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4. How has Gorbie done so far?

- a. performance over past year and a half highlights both strengths and weaknesses in his program
- b. in 1986--1st full yr of Gorbie's rule--was a good yr for Sov economy. GNP grew at fastest rate in a decade (4%). Industrial growth also highest in nearly a decade (3.5%). Ag harvest 4th largest on record. Supplies of many quality foods increased and additions to housing stock largest in 2 decades.
- c. on the down side, 87 performance not living up to Gorbie's hopes. Industrial production in 1st half 87 about 1% less than in 1st half 86. Machinery production--of crucial importance to mod program--actually fell slightly compared to a year ago. New system of quality control causing confusion and even chaos as inspectors reject output.
- d. continue to receive indications Gorbie's policies running into resistance. But nothing to suggest that Gorbie intends to back down. June 87 CC plenum suggests just the opposite. But problems indicate how difficult it will be to overcome inertia in Sov system.
- e. PROSPECTS TO 1990--In short, based on what we've seen of Gorbie's program and problems encountered so far; we project GNP growth of 2% per year during remainder of this decade. Growth could be higher if Sovs get good weather and hence good ag harvests. But odds are that if anything, actual performance will be even lower than predicted

5. Accommodating Military Demands

- a. Gorbie will be facing several military demands during the next few years--a period that will probably be one of slow economic growth.

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- A. Difficulty of Maintaining Their Current Status - Under any circumstances, the Soviets face formidable costs in maintaining the world's largest military establishment.
1. ~~████████████████████~~ the Soviets maintain very large stocks of military equipment in their standing forces.
 - a. These weapons and equipment wear out and must be replaced-- from every several years for trucks to every 30 years or so for major naval combatants.
 - b. Thus, simply to keep their forces at the current level requires the Soviets to procure thousands of major weapons every year.
- B. Modernizing the Forces - The Soviets, moreover, have worked hard to improve the quality of their weapons by initiating a great many new development programs.
1. During both the 1960s and 1970s the Soviets fielded about 140 major new systems and 200 to 400 major upgraded systems, and this total may be slightly higher in the 1980s.
 2. ~~As Figure 2-33~~ ~~████████████████████~~ ~~████████████████████~~ the Soviets have supported this effort with steadily growing military RDT&E expenditures that have exceeded comparable US outlays since the early 1970s.
 3. Through these efforts the USSR has raised the average level of its military technologies considerably in some areas, narrowing the gap between them and the technologies found in deployed US systems. However, ~~as indicated in Figure 2-33~~ ~~████████████████████~~ this success has come at a price--markedly higher costs to procure these weapons.
- C. Defense Industrial Challenges - The military production base can manufacture large quantities of weapons, ~~as is shown in Table 2-3~~ ~~████████████████████~~ But Soviet defense industry has been challenged over the last decade to assimilate production of increasingly complex modern weapons.
1. Over the last 12 years, the USSR has turned out many more weapons than has the United States.
 - o For the most part these weapons are less capable and easier to manufacture than their US counterparts.
 - o Since the early 1970s, however, the Soviets have modified their weapon acquisition strategy, introducing a number of systems that required advanced production technology.
 2. The manufacture of these advanced systems was frequently constrained by an obsolescent industrial base. It often relied on labor-intensive production processes using simple machinery.

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3. In the early 1970s, therefore, the USSR began a comprehensive modernization of its defense industries, retooling major plants with advanced machine tools and other automated equipment. Military electronics production was also upgraded substantially.
- D. Emerging Weapons and Production Technologies - This defense-industrial modernization helped the Soviets to master the production of some very complex systems, like the MIG-29 fighter and T-80 tank. But it also set the stage for intensified competition with civilian interests in Gorbachev's industrial modernization program.
1. ~~As Figure 5 suggests,~~ Soviet weapons entering production over the next decade will require further improvement in design and manufacturing technologies.
 2. In sum, Gorbachev is under pressure to continue the accelerated modernization of Soviet defense industry.
 - o As in the West, the Soviets will be forced to recycle industrial capital every 9 to 12 years.
 - o Thus, defense industry will demand substantial quantities of some of the best machinery and equipment.
 3. In fact, the civil-military competition is already severe for a whole range of materials, products, and manpower. ~~We have tried in Figure 6 to highlight some of the areas where the competition is keenest.~~

IV. Reconciling Competing Demands

This brings me to the last part of my remarks and the really critical question as far as US interests are concerned. Faced with the heavy military demands I've just described, ~~how fast will Gorbachev be able to push his overall modernization program, not just during the rest of this FY, but during the 1990s. While there are too many variables to allow one to predict with any certainty how the economy's going to be performing a decade from now, I will suggest some of the things that could go right for Gorbachev's modernization program, and some of the things that could go wrong. I will also briefly look at how issues such as arms control and more drastic economic reform fit into the equation.~~

how will Gorbachev reconcile the competing demands for resources?

