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MEMORANDUM FOR: D/OER; D/U; ~~St~~/P/C(2)
1-CRS/ZSG (4/2/75)

The attached material was forwarded to Mr. J. Mishell George, Director of Joint Commission Secretariat, Department of Commerce. They will form part of a briefing book being assembled in support of the Fifth Session of the Joint US-USSR Commercial Commission, which is to meet in Moscow on April 10-11, 1975.

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27 March 1975
(DATE)

FORM NO. 101 REPLACES FORM 10-101
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BACKGROUND PAPER

Japanese-Soviet Negotiations on Siberian
Economic Development

The pace of Japanese involvement in Siberian and Far Eastern development picked up markedly with the recent signing of three separate agreements dealing with (a) forestry development, (b) exploitation of coking coal deposits, and (c) exploration and development of offshore oil and natural gas. Negotiations are also underway for pulp/paper plants costing more than $1 billion. Prior to 1974, the Japanese had signed agreements for a small forestry development project (1968), port construction at Vrangel Bay (1970), and a wood chip processing plant (1971).

Projects Completed and Underway

Timber and Forestry Agreements

In 1968 the USSR and Japan concluded a five-year agreement on the development of timber resources in the Sikhote Alin Mountain area of the Soviet Far East. Under the agreement, a Japanese consortium supplied $166 million worth of equipment and consumer goods. A second and larger agreement was signed last July whereby the USSR will receive $550 million in timber cutting and processing equipment, ships, and consumer goods. In both cases, Soviet purchases are covered by Japanese Eximbank credits. Soviet ability to repay the credits was guaranteed by long-term Japanese commitments to purchase Soviet timber. In 1971 a different Japanese consortium concluded an agreement for the construction of a wood chip plant. The USSR received $50 million in equipment and consumer goods under credit in return for deliveries of wood chips and pulp over a ten-year period.

Port Development

In December 1970 an agreement was signed for construction of a new seaport, Vostochny Port, located on Vrangel Bay about nine miles from

Nakhodka. The Japanese Export-Import Bank furnished an $80 million credit for machinery and equipment. The new seaport will be capable of loading coal and wood chips as well as handling containerized cargo. Storage and warehouse facilities, railyards, and a railroad spur connecting with the Trans-Siberian railroad are being built. Vostochny Port could play an important part in long-term Soviet-Japanese development of Siberia since it would facilitate movement of goods and raw materials of considerable interest to Tokyo.

Chul'man Coal Deposits

In June 1974 the USSR signed an agreement with a consortium of Japanese firms to develop coking coal deposits near Chul'man in Eastern Siberia. Concomitantly the Soviets concluded an agreement with Japan's Eximbank for $450 million in long-term credits to finance Soviet purchases of coal mining equipment, railway equipment, and consumer goods. In return the USSR will supply the Japanese consortium with 104 million tons of coal in 1979-99, representing 5% of projected Japanese needs. Soviet earnings from the project could exceed foreign exchange costs by several billion dollars. US firms may be asked to supply some of the advanced equipment required by the USSR.

Offshore Exploration for Sakhalin Oil and Natural Gas

In January 1975 the USSR and Japan reached agreement to jointly explore oil and natural gas deposits along a portion of the continental shelf around Sakhalin Island. A Japanese-led consortium will extend up to $200 million in risk capital over the next five years to cover its share of exploration costs, and the USSR will receive $50 million in capital goods under an Eximbank credit. In return Moscow has granted the consortium a long-term option to purchase up to one-half of all oil recovered.

Projects Under Discussion

Pulp/Paper Plants

Moscow has requested Japanese firms to submit cost estimates for two pulp/paper plants to be built in the Soviet Far East. Together the plants would have a planned annual production capacity of roughly 1 million tons of newsprint, paper, and bleached pulp and are expected to cost over $1 billion. The Japanese would probably import a sizeable share of the output.

Yakutsk Natural Gas Exploration

In April 1974 the Japanese Eximbank agreed to provide $100 million in long-term credits to finance the Japanese share of the exploration phase of the Yakutsk natural gas project. The loan was contingent on the availability of matching funds from the US, which have not yet been granted. (Additional information on Yakutsk is contained in a separate paper.)

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Major Credit Needs and Availability for USSR

Need for Credits in Perspective

Moscow has relied heavily on medium and long-term Western credits to finance capital equipment imports from the West since these credits became generally available in the mid-1960s. Credits covered practically the entire hard currency trade deficit incurred by the USSR in 1966-71. Very little gold was sold. In 1972-73, the USSR incurred a cumulative deficit of $3.1 billion, more than double the deficit of the previous six years. In large part the deficit resulted from record imports of Western grain. Even so, the USSR imported a substantial volume of machinery and equipment thanks to the availability of Western credits. Net Western medium-term and long-term credits of $1.3 billion covered less than half of the deficit of 1972-73. Large sales of gold (at rising prices) and short-term borrowing covered the remainder.

