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GLOBAL ECONOMIC AND TECHNOLOGICAL CHANGE: FORMER SOVIET UNION AND CENTRAL AND EASTERN EUROPE, AND CHINA

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BEFORE THE

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CONGRESS OF THE UNITED STATES

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

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FOR THE RECORD

FRIDAY, JUNE 11, 1993

ECONOMIES OF THE FORMER SOVIET UNION AND CENTRAL AND EASTERN EUROPE

FRIDAY, JUNE 11, 1993

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The Committee met, pursuant to notice, at 9:43 a.m., in room SD–628, Dirksen Senate Office Building, the Honorable Jeff Bingaman (Member of the Committee) presiding.

Present: Senators Bingaman, Boxer and Craig.

Also present: Richard F Kaufman, General Counsel; Ed Hudgins, professional staff member.

OPENING STATEMENT OF SENATOR BINGAMAN, MEMBER

SENATOR BINGAMAN. Good morning.

The Joint Economic Committee began its regular annual reviews of the economies of the Soviet Union and other Communist systems in 1974.

Obviously, the world has changed substantially in the 20 years since that first hearing.

Most significantly, instead of the cold war concerns with the Soviet capacity for supporting military activities, the present focus is on the problems accompanying the transformation of regimes that practice centralized planning, that transformation to a market type system.

While the threats to U.S. and Western security have diminished, it remains vitally important for us to continue to monitor the developments in these countries.

Of course, the former Soviet Union's nuclear capabilities remain very high. We need to be assured of the stability of the region and the reliable control of those and other weapons of mass destruction.

We're also committed to a major effort to provide Russia and other nations with economic assistance. Obviously, it is in our interest to encourage reform efforts and to understand how the U.S. and Western aid is being utilized.

But because of the uncertainties and risks that exist during this unprecedented period of transformation, it is arguably more important than ever that we stay abreast of the changes taking place, and that we keep ourselves as fully informed as possible.

To help in this endeavor, we once again have asked the Central Intelligence Agency and the Defense Intelligence Agency to give their assessments of recent economic performance in the countries in question, and to make some projections into the future.

Testifying this morning are Christine Williams, Deputy Director of Slavic and Eurasian Analysis; Robert Blackwell, Deputy Director of the Office of European Analysis, both of whom are with the CIA; and William Grundmann, Director of Combat Support in the DIA.

We're very pleased to welcome all three of you.

We'll proceed. Why don't we start with Ms. Williams, and proceed across there, unless you have another order that's preferable. Once we've heard your testimony, I hope we can think of some good questions.

Why don't you go right ahead.

[The *Paper* presented to the Committee by the Central Intelligence Agency and the Defense Intelligence Agency starts on p. 28 of Submissions for the Record:]

STATEMENT OF CHRISTINE WILLIAMS, DEPUTY DIRECTOR, OFFICE OF SLAVIC AND EURASIAN ANALYSIS, CENTRAL INTELLIGENCE AGENCY

Ms. Williams. Thank you, sir.

Let me begin by saying what a pleasure it is to be here on this twentieth anniversary of our first JEC testimony.

We are proud of our record of supporting the work of this Committee and the Executive Branch during the years of the Cold War. We alerted you to the growing decay of the command economy, the widening technological gap with the West, and the heavy burden of the defense sector that relegated Soviet citizens to third-world status.

Now, we are analyzing the dramatic changes underway in Russian, Ukraine, and the other new states as they undergo three simultaneous revolutions: The turn away from the command economy toward the creation of markets; the repudiation of their totalitarian political system and the construction of new political institutions; and the disintegration of the Soviet empire and the creation of new relationships among successor states.

Since Gorbachev set this process in motion, Russia and its neighbors have seen dramatic changes for the better. These have had a great and favorable impact on U.S. interests and hold substantial promise for creating a more secure and stable world order.

But these revolutions will take years and possible decades to unfold. Instability will be commonplace and there is considerable uncertainty about the outcome.

While we hope to see democratic governments and market economies evolve from these major changes, the West remains concerned about the dangers inherent in this transformation process. At present, it is the weaknesses of the new states that present worrisome threats.

The four nuclear states—for example, Russia, Ukraine, Kazakhstan, and Belarus—retain nuclear weapons, and the danger of proliferation will be substantial in the face of continuing political and economic instability.

Moreover, the risk associated with the possible sale of nuclear materials, as well as Russia's open marketing of arms to earn much-needed hard currency, further complicate the quest for a more secure world.

Crises and dangers abound around Russia's periphery and in its relations with the 14 former Soviet republics.

Conflict and violence in all three Caucasian states, Moldova and Tajikistan bear careful monitoring, and there are dangers in tensions between Russia and Ukraine.

The breakaway republics are inevitably forming new alliances with neighbors and like-minded states that might strengthen regional powers unfriendly to the U.S. interests.

Economics will play a major role in this process of change, affecting struggles for political power, the creation of stable governments, the staying power of political leaders, the military capabilities of the new states, and the attitudes of the people toward their leaders.

A key question is whether aid, and in what amounts and in what forms, will have a positive impact. In any case, aid will absorb U.S. and Western resources at a time when many are facing recessions of their own.

In last year's testimony, we focused on the first steps that Russia and the other new states had taken on the long and painful road to marketization and democratization.

This year, we want to look at how far they have come along this road and how much farther they have to go.

We also want to emphasize that our assessment of the economic situation is inextricably linked with the outcome of political power struggles and the creation of new sovereign bodies.

Clearly, these new situations present new analytical challenges for us.

The virtual collapse of the old command economic system requires us to track both the dismantlement of old institutions and the building up of new ones.

And we will continue to ask what's really happening in these economies. To what extent are they really pushing ahead with reforms. What remnants of the old bureaucracy and other impediments to efficiency are getting in the way, and so on.

Now, let me begin recounting the tremendous strides that Russia has made over the past year and a half in reforming its economy.

Prices have been freed on more than 90 percent of its goods and services, allowing them to provide, for the very first time, a valid guide to investment, production and consumer decisions.

The old centralized distribution system has been virtually eliminated, forcing enterprises to seek suppliers and customers through the market.

Reduced demand for the products of heavy and defense industries have heralded the beginning of a reorientation toward consumer needs and export markets.

The explosion of free enterprises has resulted in an emerging private sector that we estimate now constitutes almost one-quarter of all goods and services produced.

The privatization of large industrial plants has just gotten underway, and is off to a good start. Shares in some 1,800 factories have already been sold. The issuing of 10,000 ruble vouchers to every man, woman and child gives all Russian citizens a stake in this process.

The death of the old system and the birth pains of the new one had a very severe impact on economic performance last year that has continued to the present.

Industrial output declined by about 19 percent in 1992, and again by 19 percent in the first quarter of this year, leaving industry at about 60 percent of its peak size in the year 1989.

What are the reasons for these developments?

First, the collapse of the old state supply system and the breakup of the union, which had been, by design, tightly integrated, had a devastating effect. The volume of trade among Eurasian states declined by as much as one-third in 1992, compared with the previous year.

Second, Russia's trade with the outside world, particularly with East European countries that were finding more profitable markets, fell by some 25 percent in 1992. The decline in imports was held to manageable levels only by foreign grants and credits.

Third, government orders for military hardware were reportedly down by as much as 70 percent last year. Investment spending by the government also plummeted by one-half. The decline in demand for these two categories of goods was responsible for a large part of the 19 percent decline in industry.

Lastly, living standards clearly deteriorated as consumer prices increased much faster than wages or personal incomes. Average real wages were about one-third lower last year than in 1991, placing 35 percent of all Russians below the official poverty line.

Concern about poor economic performance and the threat of unemployment and related social unrest led the legislature and the government to loosen the reins on spending in the second half of 1992. This resulted, by year end, in a budget deficit of about 10 to 15 percent of gross domestic product, and massive credit extensions to enterprises in the former republics boosted inflation to about 30 percent a month.

Fear of hyperinflation, as a result of these developments, caused the government to undertake spending cutbacks, reducing inflation to about 17 percent in April and May of this year.

But government spending began to rise sharply in the spring, in part due to the pre-referendum promises made by Yeltsin and the legislature. Inflationary pressures remain high, and the rate could easily climb back up to about the 20 to 25 percent range or beyond.

SENATOR BINGAMAN. Is this 20 to 25 percent per month?

MS. WILLIAMS. Yes.

The non-Russian states have suffered similar economic fates over the last year, with most fighting a losing battle against inflation and production declines.

The Baltic countries are the exception, with all of them making major progress in promoting the development of the private sector, creating market-oriented laws and institutions, and restructuring their foreign trade toward the West.

Estonia and Latvia have introduced stable currencies and are bringing inflation under control.

