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Issue No. 7
5 May 1989

East European

Regional Economic Wrap-up

DATE 5-5-89
DOC NO EM 20090
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EAST EUROPEAN REGIONAL ECONOMIC WRAPUP (U)

5 May 1989

Page

Relations Outside the Bloc

Most East European Joint Ventures Objectives Unfulfilled 1 (b)(3)

East European countries have liberalized their joint venture laws in recent years to attract Western technology and boost exports, but the results so far have fallen short of regime expectations. (b)(3)

Courting Iran and Iraq 3 (b)(3)

The East European regimes are trying to profit from the postwar reconstruction effort in Iran and Iraq, but the interest of these Persian Gulf countries in reviving ties with the West and hard bargaining over oil barter agreements will limit opportunities for the region. (b)(3)

Opening Up to South Korea 7 (b)(3)

Some countries, particularly Hungary, are expanding ties with South Korea in hopes of obtaining high technology, credits, and joint ventures. South Korea is offering these sweeteners in an attempt to isolate North Korea. (b)(3)

Expanding Ties with Israel 9 (b)(3)

A number of countries recently began renewing contacts with Israel in hopes that this will earn economic rewards from Washington as well as commercial and technological benefits from Israel, but Eastern Europe will play this card cautiously to prevent alienating Arab nations. (b)(3)

Relations Within the East Bloc

CEMA: Slow Growth for Grass Roots Economic Integration 11 (b)(3)

Gorbachev's initiative to encourage direct ties between CEMA enterprises as a way to promote economic integration has generated more public relations than substance. Without price and currency reform, the efforts to transform CEMA into an Eastern "EC" will flounder. (b)(3)

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Defense Spending to Fall [redacted] **13** (b)(3)

In a move that was probably carefully orchestrated, nearly all of the East European Warsaw Pact members have announced unilateral cuts in defense spending and military manpower since Soviet leader Gorbachev's announcement of Soviet troop withdrawals from Eastern Europe. While this move is aimed largely at weakening NATO's consensus on arms negotiations, the regimes hope that reductions in defense spending will free resources to deal with other key economic problems. [redacted] (b)(3)

How Will Eastern Europe Respond to Soviet Pressures to Use Natural Gas? [redacted] **15** (b)(3)

The region must make tough decisions about energy policies as it formulates its economic plans for the 1990s. The region, which is heavily dependent on Soviet oil, must decide how much to invest in conversion to natural gas since Moscow refuses to provide greater quantities of oil. [redacted] (b)(3)

Internal Affairs

Grain Harvest Average [redacted] **17** (b)(3)

The 1988 winter grain harvest was about average but the drought increased crop losses in some countries. Overall consumer supplies will be adequate in most countries, but spot shortages will contribute to consumer grumbling. [redacted] (b)(3)

Albania: Persistent Economic Difficulties [redacted] **19** (b)(3)

Albania's economy is the most backward in the region, and little improvement is likely until the leadership sheds long-held ideological beliefs that leave Albania largely isolated from the world economy. [redacted] (b)(3)

This document was prepared by [redacted] East European Division, Office of European Analysis. Comments and questions are welcome and should be addressed to [redacted] Chief, East European Division [redacted] (b) (3) (b)(3) (b)(3)

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Most East European Joint Venture Objectives Unfulfilled [redacted]

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Most East European countries have liberalized their joint venture laws in the past two years in a bid to obtain Western technology and boost hard currency exports. Most regimes, however, are disappointed in the number of Western firms attracted and are offering further concessions in hope of achieving their objectives. [redacted]

The growing competition among East European countries to woo Western investors has spurred most regimes to amend their joint venture laws repeatedly in recent years. Yugoslavia and Poland passed new legislation in December 1988, while Hungary and Czechoslovakia amended their laws in January 1989. Bulgaria amended its law in 1987, but is planning more changes later this year. East Germany recently expressed interest in trilateral joint ventures with West Germany and the USSR, but no specifics were given. Only Romania has not changed its law since 1972; apparently the regime has little interest in attracting new foreign investors. [redacted] (b)(3)

Most of the joint ventures attracted are small and have not brought in the high technology wanted by the regimes. Yugoslavia and Hungary, the most successful, have around 200 joint ventures each. Less liberal laws and poorer business climates in Poland, Bulgaria, Czechoslovakia, and Romania continue to discourage Western firms. Until its recent expression of interest, East Germany was indifferent to joint ventures largely because of its determination to maintain close central control over economic decisions and its good access to Western markets through inter-German trade. [redacted] (b)(3)

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Eastern Europe: Joint Ventures[a]

EE Country	Date of Latest Change	Year First Permitted	Number	Permits Western Majority Ownership	Profit Tax Rate (Percent)	Tax Free Period (Years)	Type of Venture
Bulgaria	1987	1980	15	Yes	20 to 30	3	Machinery, consumer goods, and chemicals
Czechoslovakia	1989	1985	8	Yes	50	0	Electronics and hotel construction
Hungary	1989	1972	220[b]	Yes	20 to 30	5[c]	Banking, tourism, machinery, and manufacturing
Poland	1988	1976	13	Yes	40	3	Hotel construction, manufacturing, and food processing
Romania	1972	1971	5	No	40	1	Export-oriented industries
Yugoslavia	1988	1967	200	Yes	10	0	Industry, mining, agriculture, and tourism

[a] As of June 1988.
[b] As of February 1989.
[c] Joint ventures in priority sectors.

