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To: Members of the Executive Board

From: The Secretary

Subject: World Economic Outlook: Supplementary Note 5 -
Economic Developments in Eastern Europe and the U.S.S.R.

The attached note on economic developments in Eastern Europe and the U.S.S.R. provides background material for the Executive Board discussion on Monday and Wednesday, April 1 and 3, 1985 of the World Economic Outlook.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Manison (ext. 7186).

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INTERNATIONAL MONETARY FUND

World Economic Outlook: Supplementary Note 5

Economic Developments in Eastern Europe and the U.S.S.R.

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(In Consultation with the Research Department)

Approved by L.A. Whittome

March 11, 1985

The background to, and the significant economic developments in, the six countries of Eastern Europe (Bulgaria, Czechoslovakia, the German Democratic Republic, Hungary, Poland, and Romania) and the Union of Soviet Socialist Republics in the opening years of the 1980s were described in a previous WEO report. ^{1/} In that report it was indicated that real economic growth, after slowing during the 1970s, slackened further in the early 1980s, particularly in Eastern Europe. The reduction in the growth rate of a number of Eastern European countries in the early 1980s resulted largely from measures of domestic demand restraint that were necessitated by the need to redress an unsustainable external payments position. With the curbing of domestic expenditures, particularly of fixed capital formation, and the associated compression of imports, a considerable improvement in the convertible currency current accounts of the balance of payments of these countries was recorded in 1981 and 1982. By contrast, the continuing deceleration in economic growth in the U.S.S.R. was primarily attributable to factors of domestic origin, in particular disappointing agricultural harvests and declining capital productivity. In general, the current account in convertible currencies of the U.S.S.R. remained in surplus as the result of rising exports of energy and precious metals.

^{1/} World Economic Outlook: A Survey by the staff of the International Monetary Fund, Occasional Paper No. 27 (Washington, April 1984), Supplementary Note 5, pp. 146-151.

I. Developments in 1983 and 1984

1. Eastern Europe

The year 1983 witnessed a distinct upturn in real domestic economic activity in the six countries of Eastern Europe, taken together, as well as in their external trade (Tables 1 and 2). After two years of substantial decline, the total volume of imports recorded a modest rise. ^{1/} This upturn alleviated some supply constraints and contributed to a resumption in industrial growth. Gross industrial production for the region as a whole is estimated to have increased by 5 percent, after being little changed in 1982. In contrast, agricultural performance, was adversely affected by rainfall shortages in certain countries, particularly in Hungary and Romania, and grew by less than 2 percent. Overall, net material product is estimated to have increased by nearly 4 percent in 1983 permitting small rises in consumption and, for the first time in a number of years, in fixed investment. The latter increase reflected a substantial rise in fixed capital formation in Poland, following a precipitous decline during the years 1979-82, and some increase in investment in Romania; in the four other East European countries, real investment was reduced further.

The external current account in convertible currencies is estimated to have recorded a surplus of around US\$3 billion in 1983, well above its level in 1982 (Table 3). ^{2/} The improvement stemmed from both a higher trade surplus and lower net service outlays, mainly reflecting lower interest payments. Developments in the trade accounts of individual countries ranged from sizable increases in the surpluses of Poland and Czechoslovakia to slight reductions in the surpluses of Bulgaria and the German Democratic Republic. The decline in the region's net convertible currency indebtedness in U.S. dollar terms in 1983 (Table 4) exceeded the current account surplus because of the falling U.S. dollar value of debt components denominated in other currencies.

^{1/} Estimating changes in the volume of trade flows for Eastern Europe and the U.S.S.R. is necessarily an imprecise exercise. The total value of trade is estimated by converting ruble trade (mostly intra-CMEA trade) into U.S. dollar terms and adding to it trade with the convertible currency area computed in U.S. dollars. However, as similar commodity exports and imports are often priced differently in the two markets, it is difficult to decompose the resulting total trade value into price and quantity components. The estimates of these components in these notes and the attached tables should accordingly be treated with some caution.

