labor unrest eventually could force Premier Mikulic to water down the reforms to such an extent that Yugoslavia would be unable to sustain a permanent economic and financial recovery.



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Scattered Unrest in Romania

Despite the poorest economic conditions in Eastern Europe, Romania has so far experienced only scattered outbreaks of unrest because of very tight control by security forces. Most food and consumer goods, as well as winter heating, remain scarce and rationed and already low wages are frequently cut for non-fulfillment of production quotas. Even if projected increases in grain harvests ease feed grain shortages, consumers may not see much improvement in scarce food supplies. President Ceausescu, obsessed with rapid repayments of Romanian debt, will probably use larger harvests to increase agricultural exports to the West and the USSR.

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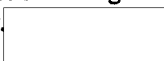
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Good 1988 Start Fizzles



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Economic performance in Eastern Europe this year may be only slightly better than the slow GNP growth of 1987 despite a mild winter which boosted industrial and agricultural production in the first six months. Disappointing harvests and only moderate growth in industrial output caused a sharp slowdown in 1987--from slightly above 3 percent in 1986 to less than half a percentage point. If the unreliable Romanian data are excluded, the rest of the region showed no growth in GNP last year.



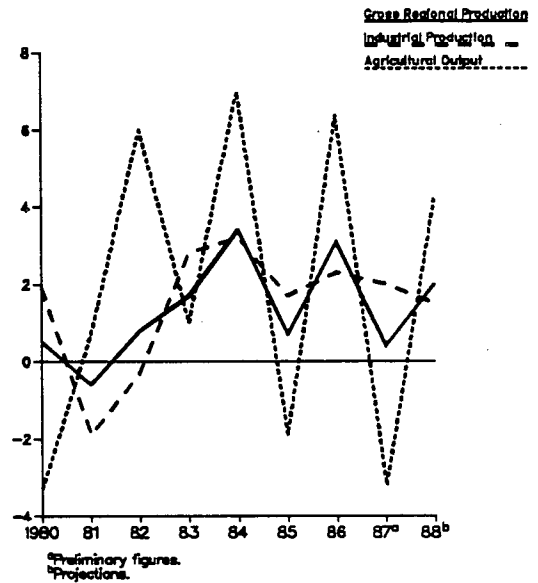
Mild Winter Helps Economies

The East European economies apparently accelerated their performance during the first half of 1988 over the previous year after being hit by a harsh winter in 1987. The region's industries benefited from mild weather in the first months of this year:

- Lower-than-average heating needs left more energy available for industrial uses than in previous years.
- Many industrial processes consumed significantly less energy with milder temperatures, so plants could operate at a higher level of capacity. This particularly aided the energy-intensive industries, such as steel, aluminum, and cement.
- The smoother operation of the transportation network helped plants avoid shutdowns induced by shortages of raw materials and spare parts.
- Milder weather extended the construction season in some countries. For example, construction was reported ahead of schedule in Hungary, where building activity in January was sharply up from the previous year.



East European Economic Growth, 1980-88 (Percentage change over previous year)



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Labor Strikes and Drought Disrupt Progress

Despite this favorable beginning, the winter recovery lost steam later in the year. Official statistics from East Germany and Poland indicate that the pace of industrial growth slowed during July and further declines in August and September can be expected for Poland as a result of the recent labor strikes. In Yugoslavia, unemployment crept up to 14 percent and industrial production declined nearly 2 percent during the first six months of the year. In much of the region, high temperatures and a summer drought have undermined early agricultural gains--surpluses of wheat and other cereal grains--as shortfalls in the production of corn, forage, sugar beets, and vegetables may require unexpected imports.



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Economic performance during the balance of the year may depend on the regimes' ability to improve consumer satisfaction and work discipline. The Polish leadership announced a plan to import \$250 million worth of consumer goods this year to satisfy growing consumer demands. East German officials also have focused attention on increasing consumer supplies although this will be done without foreign borrowing. Yugoslavia risks confrontations with its population as it attempts to implement debt-induced austerity programs that will prolong declines in living standards.



