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MEMORANDUM FOR: John Yeo
Office of the Special Assistant to the Secretary for National Security Affairs
Department of the Treasury
Washington, D.C.

SUBJECT : Paper on Soviet Trade and Debt

In response to your request, two copies of a paper on Soviet hard currency trade and debt are forwarded herewith for the use of Secretary of Commerce Dent.

Office of Economic Research

Attachment:
As stated

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USSR Hard Currency Trade and Debt

Conclusions

The Soviet Union has coped with large hard currency payments deficits in the past two years, thanks chiefly to Western government-backed low-interest credits and large sales of high-priced gold. The Soviet balance of trade will improve in 1974 and probably will be in surplus for the first time in seven years because imports of grain will decline and the value of exports will increase as a result of higher world prices for major Soviet exports, particularly oil.

The Soviet balance of payments picture is thus brighter than it has been for a decade. Soviet export earnings could reach \$5.8 billion in 1974 -- up from \$2.8 billion in 1972. Further substantial increases in exports are possible in 1975 and 1976. Prospects for Soviet gold sales are also favorable and represent a large additional source of hard currency earnings. Sales from current production alone would -- at current market prices -- earn the USSR an additional \$1.3 billion in 1974 and \$1.5 billion in 1975.

The expected rise in hard currency earnings will increase the ability of the USSR to import the technology and equipment it desires from the West. The exact level of imports that the USSR attains during the next several years will depend upon several factors including raw material

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prices, gold sales, and Soviet debt management. The expected increase in hard currency earnings in any event will provide the USSR with additional flexibility in their import decision making, allowing them for example to pay cash for a substantial portion of its capital goods imports. The increased export base will also serve to alleviate the burden of debt service throughout much of the remainder of the decade.

Background

The Soviet hard currency deficit[1] averaged about $250 million annually during the period 1960-71 (Table 1). Until the mid-1960s, these deficits were financed primarily by gold sales, and by the end of 1965, Soviet gold reserves were down to about 900 tons. After 1965 Western government-guaranteed medium- and long-term credits applied to Soviet purchases of capital goods replaced gold as the chief element in financing Soviet deficits. In the period 1966-71, Soviet gold sales were virtually nil and reserves grew to an estimated 1,750 tons by the end of 1971. But Soviet medium- and long-term debt to the West (on government-guaranteed credits) apparently grew to more than $2 billion (Table 2). In 1971 debt service (principal and interest) took about 17% of Soviet hard currency exports.

1. Deficit refers to the merchandise trade deficit. Several elements of the current account cannot be estimated. Those that can (e.g., tourism and interest on loans) indicate that the merchandise trade balance does not differ substantially from the balance on current account.

Table 1

USSR Hard Currency Trade Deficit and Gold Sales
1960-1973

	Hard Currency Exports (In Million US $)	Hard Currency Imports (In Million US $)	Balance[a]	Gold Sales[b] (Million $)	Gold Sales[b] (Tons)
1960	739	1,018	-279	149	132
1961	866	1,059	-193	310	275
1962	912	1,179	-267	239	212
1963	969	1,279	-310	523	564
1964	1,011	1,544	-533	520	462
1965	1,331	1,546	-215	490	435
1966	1,479	1,746	-267	45	40
1967	1,688	1,604	+84	10	9
1968	1,896	2,004	-108	10	9
1969	2,109	2,422	-313	n.r.	n.r.
1970	2,182	2,699	-517	4	3
1971	2,646	2,955	-309	22	19
1972	2,815	4,171	-1,357	250-300	150
1973[c]	3,300	5,000	-1,700	900-950	300

a. Based on official Soviet data.
b. Calculated at the official rate of $35 an ounce for sales in 1960-68 and estimated free market prices subsequently.
c. Estimated.

Table 2

Estimated Soviet Drawings and Scheduled Repayments on Western Government-Guaranteed Medium-Term and Long-Term Credits

Million US $

Year	Drawings	Scheduled Repayments Principal and Interest	Net Credits	Outstanding Debt at the End of the Year
1966	275	170	105	505
1967	305	181	124	658
1968	510	255	255	951
1969	630	322	309	1,316
1970	700	379	321	1,717
1971	700	463	237	2,057
1972[a]	1,030	562	468	2,649
1973[a] [b]	1,690	895	795	3,612

a. Includes drawings on 3-year CCC credits.
b. Preliminary.

