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East European

Regional Economic Wrap-up

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EAST EUROPEAN REGIONAL ECONOMIC WRAPUP
Synopsis of this Issue

A. Economic Relations Between East and West

1. **Financial Problems Continue**

   Declining trade surpluses over the past two years indicate that most East European countries, have done little to correct fundamental balance of payments weaknesses.

2. **Slow Progress on CEMA-EC Bilateral Agreements**

   Several obstacles continue to slow progress toward accords between the EC and CEMA countries, and we doubt any CEMA member will conclude an agreement with the EC soon.

3. **Increased Soviet Pressure on Eastern Europe for Computer Technology**

   The CEMA effort to modernize its computer technology is lagging, and this may result in increased efforts to acquire Western technology.

4. **East European Economic Ties with Japan Remain Modest**

   Several East European countries and Japan have increased economic contacts over the past year, but these discussions are not likely to result in a significant increase in trade or joint venture activities.

B. Regional Problems

1. **East European Economic Growth Slows in 1987**

   Our preliminary estimate for East European economic growth in 1987 is about 1.5 percent, slightly below last year's rate of just over 2 percent, and we project about the same growth rate this year.

2. **East Germany: Impending Economic Slowdown**

   We estimate that GNP growth last year was slightly less than the 2 percent gain recorded in 1986, partly due to bad weather and electricity shortages.

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3. High Costs of Progress Pipeline for Eastern Europe

The Progress natural gas pipeline--a Soviet-East European joint venture--is on schedule, but it is proving to be an expensive proposition for the East Europeans.

4. East European Harvest Results Mixed

Smaller harvests in 1987 will add to economic strains in the southern countries of Eastern Europe, while most of the northern countries will benefit from increased production.

Financial Problems Continue

Most East European countries will continue to struggle with hard currency debt problems into the next decade. Improved hard currency trade performance in 1982-84 sparked some optimism in East and West that the region could eventually recover from its financial crisis. Declining trade surpluses since then, however, indicate that most East European countries have done little to correct fundamental balance-of-payments weaknesses.

- o Poland increased its trade surplus in 1987, but its debt continued to rise due to the falling dollar and missed interest payments. Warsaw has given up all pretense of repaying its debt soon and rescheduled debt last year initially rescheduled in the early 1980s.

- o Despite a decreased trade deficit and debt level last year, Yugoslavia did not cover all obligations on earlier rescheduling agreements and sought further rescheduling and credits at the end of 1987.

- o After reducing debt in 1981-84, Hungary has since run record current account deficits, enlarged its debt, and risks requiring its first rescheduling this year.

- o Romania has held to its policy of rapid debt reduction--at the cost of depressed economic performance and crushing austerity on the population--but even sizable trade surpluses have not been enough to prevent liquidity shortages and debt reschedulings.

- o East Germany, Czechoslovakia, and Bulgaria have avoided debt servicing problems and maintained good credit ratings, although the sudden burgeoning of Sofia's trade deficit in 1986 forced a retrenchment on imports in 1987. [redacted] (b)(3)

Eastern Europe's problem debtors will continue to pose headaches for Western banks and governments. These regimes will repeatedly petition their creditors for generous debt relief and new credits but resist most demands for actions that would improve their ability to repay borrowings. While they may make veiled threats about declaring extended moratoria on payments, the East Europeans are unlikely to take such actions because they still hope to obtain more financial assistance and restore their creditworthiness. The Poles and Yugoslavs, however, will watch closely any concessions creditors make to Latin American debtors and press for similar treatment.

- o Poland hopes to unlock new lending by banks and governments with an IMF standby program. Although Warsaw has announced a new program of economic reforms, the Fund and creditors will have difficulty persuading the Poles to implement the painful measures needed to improve hard currency trade performance, especially since an austerity program was rejected by voters in the November 1987 referendum.

o Yugoslavia is already negotiating with the IMF for a $400-600 million standby agreement, and is hoping for rescheduling accords with banks and official creditors early in 1988. If negotiations stall and already low foreign exchange reserves are drawn down further, Belgrade could face a severe liquidity crisis in the next few months.

Eastern Europe: Gross and Net Debt

Billion US $

[redacted] (b)(3)

- Hungary also intends to sign an agreement with the IMF this year for a standby loan worth $1.5 billion over three years. If Budapest fails to enact an adequate program, it risks falling into the endless debt trap that has ensnared Poland and Yugoslavia.