^{2/} The magnitude of this surplus is overstated (as also in 1982 and 1984) in that no allowance is made for the nonpayment by Poland of certain interest obligations. Official Polish estimates of these arrears are presented in Table 3.

Preliminary data on developments in Eastern European economies in 1984 suggest that the recovery in domestic production and external trade continued. In most countries the rates of growth in aggregate production and industrial output were approximately in line with or just above those planned, with the rise in real net material product for the region as a whole being again estimated at 4 percent. With good grain harvests in Hungary, the German Democratic Republic and Poland, the rate of growth of agricultural production accelerated markedly.

The rise in real domestic expenditures in Eastern Europe in 1984 appears to have been below that of real domestic output thus permitting a further improvement in the external current account. Consumption expenditure is estimated to have increased by around 2 1/2 percent in real terms in 1984, while real fixed investment is thought to have been virtually unchanged. The continued recovery in capital formation in Poland appears to have offset falls in investment in other Eastern European economies, particularly in the German Democratic Republic and Hungary where the declines were quite substantial.

The growth in domestic production in 1984 is estimated to have entailed an increase in import volume at much the same rate as in 1983. Imports from the CMEA ^{1/} are thought to have again expanded at a faster rate than total imports, in part because of a lower need for grain imports from the West in 1984. The volume of exports continued to rise more rapidly than that of imports--a development which was only partly offset by a further, albeit lesser than in 1983, deterioration in the terms of trade. With regard to transactions settled in convertible currencies, a further increase in the trade surplus (of about US\$1 billion) is estimated to have occurred in 1984 and, with it, a corresponding improvement in current account surplus (to about US\$4 billion).

There was a further decrease in the net external indebtedness in convertible currencies of Eastern European countries during 1984. As in 1983, this took the form of a buildup of deposits with Western banks, rather than a reduction in gross foreign debt. The decline in the net debt in U.S. dollar terms during 1984 as shown in Table 4 is not as great as the estimated current account surplus in convertible currencies for Eastern Europe and valuation changes would seem to indicate. This difference is explained largely by the fact that the gross debt of Poland includes some interest arrears not reflected in the current account of the balance of payments. In addition, net debt in Table 4 is defined as gross debt less deposits in banks reporting to the Bank for International Settlements; in 1984, certain Eastern European countries may have increased their claims on foreign entities not reporting to the BIS.

^{1/} Consisting of the six Eastern European countries listed here, the U.S.S.R., Cuba, Mongolia, and Vietnam.

The improvement in the external current account and debt positions of Eastern Europe has been associated with a change in the attitude of creditors toward most countries in the region, and a resumption of borrowing by some countries. The type of borrowing shifted back to more conventional forms, such as syndicated bank loans and officially-backed trade credits, and away from financing in the form of unguaranteed suppliers' credits and proceeds from energy re-exports. It is estimated that funds raised on international markets by Eastern European countries increased from US\$0.6 billion in 1982 to US\$1.0 billion in 1983 and further to nearly US\$2.5 billion in 1984. The better standing of Eastern Europe has also been reflected in the willingness of most OECD governments to guarantee short-term trade-related credits to all countries, except Poland, and for the country-specific terms of bank credits to have generally improved.

In sum, during 1983-84 most Eastern European economies made some progress in strengthening their external financial positions while at the same time resuming economic growth. Although domestic policy actions initially encompassed sharp cutbacks in demand and imports, economic performance in this period seems to have benefited from various reforms in the system of economic management in some countries. These reforms have varied widely across countries and in certain cases antedated the external payments difficulties of the 1980s. Most countries have sought to change and rationalize their production structures by economizing on the use of imports and scarce capital resources. Some countries have also proceeded with the realignment of their domestic prices and have simplified their exchange systems so as to make their economies more export-oriented. In addition, in some countries measures have been taken to boost labor productivity through relating earnings more closely to enterprise performance and by extending the scope for groups of workers to enter into subcontracts with enterprise management. Various steps have also been taken to decentralize decision making to the enterprise level.