Recent Developments

A poor harvest in 1972 forced the USSR to purchase large quantities of grain and other agricultural products to sustain Brezhnev's program for upgrading the Soviet diet. At the same time, the continued disappointing performance in the industrial sector strengthened the leadership's determination to upgrade its industrial plant by stepping up imports of high technology machinery and equipment. In 1972 the trade deficit rose to a record \$1.4 billion. (See Table 1) Large imports of grain -- about \$750 million worth -- and other agricultural products accounted for much of the deficit, but imports of machinery and equipment and steel pipe also rose. Exports of oil -- the USSR's main hard currency earner -- declined slightly,[2/] while other traditional exports declined or did not increase.

The USSR's hard currency merchandise trade deficit apparently was even greater in 1973 -- perhaps about \$1.7 billion -- largely because much of the grain purchased in 1972 was delivered in that year. The USSR probably imported at least \$1.5 billion in agricultural products (chiefly grain) and about \$1.5 billion in machinery and equipment. Export performance was better than in 1972, however, in part because of higher prices for oil.

To cover the 1972 deficit the USSR relied chiefly on credit. Government-backed net medium- and long-term credits amounted to about \$500 million, and about \$100 million of CCC 3-year credits were drawn to finance grain purchases from the United States. As a result of its extensive borrowing in 1972, total outstanding debt on government-backed credits climbed to about \$2.6 billion. The USSR also tapped the

2. Oil exports might have declined even more were it not for Soviet imports of oil from the Middle East.

Eurocurrency market for several hundred million dollars in both medium- and short-term credits to finance imports of machinery and grain. The USSR also sold gold in substantial quantities for the first time since 1965.

In 1973 the USSR took advantage of high gold prices (and generally avoided high interest rates in the Eurocurrency market) in financing its hard currency trade deficit. The USSR sold about 300 tons in 1973 which probably earned the Soviets about $950 million. Much of the remaining deficit was covered by government-backed Western credits (including $400 million in CCC credits). Thus the burden of the USSR's recent trade deficits was lightened considerably by easy access to Western credits and by the windfall arising from the sharp increase in the price of gold. In addition, dollar devaluations will permit the substantial Soviet borrowing on the Eurodollar market in 1972 to be repaid by cheaper dollars.

Balance of Payments Prospects 1974-1975

Soviet hard currency earnings will be buoyed by rapid price increases for traditional Soviet exports and record gold prices, and payments surpluses rather than deficits are anticipated for the next few years. In 1974 with expenditures for Western grain expected to be half or less of 1973 outlays, these earnings could easily support a substantial rise of Soviet imports of Western plant, equipment and other goods.

Barring crisis-associated imports on the scale of 1973, this should be true for 1975 as well. The Soviets traditionally have been loath to hold foreign exchange in excess of working balances because of fears of Western devaluations. Foreign exchange earned in excess of such balances might be used to increase Soviet imports from the West. The value of these cash surpluses, and thus the extent to which the USSR can increase their imports, e.g., import maximize, is dependent upon several factors. These includes the use of Western medium-term and long-term credits, the value of Soviet exports, and the value of gold sales.

Exports

Exports will rise sharply during 1974-1975 because of the much higher prices the USSR will be receiving for oil and raw materials. Supported by Soviet imports from the Middle East under barter arrangements, exports of crude oil may reach 42 million tons in 1974 and 51 million tons in 1975 (up from 35 million tons in 1973). With market prices expected to range between $7 and $10 per barrel, oil exports alone may earn the Soviets $2-$3 billion in 1974 and $2.6-$3.7 billion in 1975. Increasing prices for wood products, chemicals, diamonds and coal, along with expanded deliveries of natural gas could push total Soviet exports to over $5.8 billion in 1974 (double the 1972 level) and $6.8 billion in

1975. Exports of goods other than gas and oil are expected to grow at a rate of 9% for the balance of the decade. (See Table 3 below).

Table 3

Soviet Hard Currency Exports, 1972-1975*

Million US $

Year	Oil	Natural Gas	Other	Total
1972	555	24	2,195	2,774
1973	840	75	2,325	3,250
1974	2,145 (3,050)	110	2,685	4,940 (5,845)
1975	2,604 (3,720)	205	2,930	5,739 (6,855)

* Oil prices during 1974-1975 are estimated at $7 and $10 per barrel (in parenthesis).