- Romania may become the region's smallest debtor by 1988, but its economy will have paid a high price. With debt paid down, an eventual post-Ceausescu leadership might seek new loans from the West to help rebuild the economy, but Western lenders are likely to be wary about Bucharest's ability to use new borrowings effectively. [redacted] (b)(3)

Eastern Europe's financially sounder regimes probably will give greater priority to increasing imports than further reducing their debts. Nonetheless, we expect these countries to remain conservative in their borrowing strategies and avoid a large runup of debt that could strain relations with Western lenders.

o Although East Germany faces no immediate financial difficulties and can afford to step up hard currency imports, the regime apparently is increasing its intra-German trade--while trade with other Western countries languishes--to acquire Western goods at minimal financial risk.

o Czechoslovakia and, to a lesser extent, Bulgaria have room to boost Western imports in the near future without risking liquidity or debt servicing problems. Their limited export earnings, however, will constrain their ability to afford large purchases without returning to Western credit markets. [redacted] (b)(3)

Slow Progress on CEMA-EC Bilateral Agreements

Several obstacles continue to slow progress toward accords between the EC and CEMA countries, and we doubt any CEMA country will conclude an agreement with the Community soon. The demands of various CEMA countries for elimination of quotas on industrial exports, lower tariffs, and concessions on agricultural sales have met strong opposition from some EC member states. These EC countries fear that an influx of East European goods--particularly agricultural items--will harm domestic producers. Another sticking point has been diplomatic recognition. Although countries typically request formal recognition by the EC before signing trade and cooperation agreements, some CEMA countries are demanding that the EC request recognition first. [redacted] (b)(3)

Status of Major EC-CEMA Bilateral Negotiations

Country	Last Meeting	Topics of Negotiation	Status
Hungary	October 1987	o Elimination of quotas on Hungarian goods, reciprocal concessions on agricultural goods, and lower tariffs. o Mutual recognition.	EC adopted negotiating mandate for comprehensive trade and cooperation accord; agreed to negotiate gradual elimination of quotas on Hungarian goods.
Romania	January 1988	o Granting EC trade concessions, business data, and commercial exchanges. o Cooperation in various fields.	Romania tabled demands that exceeded EC's negotiating mandate.
Czecho-slovakia	November 1987	o A limited trade accord, including MFN. o Easing quotas on industrial goods.	EC adopted negotiating mandate but no real bargaining started.
Poland	September 1987	o Granting MFN, quota reductions, preferential tariffs, credits, and cooperation.	EC officials rejected Polish demands, offered to discuss trade accord only.

[redacted] (b)(3)

If bilateral agreements are signed in the future, they probably would have greater implications for US political interests in Western Europe and technology transfer than for US trade:

- o Bilateral accords would help lay the groundwork for a formal group-to-group accord between the EC and CEMA; this would allow the Soviet Bloc a larger presence in Western Europe, greater access to EC personnel, and increased opportunities to influence the Community.
- o Agreements probably would call for increased industrial cooperation, potentially allowing CEMA countries greater access to high technology industries, but restrictions on technology transfer would still apply to EC member states in COCOM.
- o EC trade accords with CEMA countries would have little effect on US exports to CEMA, which totaled about $700 million in 1986. CEMA countries probably still would purchase a fair amount of this total.
- o Nor would US exports to the EC be affected significantly by increased CEMA sales to the Community. [redacted] (b)(3)

Increased Soviet Pressure on Eastern Europe for Computer Technology

Moscow is placing high priority on accelerated development of computer technology and is pushing Eastern Europe to speed up its lagging computer effort, as part of the region's contribution to the CEMA 2000 Science and Technology program. East European regimes appear more concerned with strengthening their international trade competitiveness through modernization. Advanced computer technology increases the productivity of both labor and machinery so that more and better quality products can be produced. Improving product quality would enable the East European regimes to compete more effectively in Western markets, earning more hard currency. [redacted] (b)(3)

Eastern Europe: Progress in Computer Technology

Country	State of Technology
East Germany	CEMA leader in the development of personal computers; developed line of high performance personal computers based on an IBM type and now exported to the USSR.
Czechoslovakia	Plans production of personal computers in 1989; plans to participate in development of more advanced integrated circuits.
Hungary	Provides computer software for CEMA programs; will produce more integrated circuits.
Bulgaria	Co-leader with the GDR in personal computer technology; leader in production of selected computer peripherals.
Poland	Lags behind all East European countries, except Romania in computer developments; participating in development of personal computers and robotics.
Romania	Not deeply involved in computer use or development, despite a joint venture with a Western computer firm going back more than a decade.

[redacted] (b)(3)

Several of the East European regimes are attempting to satisfy the computer subtasks of the CEMA science and technology effort. East Germany, Czechoslovakia, Hungary, and Bulgaria, in particular, have made some progress in developing minicomputers, disk drives, and applications software programs. Nonetheless, the overall effort is advancing more slowly than projected by Moscow because of problems with pricing of labor and capital, currency convertibility, and East European fears that the Soviets will dominate regional science and technology programs. The Soviets had hoped that CEMA's computer programs would enable the East Bloc to become independent of Western technology and ease the constraints imposed by COCOM restrictions and hard currency shortages. The slow developments to date have not accomplished this goal and are not likely to over the next few years. [redacted] (b)(3)

