

Jp 0317

MR POWELL

c Sir Robert Armstrong

Soviet Economy: Recent Developments and Prospects to 1990

Before her departure for Moscow the Prime Minister may wish to see the attached paper. It is a summary version of an assessment which will shortly be considered by the JIC.

2. The paper is a good one and reaches some interesting conclusions:

- (i) Soviet statistics claim that the economy grew by an average of 3-4 per cent in 1985 and 1986. But, on analysis, these claims for real growth can only be true if we assume there was significant negative inflation. We do not believe this.
- (ii) Moreover, other and conflicting Soviet statistics may indicate that real growth in both years may have averaged only 1 per cent per annum in Soviet terms. On balance we believe that growth over the past two years was considerably lower than the Russians claim.
- (iii) Our own forecast for the period 1986-90 is for annual growth of about 3 per cent. This may not look so bad, but it is not only below the 4 per cent plan targets; it is far below what Gorbachev himself is looking for in his effort to revitalise the Soviet economy. It will present him with extremely difficult resource allocation choices; it will not meet the increased expectations of Soviet consumers; and it will provide ammunition for doubters and opponents.

An interesting & snappy paper, which shows the scale of the economic problems facing Gorbachev. It's going to take a lot longer than eight years for changes to produce results.

CJP
24/3



3. A further conclusion, not so clearly drawn in the paper, is that there will be sharp economic pressure on Gorbachev for arms control agreements (provided always these can be achieved without damage to Soviet security). We do not think these can bring early savings; but at the least he will be anxious to avoid increased defence spending.

4. I do not suggest that the Prime Minister should raise any of this with Gorbachev. But Ryzhkov has indicated a willingness to talk about Soviet economic prospects. The Prime Minister could say to Ryzhkov that UK experts foresee slower growth over the rest of the decade than the Russians have planned for. However, our experts have some trouble in interpreting recent Soviet statistics, and their assessment may be in error. It might be worth floating the idea with Ryzhkov that his experts could help ours by explaining what we see as anomalies in Soviet statistics. Our officials would be glad to travel to Moscow for this purpose.

PERCY CRADOCK

24 March 1987

THE SOVIET ECONOMY: RECENT DEVELOPMENTS AND PROSPECTS TO 1990

Gorbachev and the Economy: 1985-86

1. Gorbachev took office in March 1985 with a clear recognition of the acute problems facing the economy. His strategy is based on a wholesale modernisation of industry. This will inevitably take time and, to improve economic performance more immediately, he revived the labour discipline campaigns begun under Andropov. Fundamental market oriented reform, however, has not so far featured in Gorbachev's agenda. The improvements he seeks are to be achieved by making central planning work better.

The Twelfth Five Year Plan, 1986-90

2. Gorbachev's economic strategy was reflected in the Twelfth Five Year Plan for 1986-90. The output of the machine building sector, which produces the bulk of capital goods for itself and the rest of Soviet industry, was scheduled to rise sharply. This sector is under remit to assimilate the fruits of Soviet scientific and technological research into more advanced and reliable machinery for the rest of the economy to underpin Gorbachev's drive for faster growth. Total output, measured in Soviet terms, was planned to rise by 4% per annum, about 2-2.5% per annum in Western GNP terms*. The plan also aimed to raise living standards quite sharply.

Economic Performance in 1985 and 1986 - Soviet Presentation

3. According to official statistics the Soviet economy grew by 3-3.5% and 3.5-4% in 1985 and 1986 respectively. Though still below Plan targets for those years, this was a distinct improvement on the 2.6-3.2% registered in 1984. The main blackspot in both years was the fall in oil prices which severely depressed hard currency export earnings (energy exports account for about 75% of Soviet non-arms export revenues). The consumer also appeared to have fared well. Retail trade (which accounts for about 80% of total consumption) reportedly rose by an average 5% per annum.

* Soviet national income statistics exclude non-productive services such as health, education, culture, leisure etc. These sectors typically grow more slowly than the rest of the economy so that, measured in GNP terms, output grows more slowly than Soviet measures of output.

Recent Economic Performance - an Evaluation

4. On the face of it Soviet economic growth improved in 1985 and 1986, a success which was partly ascribed to the new leadership. However, some mysteries have emerged regarding Soviet statistics. Soviet claims for real growth and consumer welfare improvements over the last 2 years can only be true if we assume that there was significant negative inflation. This is implausible and does not square with what we know about Soviet price movements. Indeed, the Soviet authorities themselves have recently acknowledged persistent, but low, inflation (0.5% per annum) - something they have always previously denied. Moreover, by manipulation of other official Soviet data it can be shown for 1985 (and can reasonably be surmised for 1986) that real growth may have averaged only 1% per annum in Soviet terms in both years. This compares with Soviet claims of average 3-4% growth per annum. On balance we believe that Soviet growth over the past 2 years was considerably lower than the Russians claim.