- A. Meeting Near-Term Military Needs--At least through 1990, we see no let-up in the very high levels of weapons procurement that have been the hallmark of the Soviet defense effort over the last two decades. The overhaul of the defense industries carried out during the late 1970s and early 1980s should allow the Soviets to manufacture most of the weapons we expect to be delivered to the Soviet forces through 1990.
 1. Nonetheless, competition for basic materials, intermediate goods, *Components* and skilled labor will probably cause the pace of production of some of these new systems to be somewhat slower and the date of

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introduction somewhat later than the Soviet military would prefer.

2. But, on balance, we expect that Soviet defense spending will continue to increase. ~~As represented in Figure 7, my own~~ ~~package,~~ ~~we think total procurement spending during 1986-90 will~~ ~~be approximately 10 percent higher than in the preceding five years and slightly above the record level of 1976-80.~~ **GRAPH 6**

B. Longer-Term Requirements--Although procurement will probably rise at a relatively slow pace, this does not mean that we expect civil-military competition to ease. On the contrary, if the economy's strong showing in 1986 proves to be transitory, as we believe likely, then extremely difficult resource allocation decisions will have to be made between competing civilian and defense interests, as well as among competing interests within the civilian and defense sectors themselves. Over the next few years, the toughest decisions are likely to be in the investment arena.

1. Despite the high targets for investment in those branches of industry key to the modernization program, we believe achieving the production targets in critical areas like the machine-building and the energy sectors will require more investment than is currently planned for 1987-90. Investment is already being given priority, however, and finding additional resources will not be easy.
2. Moreover, a major part of Gorbachev's short-term economic strategy depends on increasing workers' incentives. The leadership has already deemed it necessary to boost investment in consumer-related areas in 1987, and further growth will probably be needed if momentum is to be maintained.
3. And, as I have already said, Soviet defense industries also will require large investment over the next few years.
 - a. Our evidence shows that new programs are in progress to update or replace older systems with improved models in every mission area, with many likely to begin series production in the mid-1990s.
 - b. The Soviets begin to prepare for weapons production during the 10 years prior to initiation of series production. The largest expenditures, including those to put in place most of the machinery and equipment, occur in the last half of this 10-year period.
 - o This suggests that they will be allocating considerable investment in the late 1980s and early 1990s to prepare for systems entering production during the last half of the 1990s.

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C. Arms Control Issues--We do not know how Gorbachev will respond to these pressures. But in putting together the 1991-95 Five-Year Plan --which must begin in earnest ^{soon} over the next year or so--the state of the economy, Moscow's perceptions of the military threat, and Gorbachev's domestic political standing would all come into play.

1. Gorbachev has based much of his political future and long range plans for sustaining the USSR's superpower status on his economic agenda, and we believe that, if at all possible, he intends to give the civilian economy the investment resources it needs. To do this, he will have to constrain the growth of military demands for these same investment resources.

2. His preferred way of accomplishing this would be to reach an arms control accord that would give him some confidence that the pace of US weapons programs would also be constrained.

a. In effect, he must manage the US strategic competition or he will have to deal with it in ways that could subvert his agenda.

3. This is one of the main reasons we think he is so interested, for example, in an INF agreement.

a. Although the resource implications of an INF agreement by itself are at best marginal, the larger process of arms control is seen by Gorbachev as his principal means of dampening both external and internal pressures to spend more on defense--at least until he can reap the productivity gains he hopes to obtain from his industrial modernization program.

b. And he probably believes that a successful conclusion of a major agreement with the present US administration will provide momentum to the process and create pressure for subsequent movement toward agreements on strategic offensive and defensive forces as the United States moves into an election year.