While the CEMA science and technology effort has not decreased dependence on Western computer technology, the cooperative effort may provide Moscow the opportunity to better coordinate illegal acquisitions. Soviet pressure on CEMA members to meet their S&T 2000 goals involves pressure to increase acquisitions of Western computer technology. We believe that the USSR is making renewed efforts to infuence and coordinate illegal transfer in the Bloc to serve its priorities. [redacted] (b)(3) [redacted] the East (b)(3) Europeans generally have maintained as much independent control as possible over their acquisition programs and have focused on acquiring Western high technology primarily for domestic use. [redacted] (b)(3)

[redacted] (b)(3) [redacted] Moscow probably will encourage its allies to pursue legal East-West ventures (b)(3) through, for example, participation in West Europe's Eureka program. Continuing legal joint ventures are desirable from Moscow's perspective because the technology often can be updated more easily than through illegally obtained computer advances. The desire to expand access to Western technology is probably one reason why Moscow now appears willing to accept West Berlin as an EC member in return for Soviet-East European entrance into the Eureka program. [redacted] (b)(3)

Eastern Europe probably will respond to Soviet pressures and increase acquisition efforts for Moscow to a greater extent than previously. Joint ventures with Western firms are increasing, especially with the current trend in the East Bloc to liberalize joint venture laws. For the East Europeans, this represents a less expensive method of obtaining current technology than through imports or illegal acquisition, but it also complicates enforcement of COCOM restrictions for the West because continuing contacts between East European and Western engineers and scientists create additional opportunities for technology diversion. [redacted] (b)(3)

East European Economic Ties With Japan Remain Modest

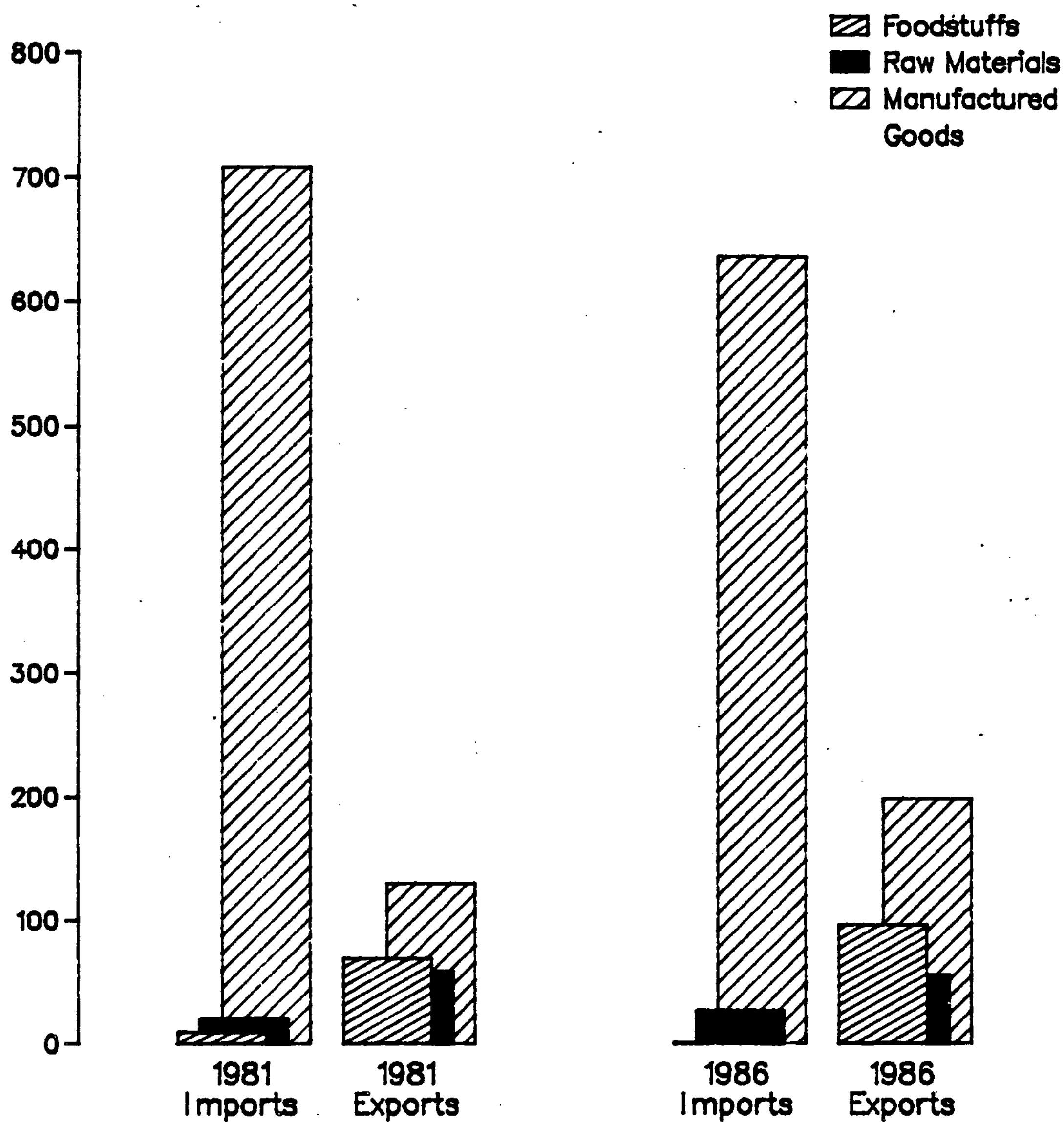
Meetings between East European leaders and Japanese Prime Minister Nakasone in the past year have focused on the potential for closer economic cooperation, but such discussions seem unlikely to produce a significant increase in trade or joint venture activity. Eastern Europe's financial problems, its traditional ties with Western Europe, the mismatch in tradable goods, and Japanese trade protectionism stand in the way of closer economic relations. Nonetheless, Eastern Europe has been seeking additional Japanese financing and technology for modernization efforts and increased exports to Japan to earn hard currency. Japan, for its part, is looking for creditworthy outlets for surplus capital and customers for industrial plant exports. [redacted] (b)(3)