At the other end of the scale, ethnic and civil strife have severely disrupted economic performance and reform in Armenia, Georgia, and Tajikistan, while conscious policy decisions have been made to go slow on reforms in Turkmenistan and Uzbekistan.

Economic progress in Ukraine, because of its strategic position, the status of nuclear weapons there, and its resource base, has great import to U.S. interests.

Resistance from old-guard forces in industry and parliament and social costs have kept Ukraine from wholeheartedly embracing reform. Now, its constitutional crisis, which is on the scale of Yeltsin's, has brought gridlock in economic decisionmaking that is pushing it closer to hyperinflation.

Recently, the factionalized legislature increased the minimum wage by 150 percent. It also tripled minimum pensions and asked the government to index savings accounts, and initially refused to raise prices to meet rising energy costs.

This resulted in fueling of inflation that was already rising at an average monthly rate of 41 percent during the first quarter of this year. The extent of the populace's concerns about economic conditions is demonstrated by this week's strikes to protest food and fuel price hikes.

Looking ahead, we see great challenges and dangers: economics and politics remain inextricably linked.

In Russia, for example, critical economic decisions await some resolution of the constitutional crisis that has wracked the country for months.

The current impasse between President Yeltsin and a congress dominated by old guard legislators may be resolved, at least partially, at the constitutional conference now meeting in Moscow.

If Yeltsin fails to bring the constitutional convention to a successful conclusion, this would prolong and deepen the political crisis. If power shifts in favor of the legislature, the wrangling between centrists and hardliners over personnel appointments and overlapping responsibilities would make policy decisions erratic and even contradictory. Reformers in the cabinet almost certainly would be replaced, and progress on privatization and other reforms would be slowed.

The economic choices will not get easier in the long term, and even today. The two major options I have in terms of economic policy look equally unpalatable.

The first, often characterized as shock therapy, would combine rapid movement toward a market economy with strict monetary and financial discipline.

This option would lay the best foundation for an eventual resurgence of economic growth, but the short-term impact would be a sharp rise in unemployment.

To choose this option, however, would risk a political confrontation with old guard industrialists who favor more gradual reforms, as well as risking major social protests from those adversely affected by reduced social spending and increased unemployment.

The alternative, more likely we think if Yeltsin is pushed aside, is a more gradual approach to reform, combined with a continuation of subsidies to inefficient firms and increased social spending.

This would mean less unemployment in the short run, but increasingly high inflation rates, raising again the specter of hyperinflation and eroding chances for a return to stable and positive growth.

This dilemma is the one now sharply posed by the strings the IMF has attached to releasing the first tranche of the $3 billion systemic transformation loan.

In order to qualify, the Russian government and Central Bank have signed an accord that promises to reduce inflation to single digits per month by year end by phasing out credits to enterprises and regions and by holding the 1993 budget deficit to under 10 percent of gross domestic product.

This is to be accomplished by reducing subsidies on grain, coal and imports, and by abolishing tax exemptions. Political pressures will obviously make it difficult to live up to many of these promises.

Thus far, neither the government nor the parliament have been willing to accept the consequences of such an austerity program that would also bring bankruptcies and again a sharp rise in unemployment.

The difficulties facing a reform-minded Russia will be great, even in the best of circumstances, but they are unavoidable, we believe, if progress is to be achieved. We emphasize that there is some light at the end of the tunnel, and it's not an approaching train.

I have several points that I'd like to make on the following.

A necessary corollary of this major economic transformation is wrenching, painful change. The late Sovietologist and former NSC Director, Ed Hewett, often said that an economic downturn can be proof that good things are happening.

Second, such a major transformation will take at least a generation——

SENATOR BINGAMAN. We need to get that word out around the country here.

[Laughter.]

SENATOR BINGAMAN. Go right ahead.

MS. WILLIAMS. Okay.

Such a major transformation will take at least a generation to complete because of the need to develop the kind of psychology and commercial infrastructure under which a market system can flourish.

And, three, despite the hardship on the Russians' lives created by this transitional phase, the April referendum has proven that the Russian people believe that they are on the right track and are willing to tolerate even more.

Fourth, overall, we can expect the reform process to move in fits and starts. It's not going to be a smooth period of change.

At the same time, the chances for a return to the old political and economic systems are becoming increasingly remote because of growing power at the local level, combined with the reduced ability of the center to impose its will, and a greater stake by workers, managers and the elite in the new system.

Finally, although most of the resources for this transition must come from the countries themselves, the West can make a difference. The political support for change shown by Western nations has already been of incalculable value to the morale and steadfastness of Russian democrats and reformers.

Technical assistance is already helping them to move further along the learning curve. And the credits and other aid provided have allowed for greater imports and at least some easing of the plight of many Russians.

Thank you, Mr. Chairman.

I'd like to turn now to my colleague, William Grundmann of DIA.

[The prepared statement of Ms. Williams starts on p. 58 of Submissions for the Record:]

SENATOR BINGAMAN. Mr. Grundmann, why don't you go right ahead.

STATEMENT OF WILLIAM GRUNDMANN, DIRECTOR FOR COMBAT SUPPORT, DEFENSE INTELLIGENCE AGENCY

MR. GRUNDMANN. Good morning, Mr. Chairman, distinguished members of the Committee.

It is my pleasure to offer a Defense Intelligence assessment of military-economic developments in Russia and the new states of Eurasia after their first full year of independence.

As in past Defense Intelligence testimony, our attention is focused on military dimensions of the economy.

In particular, we address the formation of new militaries, defense spending, weapons production, conversion, arms sales and proliferation.

The governments of the U.S.S.R. successor states are still struggling to define national priorities, build new political institutions, and reform and revitalize their weakened economies.

Inherent in all these processes are uncertainties about the future role of the military.

The fundamental question facing the new governments is what kind of military and defense industrial structures are compatible with new geopolitical conditions, threat perceptions, and economic capabilities.

I will begin with our assessment—a survey of efforts by the successor states to form new militaries.

Russia, heir to the lion's share of the Soviet armed forces, faces the greatest challenge in transforming the military into an institution compatible with new geostrategic realities.

Russia's immediate security concern is the potential for internal and regional conflict.

Russian forces are involved to varying degrees in conflicts in Tajikistan, Georgia, Moldova, and the Russian Federation itself. The Russian Ministry of Defense, MOD, is developing forces for these new security concerns, including rapid reaction and peacekeeping troops.

A fundamental debate continues among radical reformers, moderates, and conservatives over the degree to which Russia needs to retain and further develop large-scale warfare capabilities. The Russian MOD continues to consider the U.S. and NATO as benchmarks for planning and evaluating force development.

One of Moscow's first tasks is to consolidate its forces onto Russian territory. Some 250,000 military personnel remain outside the country. Russia is committed to returning all troops by 1995, and withdrawals are proceeding on or ahead of schedule.

In the Baltic States, Russia signed an agreement to withdraw forces from Lithuania by this August.

Negotiations with Latvia and Estonia, however, have been complicated by Moscow's concern over the status of ethnic Russians in both countries, as well as insufficient housing in Russia for returning troops.

Nevertheless, forces are actually continuing to leave all three Baltic states.

To the south, Azerbaijan, last month, became the first former republic to secure total withdrawal of Russian forces.

A major hurdle in returning the forces is a shortage of housing, motor parks, and support facilities. Even with Western help, housing construction is not keeping pace.

Defense Minister Grachev has said it will take until 1997 to alleviate military housing shortages.

Withdrawals are but one component of three ongoing processes: reductions, reorganization and restationing.

Russia is making deep reductions in weapons and personnel strengths in response to economic constraints, a reduced manpower base, CFE treaty limits, and changing force requirements.

Manning has declined to less than two million. The Russian legislature capped military manpower at 1 percent of the population, about 1.5 million, by 1995.

Indeed, Defense Minister Grachev said recently that manning will fall below one million.

Forces are being reorganized as they are reduced. Ground forces, for example, re-evolving from the heavy army and division structure to smaller, more efficient and flexible corps and brigades.

At the same time, the most modern weapons and equipment are being consolidated in the remaining units. For instance, all Western border military districts now possess modern T-80 tanks.

Russian forces are also being restationed to compensate for the loss of forward bases, airfields and logistics networks in the forward area of the former Warsaw Pact and Western U.S.S.R.

For example, the North Caucasus Military District, once considered a military backwater, will see an increase in ground forces by more than 50 percent this year. The buildup, including upgrades of air defense, combat strike aircraft and internal troops, reflects Russia's intense concern with instability to its south and strained relations with Ukraine in the West.

A complex of problems has caused the readiness of conventional forces to fall dramatically. These include acute shortfalls of conscripts and junior officers; low morale and worsening corruption in the officer corps; lack of funds, supplies and spare parts; and inadequate training and infrastructure.

