Hungary: Reform Tested by the Credit Crunch [redacted]

Key Judgments

Information available as of 3 September 1982 was used in this report.

Despite its reputation as having the best managed East European economy, Hungary is dangerously close to insolvency. After suffering cutbacks in Western credits for over a year, Hungary is beginning to receive from Western governments, banks, and the IMF the loans needed to forestall rescheduling in 1982. Nonetheless, Hungary is still well short of covering its 1982 borrowing requirement and, without more funds, could fail to meet obligations late this year. Even if Hungary raises all the loans it projects, we believe it will face a financial crisis again next year unless its trade performance or borrowing conditions improve. [redacted]

Much of Hungary's plight stems from events beyond its control—Western recession, high interest rates, and the collapse of bank lending to Eastern Europe. The Hungarians have tried to reduce their hard currency deficits in recent years through deliberate economic slowdown and revitalization of their market-oriented reforms. The reform program, however, has not produced the expected gains in efficiency and competitiveness; as a result, Hungary's trade performance has not improved sufficiently to offset rising debt service. The prospect of continuing tight financial markets—coupled with increasingly difficult trade relations with the USSR—forces Hungary to reduce investment and economic growth even further and to demand sacrifices from the consumer. Although external pressures may lead to a strengthening of some central controls, we believe that Hungarian leaders are committed to economic reform. [redacted]

Secret
EUR 82-10088
September 1982

No Objection to Declassification in Part 2010/10/08 : NLR-753-41-8-16-1

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Hungary: Chronology of Significant Economic Events

November 1966	Central Committee approves New Economic Mechanism.
1 January 1968	New Economic Mechanism implemented.
1969-71	Trade deficits increase and investment rises sharply.
1971-73	New Economic Mechanism under fire from hardliners who want to recentralize. Growth remains high; some recentralization begins.
1975-78	Trade deficits soar—reach \$782 million in 1978. Hard currency debt rises sharply.
1978	Government announces slowdown in growth to achieve twin goals of external equilibrium and maintaining living standards. Reform increases markedly.
1979	Investment slashed. Consumer prices raised, cost of living climbs 9 percent. Growth slows precipitously. Current account deficit shrinks.
1 January 1981	Three branch industrial ministries merged into single, leaner Ministry of Industry. Bureaucrats laid off. Enterprises given greater autonomy.
1 October 1981	Budapest unifies commercial and noncommercial forint exchange rates and promises ultimate convertibility of forint.
4 November 1981	Hungary applies for membership in IMF.
1 January 1982	Small business reform implemented. Greater scope for individual initiative granted.
6 May 1982	IMF membership attained.
May 1982	Hungary draws down \$210 million in credits from Bank for International Settlements.
August 1982	Hungary receives \$260 million commercial loan. Budapest raises some food prices and announces limits on imports.

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Implications of the USSR's Hard Currency Problem for Aid to Allies and Clients (U)

Faced with tighter hard currency supplies and potential Western credit restrictions, Moscow is trying to conserve foreign exchange, in part by reducing support to dependent allies and clients. This policy almost certainly will increase problems in bilateral relations with East European and Third World countries. On the other hand, the Soviets remain willing to continue military assistance in Third World regions important to US interests, because they view arms sales as a major source of influence and foreign exchange. (S NF NC)

Growing Hard Currency Problems

Soviet hard currency revenues probably will remain level or even decline in real terms during the next several years while the need for Western goods and technology increases. The economy's slowdown raises the importance of imports in helping to maintain or increase productivity growth and reduce industrial and food supply bottlenecks. However, the USSR's hard currency position worsened in early 1981, primarily because of stagnating world prices for oil, the Soviets' largest export earner, and sharply increased agricultural imports after a string of poor harvests. Although the payment situation has improved since mid-1981—partly because of reduced nonagricultural imports—prospects for continuing this improvement are bleak. Our analysis indicates that:

- Oil exports will decline.
- Rising gas exports will not completely offset the drop in oil revenues, even if the pipeline to Western Europe is built.
- Real earnings from other exports, including arms, are unlikely to grow appreciably. (C)

Moscow probably does not see substantially increased reliance on Western credits as a solution to the decline. The financially conservative Soviet leaders and Western bankers presumably would be reluctant to increase substantially the Soviet debt burden. Moreover, some officials apparently believe that concrete Western credit restrictions might become a reality, as suggested by Soviet press commentary prior to the Versailles summit in June. Although the vague language of the credit agreement achieved at Versailles may have eased its apprehensions, Moscow probably still recognizes that credits will be more costly to obtain than in the 1970s. (C NF NC)

Cutting Corners Around the Globe

With tighter hard currency supplies in mind, the Soviets are reducing their foreign exchange expenditures across the board. Trade with the West, economic support of Eastern Europe, and assistance to less developed countries (LDCs) are being affected. Although we cannot yet estimate precisely the overall size or duration of the cutbacks, reductions in imports of Western goods and in exports to allies of oil at below-market prices could bring savings of a few billion dollars. (S NF NC)