2. U.S.S.R.

As in Eastern Europe, the growth rate of domestic production in the U.S.S.R. also quickened in 1983 mainly as a result of a substantial increase in agricultural output and higher growth in labor productivity in the industrial sector. The relatively favorable grain harvest appears to have permitted some reduction in grain imports which, together with a further rise in energy exports--including resales of oil from OPEC countries--resulted in a larger surplus on trade account in convertible currencies. With lower interest payments offsetting reduced sales of nonmonetary gold, the current account surplus is estimated to have increased in line with the trade surplus.

Preliminary figures on developments in 1984 indicate that the rate of increase of aggregate production was below that in 1983 with a substantial shortfall from plan being recorded in the grain harvest. Industrial production was slightly above that planned, with a higher

output of manufactured goods and natural gas offsetting falls in crude oil and coal production. Real net material product is estimated to have risen by 2 1/2 percent.

The growth in exports is estimated to have slowed further in U.S. dollar terms in 1984, as larger shipments to the CMEA area and to Western Europe were partly offset by a sizable decline in shipments to developing countries, but to have continued to outpace the growth in imports. The trade surplus in convertible currencies is thought to have increased sufficiently to permit a further enlargement of the current account surplus, despite a lower estimated surplus on invisibles. Partial data from CMEA trading partners suggest that a lower current account surplus was probably recorded by the U.S.S.R. with the nonconvertible currency area in 1984.

Despite its relatively good credit standing in international financial markets, external borrowings by the U.S.S.R. were small over the three years to the final quarter of 1983. Since then, the U.S.S.R. has raised considerable funds in foreign markets, mainly in the form of syndicated loans from West European, Japanese and Middle Eastern banks. The net indebtedness of the U.S.S.R. in convertible currencies continued to fall in 1983-84, but the decline is thought to have been much less than the estimated current account surplus and the effects of valuation changes would suggest. This reflects the fact that the U.S.S.R. is estimated to have extended considerable credits in convertible currencies to developing countries--the reporting of which is not included in international banking statistics.

The policies of the U.S.S.R. in the recent period to improve economic performance have centered on efforts to raise the efficiency with which scarce productive resources, particularly fixed capital assets, are used. Toward this end, experiments were begun in 1984 aimed at providing managers at the enterprise level in two key heavy industrial ministries (electrical and transportation machinery) and three consumer goods ministries with increased independence. Specifically, management was to be given greater flexibility to choose suppliers, to redeploy labor, and to allocate investment funds. In addition, new forms of labor organization have been introduced on a selective and experimental basis, aimed at raising productivity.

II. Outlook

1. Eastern Europe

In assessing the outlook, a key question for most Eastern European economies is whether growth can be sustained at the rates achieved in 1983 and 1984 without jeopardizing their external financial positions, which in some cases are still fragile. The forecasts presented in Tables 2 and 3 are based, inter alia, on the assumption that Eastern Europe's export markets will grow at a similar rate to that estimated for the period 1983-84. However, the ability of Eastern European countries to maintain their export market shares could be adversely affected by increasing competition from other industrializing countries and by the limited technological quality of their export products, that in part reflects low investment goods imports in recent years. Furthermore, their capacity to increase their exports to the convertible currency area will depend on the terms on which the U.S.S.R. is prepared to continue providing energy supplies and other raw materials to them. If--as seems to have been foreshadowed at the June 1984 CMEA summit--Eastern Europe is required to raise the quality of the goods exported to the U.S.S.R. in order to secure deliveries of energy and raw materials, there could be some diversion, at least in the short run, of convertible currency exportables to the nonconvertible currency area. The need to reduce accumulated debt to the U.S.S.R. could lead to a similar diversion, or to an increase in inputs from the convertible currency area to generate the larger ruble exports needed to strengthen the current account position vis-à-vis the nonconvertible area. Against this background, the forecasts for 1985 look for a small reduction in the convertible currency trade surplus, both in the aggregate and for most individual countries. Lower projected interest payments are expected to compensate for this, however, leaving the current account surplus little changed.