Readiness is expected to reach its ebb by mid-decade. There could be gradual improvement in military readiness with completion of ongoing force redeployments and the potential beginnings of economic recovery.

To alleviate manning problems, the Russian MOD is attempting to accelerate the introduction of a mixed conscript and contract manning system; thus far, however, achieving only limited success.

Despite low readiness overall, Russia is striving to develop a core of combat-ready units.

For example, the MOD is attempting to maintain about one-third of its units—the historic norm—at a ready level with at least 50 percent manning.

The military has also completed its most ambitious training cycle since the summer of 1991. While no large-scale field exercises have been held since 1991, the forces are practicing missions that emphasize smaller, more mobile units capable of reacting to crises in the former Soviet Union.

In the strategic arena, Russia is maintaining potent capabilities while streamlining the force to dramatically reduce treaty accountable and obsolete weapon systems.

Strategic nuclear forces will continue to be a high priority into the next century, as weapons are consolidated in Russia.

Although these forces belong nominally to the Commonwealth of Independent States, the Russian General Staff continues to exercise effective command and control, this notwithstanding Ukraine's assertion of ownership over strategic forces on its soil.

Now, turning to Ukraine's military force developments, Kiev took control of some of the most modern ground and air forces from the dissolving U.S.S.R. The Ukrainian MOD is moving to restructure and redeploy its forces to reflect new security concerns over Russian intentions and instability in Moldova.

Ukraine's MOD is facing conscription shortfalls, tensions between Russian and Ukrainian officers in its units, and discontent over lack of housing. The armed forces, numbering more than 400,000, are expected to be reduced to 200 to 250,000 over the next several years.

Ukraine and Russia have a full agenda of political-military disagreements to settle. These include disputes over the division of the Black Sea fleet and ownership and ultimate control of the strategic nuclear forces.

The latter dispute is fed by Ukrainian anxiety over Russia's conditional recognition of its borders and calls by some Russian government officials for reexamination of the status of Crimea.

Economic differences—for example, over the level and price of Russian oil and gas export to the Ukraine—are also clouding relations.

In Belarus, the other significant military power of the newly-independent states, the government has neither the desire nor capability to maintain an inherited force of about 145,000. It is currently downsizing and restructuring the military.

In contrast to most successor states, Belarus has signed and agreed on a new military doctrine, which states an intention to be neutral and nuclear-free. Mensk signed the Start Treaty and the Nuclear Non-Proliferation Treaty, agreeing to return nuclear forces on its territory to Russia.

Despite declared neutrality, significant actors in the government favor closer military ties with Russia. Mensk has entered into a five-year agreement with Moscow on coordinating military activities.

To the south, the Central Asian States have all claimed jurisdiction over former Soviet forces on their territories. Lacking resources and experience, they are moving slowly to form independent militaries. Russia retains de facto, and in many cases, de jure control of former Soviet forces in the region. The Central Asian States envision continued defense cooperation with Russia.

Other successor states—Moldova, the Baltics and Transcaucasus States—also have established only rudimentary militaries.

Mr. Chairman, we now turn to defense spending.

After peaking in 1988, Soviet defense spending fell about 25 percent through 1991. Following the breakup of the U.S.S.R., Russia continued to reduce military outlays. Cuts were concentrated on weapons procurement, affecting virtually all weapon types. Spending on research and development, personnel and other activities also fell. Russian defense spending in 1992 was roughly half the 1991 total for the Soviet Union.

About half the 1992 decline represented the loss of the other republics, which began to take over funding of their own militaries at much reduced rates. Most of their budgets are directed towards personnel-related costs, with very little spending for procurement or R&D.

In the Caucasus and Tajikistan, however, increased defense spending on the conflicts in those regions is further straining fractured economies.

For 1993, Russia plans to hold its defense budget at the 1992 level in real terms. Procurement is slated to rise 10 to 30 percent. The exact increase is unclear from the Russian data.

This increase represents a victory for the persistent arguments, especially by industrialists, that cuts have gone too deep too fast, threatening massive unemployment and loss of manufacturing capabilities. The 1993 state budget published last week includes military procurement on the list of protected items for which full funding is approved, regardless of revenues.

Military R&D budget outlays will fall again in 1993. However, the large science budget, as well as off-budget funds to preserve scientific capabilities and develop dual use technologies, could offset much of the R&D decline.

Military leaders are more concerned with R&D for future weapons and system improvements than with procuring large numbers of current weapons.

The main thrust of military technical policy is toward creating forces with greater mobility, fire power, and improved command, control and communications systems. This strategy calls for protecting the R&D structure to ensure development of core technologies and programs necessary to meet future military requirements.

With regard to weapons production, the pattern of declining military production continued during 1992. Output in many weapon categories dropped 50 percent or more last year. This trend is indicated in the accompanying table.

Even with these large declines, some weapons—tanks and certain fighter aircraft, for example—were produced in excess of domestic or foreign numbers. While some plants idled military production lines and furloughed workers, other factories continued to produce arms to keep plants running and workers occupied.

Some cooperation continues between Russia and the other new states. Belarus and the Central Asian States, in particular, are trying to preserve their supplier role to Russia. In mid-January, Ukraine and Russia signed agreements to restore cooperation in virtually all areas of military production. These agreements, despite the tensions between the two countries, reflect concessions to the reality of the integrated defense industrial sector of the former Soviet Union.

As long as antagonisms exist in the political sphere, however, Ukraine and Russia will attempt to lessen their mutual reliance over the long run. Ukraine, for example, is seeking to expand defense industrial contacts with Eastern Europe.

Defense Industry conversion is an area of major concern.

The U.S.S.R. successor states have made only limited progress in converting defense plants to civilian production.

In Russia, which inherited about three-fourths of the former Soviet defense industrial base, many plants used the State's limited conversion assistance last year to meet payrolls and avoid unemployment.

Some Russian officials claim about 600,000 defense workers were released in 1992. As in the previous year, however, a large portion probably remained on the payrolls, accepting shorter work weeks and extended leave at reduced pay.

Regional leaders are increasingly questioning Moscow's ability to manage and fund conversion. Some regions and cities are developing their own programs, a trend that is likely to continue. Many managers and officials have concluded that arms exports are the best answer to the defense plants' financial problems.

Last week, the Russian Government unveiled a new conversion plan for 1993 to 1995, which provides for a significant level of funding, both from the State budget and bank lending. The key, however, will be how the funds are used.

For 1993, more resources appear to be allocated to preserving production capacities than to actual conversion.

Last year's experience showed that even funds targeted for real conversion often were redirected to other uses.

Privatization of defense industries is in its infancy. In Russia, defense enterprises have begun to incorporate as joint stock companies, but in most cases, the government or existing management will retain controlling interest, at least for three years. Much remains to be settled in terms of what plants will be allowed to privatize, the degree and forms of state involvement and the allowance for foreign ownership or partnership.

Over the long term, the intention to downsize and restructure the defense sector is a widely-shared policy goal. Nevertheless, few of the necessary hard choices have been acted on regarding which defense industries to retain, and which to convert or close. Nor is there agreement on the kind of defense industrial structure Russia can realistically expect to support in the future.

Among Russian industrialists' more ambitious visions is the creation of large holding companies, adapted from the model of Asian market economies, that can diversify into a range of civilian and military products and serve as locomotives for economic growth.

Ukraine and Belarus, representing, respectively, some 15 and 5 percent of the defense industrial base, have developed ambitious conversion programs that count heavily on Western assistance and funding from military exports.

Ukraine offers tax advantages and other incentives to foreign investors, but still has some way to go to create an attractive investment climate and business infrastructure.

Belarus seeks to develop a high-tech economy, centered around computers and electronics. Both countries are farther along than Russia in some respects, but are still facing daunting problems.

Mr. Chairman, we are also closely monitoring trends in arms exports. The value of the former U.S.S.R.'s arms exports plummeted from a high of over $20 billion in the late 1980s to some $6 billion in 1991.

In 1992, arms exports from all the former Soviet republics fell to $2.5 billion, with about $1 billion in hard currency earnings. Russia accounted for more than 90 percent of the total. Ukraine was the only other state to export major equipment, and that was in cooperation with Russia to fulfill existing Soviet contracts.

Much of the decline results from discontinuing the Cold War motivated arms deliveries to poor, third world client states, such as Afghanistan, Angola, Ethiopia and Nicaragua, which in the past had received weapons free, or at deep discount.

In addition, generous loan and barter programs with major recipients, such as India and Syria, were replaced by demands for cash payments. Some of the lost trade came from compliance with U.N. arms embargoes, particularly against Iraq and Libya.

Russia and Ukraine now view arms sales as a means to avoid unemployment and to fund imports, military housing and defense industry conversion, as well as the development of new weapons. They simply can no longer afford to subsidize clients.