Large Soviet Orders Based on Credit

Heavy reliance on Western credits enabled the Soviets to boost orders for machinery and equipment to $4.1 billion in 1974 compared with $2.3 billion in 1973. Also in 1974, the USSR contracted for about $2.5 billion in large-diameter pipe in Western Europe. The majority of the equipment orders and all of the pipe orders are supported by long-term Western credits which will be drawn down as deliveries are made in the next few years.

Continuing Need for Credit

The turnaround in terms of trade with the West and the resulting hard currency surplus of $1 billion in 1974 does not signal the end to Soviet need for Western credits. For one thing, continuing inflation in the West is eroding the price advantage recently won by Moscow. Secondly, Moscow's strategy for increasing trade with the West relies on a continuing stream of long-term credits, especially in connection with its ambitious resource development projects and their commodity pay-back provisions. Thirdly, even if the USSR continued to generate hard currency trade surpluses, Moscow still would profit from using low-interest, long-term credits if the rate of inflation continues to exceed the interest rate.

Ready Availability of Credit

Nearly all major Western countries continue to offer large lines of credit with easy repayment provisions to promote their exports to the USSR. Recent lines of credit include (a) the April 1974 extension by Japan of $1.1 billion in support of Siberian development projects, (b) the December 1974 extension by France of $2.6 billion, (c) the January 1975 extension of Italy of $600 million, and (d) the February 1975 extension by the United Kingdom of $2.3 billion. In addition, Japan continues to grant low-interest, long-term credits to support other equipment orders. An additional $1-$2 billion in credits from Japan and Italy seem likely in the near future. The West German government does not subsidize interest rates as do other Western governments; instead, the German financial community continues to come up with substantial long-term credits to support major equipment orders placed by Moscow, notwithstanding the alleged cash deal for the Kursk steel project. Meanwhile, Moscow is able to augment these traditional sources of credit by borrowing in the Eurocurrency market and from the newly affluent oil-producing nations.

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Current Outlook for the Soviet Economy

The Soviet economy grew by an estimated 3.2% in 1974, shielded from the recession and double-digit inflation plaguing the West by (a) its centrally controlled economic mechanism, and (b) its high degree of economic self-sufficiency.

-- Industrial output in 1974 grew an estimated 6.8%, the highest rate since 1970. The leading growth sectors were energy, producer durables, chemicals, and processed foods, a reflection of the priority given technological advance and expansion of farm output.

-- Agricultural production fell 3.3% below the record set in 1973 because of poor weather; nevertheless, grain output at 195.6 million tons was the second largest in history, and cotton output reached a new high. Moscow bought only 6½ million tons of Western grain for delivery in fiscal year 1975, compared with 10½ million tons delivered in FY 1974, and carried over large grain stocks from the 1973 record harvest.

-- Consumer welfare continued its steady rise, featured by increased availability of meat and dairy products, soft goods, and automobiles.

-- The hard currency trade surplus reached an estimated $1 billion in 1974, compared with a nearly $1 billion average <u>deficit</u> in 1970-73; price increases for Soviet oil and other raw materials far outweighed price increases for imports. Trade with the West boomed, growing by almost 48% and accounting for 31% of total Soviet foreign trade.

The Soviet economic plan for 1975 anticipates that GNP will grow at more than double the 1974 rate.

-- The planned matching of last year's industrial growth will be difficult to fulfill. According to Soviet statistics, industrial output this January grew only 6.7% compared with 9.6% in January of last year.

-- A jump of almost 11% in agricultural output is scheduled. So far this year the weather has been favorable for winter grains, making a record crop possible. Moreover, history shows that good winter crops are usually followed by bumper spring crops.

-- Many original consumer targets for 1975 will not be met because of disappointing harvests and lackluster performance in housing and the light and food industries. Nonetheless, Moscow remains firm in its commitment to raise living standards, as witness the continued strong support for agriculture in 1975.

-- The hard currency trade surplus in 1975 may match the $1 billion of 1974 in spite of a decline of some raw material prices. This financial cushion will help the Soviets to pay cash for some purchases and to resist high interest rates for Western credits.

From a longer-run perspective, the Soviet economy continues to be restrained by endemic problems. Moscow cannot readily translate its temporary advantages in dealing with the West into remedies for these problems.

-- Increases in productivity remain below expectations, particularly in the farm sector.

-- The slow introduction of new techniques and new products into large-scale production continues to characterize Soviet industry and is unlikely to be remedied by the piecemeal reforms under consideration.

-- The poor assortment and quality of consumer goods, the dismal quality of consumer services, and the housing shortages persist.

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