The growth rate of real net material product for most Eastern European economies is planned to show a slight deceleration in 1985, and in aggregate, is forecast to be around 3 1/2 percent. This deceleration is expected to result from some slackening in labor productivity advances in the industrial sector and from smaller increases in agricultural production following the record grain harvests registered in a number of countries in 1984. Consumption expenditures are forecast to grow by around 2-3 percent in most countries in 1985, while real fixed investment in the region as a whole is expected to increase by 1 percent to 2 percent. However, for individual countries marked differences are expected from the pattern of 1984, with modest increases in fixed investment forecast in Czechoslovakia and the German Democratic Republic and little change foreseen in Hungary and Poland. As a result of the moderate economic growth expected in 1985 and the adverse effects of the tenuous external financial positions on domestic growth in the preceding four years most Eastern European countries are likely to fall well short in meeting the real growth targets for the 1981-85 Plan.

Growth objectives for Eastern Europe for 1986 and for the 1986-90 Plan are likely to continue to be modest since external financial constraints on most countries are expected to result in the pursuit of cautious domestic demand management policies. With only limited scope for stepping up the rate of fixed capital formation, growth performance over the medium term is likely to depend crucially upon the effectiveness of reform efforts to raise labor productivity.

The outlook with respect to the debt situation of the Eastern European countries is mixed. All countries, with the exception of Poland, are estimated to have steadily reduced their net external debt in convertible currencies since 1982, both in U.S. dollar terms and in relation to merchandise export receipts. However, the overall improvement in the external debt position conceals the diverse situation facing different countries. Despite considerable debt relief from foreign banks in each of the last four years, Poland's external debt servicing burden continued to be extremely heavy, resulting in very tight restraints on imports and further accumulation of payments arrears to official creditors. Furthermore, Poland, along with Romania, will be confronted by rescheduled debt again falling due in the second half of the decade. Current and prospective debt-servicing ratios continue to be relatively high for Hungary and the German Democratic Republic because of the bunching of maturities. However, as indicated by their considerable external borrowings in 1984, these countries enjoy greater access to international financial markets. Bulgaria and Czechoslovakia, by contrast, face relatively low debt servicing obligations and continue to exhibit considerable caution in taking up new international loans, preferring instead to reduce their external indebtedness.

2. U.S.S.R.

The external trade position of the U.S.S.R. is forecast to weaken in 1985 as a sizable increase in the volume of grain imports is expected, while receipts from energy exports to the convertible currency area are thought likely to fall back as a result of lower average world prices for oil and natural gas. The impact of this on the convertible currency account could, however, be partly offset by increased sales of nonmonetary gold.

With respect to domestic economic prospects, the official plan for 1985 calls for a growth rate of real net material product of 3.5 percent, predicated on a substantial recovery in agricultural production and a rate of increase in industrial production similar to that recorded in 1984. The latter may be difficult to sustain as recent official efforts to boost labor productivity are reported to be producing disappointing results, while the production of crude oil and coal has been stagnating or falling back. In the absence of an improvement in productivity and efficiency, real economic growth over the medium term is likely to proceed at similar rates to those of recent years, viz., 2 1/2 percent to 3 percent.