[redacted] (b)(3)

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[redacted]

Despite recent tinkering with joint venture laws, most regimes remain reluctant to take the major steps necessary to attract Western firms because they still fear foreign intrusion into their economies. Western businessmen remain wary about investments in Eastern Europe because of the poor economic and political climate in some countries, often capricious regulations, unrealistic exchange rates, and restrictions on converting profits into hard currency. The central allocation of supplies and prohibition against wage incentives in most countries also lead Western firms to doubt the potential profitability of East European joint ventures. [redacted] (b) (3)

The willingness of most East European regimes to continue experimenting with joint venture laws is heightened by Soviet interest in attracting Western investors. Further liberalization of Soviet joint venture regulations will widen the scope for change in East European laws and stiffen the competition in attracting Western firms that generally are more interested in the much larger Soviet market. US firms' participation in Eastern joint ventures may promote better East-West ties, but some ventures could pose the risk of illegal technology transfer. [redacted] (b) (3)

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Courting Iran and Iraq

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Most East European regimes are trying to profit from postwar economic reconstruction in Iran and Iraq. The East Europeans hope increased exports of civilian goods and services will augment continued sizable arms sales, at least to Iran, or at worst they will offset a possible reduction in weapons exports. However, Baghdad's and Tehran's interest in reviving ties with the West and hard bargaining over the terms of oil barter agreements will be obstacles to expansion of this trade.

All East European countries except Albania have been exploring ways to commercially exploit the postwar needs of both countries. There has been a flurry of official visits and exchanges since the ceasefire, and Yugoslavia, Hungary, Czechoslovakia, Bulgaria, East Germany, and Poland have already signed oil barter agreements with either Iran or Iraq.

Most of these deals involve East European exports of machinery, vehicles, and construction services, particularly for rebuilding the oil industry, roads, power plants, and other public services. These are sectors where the East Europeans are competitive. Other opportunities for Eastern Europe include building materials and equipment, agriculture and food industries.

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The potential for East European sales is probably greater in Iran than Iraq. Iran faces a hard currency crunch and is reluctant to accept foreign loans, and the East European countries are more willing than many Western countries to accept oil in payment. Iraq's goals of expanding commercial ties with the West and acquiring high technology goods limit East European opportunities, but Eastern Europe could increase business with cash-short Baghdad if it is willing to offer trade credits.

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Yugoslavia has become the frontrunner among East European suppliers. The Iraqis and Iranians consider Yugoslav technology, engineering, and construction services, to be the most advanced in Eastern Europe according to Embassy Belgrade. Moreover, Belgrade's leading role in the Non-Aligned Movement meshes with the political image Iran and Iraq wish to project. The Yugoslavs view Iran and Iraq as lucrative long-term markets and, according to the Embassy, may accept short-term losses to gain market share.

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Eastern Europe's civilian commercial dealings with Iran and Iraq probably will not duplicate the success it enjoyed with arms sales. Besides Iraq's preferences for Western commercial suppliers, the lifting of some Western sanctions against Tehran will give East European exports stiffer competition. The valuation of oil in barter deals will also be a sticky issue. The East Europeans will cite soft oil markets while Iran and Iraq will point to the poor quality of East European offerings.

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Eastern Europe [a] Trade With Iran and Iraq *Million US $*

	Iran		Iraq	
	1986	**1987**	**1986**	**1987**
Exports	**342.1**	**488.6**	**1,155.6**	**1,246.4**
Bulgaria	83.0	81.4	303.9	395.9
Czechoslovakia	39.8	49.5	155.0	214.0
East Germany [b]	72.1	98.8	151.6	127.7
Hungary	51.7	112.0	57.1	32.1
Poland	19.5	21.9	145.0	63.7
Yugoslavia	76.0	125.0	343.0	413.0
Imports	**602.7**	**549.5**	**1,053.3**	**750.5**
Bulgaria	119.8	44.0	80.5	55.2
Czechoslovakia	94.6	78.0	1.0	1.0
East Germany [b]	72.1	98.8	151.6	127.7
Hungary	65.9	104.0	1.1	1.9
Poland	50.3	22.7	25.1	16.7
Yugoslavia	200.0	202.0	794.0	548.0

[a] No data from Romania were available.
[b] We are uncertain whether these figures include arms deliveries.