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~~...several initiatives in the international
...year or two.~~

~~A reorganization of the foreign trade sector now allows over
...ministries
...directly with foreign businesses.~~

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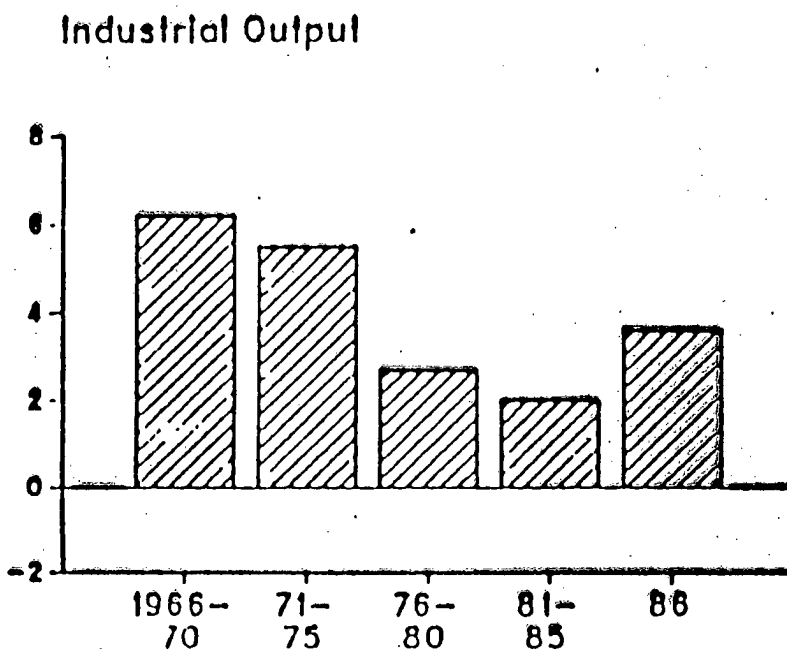
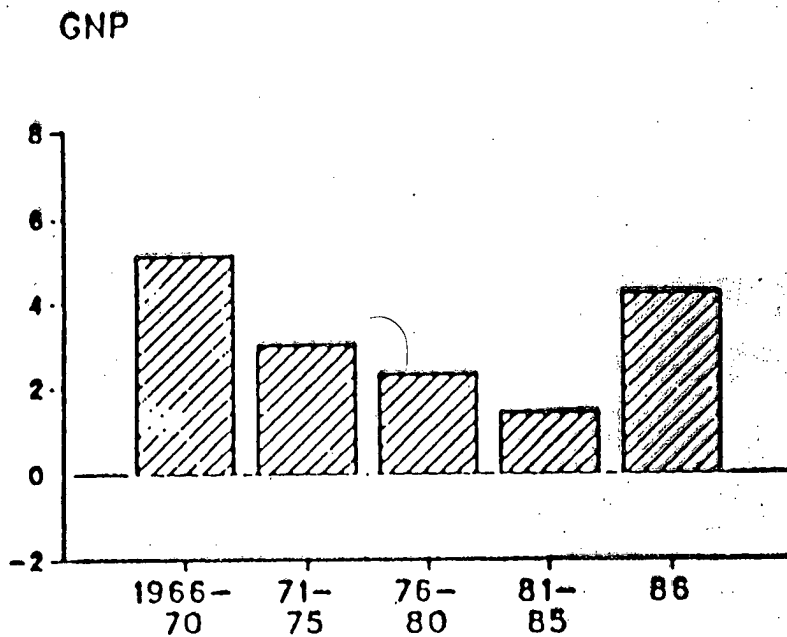
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6. Final Thoughts