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Foreign Borrowing Increases

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Eastern Europe increased its borrowing through syndicated loans and bond issues by over 50 percent to about \$2 billion in 1987, and will probably borrow a larger amount this year to purchase Western technology and cover debt payments.

Bloc. Other Western banks appear willing to lend to some countries in the region, but they could raise their rates, as in a recent Hungarian syndication, or limit additional exposure if borrower creditworthiness deteriorates.

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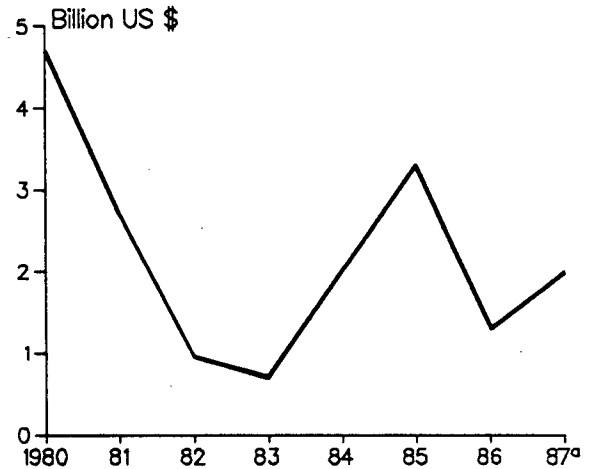
Hungary, which needs sizable credits to cover debt service costs, was Eastern Europe's largest borrower from Western commercial lenders in 1987. Budapest received about \$800 million in syndicated loans--about the same amount as in 1986--and doubled its participation in the Japanese and European bond market to over \$500 million. Over 60 percent of Budapest's new borrowings came from Japanese banks.

Bulgaria, Czechoslovakia, and East Germany--the region's financially strongest countries--took advantage of favorable terms offered by banks to increase their syndicated borrowing. Japanese banks granted about two-thirds of the \$625 million lent to these countries, including large loans to Sofia and Prague. These countries increased borrowings to finance more imports of Western capital and technology at a time when hard currency earnings fell or stagnated.

Romania, Poland, and Yugoslavia remained out of the market for major syndications in 1987. Because of President Ceausescu's debt repayment policy, Bucharest shunned Western loans, while Warsaw and Belgrade--forced again to reschedule--were considered poor credit risks by most banks.

Although Eastern Europe on the whole probably will borrow more from Western creditors this year, some borrowers could face more lender resistance, hampering their efforts to finance imports of Western technology. Japanese banks remain interested in the more creditworthy countries, but they may be more cautious about significant increases in their exposure because of political sensitivities toward lending to the East

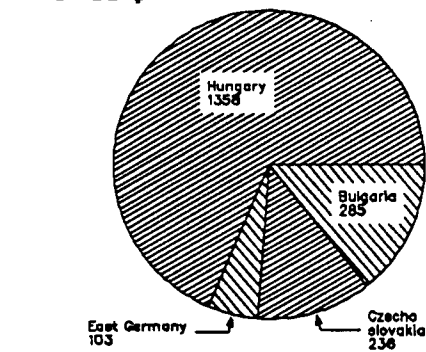
Eastern Europe: Amount of Bonds and Syndicated Loans, 1980-87



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1987^a
Million US \$



^aPreliminary

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Hungary probably will remain the largest East European borrower in 1988; as of July 1988, Budapest had raised about half of the \$2.5 billion needed to cover its financing requirements this year. An IMF standby agreement approved in May should help Budapest maintain the confidence of bankers and secure the commercial loans it needs at least this year. If Budapest fails to reduce its current account and budget deficits this year, however, the IMF may deny additional drawings on its standby loan, and commercial banks will probably balk at further lending, setting the stage for a probable rescheduling of Hungarian debt.