[redacted]

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Examples of Developments Since the Ceasefire

- *Iraq's request for bids from Yugoslav firms on 45 different infrastructure projects and the award of $208 million in contracts to Yugoslavia for work on the Bekhme Dam project.*

- *Yugoslavia's sale of trucks, iron foundries, heavy machinery, and construction machinery, in exchange for 1.3 million tons of Iranian oil.*

- *Czechoslovak construction of power stations in Iran and Iraq, as well as assistance in construction of other public works projects and industrial facilities in Iraq.*

- *Hungary's sale to Iran of such items as water pumps, parts for oil drilling equipment, and electric motors in return for agricultural commodities.*

- *Iranian cooperation with Hungary in ore and mineral mining, the aluminum, iron and steel industries, and the processing of non-ferrous metals. Hungary recently agreed to process chromium and manganese ore in exchange for oil and mineral exports.*

- *A Polish agreement with Iran for the repair and reconstruction of the Rahmin Power Plant near Ahwaz.*

[redacted] (b) (3)

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Approved for Release: 2018/08/22 C06275630

Opening up to South Korea [redacted]

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Most East European countries are seeking to expand economic links with South Korea. They see the strong South Korean economy as a potentially valuable source of high technology, consumer goods, credits, and joint ventures, as well as a growing market for some of their exports. Seoul is using expanded dealings with the Soviet Bloc primarily as a way to pressure North Korea into a more conciliatory relationship but also as a means to diversify its export markets. The development of South Korean-East European ties will be limited by Eastern Europe's shortage of foreign exchange, South Korea's reluctance to enter into any overly risky economic ventures with Eastern Europe, and the strong objections of North Korea to rapid expansion of contacts with South Korea. [redacted]

Eastern Europe Trade With South Korea, 1986-87 *Million US $* [a]

	1986		1987	
	Exports	Imports	Exports	Imports
Hungary	0.8	7.0	2.8	13.3
Yugoslavia	1.0	9.0	2.0	22.0
East Germany	4.0	20.0	5.0	25.0
Poland	NA	NA	5.0	17.0
Romania	NA	NA	2.1	0.1
Czechoslovakia	NA	NA	8.0	4.2
Bulgaria	NA	NA	3.0	0.7

[a] Estimated.

[redacted]

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Relations Improve

Significant movement toward opening up South Korean-Eastern European relations began with the decision by all countries in the region, except Albania, to participate in the 1988 Summer Olympics in Seoul over P'yongyang's opposition. Hungary took the lead by becoming the first Communist regime to agree to exchange trade offices and eventually establish diplomatic relations, which it formally announced on 1 February 1989. The Yugoslav republic of Slovenia, Poland, and Bulgaria also agreed to open trade offices during the past few months. East Germany and Czechoslovakia have expressed interest in an exchange of trade offices, although formal diplomatic links do not appear imminent. [redacted]

Eastern Europe's Economic Motivations

Trade with South Korea offers the East Europeans several economic advantages.

- The region probably hopes Seoul's relative lack of experience in controlling technology sales to the Bloc and its eagerness to promote exports will improve its access to advanced technology, ranging from personal computer components to automobiles to consumer electronics.

- South Korean exports often cost less than comparable Japanese and West European products because of low labor costs.

- The East Europeans probably see the rapidly growing Korean economy as an expanding market easier to penetrate than the developed economies of the United States, Western Europe, and Japan. [redacted]

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The East Europeans are also trying to fan Seoul's interest in joint ventures. The East Europeans see such ventures as opportunities for technology transfer, increased foreign investment in their economies, and hard currency earnings from sales

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to third markets. The Hungarians, in particular, are eager to promote large-scale joint ventures in industries that will earn hard currency, such as automobile production, aluminum processing, tourism, food industries, and chemicals. [redacted] (b)(3)

The Hungarians and perhaps other East Europeans, have raised the possibility of loans from Korea. Some South Korean government officials believe loans will encourage faster growth of trade with the East Europeans, and it appears that the South Korean government is willing to extend modest trade credits. Late last year, loans totalling $125 million were extended to Hungary as an incentive for exchanging ambassadors. Seoul's rapidly strengthening financial situation could increase chances for debt-plagued East European countries to obtain financial assistance in the near future. [redacted] (b)(3)

The South Koreans view the opening to Eastern Europe in broader terms than economic gain. By developing ties with the communist world, including the Soviet Union and China, South Korea is trying to end P'yongyang's monopoly on dealings with socialist countries. [redacted] (b)(3)

Apart from these political calculations, the South sees some potential economic benefits. Seoul believes Eastern Europe can provide cheaper semi-processed goods than its traditional Japanese suppliers. South Korean importers have expressed particular interest in purchasing chemical products. Pharmaceuticals, machine parts, and heavy industrial and electrical machinery are among other items South Korea could purchase from Eastern Europe instead of Japan if East European products are competitive in quality. [redacted] (b)(3)
[redacted] (b)(3)

Outlook

We expect further significant growth in economic activity between most East European countries and South Korea in the next few years. Under pressure to improve economic performance, the East Europeans will be increasingly reluctant to sacrifice the gains from trade with South Korea in order to placate P'yongyang. If some East European regimes move ahead with even modest economic reforms, they will be more attractive as investments for the South Koreans. Within the region, Hungary, Poland, and Yugoslavia will remain the most active in exploring the potential of this relationship. [redacted] (b)(3)

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Expanding Ties with Israel [redacted]

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A number of East European countries recently began renewing economic, political, and cultural contacts with Israel, ending the 21-year freeze in relations imposed by most regimes in the wake of the 1967 Arab-Israeli War. Signs of this increased activity include: high-level official visits, upgrading of technical and trade cooperation, tourism and cultural agreements as well as other preliminary steps towards possible diplomatic relations. [redacted]

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Recent Moves Among East European Countries

The East Europeans have markedly stepped up both unofficial and official contacts with Israel during the past year.