Russia and Ukraine are making concerted efforts to find new cash-paying customers, particularly in the Middle East and Asia. They have begun to market variants of their most advanced weapons systems. In addition, both countries have high hopes of commercially exploiting their strategic ballistic missile know-how to penetrate the space launch vehicle and booster market, in some cases in partnership with each other.

China is now Russia's most important arms customer. Beijing received 26 SU-27 flanker aircraft last year, signed a contract for SA-10 air defense missile systems, and is negotiating for other weapons.

Iran, another important customer, received the first of three kilo submarines in 1992, and will probably accept a second later this year.

The arms sales push has only had limited success. The sale of 450 BMP-3 infantry combat vehicles to Abu Dhabi was Russia's only successful breakthrough against Western suppliers. One obstacle is the poor image of Soviet or Russian-made weapons after the Gulf War, which Russian exporters are trying hard to dispel at international arms exhibits.

The problem, however, stems more from Russia's reliability as a supplier. Many potential buyers are concerned that they will not be able to secure spare parts and after-sales support.

Moscow is now willing to include the transfer of production technology for key components to boost sales. However, exports will not return to the high levels of the past with the current decline in the international demand for arms. New orders, particularly for hard currency, will be crucial to the survival of some plants.

Foreign military sales have become a highly sensitive issue for Russian leaders who are unlikely to curtail conventional arms exports in current economic conditions. Nevertheless, foreign sales alone cannot sustain the current size of the defense industrial sector.

Moscow is expected to attempt to restrain trade with international pariah states, most of whom are short of hard currency anyway, while trying to expand sales with countries such as China, Iran and India.

Government regulation of arms sales is hampered, however, by conflicts in the bureaucracy, the emergence of many independent arms export organizations, and by President Yeltsin's special permission for selected plants to enter arms markets directly.

Proliferation of weapons and technologies is a priority issue. Poor government export controls and the difficult internal situation in the successor states have raised apprehension in the West about the possible proliferation of materials, technologies, or expertise related to weapons of mass destruction. We have no convincing evidence of significant transfers thus far, but remain concerned that the current environment increases their likelihood.

Russia and Ukraine increasingly are authorizing export of sensitive dual-use space launch, chemical and biological technologies, as they attempt to save their weapons facilities and prevent unemployment.

Some countries are establishing substantial bilateral exchanges with Russia, Ukraine and the other new states that will increase the danger of nuclear technologies being transferred.

Facilities that were once isolated in closed cities are increasingly open to international contacts. Organized crime in the region may also view materials and technology relating to weapons of mass destruction as lucrative new commodities.

The Russians have declined to sign the Missile Technology Control Regime, claiming it is an effort by the West to squeeze them out of a market in which they believe their aerospace industry can successfully compete.

Russia has said that it will not sell nuclear-capable missile systems, and the government has developed its own missile export control legislation.

Even with consistent government commitment and Western assistance, law enforcement organizations and new export control bureaucracies will need several years to implement effective licensing and enforcement regimes.

The concern is that organizations and individuals, facing enormous pressure to survive financially, will try to evade government controls over export activities.

Mr. Chairman, we conclude the opening statement by Defense Intelligence with an outlook summary.

As we noted in our testimony last year, the dissolution of the Soviet Union has irrevocably changed the context in which we assess military-economic developments.

Economic resources of the former U.S.S.R. no longer can be mobilized as an aggregate to develop and sustain military forces. The outcome of current political struggles over economic and defense policies will hold important implications for the future military capabilities of the Soviet successor states.

To the extent Russia, Ukraine and the other new states push ahead with market reforms and reductions in the resources devoted to the defense sector, their economies are likely to recover more quickly, perform more robustly in the future, and ultimately better support smaller modern militaries appropriate to new geopolitical conditions.

To the extent the successor states slow economic reforms, retain more of the current defense industrial structure, and devote more resources to the military, economic recovery is likely to be slower, and domestic prosperity postponed.

The latter path would likely result in larger armed forces, but economies that ultimately are far less capable of meeting the military requirements of the 21st century.

The transitions taking place in Russia and Eurasia will be long, contentious, subject to recurring crises, and marked by large downside risks.

While the military threat to the West has been dramatically reduced, the potential for local and regional conflicts, as well as the proliferation of sensitive weapons-related technologies, remains high.

Both can have adverse impacts on Western security interests.

The questions we are now being asked are more complex and difficult because of the breakup of the Soviet Union and the current political, economic and military turmoil.

In this uncertain environment, Defense Intelligence considers its mission to assess the military economic indicators of change, continuity and conflict to be a first-order priority.

Mr. Chairman, this concludes my statement.

Mr. Robert Blackwell will now present a statement.

[The prepared statement of Mr. Grundmann starts on p. 63 of Submissions for the Record:]

SENATOR BINGAMAN. Thank you very much.

Mr. Blackwell, why don't you go ahead.

STATEMENT OF ROBERT BLACKWELL, DEPUTY DIRECTOR, OFFICE OF EUROPEAN ANALYSIS, CENTRAL INTELLIGENCE AGENCY

MR. BLACKWELL. Thank you, Mr. Chairman.

Before beginning my remarks, I would like to acknowledge the significant contribution to our analysis on political and economic issues in Eastern Europe made by the three people behind me; Dennis Barkley, Lee Davis, and Sally Hicks.

I also think it's appropriate, since Christine Williams mentioned him in her remarks, to at least note for the record, the great loss—and a great loss to the country, for that matter—and certainly the significant contribution made to the analysis of Soviet economic issues, in general, in Eastern Europe, of Ed Hewett. He was a friend, colleague and advisor, and I think we will all miss him a great deal.

SENATOR BINGAMAN. Let me just say that I agree totally with that. I'd had the good fortune to consult with him several times on Soviet economic issues, and he was a great advisor to many in the Congress about these issues.

So I totally agree.

MR. BLACKWELL. Our message today, Mr. Chairman, is basically a positive one for Eastern Europe.

Eastern Europe has made great strides in the transition to a market economy. Progress has been greatest in the Northern Tier—Poland, Hungary and the Czech Republic—but even in Bulgaria and Romania, overall tends are more positive than a year ago. Although the region will continue to suffer economic hardship as part of the transition, several of these countries have reached the point of no return on the road to a market economy.

The reform process is moving forward throughout the region, albeit now more slowly than previously. Although leaders and publics reject a return to socialism, East Europeans are increasingly wary of full exposure to market forces.

In the past year, pressures have grown throughout the region to proceed more cautiously to ease the economic pain of reforms. Leaders in

Bulgaria, Romania, and Slovakia in particular, talk increasingly of slowing the pace of reform.

Still, economic reforms have moved ahead in the past year, and market forces are well established in the Northern Tier countries. The shift of ownership from the state to private owners continues throughout the region.

The private sector now represents nearly half of output and employment in Poland and Hungary, thanks largely to the initiative of small entrepreneurs. The private sector also has grown in both Bulgaria and Romania to 15 percent of the economy, compared with virtually nothing three years ago.

Although implementation has lagged, most countries have established mass privatization schemes to sell off large state enterprises. Moreover, many of these enterprises already have dramatically slashed employment and changed their product mix in response to market forces. This is particularly true, for example, in the various shipyards in Poland.

The East Europeans have made progress on other reforms as well.

Most countries have passed agricultural land restitution laws to redistribute land seized by the Communists after World War II.

The Northern Tier countries have begun buying up bad debts by issuing government-guaranteed bonds to clean up bad bank loans.

East European governments now set very few prices, although the prevalence of subsidies, wage indexation and monopoly influences from state-owned enterprises undermine the impact to some degree.

The next year will be pivotal for the key reform issues of privatization in banking. Czechoslovakia's head start on privatization will be tested by the actual transfer of shares, its new bankruptcy law, and Slovakia's apparent lack of faith in the market.

Poland will have to grapple with an uncertain political situation that threatens to delay the sale of large state-owned firms. As you know, elections are scheduled there for September, and the outcome isn't all that clear.

Bulgaria has sold only one large enterprise in the year since its privatization program was approved.

And Romania, which has distributed privatization vouchers, still needs to identify the companies it intends to sell.

In addition, a robust banking sector will be critical to the selection process that nourishes promising firms and weeds out the weak and inefficient ones. While many banks will have stronger balance sheets after being relieved of bad loans, they will face the challenge of making good lending decisions, opening the flow of credit without incurring another load of bad debts.

The economic performance projections are also finally starting to look better, particularly because of the reform process that is well underway.

Although Eastern Europe registered its fourth consecutive year of economic decline in 1992, the rate was less steep and some signs of growth were evident at the end of the year. The region's gross domestic product fell less than 5 percent in 1992, compared with 13 percent in 1991.

Poland recorded the first positive growth in the region since the late 1980s, and others look poised for an upturn within the next year.