5. Indicators for January and February 1987 suggest that economic growth in key sectors, especially machine building, fell sharply on a year earlier. In part this is explained by the disruptive influence of unusually severe weather. But it is also officially ascribed to failure to adapt to the new economic order and the rejection of large quantities of sub-standard goods by newly appointed quality control inspectors. This will probably lead to a fairly depressed outlook for 1987 as a whole.

The Forecast

6. Forecasting against this background is clearly difficult. We have no clear idea of where the economy has been recently, even before we attempt to project it in the future. However, we forecast some recovery in Soviet economic growth rates from the low levels expected in 1987. Soviet national income is expected to rise by about 3% per annum over the period 1986-90, about 1.7% per annum in GNP terms. Not only is this slower than growth in the previous Five Year Plan period, it is also far below what Gorbachev himself is looking for. It will present extremely difficult resource allocation choices between industry, defence and the consumer. On past form, defence spending is likely to be preserved from any drastic cut. His strategy for long run growth also means that industry must be given considerable new investment resources. This

implies that it is the Soviet consumer who is likely to take it on the chin. Per capita living standards are forecast to grow barely at all over the rest of this Plan period. This last finding goes right against the grain of Gorbachev's intentions.

The Problems

7. What prevents the Soviet economy from growing as fast as Gorbachev would like? There are a number of constraints. Even if Gorbachev had as many investment resources as he wished, there is a limit to how fast the crucial machine building sector could absorb new investment. What Gorbachev is asking this sector to do is to provide the means for more dynamic long run growth for the whole economy. But before it can do this it needs to revive itself. This includes designing and building more modern and sophisticated machinery for its own use before it can do so for everybody else's.

8. But investment resources are not freely available to the machine building sector. This inhibits the supply of domestically produced investment goods even more. At the same time, a weak oil price leaves the Soviet Union with a bleak hard currency balance of payments outlook, which will constrain imports from the West. (The Soviet Union has an impeccable hard currency debt repayment record. We doubt that Gorbachev would jeopardise this by significant new borrowing, even though there would be willing lenders.) Imports of Western machinery, therefore, cannot significantly augment domestic supplies. Nor do we see Eastern Europe making much contribution by way of machinery exports to the Soviet Union. Moreover, Gorbachev's drive to improve labour productivity is likely to come to grief through lack of material incentives for the labour force.

What can Gorbachev Do?

9. Gorbachev may well be prepared for 2 or 3 years of sluggish growth, recognising that the changes he wants to bring about are likely to be initially disruptive. Indeed, he himself said in Riga on 19 February:

"... on a clear, objective and realistic view of the situation, the hardest years for us will be this and the next two".

But his hope is that by 1990 the economy will be better placed to set off on a more sustained, high growth path. According to our projections the economy will be little - if at all - better placed in 1990 to achieve such an objective. What else can he do? Viewed from here it is difficult to know. In Soviet conditions the strategy he is following may be broadly correct. A more thorough-going market-oriented economic reform, for example, might be even more disruptive than the changes he already plans. In the short term, therefore, there seems little extra he could do except, perhaps, to reduce the growth in defence spending. Defence spending imposes a considerable burden on the Soviet economy, taking about 13-15% of GNP. It also absorbs best quality machinery, raw materials and labour. Some of this could undoubtedly be used in the domestic economy to the benefit of growth. But in the short term the gains are not likely to be significant - even if, against past form, such a move was politically acceptable.

Assessment

10. It is worth re-iterating that all forecasts, and especially forecasts of the Soviet economy, are uncertain. But, if we are broadly correct, Gorbachev faces a difficult period ahead. Few of the targets, if any, will be reached. Suffering from endemic inefficiency, poor quality, a sullen labour force and lack of flexibility, it will take some time for Gorbachev to engineer a substantial improvement. He has made a start and, in Soviet circumstances, his strategy may be appropriate. But, if it works, it will not work for some time. Meanwhile he faces the prospect of slower growth, than he seeks. All this may confound the increased expectations that Gorbachev has planted among the Soviet population. This will not help him in his efforts to improve labour discipline and productivity. Nor will it leave the Soviet economy well placed to support its CMEA partners and other client states. Gorbachev and his senior political supporters have anticipated a difficult couple of years early in the course of the 12th Five Year Plan. Whether they foresee such a protracted, below Plan performance as we do is a moot point. But if we are broadly right, the economic prospect outlined here will provide ammunition to Gorbachev's doubters and opponents.

23 March 1987