- Hungary was one of the first to signal interest in new contacts with Israel. Hungarian Premier Grosz told US officials that he plans to reestablish diplomatic relations with Tel Aviv by May of this year and predicted several others would follow suit. The Israeli press recently claimed that Israel and Hungary had signed a seven-year trade pact.
- Poland and Israel have agreed to raise their interest sections to independent representations headed by ranking diplomats.
- Czechoslovakia and Bulgaria will establish an economic representative and an interest office, respectively, according to Embassy Tel Aviv.
- East Germany has considerably softened its hardline anti-Israel stance, although the issue of Jewish war claims will slow the development of official relations.
- Romania, with its independent foreign policy, was the only East European country that did not

East European Trade with Israel, 1985-87 *Million Dollars*

	1985		1986		1987	
	Exports	Imports	Exports	Imports	Exports	Imports
Hungary	8	5	12	8	10	9
Yugoslavia	11	24	11	20	15	22
East Germany	0	1	0	0	0	2
Poland	0	1	0	1	0	4
Romania	20	10	29	7	31	7
Czechoslovakia	0	2	0	3	0	3
Bulgaria	6	5	2	5	3	1
Total	45	48	54	44	58	48

Unclassified

break with Israel in 1967. Bucharest already serves as a transit point for Soviet Jews emigrating to Israel. In addition, Bucharest agreed last fall to buy raw materials from the USSR such as oil, coal, and diamonds, for trans-shipment to Israel.

- Even Yugoslavia, which has been more cautious in establishing ties with Tel Aviv to avoid jeopardizing its leadership role in the Non-Aligned Movement, has increased official and non-official contacts with Tel Aviv.

- Albania's strongly anti-Israeli policy remains unchanged. [redacted]

Motivations Largely Economic

Some regimes believe the opening to Israel will improve their standing with the US and pay off with trade, financial, and technological benefits from Washington. Moreover, the regimes perceive Israel as a potential source of technology, trade, and joint venture agreements. Although Israel's trade with Eastern Europe is relatively small (around $100 million in 1987), there are a number of potentially lucrative deals and joint ventures which could increase this volume. Israel could supply electronics, medical equipment, laser technology, and biotechnology, while Eastern Europe could supply semi-finished manufactured goods, chemicals, and agricultural products. [redacted]

Some East European countries want to take advantage of Israel's free trade agreement with the US by setting up joint ventures in Israel for export to US markets.[1] The Israelis have hinted at setting up a joint venture with the Hungarians in the food and electronics industry, using Israeli equipment and American capital. Poland reportedly is interested in Israeli investment in industry, agriculture, and tourism. [redacted] (b) (3)

Increasing contacts in the travel and tourism field are also being made. Embassy Tel Aviv reports that the Israeli airline El Al will soon introduce regular flights to Prague and Sofia, with charter flights going to Budapest. [redacted] (b) (3)

Outlook

We believe that the outlook is for a steady but cautious upgrading of ties, with the pace heavily influenced by political factors. On the economic front, the East Europeans will continue their interest in joint ventures, trade, and credits with Israel. Soviet actions towards Israel will guide the decision of most regimes about the appropriate scope for political and economic relations. The East Europeans will attempt to balance their economic interests in Israel against the political sensitivities of Arab nations and will move cautiously before establishing diplomatic ties with Tel Aviv. While attempting to improve economic links with Tel Aviv, most countries will continue to criticize Israeli handling of the Palestinian problem and will support a PLO presence in any talks on the Arab-Israeli conflict. [redacted] (b) (3)

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1. In order to export to the US through joint ventures, a minimum of 35% of the products must be made in Israel and 65% can be made in the partner country. [redacted] (b) (3)

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CEMA: Slow Growth for Grass-Roots Economic Integration

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Decentralization of foreign trade is a key aspect of the economic reforms and reorganizations under way in several of the East European CEMA countries. Moscow and most of its allies hope that this liberalization will:

- expand intra-CEMA trade,
- promote regional economic integration at the enterprise level,
- and encourage specialization within industries.

Decentralization involves diminishing the control of ministries and foreign trade organizations over day-to-day trade decisions. This is intended to promote commercial contacts and joint ventures between enterprises in different CEMA countries. Expansion of these contacts in response to economic incentives rather than administrative directives would promote more efficient trade as more and more firms around the region are put on a self-financing basis enabling them to choose partners freely, select the mix of products for trade, and set their own prices.

The campaign to build "direct ties[1] " gained momentum after Gorbachev came on the scene. His concept is endorsed in dozens of bilateral accords concluded between the USSR and individual East European countries since 1986. Some East European CEMA members, such as Poland and Hungary, have also signed special bilateral agreements with each other to boost direct enterprise links.