East European trade with Japan is small compared with the region's trade with West Germany, Italy, Austria, and the United States. Eastern Europe exports chemicals, textiles, and foods and imports Japanese chemicals, machinery, and equipment. The region has increased sales of chemicals and steel manufactures since 1981 and wants to increase food exports. Boosting exports to Japan, however, has been difficult because of the poor quality of East European goods, competition from the newly industrialized countries, and trade barriers, especially for food. The region's technology needs have resulted in a number of purchases from Japan, particularly in microelectronics, machine tools, and robotics. [redacted] (b)(3)

East European economic relations with Japan are not likely to expand rapidly due to the following additional obstacles:

- COCOM Regulations. [redacted] (b)(3) (b)(3) (b)(1)
- Restrictions on Joint Ventures. Japanese businessmen claim that shop floor control over production processes is key to successful joint ventures, but Poland, East Germany and Czechoslovakia appear unwilling to grant such latitude to attract Japanese ventures. Moreover, the output of Japanese export-oriented joint ventures in Eastern Europe would compete against Tokyo's exports originating elsewhere. [redacted] (b)(3)
- Tougher Japanese Financial Terms. The Japanese government is one of the leading official creditors of Bulgaria, East Germany, and Hungary, but Japanese commercial banks have extended a much larger amount of credit in recent years. The creditworthy East European countries--East Germany, Bulgaria and Czechoslovakia--most likely still have access to Japanese banks. Recent negotiations on the issue of a $200 million Hungarian bond on the Tokyo market also show that banks are prepared to lend to Budapest, despite its financial problems, probably because bankers view the economic reforms positively. The chronic debtor countries, however, will come under closer scrutiny in lending decisions. [redacted] (b)(3)

East European Trade with Japan
Million US $



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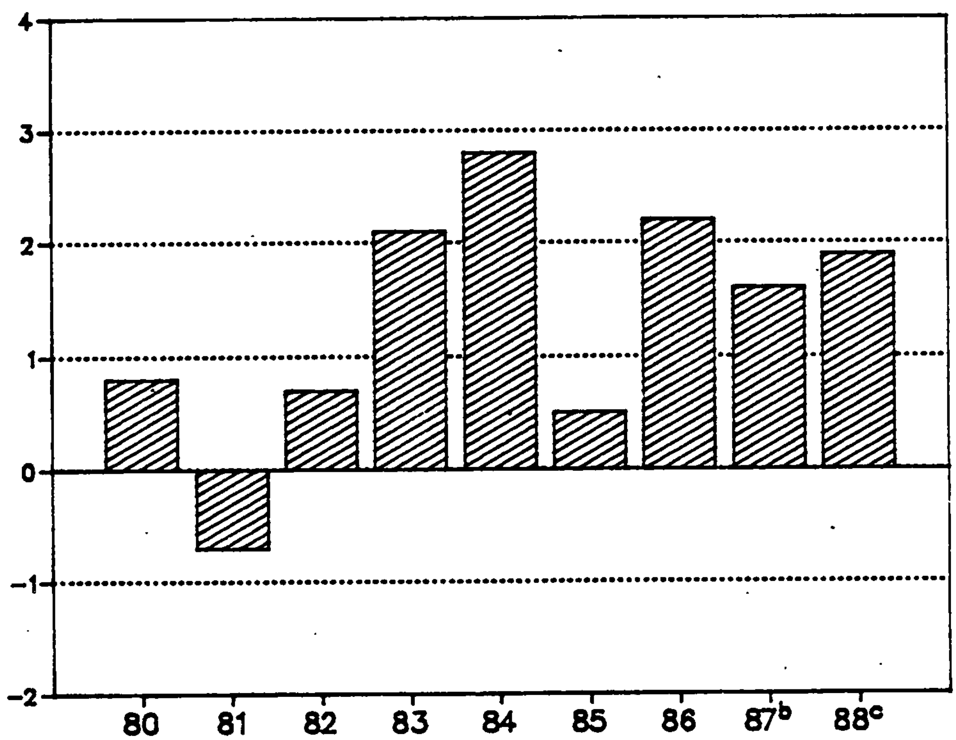
East European Economic Growth Slows in 1987