Two serious problems, of course, are still very much in evidence. Inflation continued to go down in 1992, although the rate of descent was slowed by the lifting of remaining price controls, rising food prices and budget deficits. Inflation ranged from 11 percent per year in Czechoslovakia, as Prague held to tight monetary and fiscal policies, to 44 percent in Poland per year, to 200 percent in Romania, where the growth of interenterprise credits fueled price rises.

Unemployment, however, remains the most troublesome side effect of reforms. By the end of 1992, more than five million East Europeans, some 11 percent of the work force, were out of work. Rates in rural areas and in one-company towns hit hardest by the shakeout in manufacturing were well over 20 percent.

The outlook in the Northern Tier countries for 1993 is for a modest upturn of industrial production and a boost in farm output with the return to normal weather. Poland should be able to meet its 2 percent growth target, and Hungary, which had to revise its earlier, rosier forecast after a plunge in first quarter exports, is projecting zero or, at worst, low negative growth.

For the Czech and Slovak republics, near-term prospects are gloomier because of the uncertainty following the breakup of the Federation, the collapse of the common currency, and the fall off of bilateral commerce.

Despite some recent signs of life in manufacturing, Bulgaria and Romania also will probably not grow for another year. At the same time, the East Europeans must still deal with rising unemployment, high levels of inflation and substantial budget deficits in 1993.

As a result of the economic and political changes we have been observing, East European trade patterns are adjusting to the new post-Cold War environment.

Since the fall of communism in 1989, Eastern Europe has directed its commerce toward the European Community and away from the former Soviet Union. The East Europeans now see their economic future as tightly linked to the West.

More than half of the Northern Tier Countries' exports in 1992 went to the European Community countries, and only 10 percent went to the former Soviet Union, compared to about 30 percent in 1989.

Even Bulgaria, traditionally the most tightly wedded to the Soviet market, reduced its share of exports to the U.S.S.R.'s successor states from 30 percent in 1991 to 10 percent in 1992.

Export growth is likely to slow or stagnate this year in Eastern Europe because of weak West European demand, despite additional market access granted by the European Community under association agreements.

As you know, Western Europe is in a recession also.

Sales of agricultural goods, where Eastern Europe has a comparative advantage, will increase only slightly, at best, because of continued European Community and European Free Trade Association restrictions, because of lagging agricultural reforms, and because of the lingering effects of the below-average 1992 agricultural crop.

Eastern Europe's increased ties with the West and the hard currency shortages in the former Soviet Union will hold down sales to Russia and other successor states.

The East Europeans will remain eager for Western investment, which has totaled about $7.5 billion in the last three years. United States' investment in this region constitutes about 36 percent of this total.

Hungary has attracted around $4 billion of investment because of its reputation for political and economic stability.

Looking to the next few years, continued progress is likely, but some hurdles remain to be overcome. The region has entered a stage where dramatic breakthroughs on the scale of those of 1990 and 1991 are not likely.

The Northern Tier countries must still grapple with economic restructuring of their state-owned enterprises. Modernizing plant and equipment will require massive amounts of capital. The East Europeans also will need to continue to develop the managerial and marketing skills to overcome an entrenched socialist work ethic.

Romania and Bulgaria probably will take years to reach the stage that most of the Northern Tier countries have already achieved.

There will be some other significant pitfalls along the way as well.

Unemployment will rise even after output begins to grow, and will tempt East Europeans to increase social spending at the risk of widening already high budget deficits.

To ease the pain, governments are also likely to consider further stretching out reform timetables. Putting off the inevitable makes political sense to leaders astride fragile political coalitions, but it also slows the transition and delays the onset of strong economic growth.

Fiscal problems will remain a major hurdle in meeting the requirements of IMF programs. Proponents of restraint will have to answer critics who will complain that governments are selling out to foreign interests.

At the same time, even with these difficulties, the East European countries, with the possible exceptions of Slovakia and Romania, have reached the point where backtracking on reforms is unlikely. The momentum generated by completed reforms and the lack of coherent alternatives make it unlikely they will reverse course, such as by nationalizing newly privatized enterprises or reimposing price controls, for example.

Even though we are still likely to hear occasional anti-reform statements from some of their leaders, that's to be expected, particularly given the political difficulties they face.

In short, the past year has strengthened our confidence that by the mid-1990s, the region will achieve the successes we projected in our testimony last year.

Most will register economic growth.

Most will make substantial progress in selling off state enterprises.

Most will become more integrated with the European Community.

And most will benefit from increased foreign investment.

To be sure, the East Europeans are still likely to turn to the West for help in reaching these goals. Many now view increased market access, especially from West European trade partners, as the favored form of assistance.

The East Europeans also will continue to press for loans from international financial institutions, and for technical assistance.

More generally, the East Europeans will want reassurances that increased attention toward Russia is not coming at their expense.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Blackwell starts on p. 70 of Submissions for the Record:]

SENATOR BINGAMAN. Thank you very much.

Why don't we follow a ten-minute rule here, and I'll start the questions.

I'd like to ask Ms. Williams and Mr. Grundmann if they would each comment on the tension that exists between Russia and Ukraine.

That's referred to, I think, in your testimony, Ms. Williams, as to the dangers and tensions between the Russia and Ukraine, and it's also referred to in your statement, Mr. Grundmann.

I'd be interested in you elaborating, if you could, on the causes of that, and where you see that leading, what the different scenarios are that result from that range of issues that seem to be dividing those two countries.

MS. WILLIAMS. Thank you, Mr. Chairman.

Of course, it's not surprising that considerable strains would have resulted from the separation of these two countries, as Ukraine became an independent state.

Both suffer serious problems because of that separation, although the Ukrainians are asserting their rights for autonomy and independence.

It hurts Russia in terms of the loss of resources and in terms of a number of the military issues.

Let me point out some of the major ways in which these relationships have been rocky and will continue to be rocky, and point out that most of the issues that have created tensions have still not been resolved between these two countries.

Economic ties. The settling of external debt questions, who would honor the debt; the issue of assets, how should these be divided between the two countries. This also relates to military questions that I will leave for my colleague, Mr. Grundmann.

A most recent source of tension was the end-of-the-year cutoff in oil shipments from Russia to the Ukraine, which causes a lot of grief for the Ukrainians and their economy. If we could say that Russia is undergoing serious problems, some of the numbers for the Ukraine are even more troublesome and negative.

There are issues about the control over nuclear weapons that we have seen mentioned a lot in the U.S. press recently.

Questions about the Black Sea fleet, and how to divide assets there; and about port facilities and how do deal with the forces.

I mentioned before the debt servicing problems.

And then again in the arms control area, the continuing waffling reluctance of the Ukrainian Parliament to take positive action on START and NPT.

In terms of the future, we see these tensions continuing until some of these issues can be successfully resolved.

On the other hand, given the major transformations and problems that both of these countries face, in terms of the economics of it, we believe that there's some reason for thinking that the linkages and the economic interdependence between the augers well for them trying to work out problems.

I would still point out, though, that there are some wild cards here. The leaderships in both of these countries are critical to how this situation evolves. We see continuing efforts by the present leaders, Grachev and Yeltsin, to try to work things out, albeit haltingly and with little sign of great progress in solving these issues, which I mentioned before.

Another thing to be watching for, for all of us, is the strength of nationalistic forces, both inside Russia and the Ukraine, who could propel them towards disagreements that could lead to continuing concerns about tensions and so on.

And I'll turn now to Mr. Grundmann.

MR. GRUNDMANN. In addition to what Christine has mentioned, and what we had pointed out in our statements, the focus is on the military issues between Russia and the Ukraine here. At the time that the Soviet Union broke apart, Kiev had taken control of very modern, conventional air forces, air defense forces, ground forces, as well as the——

SENATOR BOXER. Could you talk a little louder?

SENATOR BINGAMAN. If you could pull that microphone up, that would be better.

MR. GRUNDMANN. At the time the Soviet Union dissolved, Kiev took control of the very modern forward deployed former Soviet ground forces, air forces, and defense forces, and of course naval forces, in addition to the very salient problem with the strategic nuclear forces.

The Ukraine is making strides to unify the armed forces that it controls in the conventional sphere. There remains a major dispute between Kiev and Moscow as to the disposition of the Black Sea fleet. There have been proposals with respect to the proportion of the naval vessels in the fleet that would be retained by the two newly independent states.

Going in position was a fifty-fifty split. Recently, the Ukraine seems to be holding out for the larger share, something on the order of 60 percent, but this remains still at loggerheads.

The status of the Black Sea fleet headquarters port facility is still in dispute. Leasing arrangements are now under negotiation and will probably continue for some time.

SENATOR BINGAMAN. Let me ask about the strategic weapons. You say that, although the forces—I think you're talking about strategic forces—belong nominally to the Commonwealth of Independent States, the Russian General Staff continues to exercise effective command and control. That's on the strategic weapons in the Ukraine?

