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BACKGROUND PAPERS:
CURRENT OUTLOOK FOR THE SOVIET ECONOMY; MAJOR CREDIT NEEDS AND AVAILABILITIES FOR THE USSR; MAJOR INDUSTRIALIZED WEST-SOVIET PROJECTS

Current Outlook for the Soviet Economy

SUMMARY

In 1976 the Soviet economy grew at only 3.7%, in part because it was still recovering from the disastrous harvest of 1975. Further recovery is expected in 1977 but growth still will be below the trend of the last decade. Construction lags will hamper industrial growth, and the consumer will continue to suffer unusually severe food shortages. In the longer run, a slowdown in the rate of growth of labor and raw materials is forcing Moscow to adopt a new growth strategy stressing productivity gains in order to keep growth rates up. One of the most serious problems of the 1980s will be the likely downturn in oil production which will have implications both for domestic economic growth and for the balance of payments.

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BACKGROUND PAPER

Current Outlook for the Soviet Economy

In 1976, the Soviet economy was still recovering from the disastrous harvest of 1975. Livestock herds were down after the distress slaughtering of the previous winter; industry suffered shortages of agricultural raw materials; and the consumer was set back in some cases to his consumption level of the 1960s. Even so, the leadership probably gave itself high marks for its stewardship through the most severe economic crisis of the last decade. The situation never became serious enough to impose constraints on Soviet foreign policy or military programs.

Soviet gross national product (GNP) grew 3.7% in 1976, about the average achieved in 1971-75, but substantially above the 2% of the previous year. Industrial growth slumped to 3.6%, the worst performance of the post-war period. A shortage of raw materials from agriculture was the principal cause, although transportation tieups and fuel problems were contributing factors. Farm output bounced back to a 4½% growth rate following an 8½% decline in 1975. A sharp increase in crop production, led by a record grain harvest, more than offset a decline in the livestock sector.

For the consumer, 1976 was a year of unusual shortages, resulting in the worst food supply situation in more than a decade. Meat shortages intensified throughtout the year, and per capita meat consumption for the year as a whole dropped to roughly the 1970 level. Although grumbling was widespread, the consumer's unhappiness apparently was not translated into open unrest. Consumers fared better on other fronts. For example, housing conditions continued to gradually improve, as more than 10 million people moved into new apartments.

Economic recovery should continue in 1977 but not as fast as the regime would like. Although the flow of agricultural raw materials will pick up, continuing lags in bringing new plant and equipment on stream will keep industrial growth down. During the first two months of the year industrial output grew only slightly faster than the 3½% rate posted in 1976. This compares with the annual goal of 5½%.

Because of the dominant effect of weather, agricultural performance remains uncertain. Prospects for winter grain, which normally account for one-third of total Soviet grain output, are favorable. The area sown to winter grain was the largest since 1968, and winterkill losses were below normal. The livestock sector should make slow but steady progress due to last year's bumper grain harvest. The consumer, however, continues to suffer food shortages, mainly of meat and vegetables. Such shortages have eased substantially only in major cities. The long anticipated upturn in meat output has not yet materialized; a Soviet official recently estimated that the meat situation would not return to normal for another six months.

The current slowdown in growth is not just the result of recent harvest shortfalls but the continuation of a general slowdown in growth begun in the 1960s. This slowdown has been caused by the using up of easily exploitable resources as well as the Soviet failure to make more efficient use of these inputs. The leadership realizes that the growth strategy of the past -- the lavish use of capital and labor -- is no longer possible and they must focus their attention on raising productivity. They have taken a number of measures to boost productivity including the large-scale acquisition of Western equipment and technology and the adoption of better managerial methods that encourage the introduction and application of new technology. While these measures will not bring back the growth rates of the 1950s, the economic pace over the next several years should be sufficient to continue their basic guns and butter policy. In the 1980s, however, the Soviets will face growing resource problems. One of the most serious will be the downturn in oil production which could dampen economic growth and create serious balance of payments problems.

Drafted by: CIA/OER

Clearances: Commerce/H.Heiss
Treasury/M.Searing
State/J.Colbert/H.
EXIMBANK/J.Fleig

BACKGROUND PAPER

Major Credit Needs and Availabilities for the USSR

SUMMARY

The rapid growth of Soviet imports of Western equipment and pipe on credit and large hard currency trade deficits have led to a sharp rise in the USSR's hard currency debt. Soviet indebtedness to the West amounted to $14 billion by year-end 1976, 50 percent held by Western commercial banks. Moscow seems reasonably assured of obtaining most of the medium and long-term government guaranteed credits it will require to finance future capital good imports from the West. Western governments remain basically optimistic with regard to Soviet creditworthiness. However, the USSR's ability to obtain non-guaranteed credits has become increasingly constrained. Because of past heavy lending to the Soviets, many Western banks have approached or hit lending limits vis-a-vis the USSR. As long as Soviet Eurocurrency indebtedness remains at or above present levels, Moscow will probably attempt to limit trade deficits to levels which can be financed without resorting to general purpose borrowing. Based on the record 1976 grain harvest and good export prospects, we believe it unlikely that the Soviet hard currency trade deficit in 1977 will exceed $3-4 billion or that Moscow will have to rely on general purpose financing.