Table 1. Eastern Europe and the U.S.S.R.: Economic Activity and Prices, 1971-85

	1971-75	1976-80	1980	1981	1982	1983	Estimate 1984 ^{1/}	Projection 1985 ^{1/}
(Percent change in constant prices)								
Net material product								
Eastern Europe	8	3 1/2	--	-2	-1/2	4	4	3 1/2
Eastern Europe excluding Poland	6 1/2	4	3	2 1/2	2	3	4	3 1/2
U.S.S.R.	5 1/2	4	4	2	2 1/2	3	2 1/2	3 1/2
Eastern Europe and U.S.S.R.	6 1/2	4	3	1	2	3 1/2	3	3 1/2
Gross fixed investment								
Eastern Europe	9 1/2	--	-4 1/2	-8 1/2	-6 1/2	1 1/2	--	1 1/2
Eastern Europe excluding Poland	7	2 1/2	--	-1 1/2	-4	--	-2	2 1/2
U.S.S.R.	7	3 1/2	2 1/2	4	1 1/2	4	3	3 1/2
Eastern Europe and U.S.S.R.	8	2 1/2	--	--	-1	3 1/2	2	3
Gross industrial production								
Eastern Europe	9	5	3	-3	--	5	4 1/2	4
Eastern Europe excluding Poland	7 1/2	5	4	4	2 1/2	4	3 1/2	3 1/2
U.S.S.R.	7 1/2	4 1/2	3 1/2	3 1/2	3	4	4	4
Eastern Europe and U.S.S.R.	8	4 1/2	3 1/2	1 1/2	2	4 1/2	4	4
Gross agricultural production								
Eastern Europe	3 1/2	1/2	-5 1/2	2 1/2	3 1/2	1 1/2	4 1/2	1/2
Eastern Europe excluding Poland	3 1/2	2	--	1	1 1/2	--	4	2 1/2
U.S.S.R.	2 1/2	1 1/2	-2 1/2	-2	4	5	--	6 1/2
Eastern Europe and U.S.S.R.	3	1	-3	-1	4	4	1	5
(Percent change)								
Consumer prices								
Eastern Europe	1 1/2	3 1/2	5 1/2	9	36 1/2	9 1/2	7	6 1/2
Eastern Europe excluding Poland	1	2 1/2	4 1/2	2	5 1/2	3	3 1/2	3
U.S.S.R.	--	1	1	1	3	2	3	2
Eastern Europe and U.S.S.R.	1/2	1 1/2	2	3 1/2	12 1/2	4	4	3

Sources: Staff estimates and projections drawing on national authorities (Hungary, Romania, and Poland) and United Nations publications.

^{1/} Data shown for the U.S.S.R. are official estimates for 1984 and official forecasts for 1985, except for gross agricultural production and consumer prices.

Table 2. Eastern Europe and the U.S.S.R.:
Merchandise Trade, 1981-85 ^{1/}

(Percent change in U.S. dollar terms)

	1981	1982	1983	Estimate 1984	Projection 1985
Exports, f.o.b.					
Eastern Europe					
Value	-4	3	5	3	6
Volume	2	5	6	4	4
Prices	-6	-2	-1	-1	2
U.S.S.R.					
Value	4	10	6	3	5
Volume	1	7	6	4	5
Prices	3	3	--	-1	--
Imports, f.o.b.					
Eastern Europe					
Value	-5	-4	6	4	5
Volume	-4	-6	3	3	3
Prices	-1	2	3	1	2
U.S.S.R.					
Value	7	7	3	1	6
Volume	7	10	4	3	5
Prices	--	-3	-1	-2	1
Terms of trade					
Eastern Europe	-7	-3	-3	-1	--
U.S.S.R.	3	6	1	1	-1
Memorandum items:					
Exports to the European CMEA area in per- cent of total exports					
Eastern Europe	60	62	63	63	63
U.S.S.R.	50	49	51	52	52
Imports from the European CMEA area in percent of total imports					
Eastern Europe	60	65	67	68	67
U.S.S.R.	51	49	49	49	50

Sources: Staff estimates and projections drawing on United Nations publications and national trade data.

^{1/} Includes estimates of trade of the German Democratic Republic with the Federal Republic of Germany.