The "direct ties" drive remains stalled, however, despite intense media rhetoric and high-level political interest. Many managers do not know how to explore and evaluate business opportunities with counterparts in other CEMA countries because central authorities made trade decisions and took care of all technical details for them under the old system. The political push for quick results drives most CEMA joint ventures into vague cooperation arrangements such as scientific-technical information sharing. The deeply entrenched mechanisms of central planning also pose major stumbling blocks to cross-border entrepreneurship, including:

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- the reluctance of central planners to relinguish control over scarce resources;
- inconsistent, unrealistic national pricing systems, which make it difficult for enterprise managers to calculate the profitability of joint ventures;
- inconvertible currencies and unrealistic exchange rates, which force managers into the negotiation of complex, time-consuming barter deals;

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- the unwillingness of trade and finance ministries to countenance the accumulation of nonconvertible trade surpluses by enterprises under their control. (b)(3)

These obstacles have limited the volume of business by direct joint ventures to a small fraction of total intra-CEMA trade. Czechoslovakia and the USSR now boast of having some 360 direct joint venture contracts, but Czechoslovak economists report that barely 25 percent of this number involve the production of goods. One of Czechoslovakia's biggest machine building firms -- CKD-Prague -- is a party to many centrally mandated specialization and coproduction contracts in CEMA, but the firm's director estimates that self-initiated joint ventures account for about 1 percent of total output. Similarly, a Polish party survey of 58

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1. The term "direct ties" is a catchall term used to describe various firm-to-firm interactions: ad hoc cooperation deals, long-term joint ventures, or mergers of firms into new multinational companies.

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Warsaw-area organizations with "direct ties" to Soviet partners reveals that only 17 have contracts for the joint production of goods with the rest geared toward information sharing and people-to-people exchanges. Almost half of the same sample rates the effects of direct cooperation to date as either minor or non-existent. [redacted] (b) (3)

Unless Gorbachev makes faster progress than we expect in implementing wholesale trade, price, and currency reforms throughout the Soviet economy and persuades his allies to follow suit, Soviet-East European joint ventures at the factory level will remain insignificant. Some countries have embarked on bilateral price and currency reforms as preconditions to expanded grass-roots trade ties, but their impact is slight thus far. In the absence of prices based on supply and demand and money convertible into adequate supplies of quality goods, East European regimes will continue to keep a tight rein on trade with CEMA partners to alleviate internal shortages and avoid worthless ruble trade surpluses. [redacted] (b) (3)

Most East Europeans are probably concerned that decentralized trade might lead to more effective Soviet hegemony over their economies because National authorities would be less able to control factory-level contacts. East Germany endorses the concept of "direct ties," but prefers to boost trade in CEMA through improved central plan coordination. Bucharest has already passed a decree to keep Soviet officials out of most Romanian plants. In general, the East European countries want to imitate Hungary's diversification of trade links with the West while paying lip service to Moscow's ideas about joint ventures and other economic integration measures. They probably feel secure in playing both sides because they see the Soviets working to build their own trade ties with the West. [redacted] (b) (3)

Defense Spending to Fall [redacted]

(b) (3)

All of the East European members of the Warsaw Pact except Romania have announced plans for unilateral cuts in defense spending and military manpower and equipment levels. We believe the timing and scope of these announcements were approved by Gorbachev and were coordinated at Warsaw Pact policy meetings late last year. [redacted]

- Hungary started the process by adopting a budget for 1989 that will cause a substantial drop in real expenditures -- perhaps as much as 17 percent if the claims of the Defense Minister are to be believed -- even though the budget will increase slightly in nominal terms.

- Poland announced a 4-percent reduction in real terms for 1989, although rapid inflation complicates actual measurement of the real cut.

- In East Germany, Honecker announced a cut of 10,000 troops and a 10-percent cut in military spending by 1991.

- Czechoslovakia's Defense Council announced its plans to reduce nominal defense expenditures by 15 percent and forces by 12,000 personnel during the next two years.

- Bulgaria's State Council and Council of Ministers said the country would reduce the budget by 12 percent for 1989 and manpower by 10,000 men.

- Romania is the sole holdout in the recent round of cuts, but its budget has remained steady or fallen in the last several years, so outlays have declined 4 percent to near the 1984 level. [redacted]

We have no clear indication how the announced budget cuts will translate into resources allocated to defense. As with the Soviet budget, we doubt that published East European figures capture the full extent of defense spending in the economy. (Even regime leaders and planners may not fully comprehend the true costs of defense, owing to price distortions in their economies; their recent interest in NATO accounting rules may represent an effort to get a better grasp on this.) Nonetheless, if we are correct in our belief that (b)(3) the budget figures provide reasonably good approximations of spending trends, the recent (b) (3) announcements would suggest that the resources available to defense probably will decrease. [redacted] (b) (3)

East European regimes have never been keen on expanding defense spending, and they may try t(b)(3) capitalize on Gorbachev's troop reduction plans and defense "sufficiency" policy as an opportunity to advance their longstanding interest in reducing the defense burden. As their economies faltered in the 1980s, the regimes' already modest support for military spending cooled further and they stubbornly resisted efforts by Gorbachev's predecessors to get them to bear a larger share of the burden. The region's published budgets show little or no defense spending growth during this period, and our estimates, in fact, even indicate a 2-3 percent average annual decline in defense procurement. [redacted] (b) (3)