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East European Financial Outlook

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Projections of the region's balance of payments, generated by a set of seven East European financial models, show that although the region will continue to need new credits and refinancings through at least 1990, prospects for stabilizing debt are improving. Even with modest export growth, East European debt is expected to fall slightly from its all-time high of \$115 billion at the end of 1987 to \$111 billion by 1990. While most countries are projected to have access to enough Western credit to meet their borrowing needs, the high debt service requirements will keep the region vulnerable to adverse developments in export markets, interest rates, and credit availability. [redacted]

The region as a whole will struggle with problems of poor export potential, high debt servicing needs, and cautious lenders; but prospects for individual East European countries will continue to vary:

- Poland, with its \$39 billion debt, will struggle with de facto insolvency as bureaucratic resistance and regime fears of provoking labor unrest undercut reform and austerity measures. Despite \$18 billion in long-term rescheduling agreements signed last year with both banks and government creditors, the regime will run up new arrears in 1989 and require additional reschedulings totaling \$5.2 billion during 1989-90.
- Yugoslavia, despite rescheduling agreements with both banks and official creditors as well as an IMF standby agreement, still faces tough times. In return for the additional funds the government must implement a tough package of IMF-directed economic reforms and austerity measures, areas in which Belgrade has shown little perseverance.
- Hungary faces large borrowing needs over the next few years, averaging \$4.8 billion annually

(including short term) during 1988-90. Budapest must impose domestic austerity and proceed with reforms in order to reassure Western creditors and to avoid another liquidity crisis similar to 1980-82.

- Romania remains unrelenting in its drive to pay off debt--projected to fall to \$200 million by 1990. Some Romanian officials have hinted that Bucharest may begin increasing imports to revitalize industry, but this would require a major change in policy not yet seen from the Romanian leadership.
- Bulgaria, although its \$6.1 billion debt is small in comparison to most East European countries, is still susceptible to a liquidity crunch. Economic disruptions as a result of poor weather, rising debt service requirements, and limited capabilities to expand exports could increase financing requirements substantially before the end of the decade. If lender nervousness were to limit Sofia's access to new credits, the regime could face difficulties in maintaining needed imports and making payments on time.
- Czechoslovakia and East Germany are in more favorable financial positions. Prague, which enjoys a solid credit standing, will likely allow debt to rise to \$6.7 billion in 1990 in order to finance selective industrial modernization. East Berlin, despite its special relationship with West Germany and continued access to Western financial markets, is likely to sustain its conservative financial policies and reduce its level of debt by approximately \$3 billion to \$17.4 billion in 1990. [redacted]

A deterioration in world-wide financial markets--caused by a steep cutback in lending by Western creditors, steep declines in export earnings, or a return to double-digit interest rates--would force the regimes to make difficult