Table 3. Eastern Europe and U.S.S.R.: Current Account in Convertible Currencies, 1980-85

(In billions of U.S. dollars) 1/

	1980	1981	1982	1983	Estimate 1984	Projection 1985
Eastern Europe						
Current account balance	-6.0	-4.5	1.0 <u>2/</u>	3.0 <u>2/</u>	4.0 <u>2/</u>	4.0
Trade balance	-2.5	-2.0	4.0	5.0	6.0	5.5
Net invisibles	-3.0	-2.5	-3.0 <u>2/</u>	-2.0 <u>2/</u>	-2.0 <u>2/</u>	-2.0
U.S.S.R.						
Current account balance	1.5	--	2.5	3.5	4.0	3.5
Trade balance	--	-2.0	2.0	3.0	4.0	3.0
Net invisibles <u>3/</u>	1.5	2.0	0.5	0.5	--	0.5
Eastern Europe and U.S.S.R.						
Current account balance	-4.5	-4.5	3.5 <u>2/</u>	6.5 <u>2/</u>	8.0 <u>2/</u>	7.0
Trade balance	-2.5	-4.0	6.0	8.0	10.0	9.0
Net invisibles <u>3/</u>	-1.5	-0.5	-2.5 <u>2/</u>	-1.5 <u>2/</u>	-2.0 <u>2/</u>	-1.0
Memorandum item:						
Poland						
Interest arrears incurred during year <u>4/</u>			1.1	1.1	1.4	

Sources: Staff estimates and projections, drawing on information from national authorities (Hungary, Poland, and Romania), national trade data sources, United Nations publications and bulletins, and Consolidated Gold Fields, Ltd.

1/ Totals may not add due to rounding.

2/ Current account surpluses in these years are overstated in that they do not take account of Poland's unpaid interest obligations.

3/ Includes sales of nonmonetary gold.

4/ Official estimates.

Table 4. Eastern Europe and the U.S.S.R.:
External Debt in Convertible Currencies, 1980-84

(In billions of U.S. dollars)

	1980	1981	1982	1983	Estimate 1984
Gross debt outstanding					
Eastern Europe	64.0	65.0	63.5	62.5	63.0
U.S.S.R.	<u>21.0</u>	<u>23.5</u>	<u>23.0</u>	<u>21.5</u>	<u>22.0</u>
Total	85.0	88.5	86.5	84.0	85.0
Net debt outstanding <u>1/</u>					
Eastern Europe	57.0	59.0	58.0	54.0	52.0
U.S.S.R.	<u>12.5</u>	<u>15.0</u>	<u>13.0</u>	<u>11.0</u>	<u>10.5</u>
Subtotal	69.5	74.0	71.0	65.0	61.5
CMEA banks	<u>4.5</u>	<u>4.0</u>	<u>3.5</u>	<u>3.5</u>	<u>3.5</u>
Total	74.0	78.0	74.5	68.5	65.0
Memorandum items:					
Ratio of net debt to convertible currency exports					
Eastern Europe	1.75	1.95	2.00	1.90	1.70
Eastern Europe excluding Poland	1.35	1.40	1.35	1.20	1.05
U.S.S.R.	0.45	0.50	0.40	0.35	0.30
Eastern Europe and U.S.S.R.	1.15	1.25	1.20	1.05	0.95
Ratio of deposits in foreign banks to liabilities to such banks <u>2/</u>					
Eastern Europe	0.14	0.14	0.15	0.24	0.34
Eastern Europe excluding Poland	0.20	0.19	0.20	0.31	0.41
U.S.S.R.	0.64	0.53	0.71	0.68	0.70
Eastern Europe and U.S.S.R.	0.26	0.25	0.30	0.38	0.46
Ratio of short-term debt to banks to total gross debt					
Eastern Europe	0.22	0.20	0.16	0.15	0.16
Eastern Europe excluding Poland	0.31	0.30	0.25	0.23	0.24
U.S.S.R.	0.26	0.21	0.29	0.33	0.33
Eastern Europe and U.S.S.R.	0.23	0.20	0.20	0.20	0.20

Sources: United Nations; Organization for Economic Cooperation and Development; Bank for International Settlements; national authorities (Hungary, Poland, and Romania); and staff estimates.

1/ Gross debt less deposits in banks reporting to the Bank for International Settlements.

2/ Banks reporting to the Bank for International Settlements.