East European GNP grew about 1.5 percent last year--based on preliminary estimates--and we project about the same growth rate for 1988. Growth slowed from just over 2 percent in 1986 because of shortfalls in industrial output in some countries and disappointing harvests in southern areas. (See section on agricultural performance.). Bulgaria and Poland probably had the highest GNP growth at 2 percent, while Yugoslavia and East Germany had the lowest at about 1 percent. Highly inflated Romanian data claim a growth rate of 4.5 percent, but we believe it is below half that rate. [redacted] (b)(3)

East European Economic Growth, 1980–88[a]

Percentage change over previous year



[a] Figures exclude Romania due to data distortions
[b] Preliminary
[c] Projected

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Industrial production increased approximately 1 percent last year compared to over 2 percent in 1986.

- o East German and Czechoslovak industrial growth rates apparently declined, partly due to harsh winter weather that disrupted transportation and factory operations early in the year.
- o Hard currency import cutbacks in Bulgaria and Yugoslavia apparently caused shortages in industrial inputs, provoking bottlenecks and production slowdowns. More than 1300 strikes in Yugoslavia to protest low wages and the declining standard of living also contributed to a fall off in production there.
- o The exception was Hungarian industrial output which probably accelerated due to increased imports and investments.

Although we do not have reliable data, we believe Romanian industrial output was about half the 1986 growth rate of 4 percent due to further hard currency import cuts, energy shortages, and low worker productivity. [redacted] (b)(3)

As a result of falling growth rates, standards of living in some East European countries deteriorated, further lowering worker morale and increasing political tensions. Romanian consumers--beset by steadily shrinking rations of energy and staple foods--were the worst off in Eastern Europe as President Ceausescu continued his policy of slashing imports for domestic use and exporting all saleable goods, including food. While conditions were better in Yugoslavia, its population had to contend with 170 percent inflation and 14 percent unemployment. Inflation rates of 26 percent in Poland and 9 percent in Hungary exceeded wage increases for consumers in these countries. Consumers in East Germany, Czechoslovakia, and Bulgaria had some usual spot food and consumer good shortages but relatively stable prices, and living standards probably rose marginally. [redacted] (b)(3)

Some East European countries are looking to plans for reform and restructuring to improve domestic economic and trade performance in 1988. Poland and Bulgaria announced extensive programs for reform last year, but the population's rejection of Warsaw's proposals in last November's referendum and Moscow's objections to the scope of Sofia's restructuring as well as domestic resistance have cast doubt on the implementation of these measures. Romania and East Germany have rejected a reform course, and Czechoslovakia has transferred only some limited decisionmaking power to managers. Hungary is trying to restructure its economy through World Bank loans and is reforming its tax system to aid the effort. [redacted] (b)(3)

To deal with worsening financial problems, several East European countries are implementing austerity programs and looking for more financial support from the West this year. Price hikes and limits on wage growth scheduled in Hungary and Yugoslavia are angering workers more, and are likely to be moderated, as Warsaw has done already, if political unrest develops. East Germany is looking to West Germany for more hard currency, while Yugoslavia, Poland and Hungary are pursuing credits through IMF stand-by agreements. [redacted] (b)(3)

East Germany: Impending Economic Slowdown

East Germany experienced a slowdown in economic growth last year partly due to bad weather and electricity shortages after four years of comparatively solid economic performance. We estimate that GNP growth for 1987 was about 1.5 percent, slightly lower than growth in 1986. East Berlin's industrial modernization drive will continue to be threatened by shortages of energy, labor, and investment through at least 1990. The economic slowdown will increase popular resentment and limit the regime's ability to meet Soviet demands for more advanced machinery and consumer goods. [redacted] (b)(3)

Shortfalls in energy production continue to be the economy's worst problem. Electricity shortages forced temporary shutdowns of some factories when an explosion last January knocked out two 500 megawatt plants--about 5 percent of the country's total capacity. For the first time since 1978, production of lignite coal--source of about 80 percent of the country's electricity--probably declined. Because East Germany already eliminated the most blatant sources of energy inefficiency in the early 1980s through tighter rationing and organizational adjustments, the regime must now invest heavily in energy-saving technologies and limit energy deliveries to factories to stretch scarce energy supplies. [redacted] (b)(3)