Other Earnings

Soviet foreign exchange earnings during this period will also benefit from increased net revenues resulting from Soviet shipping and Western tourists traveling in the USSR. Together these sources are expected to earn about $150 million in 1974 and $200 million in 1975. Soviet gold sales, however, represent the largest single additional source of potential foreign exchange earnings. Soviet gold reserves are currently estimated at about 1,700 tons[3], a far more than adequate

3. Valued at almost $10 billion at current market prices if all could be sold at such prices.

amount in view of the USSR's annual value of imports -- $5 billion estimated for 1973 -- and existing long-term debt -- $3.6 billion by end of 1973. As a result the Soviets would be free to market most, if not all, of current gold production in Western markets. Such a course of action would earn the USSR (at a price of $100 an ounce) some $720 million in 1974 and $890 million in 1975.[4]

Credit Drawings

Credit drawings and debt service are the other major variables affecting Soviet import potential. To the extent that the USSR continues to draw heavily on Western credits, total import capacity will be enhanced over the short term. Conversely, continued borrowing at such levels will lead to a more rapid accumulation of debt and larger debt service payments over the long run. Continued Soviet insistence on long-term credits in support of orders recently concluded or currently being negotiated in the West indicates that a large volume of deliveries for capital equipment during 1974-1975 will be on credit. It is quite possible, however, that the large export surpluses will allow the USSR to pay cash for capital imports, particularly if lucrative credit terms cannot be obtained. The USSR has just agreed to pay cash, for example, for all purchases connected with the

4. At the current gold price of $175 these sales would amount to $1,260 and $1,500 million respectively.

West German construction of a $1 billion iron ore complex at Kursk. The contract had been stalled by differences over credit terms, and the Soviets were unable to get the West Germans to provide credits at less than market rates (11%).

Import Maximization

Projected increases in Soviet earnings from exports, gold sales, and invisibles should provide the USSR with the ability to significantly increase 1974-1975 hard currency imports over the levels reached in 1972-1973. The potential increases in Soviet imports of machinery and equipment and consumer goods will be even greater since a large share of 1972-1973 Soviet imports consisted of crisis-associated purchases of agricultural products.5/

If the Soviets were to maximize imports6/ during 1974-1975, imports could rise as high as $6.8 billion and $8.2 billion in 1974 and 1974 respectively. For such levels to occur, however, the following conditions must prevail.

- Oil will sell at $10 per barrel and in the quantities projected.

5. Agricultural products, for example, represented 30% of the $5 billion in total Soviet imports from hard currency countries in 1973.
6. For analytical purposes any lags which may occur between cash receipts and disbursements for additional imports are disregarded.

- The Soviets will sell all of current gold production at $100 per ounce.
- The USSR continues to secure long-term financing for roughly 50% of its machinery and equipment imports.

If oil prices were to sell at $7 per barrel, potential import levels would be $900 million less in 1974 and $1,100 million less in 1975. Similarly, if the USSR does not continue to sell gold during 1974-1975, attainable import levels would be reduced by $720 million and $890 million respectively. Evidence indicates, however, that the Soviets may be selling gold this year in response to high prices.

A change in Soviet debt management would also affect potential import levels. If, for example, capital equipment in 1974-1975 were to be paid for solely in cash, the attainable import levels would fall by $1,270 million in 1974 and $1,500 million in 1975. Thus the least optimal combination -- $7 oil, no gold sales, and no purchases on credit -- would permit imports of $3.9 billion in 1974 and $4.7 billion in 1975.

Of these possible combinations of events it appears unlikely that the USSR will opt for cash payments for most of their capital goods imports. In particular Moscow will continue to press for long-term, low-interest credits for the multibillion dollar resource development projects such as the LNG proposals. The Kursk deal, however, indicates that the USSR may become more selective in their use of credits.

Debt and Debt Service

Regardless of the course it follows the USSR will continue to be in good shape with respect to debt accumulation and debt service in the short term. If, for example, the USSR continues to finance the same portion of its capital goods imports under long-term credits as it has in recent years, outstanding debt will reach $4.7 billion by the end of 1975. Because of the expected increases in Soviet export revenues, however, by 1975 debt service will account -- depending on oil prices -- for 21% to 25% of Soviet export earnings. The former percentage represents a decrease from the 25% of 1973 exports which was required to finance current Soviet debt. Any policy of debt prepayment or reduction of purchases on credit would serve to reduce the level of accumulated debt and annual debt-service payments

Balance of Payments Prospects 1976-1980

For the balance of the decade the outlook for Soviet balance of payments is less favorable than for the 1974-1975 period. Soviet exports of crude oil to the West is expected to peak in 1976 at 55 million tons, and subsequently decline, perhaps falling to 20 million tons in 1980. This is because of domestic supply constraints, increased domestic consumption, commitments to Eastern Europe and limitations on barter imports from the Middle East. While this decline will be partially offset by an increase in the value of other Soviet exports, particularly natural gas, the net effect will be a stagnation in Soviet exports to hard currency countries. (See Table 4).