BACKGROUND PAPER

Major Credit Needs and Availabilities for the USSR

The rapid growth of Soviet equipment imports from the West and large hard currency trade deficits have combined to heighten Moscow's need for Western credit. The concomitant rise in the USSR's hard currency debt has limited Moscow's ability to obtain new credits -- at desirable interest rates -- from Western banks. The USSR will continue to face these conditions, at least for the near term.

The Soviet Union relies heavily on Western credits to manage its hard currency balance of payments; the availability of long-term credit weighs heavily in Soviet decisions to buy equipment from the West. Large-scale development projects are particularly dependent on long-term Western financing. The USSR also has used credits to finance unplanned hard currency deficits, particularly in recent years.

The growth in imports of Western equipment and pipe on credit and the unexpectedly large deficit in 1975 led to a sharp rise in the Soviet Union's hard currency debt, forcing Moscow to cut non-grain imports in 1976. Net indebtedness, which rose by \$5 billion in 1975, grew by \$4 billion in 1976 to hit \$14 billion. Roughly 70 per cent of this total was medium- and long-term debt. The share of Soviet hard currency debt held by Western commercial banks has risen sharply, from roughly 10-15 per cent at the end of 1974 to about 50 per cent at the end of last year. The USSR's net liabilities to Euromarket banks -- a large part of which are short-term -- increased by over \$6 billion in the 1975-76 period.

The Soviet Union seems reasonably assured of obtaining most of the medium- and long-term credits it will require to finance future capital goods imports from the West. The governments of France, West Germany, Japan, the UK, Canada, and (domestic conditions permitting) Italy either have advanced or guaranteed large credit lines or can be expected to do so in the future on the basis of new Soviet orders. Although Western governments are looking more closely at the rapid growth in Soviet indebtedness, they remain basically optimistic with regard to Soviet creditworthiness.

In contrast, Moscow's ability to obtain non-guaranteed credits will be constrained in 1977 just as it was in 1976. Because of past heavy lending to the Soviets, many Western banks have approached or hit lending limits vis-a-vis the USSR. As a result, these banks have become more selective in granting new loans; many want higher interest rates and front-end fees for syndicated medium-term loans despite the fact that loan demand is slack. Most bankers seem to prefer suppliers' credits, whereby loans are tied to Western exports and financing is often undertaken at the behest of the Western exporter. This type of financing not only yields a profitable return but also enhances the lending bank's relationship with the Western exporter.

The USSR realizes that its heavy past borrowing will continue to limit its ability to tap the Euromarket for new funds in 1977. Soviet borrowers remain extremely sensitive to the nominal interest rates they must pay and view any rate increase, relative to what other borrowers pay on similar syndicated loans, as an adverse reflection on their credit standing in the West. To protect its credit rating and borrowing capacity, Moscow will continue the cautious financial posture it adopted in 1976 in order to minimize its dependence on the Euromarket for financial credits. The steps that the USSR is expected to take include:

- limiting the growth of machinery and equipment imports according to the availability of government-backed credits and growth in hard currency export earnings.
- a continued use of medium-term promissory note financing for some equipment imports instead of paying cash.

- sales of gold worth $1.2-1.5 billion during 1977. The gold market has rebounded since last summer's low point, and Moscow can be expected to continue moderately heavy sales.

The USSR will exercise restraint in seeking a Eurocurrency loan syndication in 1977. Because of continued market liquidity, interest rate spreads have narrowed since Moscow borrowed $250 million at a relatively low 1.25% over LIBOR last July. The Soviet Union has been quietly sounding out bankers for syndicated credits at 1% over LIBOR, a rate that the USSR thinks is desirable. However, most banks are not interested in lending to Moscow at such a rate.

As long as Soviet Eurocurrency indebtedness remains at or above present levels, Moscow will probably attempt to limit trade deficits to levels which can be financed without resorting to general purpose borrowing. Moscow will continue to make greater use of government-backed credits and promissory note financing. Together with revenues from gold and arms sales, transportation earnings, and tourist receipts, such tied borrowing should allow the USSR to finance moderate annual trade deficits for the foreseeable future. Should the USSR again incur unexpectedly large trade deficits, it will probably have to place greater emphasis on expanding exports and/or cutting back on non-grain imports than in 1973 or 1975-76, when general purpose borrowing was used to make up much of the shortfall. Based on the record 1976 grain harvest and good export prospects, we believe it unlikely that the Soviet hard currency trade deficit in 1977 will exceed $3-4 billion or that Moscow will have to rely on general purpose financing.