MR. GRUNDMANN. That's right, Mr. Chairman. We assess that the Commonwealth, although nominally maintaining the possession and control of the strategic nuclear forces of the former Soviet Union, the Russian General Staff in fact, through its facilities and capabilities, is maintaining control.

The question, of course, remains as to what the intentions of Ukraine are with respect to its assertion of administrative control over those some 175 ballistic missiles and some 40 strategic bombers that are on its territory.

SENATOR BINGAMAN. Let me ask about this mid-January agreement between Ukraine and Russia, to restore cooperation and military production.

I mean, that seems like it's going against the general trend that Ms. Williams described about growing tensions between the two countries, or continuing tensions between the two countries.

Is there a different attitude on the part of the military leadership in the two countries about the extent to which those countries ought to be working together?

MR. GRUNDMANN. With respect to production, Mr. Chairman?

SENATOR BINGAMAN. Yes, production control of weapons, or any of the rest of it.

MR. GRUNDMANN. I believe the military is postured to maintain separate programs, separate strategies, and of course, the continuing cooperation that we've seen, as we mentioned in our statements, seems to be some momentum from the past relationship in completing progress on existing Soviet orders.

So we expect that as long as political relations remain adversarial, they will lessen their mutual reliance in the future.

SENATOR BINGAMAN. All right.

Let me ask, on a different issue, somewhat different at any rate, proliferation, which you deal with, Mr. Grundmann, in your statement.

You have a statement that says:

> Some countries are establishing substantial bilateral exchanges with Russia, Ukraine and the other states that will increase the danger of nuclear technologies being transferred.

Can you tell us what other countries those are, or what countries you're referring to, and what, if any, action we've taken to deal with that?

MR. GRUNDMANN. Mr. Chairman, if necessary, we could discuss that in a closed session. Otherwise, we could make that question for the record.

SENATOR BINGAMAN. Okay. Maybe you could respond for the record. That would be preferable.

MR. GRUNDMANN. We'll do that.

SENATOR BINGAMAN. The figures for the amount of currency, the amount earned by Russia in the sale of weapons overseas, have dropped dramatically.

But what about the quantities of weapons sold or delivered? Are those also dramatically reduced from previous years, or are they selling things more cheaply?

Do we have a fire sale going on in Russia and Ukraine at the present time, as far as sales of weaponry around the world?

MR. GRUNDMANN. Certainly, the marketing strategy is to reduce the prices for military equipment. I don't have exact figures of the actual quantities of weapons that have attended the drop in the earnings, but certainly the trend would be that the quantity has dropped significantly, as well as the——

SENATOR BINGAMAN. You think the quantity has dropped as well as the dollars received?

MR. GRUNDMANN. Yes, Mr. Chairman.

SENATOR BINGAMAN. Okay. But you indicate that production is being maintained, at least at some reasonable level, in a lot of their defense plants. Are they just stockpiling a lot of weapons for future sales in case they ever find someone who can pay them?

MR. GRUNDMANN. There's an element of that. The stockpiling of some systems, such as modern fighters, for which the Russians expected foreign orders but did not receive any. However, across the board, we're seeing a dramatic reduction in the output of military systems production.

SENATOR BINGAMAN. How many fighters are they continuing to produce? Do you have an estimate as to how many fighters they'll produce this year?

SENATOR BINGAMAN. With respect to the trend, I can speak to that first. We've seen, and this is shown in the table we've presented, that the Soviet output in 1990 was 575. It dropped to 350 fighters in 1991, and down to 150 in 1992.

We expect that the output will remain low. I'm not certain whether we have an expectation that it will continue to drop, but we expect that it will remain at a low level.

SENATOR BINGAMAN. How does that compare to our own production of fighters?

MR. GRUNDMANN. I'm afraid I don't have those figures, Mr. Chairman, for U.S. production.

SENATOR BINGAMAN. Let me defer to Senator Boxer for her questions.

SENATOR BOXER. Thank you so much, Mr. Chairman.

I really appreciate it because I have an appointment in my office at 10:30, and I was hoping I'd have my chance to ask questions, and I thank you for this hearing.

In my ten minutes, I'd like to ask my questions to Mr. Grundmann. You said in your testimony that the Russian Ministry of Defense continues to consider the United States and NATO as benchmarks for planning and evaluating force development.

When you say, as benchmarks, do you mean as a potential enemy, or is it a potential friend, or in what way are they looking at NATO and the United States at this time?

MR. GRUNDMANN. The context in which the statement, benchmark, is as more of a model. The size and the quality of the armed forces of the U.S. and NATO would ——

SENATOR BOXER. Could you speak up a little bit, please? I can't hear you.

MR. GRUNDMANN. The benchmark is intended to be regarded as a model for the development of Russian armed forces in the future, as they're developing their military doctrine and formulating their plans for force structures and future force developments.

It is not necessarily regarded as an adversarial benchmark, but certainly in developing their military, they have to consider that possibility.

SENATOR BOXER. So that doesn't look like it's any kind of change at all, does it?

I mean, in the past, they were in competition with the United States and NATO. They had the Warsaw Pact, and they developed their own military.

You're saying that they're still looking at NATO. Do you think there's ever a hope that they'd join NATO?

MR. GRUNDMANN. There have been discussions, certainly, of mutual collective security arrangements, but with respect to Moscow's hopes of joining NATO, I don't believe that that's——

SENATOR BOXER. You don't?

MR. GRUNDMANN. ——considered to be a viable——

SENATOR BOXER. You mentioned that the ethnic Russians in the Baltic States as a potential problem in terms of ethnic conflict, and I've heard that from Senators. Senator Biden, for example, had raised that issue.

Do you think that the historic hatreds, if you will, if that's the right word, match that of the Bosnia situation? Or is it a different——

MR. GRUNDMANN. Anyone else?

MR. BLACKWELL. I would. I'll venture in that.

SENATOR BOXER. Yes, please.

MR. BLACKWELL. I think they, in no way, are comparable to what you have in the former Yugoslavia, either historically or by experience, or otherwise.

There obviously are tensions, particularly in Latvia and Estonia, because there are a large number of Russians there, and there's some sense of discrimination on their part, or they feel it anyway.

But in Bosnia, or in Yugoslavia generally, those hatreds go back centuries and they have been reinforced, time and time again, by mutual periods of slaughter on each side. So it's a bit different.

SENATOR BOXER. Thank you. That's good to know.

Mr. Grundmann—this is just a comment in passing—I know it must be a CIA "manning," but I would hope that you would take a look at the word "manning," because I would prefer that you said to alleviate personnel problems, rather than manning problems, because, you know, right on this panel, you have a representative of the other gender, so that's just——

MR. GRUNDMANN. That's a point that's very well taken, Senator.

SENATOR BOXER. Thank you very much.

I know it's hard to move language that's been deeply ingrained, but I mention that in passing.

In your testimony, you say that economic resources of the former U.S.S.R. no longer can be mobilized as an aggregate to develop and sustain military forces.

Do you view that as a permanent statement? Or are you too nervous to say that would be a permanent situation? And if it isn't a permanent situation, can you give us sort of a ... let's say everything turned around tomorrow? How quickly could it go back to what it was before?

MR. GRUNDMANN. Senator, we see that as a permanent statement. We reiterated that statement this year from last year's testimony to emphasize that the aggregate capabilities of the former U.S.S.R. could no longer be mobilized to support, in the aggregate, military forces.

SENATOR BOXER. And my last question, Mr. Chairman.

In your testimony, you say that transitions taking place in Russia and Eurasia will be long contentious, subject to recurring crises, and marked by large downside risks.

What are those large downside risks?

MR. GRUNDMANN. If you would, Mr. Chairman, could I recognize Mr. John Gore to answer that question?

SENATOR BINGAMAN. Certainly.

Mr. Gore. Yes, Mr. Chairman, Senator Boxer.

I would refer to the types of things that Ms. Williams was talking about, and that is the dangers of political instability, the political problems that come with economic austerity, the discontent that arises from that type of economic reforms, which are needed.

Those sorts of things are what we're talking about.

SENATOR BOXER. But they're not large downside risks for America necessarily, except as they might make the area unstable?

Mr. Gore. Yes. Yes. Certainly not large downside risks for the United States or for the West in that sense, no.

In that respect, perhaps the largest downside risk would be the effects of any instability on the control of nuclear weapons, but beyond that, no, I don't think we would consider those to be large, downside risks to the United States, but rather to the stability of Russia.

SENATOR BOXER. Thank you.

Thank you very much, Mr. Chairman.

I wonder if I might ask unanimous consent that I have some other questions that could be answered in writing?

SENATOR BINGAMAN. Yes. We'll ask that those be responded to, if you could, please.