East-West Trade. The Soviets have launched a major effort to reduce foreign exchange expenditures in the West, [redacted] Several 25X1 domestic investment projects requiring Western goods and technology have been scaled back or postponed. Although most cutbacks reportedly will affect consumer-oriented projects, purchases of some industrial equipment also have been reduced below earlier targets, according to Western business sources. Imports of certain mining and construction vehicles, for example, reportedly will be cut this year because of foreign exchange constraints. Soviet sources report that overseas commercial offices have been ordered to reduce local hard currency purchases. [redacted] 25X

Eastern Europe. [redacted] ha 25X1 currency worries have been largely responsible for a reduction in Soviet economic support to several East European countries. [redacted] 25X1 [redacted] Moscow cited the pressures of financing 25X1 increased grain imports as a major reason for cutting subsidized oil deliveries to Czechoslovakia and East Germany this year to volumes at least 10 percent below those previously planned, and to Hungary by 5 to 10 percent. The reduction could exceed 100,000

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barrels per day, roughly 6 percent of shipments to Eastern Europe in 1981. Meanwhile, Bulgaria has been denied increases in oil shipments, and cutbacks there are possible. We believe that Moscow is motivated primarily by a desire to increase hard currency earnings. The USSR's projected requirement for above-average grain imports in the coming years, moreover, will probably extend the oil delivery cutback beyond 1982. (S NF NC)

Developing Countries. In the Third World, Moscow's belt-tightening apparently has affected its economic support of some Communist clients. Some indications in recent months of this tougher stance are that:

- Public Soviet statements suggest that Vietnam's pleas for increased subsidized shipments of oil and food have been turned down.
- Reductions in oil shipments to Cuba in 1982 were considered, [redacted] although the Soviets agreed instead to provide financial incentives for cutting oil consumption. The option of reduced deliveries in subsequent years, however, has presumably been left open.
- [redacted]

The USSR almost certainly is more unwilling than ever to make hard currency outlays for assistance to non-Communist LDCs. Moscow rarely provides hard currency aid to such countries, but instead emphasizes project assistance repaid with the resulting LDC products. Repayment terms have hardened over the past five years, with 10-year repayment periods more common than earlier 12-year credits. The primary goal in extending development aid has been to sell Soviet equipment, although more recently Moscow has focused on procuring products important to the Soviet economy through commodity payback and barter contracts, which minimize Soviet hard currency expenditures. The current foreign exchange problem has not affected that program but has left Moscow no more lenient than before with LDCs where hard currency is involved. Some recent indications of that position are that:

- Nicaragua, despite the economic cooperation pledged during junta coordinator Daniel Ortega's May visit to Moscow, has still not obtained the substantial level of hard currency aid it has been seeking since 1980.

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- Guyana has publicly criticized proposed industrial cooperation programs, in part because Moscow has demanded that Georgetown pay more of the hard currency expenses associated with planned projects. [redacted] 25X1

Some Political Implications

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The Soviets are aware that these actions carry a political price, but they are apparently hoping that it will be bearable. In Eastern Europe, their hopes probably rest on the assumption that there is enough fat in the East European economies to enable them to adapt. As for the Third World, the Soviets' qualms may be lessened by the fact that economic assistance has rarely brought substantial political benefits. Nonetheless, they cannot be certain that problems created by aid reductions will not ultimately harm their relations with their allies and some important Third World countries. (S NF NC)

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Moscow's budget cutting will, in fact, almost certainly increase tensions with Eastern Europe. Economic stagnation, already likely in several countries, will be aggravated by the reductions in important forms of aid and will probably sharpen the debate over increased East European contributions to Warsaw Pact force modernization. The cutbacks also will complicate Moscow's efforts to increase regional economic integration. Hungary's recent admission to the IMF suggests that the Soviets may have minimized their objections because of their reduced assistance. (S NF NC)

Soviet influence with some Third World clients may suffer as an already niggardly economic aid program fails to meet those countries' growing needs. Moscow has long incurred general Third World criticism for its meager economic assistance, and it may now encounter growing trouble with economically hard-pressed countries that have been seeking increased Soviet help. Ties with Vietnam are strained over the issue of aid, and [redacted] Hanoi is seeking greater Western assistance. Relations with Cuba, where aid-related tensions do not yet appear serious, could be affected if Cuba's economic health declines as projected. Among non-Communist countries, Ethiopia and South Yemen probably are increasingly unhappy with their inability to augment Soviet military assistance with extensive cooperation in economic development. Angola, whose oil exports give it more ability than most major Soviet clients to make hard currency down payments on aid projects, is the only one to obtain a major ($2 billion) new assistance commitment. (S NF NC)

On the other hand, the Soviets' hard currency problem almost certainly will not constrain their ability or willingness to extend military assistance in regions important to US interests or weaken their support for revolutionary movements. Moscow will continue to rely on its arms sales program as the most effective means of competing with the United States and as an important source of foreign exchange. Although many LDCs are experiencing severe balance-of-payments problems, we have seen no significant decline in Soviet hard currency sales. Orders dropped to $6 billion in 1981, down from the 1980 record high of $14 billion, but still reflected the sales pattern established since the mid-1970s. Although concessionary military assistance may be scrutinized more carefully, aid to major clients such as Cuba, India, and Vietnam probably will remain based primarily on political rather than economic considerations. (S)

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