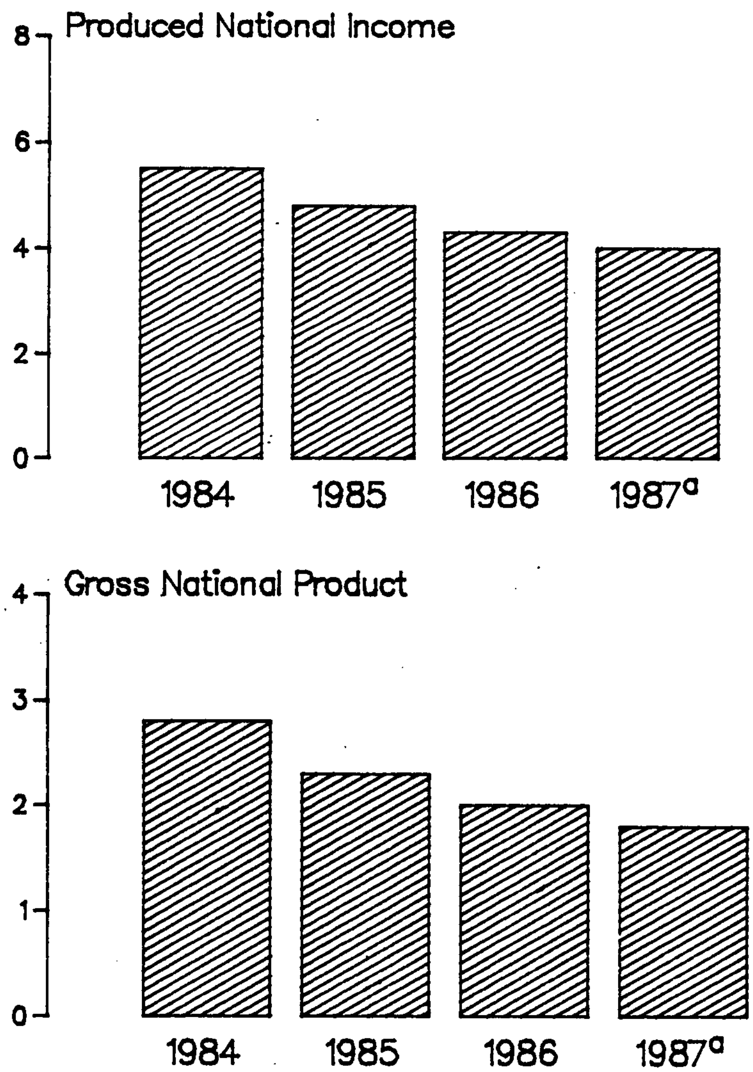
The regime must also deal with other serious problems to avoid further economic slowdown:

- Meeting Soviet demands for more high technology goods and greater CEMA integration will divert resources from domestic development and trade with the West.
- Alleviating massive environmental damage--due mainly to burning low-grade lignite coal for energy--will require heavy investments.
- An aging population will allow virtually no growth in the labor force, aggravate problems in labor productivity, and burden the economy with rising pension and health care costs.
- Modernizing the aging capital stock will require completion of a heavy backlog of investment left over from the early 1980s. [redacted] (b)(3)

East Germany's foreign trade position -- though still solid by Eastern Europe's standards -- also is weakening. Its short-term financial situation is secure due its $8 billion hard currency holdings, but it faces growing problems in sustaining hard currency trade surpluses because of the growing obsolescence of its machinery exports, low prices for its petrochemical exports, and strong competition from developing countries. The data are scant, but it appears that East Germany's hard currency trade performance did not improve significantly over 1986, when its hard currency trade surplus plunged nearly 50 percent. [redacted] (b)(3)

Despite these problems, the Honecker government appears resolved to maintain its highly-centralized approach to planning and management, making it a conspicuous exception to the decentralization efforts being undertaken in most other Bloc countries. To cushion against an expected downturn, the regime may seek closer economic relations with the West Germans. Following Honecker's visit to West Germany last September, Bonn and East Berlin have announced a number of agreements in environmental protection and nuclear safety. If East Berlin anticipates severe financial problems, they may seek a large loan from West Germany to help them through the period. (b)(3)

East Germany: Economic Growth Measures
Percent



[a] Preliminary estimate

Sources: GDR official statistics, Western estimates
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High Costs of Progress Pipeline for Eastern Europe

The 4600-kilometer Progress natural gas pipeline--a joint venture between Eastern Europe and the USSR--is on schedule, but is proving to be an expensive proposition for the East Europeans. The high pipeline construction costs, the overvalued price for Soviet natural gas, and the inability of East European economies to use extra natural gas without large investment made the East Europeans reluctant to participate in this venture. Despite this, all East European countries, except Romania, have signed participation agreements and are scheduled to receive a total of 20 to 22 billion cubic meters per year for twenty years as compensation for costs incurred in construction. [redacted] (b)(3)

Negotiating the participation agreements was more protracted than the Soviets had anticipated because the East Europeans did not immediately need extra gas and most regimes were reluctant to spend the hard currency required for Western imports of pipeline material. The USSR had expected to conclude negotiations by the end of 1984, but most of the agreements were not signed until 1986.

- o Czechoslovakia and Bulgaria were reluctant to sign because the extra gas could not be utilized in the near future.
- o Poland did not want to make hard currency pipeline purchases.
- o Romania--which still has not signed its formal agreement--does not want to spend hard currency on pipeline imports and has a large reserve of natural gas relative to the rest of Eastern Europe. [redacted] (b)(3)

Moscow's unfavorable terms and the substantial domestic investment costs also dampened East European enthusiasm for the project:

- o The Soviets undervalued East European contributions to the pipeline and locked in future natural gas prices at the high CEMA price in effect at the time the accord was signed. Because gas prices have subsequently fallen, Eastern Europe in effect will receive less gas in repayment for its investment than it would if the deliveries were valued at the price Moscow charges its West European customers.