SENATOR BOXER. Thank you very much.

SENATOR BINGAMAN. Thank you very much.

MR. BLACKWELL. Could I add to the last answer?

SENATOR BINGAMAN. Please go right ahead.

MR. BLACKWELL. The notion of no risk to the United States is one thing, and I would agree with the answer. But if you have large instability in Russia or in Eurasia with some violence, or maybe not, but if it was very unstable, very uncertain in political terms of those kinds of things, the East European countries would, quite frankly, go bananas and much of Western Europe with them.

It would create a lot of uncertainty in Europe, and that would in fact end up complicating political relationships and other things, and it would make them even more inclined to want to look for U.S. leadership, U.S. troops and political relationships in Europe, as well.

I mean, these things, in a broad sense, are very much tied into U.S. interests, if not necessarily in the sense of being a direct threat to us.

SENATOR BOXER. Thank you.

SENATOR BINGAMAN. All right.

Let me see if I'm clear. You're still finalizing reports on both the Russian former Soviet Union and then on Eastern Europe. Is that correct?

Ms. WILLIAMS. Yes, Mr. Chairman.

We have drafts of them ready now, and we will move quickly to publication.

The Russian and former Soviet Republics' report will be done jointly with our colleagues at DIA.

SENATOR BINGAMAN. Okay.

MR. BLACKWELL. And we're very close to having the one on Eastern Europe, Senator.

SENATOR BINGAMAN. Okay.

The strong message that I get out of this, and I just say this to elicit any kind of reaction, but I certainly am encouraged by the news about Eastern Europe.

It seems like much of Eastern Europe is making progress toward greater economic prosperity, toward more stable political systems.

In the case of Russia and other former Soviet Union countries, it strikes me that they are still in a very precarious position, and that economically the situation is precarious, and politically, it's precarious. And we really don't have a great deal of confidence about which way that's going to resolve itself.

MS. WILLIAMS. I think that's exactly right, Mr. Chairman.

I think the two words that we would use is unpredictability and uncertainty, which of course make it all that much more important for all of us to be looking very directly at these countries and what's happening.

SENATOR BINGAMAN. Okay.

I appreciate the testimony. I think it's been a good set of testimony, and we look forward to seeing the final reports.

Thank you all very much.

The hearing is adjourned.

[Whereupon, at 10:22 a.m., the Committee adjourned, subject to the call of the Chair.]

SUBMISSIONS FOR THE RECORD

ECONOMIC TRANSITION IN RUSSIA AND EURASIA: PROGRESS AND PITFALLS

Paper prepared by the Central Intelligence Agency and the Defense Intelligence Agency for the Joint Economic Committee, Congress of the United States

July 1993

SUMMARY AND CONCLUSIONS

Since the fall of the Soviet Union in December 1991, all 15 Eurasian successor states have gone through dramatic political and economic changes. All continue to declare their intentions to build democratic political systems and market-oriented economies, but the transition to these goals will not be easy. Progress to date varies greatly, and individual countries will continue to pursue separate reform strategies that reflect their own capabilities and preferences.

Russia's Transformation

Russia, which continues to influence events throughout the former Soviet Union because of its size and extensive economic ties with the other new countries, has made tremendous strides over the past year and a half in reforming its economy:

- Prices have been freed on more than 90 percent of goods and services, allowing prices to begin to provide for the first time a valid guide to investment, production, and consumer decisions.
- The old centralized distribution system has been virtually eliminated, forcing enterprises to seek suppliers and customers through the market.
- Reduced state investment in and demand for the products of defense and heavy industries have heralded the beginning of a reorientation toward consumer needs and export markets.
- The explosion of free enterprise has resulted in an emerging private sector that we estimate now constitutes almost one-quarter of all goods and services produced.
- The privatization of large industrial plants has just gotten under way but is off to a good start--shares in some 1,800 factories have now been sold. The issuing of 10,000-ruble vouchers to every man, woman, and child gives all Russian citizens a stake in this process.

The demise of the old system and the birth pains of the new had a severe impact on economic performance last year that has continued into the present. According to Russian official statistics, gross domestic product (GDP) declined by 19 percent in 1992 and by 16 to 18 percent in the first quarter of this year compared with last, leaving the economy at about 70 percent of its peak size in 1989.

- The collapse of the old state supply system and the breakup of the union—that had been by design tightly integrated—was devastating. The volume of trade among the Eurasian states declined by as much as one-third in 1992 compared with the previous year.

- Russia's trade with the outside world fell by almost one-fourth in 1992, and trade with East European countries that also were seeking new markets dropped even more sharply. The decline in imports was held to manageable levels only by foreign grants and credits.
- Government purchases of military hardware were down by about 60 percent last year, according to our independent estimates, and shortages of budget and enterprise funds for investment drove this traditionally favored resource claimant down by 45 percent, according to Russian official statistics. The drop in demand for these two categories of goods was responsible for a large part of the industrial decline.
- Living standards clearly deteriorated as consumer prices increased much faster than wages and other personal incomes. Average real wages were about one-third lower last year than in 1991, placing roughly one-third of all citizens below the official poverty line.
- As concern mounted over poor economic performance and the threat of unemployment, controls over monetary and fiscal policy loosened, causing macroeconomic instability. The monthly inflation rate, which had dipped to single digits at mid-year, grew to 25-30 percent by yearend, fueled by a budget deficit of about 7 percent of GDP financed domestically and massive credit extensions to enterprises and the other Eurasian states. In response, the value of the ruble on the Moscow foreign exchange market fell precipitously, reducing some imports and making it more expensive for the government to subsidize vital imports such as grain.

The economy has shown few improvements so far this year. Although fear of hyperinflation and the desire to meet IMF loan requirements resulted in some spending cutbacks, inflationary pressures remain. Increased demands for social spending, new investment funds in key sectors such as energy, continued subsidies for loss-making enterprises, and indexation of wages and pensions cannot be ignored without paying the penalty of bankruptcies, high unemployment, and the threat of consumer unrest.

Changes in Other Eurasian Countries

The non-Russian states have suffered similar economic fates over the last year and a half, with most fighting a losing battle against inflation and production declines. The Baltic countries have suffered sharp drops in output but are making major progress in promoting the development of the private sector, creating market-oriented laws and institutions, and restructuring their foreign trade toward Western markets. Estonia and Latvia have introduced stable currencies and are bringing inflation under control. At the other end of the scale, ethnic and civil strife have severely disrupted economic performance and reform in Armenia, Azerbaijan, Georgia, and Tajikistan, while conscious policy decisions have been made to go slow on reform in Turkmenistan and Uzbekistan.

In Ukraine, resistance from old-guard forces in industry and parliament and fear of the social costs kept leaders from wholeheartedly embracing reform. Following some forward motion in late 1992 and early 1993, a political struggle developed in mid-May between President Kravchuk, Prime Minister Kuchma, and the conservative legislature over who should direct economic policy, resulting in disarray in economic policymaking that has brought

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Ukraine to the brink of hyperinflation. As living standards erode, support for the current political system could evaporate and prospects for large-scale social unrest could increase, bringing new threats of regional separatism.

More Turmoil Ahead

Looking ahead, we see great dangers and challenges for Russia and the other Eurasian countries.

Economic dilemmas will continue to complicate the solution of political problems and vice versa. In Russia, for example, critical economic decisions await some resolution of the constitutional crisis that has wracked the country for months. If the constitutional conference approves Yel'tsin's draft and devises a ratification method that has the clear support of most of the delegates, Yel'tsin may be able to put a new constitution in place and hold a new legislative election this year. Even so, the election of true reformers is far from assured, and even elected reformers will be reluctant to vote for tough austerity measures. If Yel'tsin fails to bring the constitutional convention to a successful close and power shifts in favor of the legislature, reformers in the cabinet almost certainly would be replaced, and progress on privatization and other economic reforms would be slowed.

The economic choices will not get easier. In Russia, the two major options look equally unpalatable. The first, often characterized as "shock therapy," would combine more rapid movement toward a market economy with strict monetary and financial discipline. Under this option, the best foundation would be laid for an eventual resurgence of economic growth, but the short-term impact would be a sharp rise in unemployment. To choose this option would risk a political confrontation with old- guard industrialists who favor more gradual reforms, as well as major social protests from those adversely affected by reduced social spending and increased unemployment. The alternative—more likely if Yel'tsin is pushed aside—is a more gradual approach to reform combined with continued subsidies to inefficient firms and generous social spending. This would mean less unemployment in the short run but continuing high inflation rates, raising the specter of hyperinflation, breakdowns in trade, even more capital flight, and the prospect of greater political instability.