Table 4

Soviet Hard Currency Exports, 1975-1980*

Million US $

Year	Oil	Natural Gas	Other	Total
1975	2,605 (3,720)	205	2,930	5,739 (6,855)
1976	2,810 (4,015)	274 (344)	3,200	6,284 (7,559)
1977	2,555 (3,650)	391 (515)	3,490	6,438 (7,652)
1978	2,044 (2,920)	441 (583)	3,800	6,285 (7,303)
1979	1,533 (2,190)	714 (1,027)	4,140	6,387 (7,357)
1980	1,022 (1,460)	741	4,515 (1,027)	6,215 (7,002)

* Oil prices are estimated at $7 and $10 per barrel (in parenthesis). Natural gas prices in turn are estimated at the caloric equivalence of prevailing oil prices, with the $10 equivalence value presented (in parenthesis).

Earnings from other sources will also serve to mitigate the impact of the declining oil revenues. Soviet tourism and transportation earnings are expected to continue to outstrip outlays in these areas, while gold production will increase steadily. If the USSR, for example, continues to sell its current gold production on Western markets, annual revenues could reach $1.1 billion by 1980 (an $100 an ounce).

The fall-off in export growth has significant implications for Soviet balance of payments and debt management. If imports on long-term credits continue to increase at present rates throughout the period, and if the USSR concludes the massive cooperative projects now being discussed with the West, e.g., Tyumen, Yakutsk, North Star, total long-term debt could reach $9 billion by 1980. Debt service associated with such a debt would require approximately $2.3 billion, or 35% of projected Soviet exports.

It is unlikely that the USSR would continue to increase drawings on Western credits at present rates. Aware of their apparent diminished export potential for the late 1970's, the USSR is likely to take a more prudent approach, using a portion of their surplus export earnings during the mid-1970's to finance a greater proportion of their capital imports, prepay some of their existing debts, or both. Such actions would reduce the rate of debt accumulation and the proportion of export earnings dedicated to debt service.

[redacted]

Soviet Hard Current Balance of Payments, 1972-1975[a]

	1972		1973[b]		1974[b]		1975[b]	
	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit
Current Account	----	1,375	----	1,860		1,153		1,490
Merchandise trade[c]	2,815	4,171	3,300	5,000	5,842[d]	6,844	6,855[d]	8,200
Transportation (net)	----	---		50	25		63	
Travel	120	25	147	28	162	32	178	37
Interest repayments on long-term credits[e]	----	124	----	190	----	265	----	308
Dividends[f]	10	---	10		10	---	10	
Transfer payments[g]		45		49		54		60
Capital Account	580	---	973		433		600	---
Medium-term and[h] long-term credits	1,030	438	1,690	705	1,410	965	1,737	1,125
Compensation payments[i]		12		12		12		12
Gold Sales[j]	300		950		720		890	
Errors and Omissions[k]	540			63		0		0

a. Policy of import maximization assumed for 1974-1975.
b. Preliminary estimates.
c. Derived from Soviet statistics; exports and imports are f.o.b.
d. Oil exports valued at $10 per barrel.
e. Interest payments are those made on medium-term and long-term credits obtained from Western countries mainly to finance imports of machinery and equipment. Interest payments and receipts on short-term loans are not included.
f. Includes profits of Soviet-owned banks and firms in the West.
g. Payments made in hard currency to the United Nations and UN-affiliated organizations.
h. Usual pattern of use -- now 50% of total machinery and equipment imports.
i. Soviet payments or principal and interest in accordance with the US lend-lease "pipeline" agreement. Future payments may vary, depending upon US approval of US-Soviet trade agreement.
j. Sales priced at $100 per ounce.
k. Includes changes in hard currency holdings, short-term capital movements, and hard currency repayments from less developed countries for Soviet credit.

[redacted]