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BACKGROUND PAPER

Major Industrialized West-Soviet Projects

SUMMARY

Since the early 1970s, the Soviet Union has proposed that Western firms supply equipment and technology for several huge projects in priority sectors. Although large Soviet hard currency trade deficits have caused some delays and scale-downs, most of the projects are still alive. US participation in Soviet projects has not been as extensive as it might have been if Eximbank credits had been available. Moscow can get government backed credits in Western Europe and Japan. The Soviets have urged Western firms to accept long-term deliveries from output of the projects to repay the credits.

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BACKGROUND PAPER

Major Industrialized West-Soviet Projects

In recent years, the Soviet Union has proposed a number of huge projects -- several valued at $1 billion or more -- to be undertaken with assistance by Western firms. Negotiations have proceeded slowly in most cases, but nearly all the proposals are still alive and some projects are well under way (albeit substantially altered in a few instances). Most of the projects are for the Soviet energy, chemical, and metallurgy industries.

Moscow's willingness to commit future resources to repay billions of dollars in credits testifies to its strong desire for Western equipment, technology, and capital. Some projects are expected to play an important role in the long-run development of the Soviet economy. For example, Western equipment and technology would be useful in developing oil reserves in Siberia and essential in off-shore Arctic areas. These reserves are pivotal to Soviet plans to increase production in the 1980s. Similarly, Soviet hopes to increase agricultural production rest to a considerable degree on the output of several chemical fertilizer complexes the Soviets have bought from the West. Although the Soviets could probably handle most if not all of the projects on their own, Western participation will allow them to be completed earlier, and Western equipment and technology will increase the productivity of the installation in question.

Recent Soviet difficulties in borrowing in the West may not affect Moscow's ability to obtain long-term credits for the projects because Western lenders prefer to provide project-associated credits rather than general financial credits for which the uses are not specified. Moscow, however, has delayed some projects or reduced the Western share in others, apparently in response to the growing Soviet debt.

Credit availability has been a factor in Moscow's shift among potential Western suppliers. US legislation has virtually closed the door to Eximbank credits for Soviet projects; as a result the Soviets have sought alternate sources of financing for the projects. While the Soviets still request bids from US firms, the US role is largely limited to selling licenses and technology, with firms in Western Europe and Japan supplying equipment. The best example is the proposed North Star LNG project, which in its present form calls for nearly all equipment to be purchased from France, the UK, and West Germany where credit lines are available. In recent months, the Soviets have also turned to the UK and Canada -- two countries which have large uncommitted government-guaranteed export credit lines open to Moscow -- for financing major projects.

The projects generally involve so-called compensation agreements: Western firms export equipment and other materials on credit to be repaid by Soviet exports from the output of the project. Western negotiators have taken a harder line in recent negotiations on the product-payback provisions of the compensation agreements. The French took a tough stand on product-payback at the June-July 1976 session of the Franco-Soviet Mixed Commission. Western firms are concerned that future large Soviet exports of fertilizers and other chemical intermediate products may disrupt Western markets. The French government, for example, reserves the right to restrict Soviet exports to France of competitively sensitive goods. Current Soviet efforts to include manufactured goods in compensation agreements have met a cool reception from firms uncertain of the marketability of these products in the West. The Soviets have had -- and should continue to have -- better success in selling their raw materials.

Drafted by: CIA/OER

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Table 1.

Major Projects with US Participation

Project	Value	Comments
Occidential fertilizer complex	$1 billion	Project well underway; production in 1978-1979; most equipment from US.
Aluminum complex	$1 billion	May 1976 contract with French firm for alumina refinery; US-German group negotiating for smelter contract.
North Star LNG	$8 billion	Revived interest in 1976, with equipment and credits sought from Western Europe; project recently shelved for various reasons, including uncertainty over US LNG import policy.
Yakutsk LNG	$7 billion	Reserves announced at 700 billion cubic meters in March 1977; development decision will be reached when proved reserves reach 1 trillion (about 1979); would call for annual exports of 10 billion cubic meters of LNG each to US and Japan. Eximbank credits would be required for the US to participate in the project in its present form. It is uncertain whether the project will conform to future US energy policy.

Table 2

Major Projects with Other Western Participation

Project	Value	Comments
Orenburg gas pipeline	$2 billion	Construction began 1975, completion scheduled 1979; FRG, France, Italy major suppliers.
Kursk iron and steel complex	$3 billion	General agreement with German corsortium in 1974; Soviets recently balked at increased cost estimates resulting from design and specification changes.
Sakhalin offshore oil and gas	N.A.	Exploration began in 1976 under agreement with Japan; Gulf Oil has small stake; development several years away.
Udokan copper complex	N.A.	Negotiations for past decade unsuccessful because of huge outlays required; interest recently revived with the start of the BAM railroad. Soviets are requesting bids for a pilot plant and are starting preliminary mine development.

MEMORANDUM FOR: Mr. J. Mishell George
Director East-West Country Affairs
Department of Commerce

Attached are the Background Papers to be usedat the Joint US-USSR Commercial Commission Meeting.

Office of Economic Research

Attachments
As Stated

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