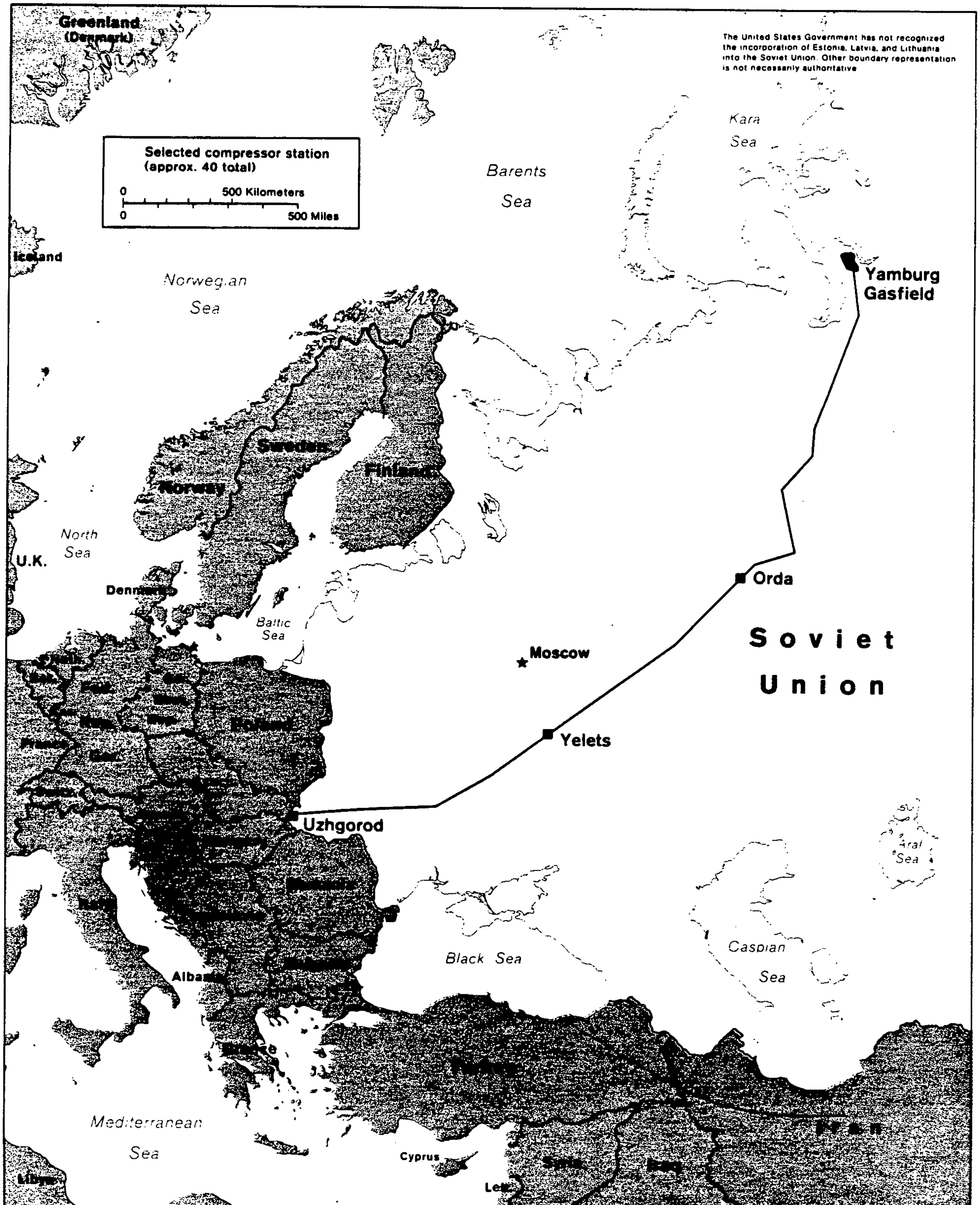
- o East European regimes probably will have to make substantial new investment in gas conversion equipment once the pipeline is complete. We estimate that the region can absorb 8 billion cubic meters of the extra gas for such immmediate needs as chemical feedstocks, but the extra 12-14 billion cubic meters probably is more, however, than Eastern Europe can efficiently absorb unless the regimes choose to invest in the storage and distribution systems required for industry to substitute gas for oil and coal. [redacted] (b)(3)

The regimes are unlikely to undertake these energy conversion investments in the near future and probably will not achieve their energy conservation goals. Hard currency shortages make it difficult to increase expenditures on gas equipment, especially because the regimes have already made a commitment to nuclear power development and are likely to continue to give this priority over natural gas investments. The East Europeans