Defense already occupies a comparatively small role in these economies. NATO estimates of defense spending in East European currencies indicate that the burden ranges from 2-4 percent of GNP in all countries except East Germany (b)(3) where it reaches 5-6 percent. These figures fall significantly below the comparable US burden of 6.5 percent and 15-17 percent for the USSR. [redacted] (b) (3)

The economic impact of a reduction in defense (b) (3) spending will depend on where the cuts come: manpower, procurement, construction, operations and maintainance, and research and development. Wherever cuts are made, they will free resources for the civilian sector, but not enough to significantly relieve the pressures on the region's beleagured economies. Moreover, freeing

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resources can cause disruptions during the transition as some workers lose jobs and plants are forced to close. [redacted] (b) (3)

- Manpower cuts could help the labor-short economies, especially East Germany's, to compensate temporarily for their inability to generate significant gains in labor productivity.

- Cuts in procurement spending and construction would allow the countries to retool some of their defense industries for civilian uses, such as investment projects that would help modernize the economy, or to concentrate on arms sales to Third World states to earn hard currency.

- Operations and maintenance cuts would free energy, skilled repair labor, and other resources that could be productively deployed to civilian industry.

- R&D cuts would free scientific personnel to concentrate on civilian industries that would modernize these economies or boost their export competitiveness. [redacted] (b) (3)

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How Will Eastern Europe Respond to Soviet Pressures to Use Natural Gas [redacted]

(b)(3)

Eastern Europe must tackle tough decisions about energy policies as it formulates its 1991-95 economic plans and longer-term development strategies. Moscow has been arguing for years that Eastern Europe should shift its reliance on Soviet energy from oil to more plentiful natural gas. Eastern Europe has been slow to do this, however, because this entails costly investments -- including large outlays of scarce hard currency. Nevertheless, Moscow has made it clear that Eastern Europe will have to pay these costs because current Soviet plans call for natural gas supplies to the region to grow by as much as 64 percent by the 1990s while at best oil supplies will be flat. [redacted]

The East European economies depend heavily on cheap and relatively plentiful Soviet energy supplies. The region has limited domestic energy resources and requires imports to cover about one-quarter of its energy needs; only Poland with relatively large coal reserves, and Romania with oil and gas deposits, can supply the bulk of domestic requirements. In addition, the main domestic resource for most of these countries is highly polluting coal and lignite. Since the USSR has been willing to barter oil and gas for Eastern Europe's low quality manufactured goods, the cash-strapped regimes have relied on the USSR almost entirely for their energy imports. [redacted]

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European Energy Imports from the USSR as a Share of Energy Consumption *Percent*

	1975	1981	1987[1]
Bulgaria	68	81	65
Czechoslovakia	33	39	37
East Germany	27	30	25
Hungary	40	49	43
Poland	14	13	11
Romania	2	5	5
Total EE	18	28	24

1. Estimated

Unclassified

The crucial decision confronting the East European regimes is how much to invest in transforming their economies from coal and oil usage to gas. They know the USSR is capable of supplying substantial quantities of natural gas, and a decision to pursue this option offers important benefits. A cutback in coal usage would reduce pollution which is causing environmental damage throughout the Bloc and into Western Europe. In addition, if gas reduced the need for nuclear power, it would limit the risk of another accident like Chernobyl. [redacted]

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Some regimes probably believe that these benef(b)(3) are outweighed by important disadvantages:

- Gas would make Eastern Europe even more energy dependent on the Soviet Union.
- The countries would bear a large share of Soviet energy development costs.
- Costly investments would be required to develop domestic storage and distribution systems to use gas on a wide scale. [redacted]

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Despite the drawbacks from gas conversion the East European regimes have few alternatives. They have little prospect of increasing oil imports; domestic reserves and nuclear power will not provide enough additional energy; nor will conservation efforts reduce energy wastage sufficiently to support the regime's economic growth targets. Most of these countries, however,

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probably cannot quickly convert their economies to use the full amount of gas scheduled for delivery beginning in 1989 through the Progress pipeline now under construction from the USSR to Eastern Europe. As a result, the region will struggle to balance competing demands for investment resources between conversion to natural gas, modernizing industries, and meeting Soviet economic demands. [redacted]