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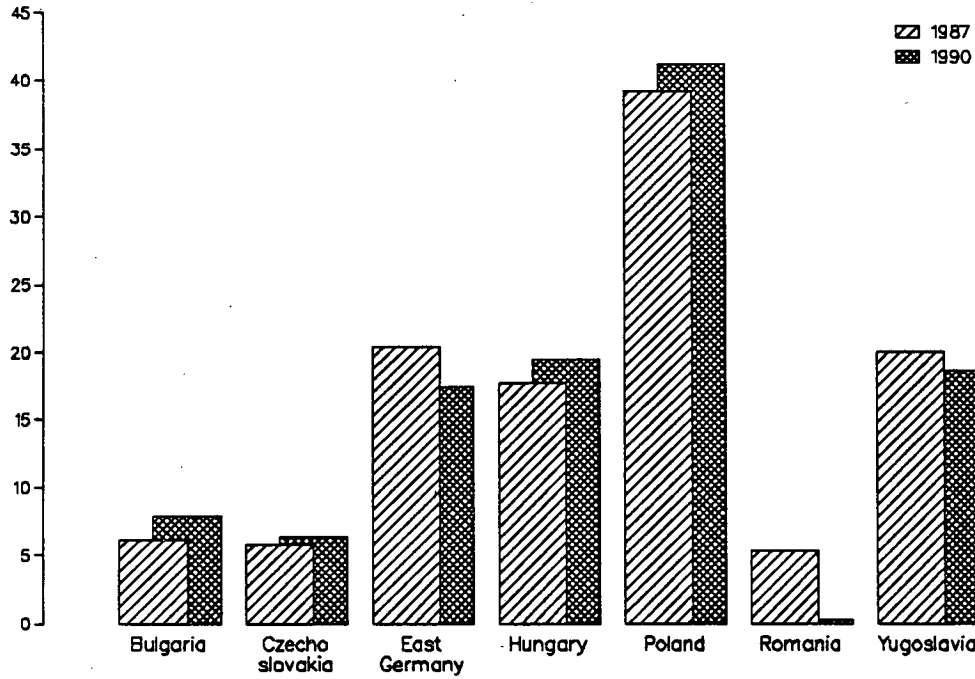
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**East European Hard Currency Debt
1987 Actual and 1990 Projected, (Billion US \$)**



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choices between meeting financial obligations and cutting imports. Under these conditions Western creditors would probably be compelled to extend even larger amounts of debt relief.



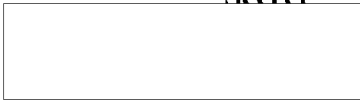
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Improved Hard Currency Trade Performance



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Eastern Europe ran a hard currency surplus of more than \$1.5 billion last year compared to a \$300 million deficit in 1986, but production problems in some countries may lead to poorer results this year. 

The surplus largely resulted from a decline in the growth rate of imports from 13 percent in 1986 to only 3 percent in 1987.

- The decisions by Yugoslavia, Bulgaria, and Romania to reduce imports and by Hungary to keep purchases constant reflect Sofia's and Budapest's growing debt service obligations, Belgrade's desire to run a smaller trade deficit to impress creditors, and Bucharest's compulsion to forego capital imports until its debt is repaid.
- Czechoslovakia and East Germany, which are in better financial condition, could afford to boost imports over 15 percent each as the regimes continued their drives to purchase more Western machinery to support ambitious modernization plans.
- Poland also increased its imports, by 7 percent--twice as much as its 1986 rate--with purchases of raw materials and food increasing the most. 

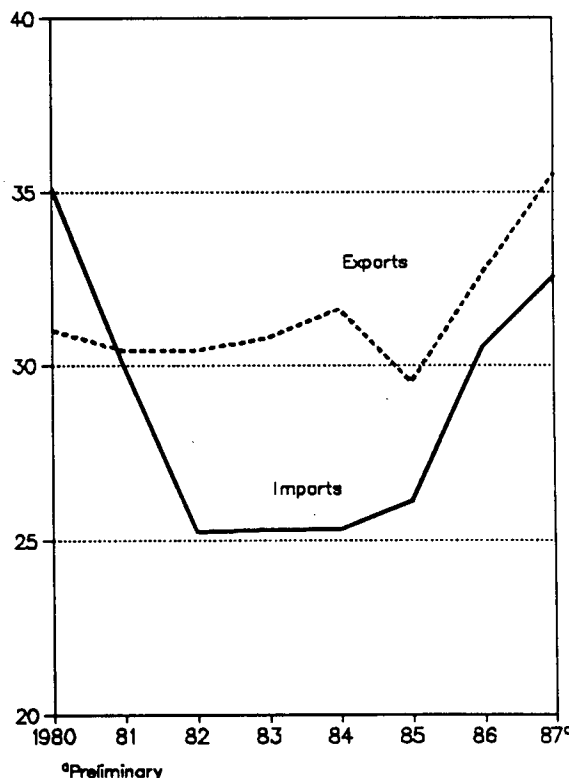
The East European trade position also was helped in 1987 by an increase in hard currency exports of over 7 percent. This was due primarily to the effects of the depreciation of the dollar which inflated the value of the region's sales denominated in non-dollar, mainly West European currencies. Sales to Western Europe make up about two-thirds of the region's hard currency exports.