SECRET [redacted] (b)(3)

are likely to increase gas consumption significantly when pipeline deliveries begin, but without new investments they probably will not make the most efficient use of this resource. [redacted] (b)(3)

Progress 1,420-mm-Diameter Natural Gas Pipeline



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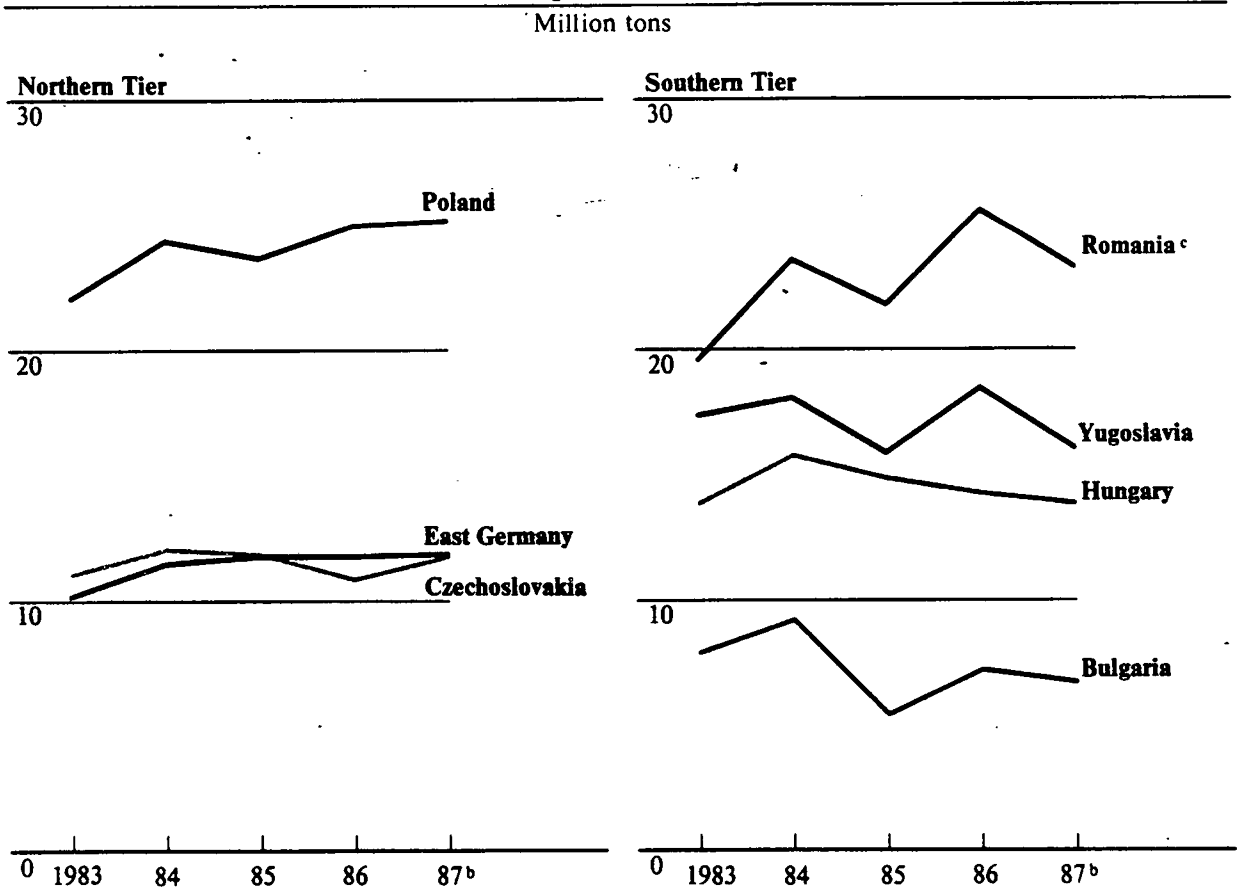
East European Harvest Results Mixed

Smaller harvests in 1987 will add to economic strains in the southern countries of Eastern Europe, while most of the northern countries will benefit from increased grain production. Harvests in Yugoslavia, Bulgaria, and Hungary were slightly below average because of drought and reduction of sown areas. In Romania, grain output probably was average, but cold weather and dry conditions reduced other crops, such as potatoes. Grain production in Poland, East Germany, and Czechoslovakia was above average, but the harsh winter damaged fruits and vegetables, particularly in Poland, leading to some consumer shortages. [redacted] (b)(3)

Eastern Europe: Grain Production[a]



[redacted]

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Already poor food supplies in Romania have worsened and most likely will contribute to continued local demonstrations, such as in Brasov, if Bucharest exports food at last year's high levels. Yugoslavia and Bulgaria probably will need to import more grain than in 1986 and reduce agricultural exports; this course will damage Belgrade's already weak hard currency position. In Hungary, grain exports also will be down, although supplies are sufficient for domestic needs. Better harvests in recent years for Poland reflect increased incentives for private farmers, a trend that may be strengthened by President Jaruzelski's reform program. [redacted] (b)(3)

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