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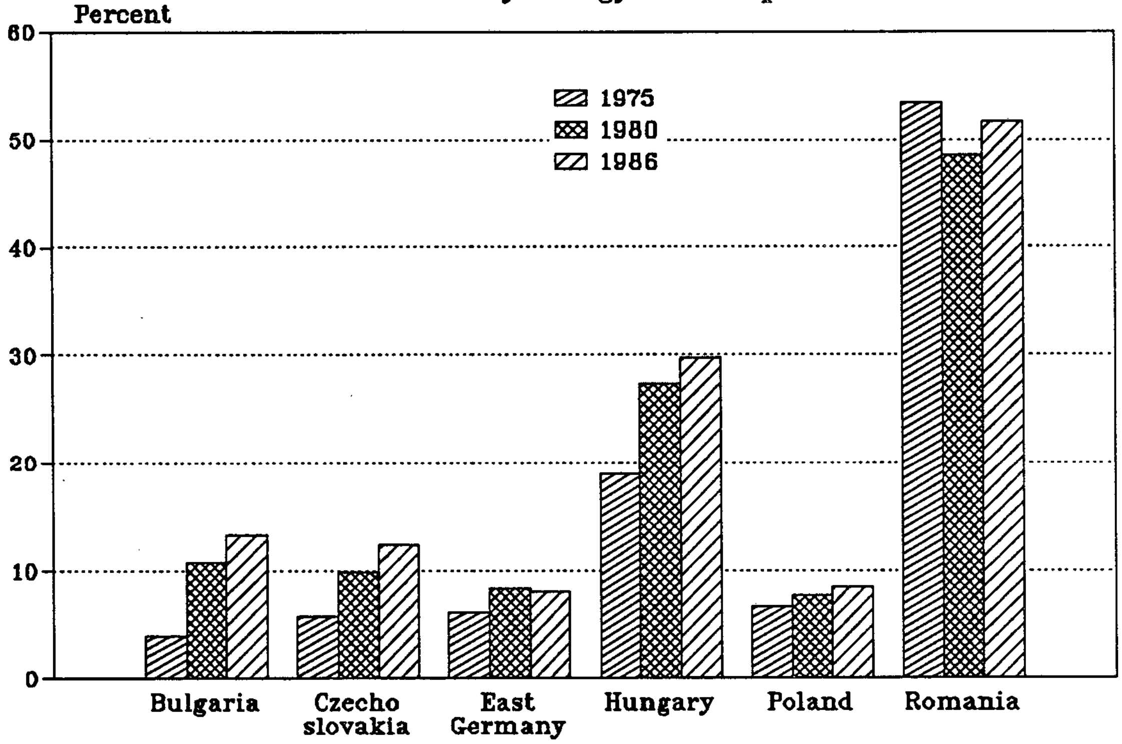
Eastern Europe:
Gas Use as a Share of Primary Energy Consumption



Unclassified

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[redacted]

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Grain Harvest Average [redacted]

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The East European countries did not receive a major boost from the 1988 harvest. Overall grain production was about average, but some countries suffered significant losses in certain crops because of drought. Although mild winter weather helped Hungary, Yugoslavia, and Romania record above-average winter wheat crops, a dry summer offset these gains by reducing output of corn and other crops. Yugoslavia and to a lesser degree, Czechoslovakia and East Germany were most affected by the drought. [redacted]

Trade performance will not benefit much from last year's harvest. Most of the countries with above average wheat harvests will export small quantities of wheat, but the extra income may be offset by their need to import corn. Yugoslavia, normally the major corn exporter in Eastern Europe, will probably suffer the largest hard currency losses because of extra import needs. Czechoslovakia and East Germany also will have to import more grain to sustain bread quality and feed supplies. [redacted]

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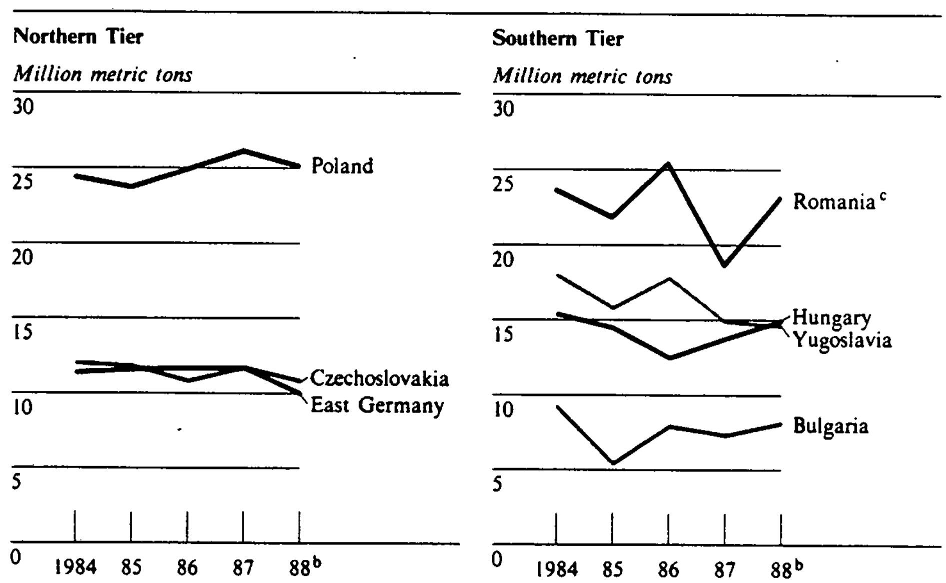
Eastern Europe: Grain Production, 1984-88 [a]



[a] USDA and CIA estimates.
[b] Estimated.
[c] Official Romanian estimates probably inflated.