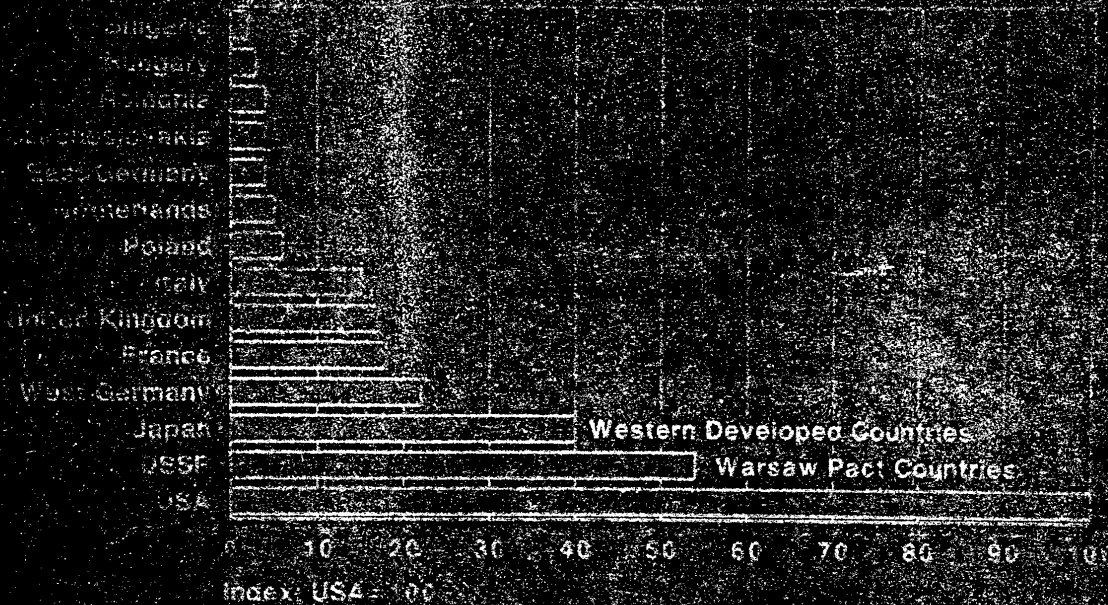
- a. In closing, even though I've been talking about what Gorbie could do to ease the resource allocation pressures he's under, if he felt he had to substantially increase the military budget, the USSR would not be a basket case.
- b. Spending more on defense would undermine the mod program and possibly forstall any gains in living standards, leaving the economy on a very slow growth path through 1990s (possibly less than 2% per year).
- c. This outcome would be unlikely to lead to economic collapse or social upheaval, however. Worth remembering that Sov economy is now so large that even at zero growth, more than 2 trillion dollars of goods and services can be produced each year.
- d. Technological gap would almost certainly widen, leaving USSR to continue playing "catch up" not only in civilian technologies, but also in some critical military technologies.

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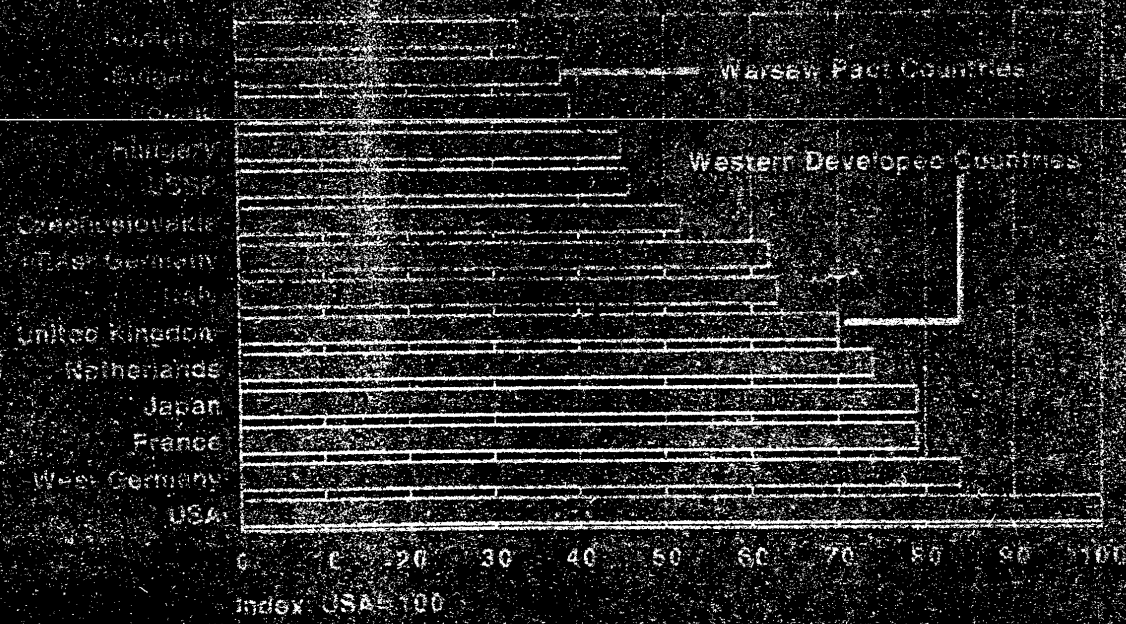
(average annual percentage growth)



Gross National Product, 1985



Per Capita GNP, 1985



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Figure 3 US and Estimated Soviet Military RDT&E Expenditures, 1965-86

Billion 1985 Dollars