- Bulgaria and East Germany recorded the highest rise in exports, by 18 and 15 percent respectively, partly due to increased raw material and food exports.

- Czechoslovakia and Poland registered increases of around 5 percent each, due to gains in food, chemical, and machinery exports.
- Financially strapped Yugoslavia and Hungary registered the lowest export growth, while we estimate Romania's sales stagnated due to production shortfalls and the quality problems of its exports. 

Based on the first half trade results, the region has had mixed results in improving its hard currency earnings. Poland's trade surplus of \$662 million

Eastern Europe: Trade with Non-Socialist Countries, 1980-87 (Billion US \$)



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[Redacted]

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was \$30 million less than in 1987. The East Germans and Romanians have complained about unsatisfactory industrial performance which could hurt export performance later this year. Czechoslovakia has admitted problems in meeting its plan to increase hard currency exports, while imports ran slightly higher than exports. On the other hand, Hungary ran a \$177 million surplus in the first six months of 1988 compared to a \$337 million deficit in the same period last year, while Yugoslavia recorded a \$75 million deficit in the first seven months of 1988--a \$625 million improvement over 1987. Bulgaria--which does not publish comprehensive trade data--also reported improved trade results. [Redacted]

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The upsurge in hard currency exports in 1987 does not indicate the region has yet established a base for sustained export growth. The regimes are counting on infusions of Western equipment and technology to speed modernization and production of more competitive goods. These investments require hard currency imports, greater export orientation among enterprise managers, reforms to spur efficiency and quality in production, and time before they can yield payoff. Soviet demands for high-quality goods also will complicate East European efforts to boost hard currency exports. Moreover, even with modernization and reform programs, it is unlikely that East Europeans can upgrade their export quality fast enough to compete effectively with Western firms, including those from the newly industrialized countries. [Redacted]

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Eastern Europe: A Major Arms Exporter

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Eastern Europe has become an important source of arms on the international market in recent years by branching out beyond traditional Warsaw Pact markets. Having captured roughly a tenth of world arms sales in 1984-87, the region ranks among the top five weapons suppliers with Czechoslovakia and Poland foremost. The region is a particularly significant arms supplier to Iran, Iraq, Libya, and Syria. A sizable portion of these arms go directly to, or otherwise end up with, countries and organizations hostile to the US, such as radical and Soviet client states, terrorist, and insurgent groups.

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demands more efficiently. Intra-Bloc arms trade, however, has afforded fewer benefits to East European members, who probably would prefer to direct resources to hard currency export industries or the civilian sector.

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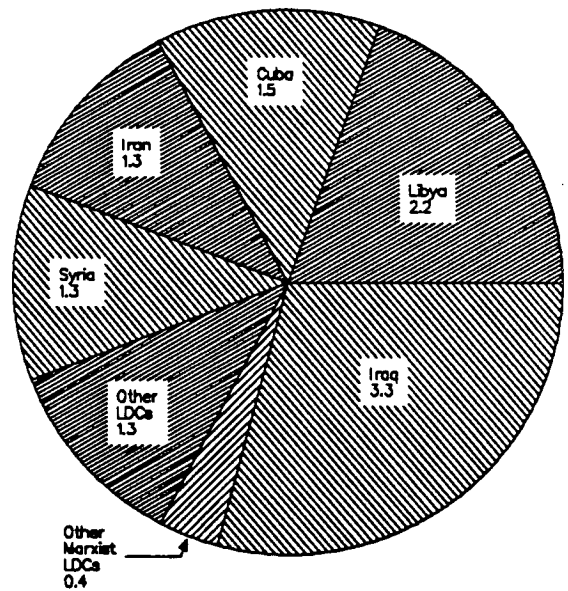
The US will continue to face major obstacles in trying to rein in East European arms export programs that run counter to its interests. Most of these countries will remain unresponsive to US pressures to discontinue military deliveries to certain arms clients. The desire for COCOM approval to purchase advanced technology, export credits, most-favored-nation trade status, or support in debt negotiations may make some countries sensitive to US pressure. We believe, however, that in most cases the regimes probably consider the economic and political benefits of continued arms sales more important than pleasing the US.