[redacted] 319196 10-88

(b)(3)

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 (b) (3)

Consumer supplies in Eastern Europe outside Romania will probably be sufficient in the coming year, but spot shortages of sugar, rice, vegetable oil and some staples will occur. The improved harvest in Romania will do little to ease the lot of long-suffering consumers because the regime will direct most of the increased production to hard currency exports. [redacted] (b) (3)

 (b) (3)

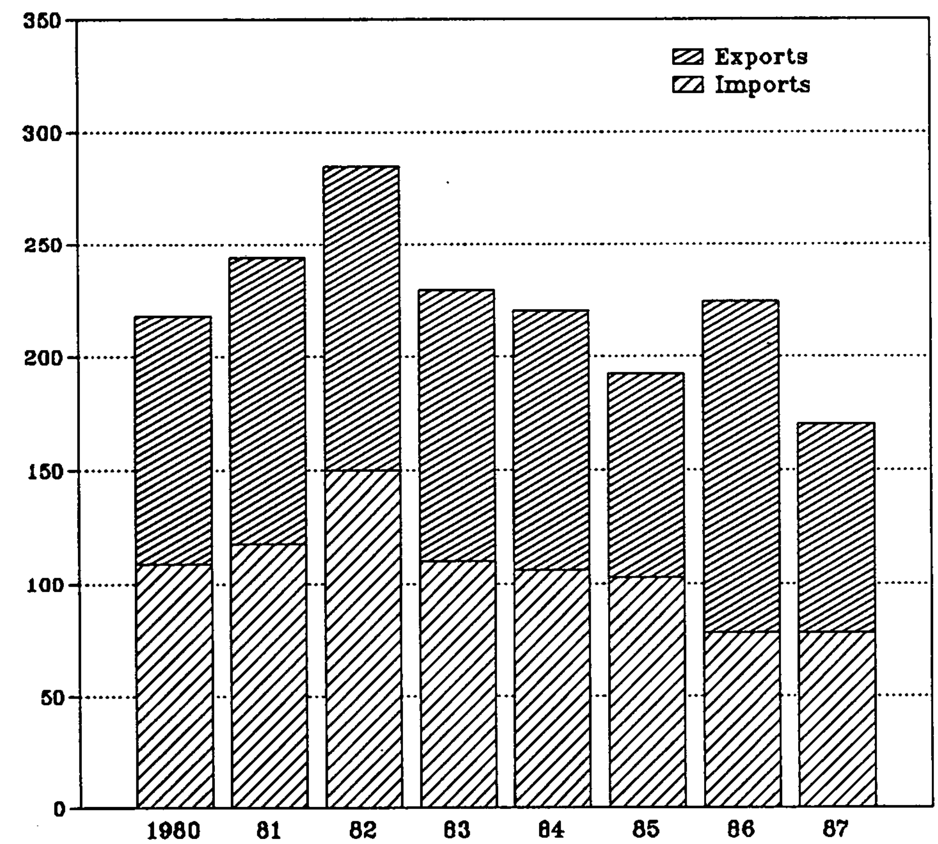
Albania: Persistent Economic Difficulties [redacted]

(b) (3)

Albania's backward economy has faltered over the past several years, and little improvement is likely soon. A limited and deteriorating industrial base, a poorly-trained and complacent work force, and the five consecutive years of drought have doomed Tirane's efforts to improve economic performance through gains in productivity. Moreover, Tirane's determination to avoid foreign debt -- enshrined in its constitution -- constrains the acquisition of Western technology. A major turnaround in economic performance is unlikely because firmly-held ideological tenents will continue to limit foreign trade and preclude economic reforms at least into the next decade. [redacted] (b) (3)

Poor economic results in 1987 forced a drastic reduction in 1988 economic targets, and even these lowered goals probably were not met. Although statistics are rarely released, Tirane acknowledged the failure of two key export sectors -- chrome and petroleum -- to meet 1987 plan targets, the stagnation of foreign trade, a

Albanian Foreign Trade With the West
Million US $



[redacted] (b) (3)

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(b) (3)

large budget deficit, and a shortfall of at least 10 percent in agricultural production goals. Albania likely had another poor agriculural year in 1988, judging by the 3 percent decline in farm output for neighboring Yugoslavia. This probably led to some food shortages unless the regime decided to import agricultural goods.

Albania's leaders are approaching their economic problems more pragmatically than in the past. Tirane recently undertook a number of measures -- significant by Albanian standards -- to reverse this negative economic trend by:

- Focusing on increasing foreign trade, particularly West Germany, to upgrade its industries. In December 1988, Albania signed a cooperation accord in which Bonn has agreed to help development of the mining, energy, chemical, and food industries through training programs and technological assistance.

- Signing trade and cooperation agreements with a number of West European nations including the UK, France, Austria, and Belgium and sending a trade delegation to Japan this month -- the first high-level visit ever.

- Considering establishment of a liaison office with the European Community in Brussels.

- Encouraging agricultural productivity by increasing the purchase price of agricultural products and reestablishing small private plots.

- Limiting the terms of office for economic bureaucrats to combat corruption and complacency.

- Signing a cooperation agreement with a Dutch firm to exchange tobacco and cement for electronic equipment, particularly video and television studio systems.

(b) (3)

While the country's leaders will approach their problems more pragmatically than in the past, these efforts probably will not be significant enough to reverse Albania's economic fortunes in the near future. Tirane's efforts have not yet produced fundamental changes in Albania's highly centralized economic and foreign trade system. Staunch ideological objections will preclude significant liberalization, let alone market-oriented reforms, at least into the next decade.

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