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The region's governments pursue arms sales to the Third World and on the gray arms markets primarily to earn hard currency, but, with the exceptions of Romania and Yugoslavia, these sales also foster Soviet political objectives. The strong financial motivation leads Eastern Europe to offer stiffer terms than the USSR, even for shipments to Soviet client states. The Soviets have used East European arms sales to non-Bloc countries to supplement and/or substitute for their own global efforts. For example, arms sales have allowed Moscow to influence foreign situations without risking public condemnation of Soviet involvement, as in the cases of Nicaragua, Iraq, and Iran. The lure of hard currency occasionally has prompted some countries to sell arms in violation of Soviet and Warsaw Pact directives, but these instances have been limited in number and significance.

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Third World Recipients of East European Arms, 1983-87 (Billion US \$)



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Although eclipsed by the growth of sales outside the Bloc, intra-Warsaw Pact arms deliveries remain important to Soviet military objectives. The Pact's program of integrated weapons production and formalized intra-Bloc arms trade has enhanced the development of the NSWP defense industries and contributed to military equipment modernization and standardization. Increased specialization and intra-Pact trade have allowed the countries to meet Soviet military

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East European Civil Air Fleet

Aircraft	Total Quantity	Numbers That Are 10 Years or Older ^a	Numbers That Fail Noise Rules	Possible Replacements	
				Western	Soviet
Total	203	133	91		
Passenger					
Tupolev 134	55	44	55	Boeing 737	Tupolev 154M ^b ; otherwise none until 1995
Tupolev 154	40 ^c	14	14	Boeing 757 Airbus 320	Tupolev 154M
Ilyushin 62	35	13	0	Boeing 757, 767 Airbus 310, 320	Ilyushin 62MK Ilyushin 96b in mid-1990s
British Aircraft Corp. Romanian BAC 111 ^d	16	5	16	Boeing 737 McDonnell Douglas 80	None until 1995
Boeing 707	4	4	4	Boeing 757 Airbus 320	Ilyushin 62MK
Cargo					
Ilyushin 18	47	47	0	None	None
Antonov 12	4	4	0	Cargo 130 Lockheed 100	None
Boeing 707	2	2	2	Boeing 757, 767	Ilyushin 62MK

^a The typical service life of a commercial plane is 20 years. At the midlife point of 10 years, most major airlines replace passenger jets and sell older aircraft to minor airlines.

^b These aircraft are twice as large as those being replaced.

^c Some new purchases being added to inventories this year.

^d Could meet noise rules if redesigned with the new British TAY engine.

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[Redacted]

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Continued Interest in Western Aircraft

[Redacted]

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The East European CEMA countries have shown considerable interest in obtaining Western civilian aircraft during the past year because of the publicized crash of a Soviet-made aircraft in Poland in May 1987, tighter EC noise restrictions on aircraft, the need to promote Western tourism, and the creative financing being offered by Western firms including offset and leasing deals. Poland already has leased one US aircraft and is considering buying or leasing more from a US manufacturer if financial terms can be worked out, while East Germany has decided to purchase two Airbus aircraft. Deals with Hungary and Romania are still possible, but they would require surmounting significant financial obstacles. Czechoslovakia and Bulgaria have expressed only minimal interest in Western aircraft. [Redacted]

the West would seriously hurt their credibility when competing for sales in other markets in the 1990s. To limit Western inroads into the East European market, the Soviets probably are offering their current generation aircraft under attractive financing arrangements until new generation aircraft become available in the 1990s. [Redacted]

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COCOM approved the sale of Airbus-310 medium-range aircraft to East Germany and Boeing 767-200 long-range aircraft to Poland and Romania in June 1988. The approval includes restrictions on spare parts and maintenance procedures because sales of these aircraft entail risk of technology loss, including navigation and flight management systems which are approximately ten years ahead of Soviet technology. The Soviets, however, already have access to many of the technologies embodied in the latest civil aircraft through Western airplane sales to several Soviet client states. [Redacted]

The region's financial problems have made East European countries cautious about purchasing Western aircraft in the absence of a strong financial incentive. All of the countries want to use their hard currency to modernize their economies or service external debts. To prod a purchase decision, Western companies are offering attractive financial packages, including combinations of credits, countertrade, and trade-in of used aircraft. These financing packages in many cases would be amortized by hard currency earnings from Western operations. Most countries also are considering leasing aircraft either from joint ventures by Western and Eastern firms or from equipment trusts formed by Western financial institutions. [Redacted]

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The Soviets apparently will acquiesce to limited East European purchases of Western aircraft because they cannot offer aircraft suitable to Eastern Europe's needs for service to the West until the 1990s; however, Moscow probably would discourage the purchase or lease of a large number of Western airplanes. The Soviets almost certainly judge that failure to sell their current and next generation civilian aircraft to East European airlines would entail some damage to their prestige and economic losses. They probably believe that sizable East European purchases from

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EC-CEMA Open Official Relations



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The EC-CEMA Joint Declaration of mutual recognition signed on 25 June and ensuing requests by individual CEMA members for diplomatic accreditation to the Community create a political framework for greater future economic cooperation, but current economic conditions make an immediate sizable upturn in trade unlikely. EC officials and West European businessmen remain skeptical about increased involvement in Eastern Europe because of the growing debt problems of some and the inability of most to generate exports that are competitive in world markets. Sustained economic and political reforms will likely be necessary to change this perspective. 

Although the economic impact of the declaration for the US is minimal, it has substantial implications for US and NATO interests. The declaration gives the Soviet Bloc a larger official presence in Western Europe, increased access to EC personnel, and more opportunities to influence the Community. In the longer term, it paves the way for negotiation of bilateral trade pacts between the EC and individual CEMA member states, which could significantly widen Soviet Bloc access to Western high-technology industries and projects. 

The declaration also bolsters the notion of Eastern and Western Europe occupying a "common European home," a key propaganda theme used by the Bloc in an attempt to undermine US influence in Western Europe. On the other hand, the EC's insistence that EC-CEMA ties be conducted on a bilateral, rather than a multilateral basis, opens opportunities for the West to weaken Soviet economic control over East European countries and to influence the East Europeans to move ahead with economic reform, political liberalization, and a greater orientation to the West. 

Typical Issues Covered in Trade and Cooperation Accords

Common Provisions of Trade Agreements:

- *Parties pledge to promote trade between the two sides;*
- *Areas of special trade interest listed;*
- *Information sharing on laws and other regulations on import-export trade;*
- *Arrangement for credit, payment, other facilities to support trade;*
- *Organization of trade fairs and exhibitions in the respective countries.*

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Common Provisions of Cooperation Agreements:

- *Working group meetings to consider options for cooperation in different areas;*
- *Exchanges of visits by experts and technicians for study, training or consultation;*
- *Research and study grants, opportunities for temporary assignments in industrial research institutions and enterprises;*
- *Exchanges of industrial knowhow and technology between enterprises, including arrangements for licensing;*
- *Organization of scientific and technical conferences;*
- *Other facilities for exchanges of scientific and technical information and documentation.*

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