The economic difficulties will continue to have a negative impact on defense programs. Although political uncertainties and delays in approving a military doctrine have made Russian military planning for 1993 and beyond uncertain, Russia clearly cannot afford the military burden it inherited from the Soviet Union. Moreover, conversion of defense plants to the production of civilian goods is likely to remain slow because of the lack of adequate financing and the difficulty of managing conversion from the center. Many defense industrialists have looked to arms exports to keep defense plants active and finance conversion, but such exports are unlikely to provide much relief.

The difficulties facing Eurasia will be great even in the best of circumstances, but there are reasons to believe that the economic transition will continue in most of these new states:

- The wrenching, painful change taking place is a necessary corollary of economic transformation.
- Such a major transformation will take at least a generation to complete because of the need to develop the psychology and commercial infrastructure under which a market system can flourish.

- Despite the hardship on people's lives created by this transitional phase, Russia's April referendum indicated that at least Russian citizens believe they are on the right track and are willing to tolerate more pain.
- Overall, we can expect the reform process to move in fits and starts, but growing power at the local level, coupled with the reduced ability of the center to impose its will, and a greater stake by workers, managers, and the elite in the new system argue that the chances for a return to the old political and economic systems are becoming increasingly remote.
- Finally, although most of the support for the transition must come from internal will and resources, the West can make a difference, particularly in areas that underwrite institutional change.

Economic Transition in Russia and Eurasia: Progress and Pitfalls

Starting Down a Long Road

Since the fall of the Soviet Union in December 1991, the 15 new Eurasian states have embarked on far-reaching transformation with the declared intention of building democratic political systems and market-oriented economies. The transition will not be rapid or easy. All of the Eurasian countries are encumbered by the legacies of the Soviet system, and all have experienced political turmoil during the period since independence. More than one-half have changed presidents or premiers, and one-third have experienced armed conflicts. Nonetheless, almost all are continuing the transformation process and developing relations with the outside world, and the four nuclear states—Russia, Ukraine, Belarus, and Kazakhstan—are engaged in negotiations with the United States to reduce or relinquish their nuclear weapons.

Economic Troubles Severe

The economic reforms launched by Russia in January 1992, accompanied by those of the smaller Eurasian states, sent shock waves throughout the territory of the former Soviet Union. Output fell, prices skyrocketed, living standards deteriorated, stabilization programs were drawn up and then abandoned, and external trade plummeted in all countries, although the severity of the transition pains varied. At the same time, all of the new states made some progress—also varied—toward market economies. Prices were liberalized, the extent of government intervention in production and distribution was reduced, and the expansion of the private sector was encouraged or at least tolerated.

Measuring economic performance during this transition period, especially at a macro-level when sectoral weights and prices are rapidly changing, is extremely difficult. Aggregate indicators such as GDP may also be misleading because of wide variations in performance among industries, regions, and social groups. Defense industries have seen sharp drops in military orders, for example, while private retail trade has mushroomed. Moreover, these difficulties in measurement are exacerbated by the biases and distortions in official statistics—the primary source of data in this paper. In particular, output statistics probably overstate the extent of the economic downturn in many countries. Overreporting of production—which was widespread in the past to demonstrate fulfillment of central plans and obtain higher bonuses for workers and managers—most likely has given way to underreporting to lower taxes and evade requirements to surrender hard currency earned from exports. Also, the statistical systems inherited from the Soviet Union are ill suited to measure the rapid expansion of private economic activity. Nevertheless, we consider the statistics presented here adequate to paint a broad picture of the economic changes that have occurred.

Falling Output

The sharp economic downturn in the Eurasian states in 1992 and the first quarter of 1993 largely reflected the collapse of central planning, disruptions in external trade, and plummeting investment and defense spending. Steep drops in trade with each other and traditional partners in Eastern Europe were especially damaging. In addition, Russia reported cuts of roughly 45 percent in investment and as much as 70 percent in military purchases of weapons. Consumer purchases, particularly of goods other than food, also fell as prices soared.

In general, the steepest declines in output occurred in the countries where economic reforms were most ambitious—Russia and the Baltic states—and where armed conflicts broke out—the Caucasian states, Moldova, and Tajikistan (figure 1 and appendix tables). The impact of trade disruptions, compounded by steep price increases for Russian oil and gas, was particularly hard on small countries that depended heavily on imported fuel—the Baltic states, Armenia, Georgia, Kyrgyzstan, and Moldova. Output decreased somewhat less sharply in countries where the government maintained a larger role in production and distribution—Ukraine, Belarus, Kazakhstan, Turkmenistan, and Uzbekistan.

Rampant Inflation

Inflation surged immediately after most prices were liberalized in January 1992, and most governments failed to maintain tight fiscal and monetary policies, increasing inflationary pressures. Because most Eurasian countries continued to use the ruble, fiscal and monetary policies in Russia strongly influenced inflation throughout the region. Tight reins on the Russian budget deficit and bank credit during the early part of last year led to a fairly steady slowing of inflation through summer. But in response to falling output, declining living standards, and threatened unemployment, Russia loosened its financial policies during the summer and fall. This loosening, which included the extension of large credits to finance trade with other Eurasian states, brought a resurgence of inflation by yearend. Lax fiscal and monetary policies in other countries in the ruble zone—notably Ukraine, until it introduced a separate transitional currency in November 1992—added further fuel to the fire.

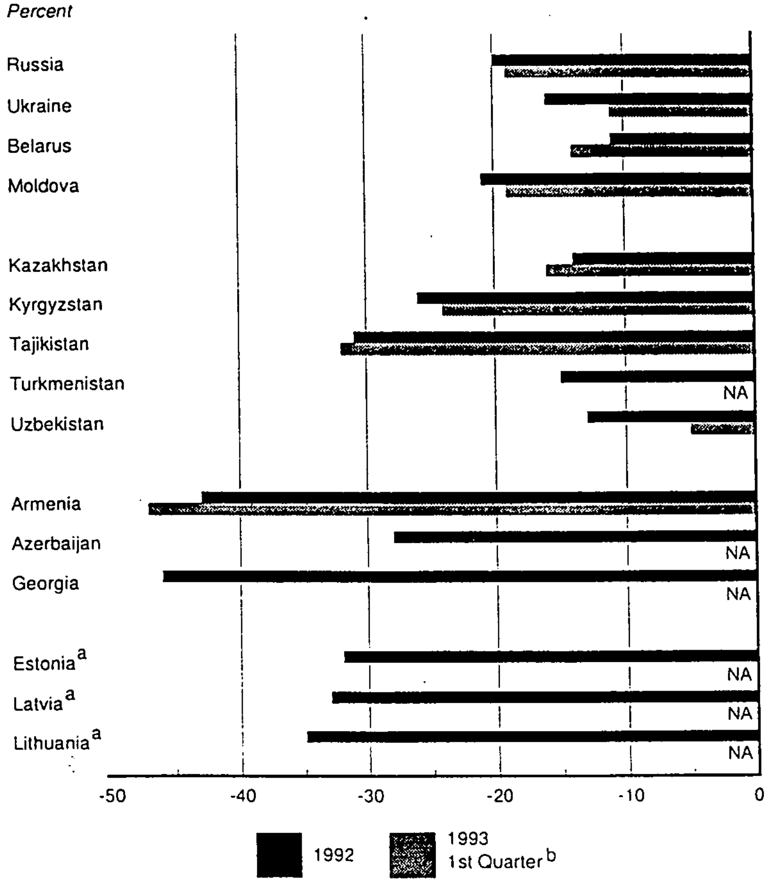
Almost all of the Eurasian states experienced quadruple- digit inflation during the year from December 1991 to December 1992 (figure 2). Inflation was lowest in Estonia and Latvia, thanks to tight monetary policies following the introduction of separate currencies last summer, and in Turkmenistan and Uzbekistan, as a result of extensive price controls on basic foods. As a result of government-decreed price increases, however, retail prices in Turkmenistan more than doubled in February 1993, and the retail prices of food and other basic consumer goods in Uzbekistan roughly doubled in June 1993. Most of the other Eurasian states experienced inflation at rates close to those in Russia, despite efforts to maintain more extensive price controls; Ukraine and Belarus apparently experienced even faster inflation than Russia.

Deteriorating Living Standards

Living standards in the Eurasian states clearly deteriorated as consumer prices increased much faster than wages and other personal incomes. In Russia, for example, average real wages were about one-third lower last year than in 1991, and the real incomes of pensioners and welfare recipients fell even more sharply. Real consumption declined less markedly, however, as people increasingly grew their own food, dipped into their devalued savings, and, in some cases, sold possessions. Our rough estimates indicate that food consumption in Russia decreased by about 2 percent per capita in terms of calories and by at most 10 percent per capita in terms of both quality and quantity. Meanwhile, price liberalization and the rapid expansion of private retail trade improved the availability of goods for people who could afford them.

Figure 1

Russia and Eurasia: Change in National Income Produced, 1992-93



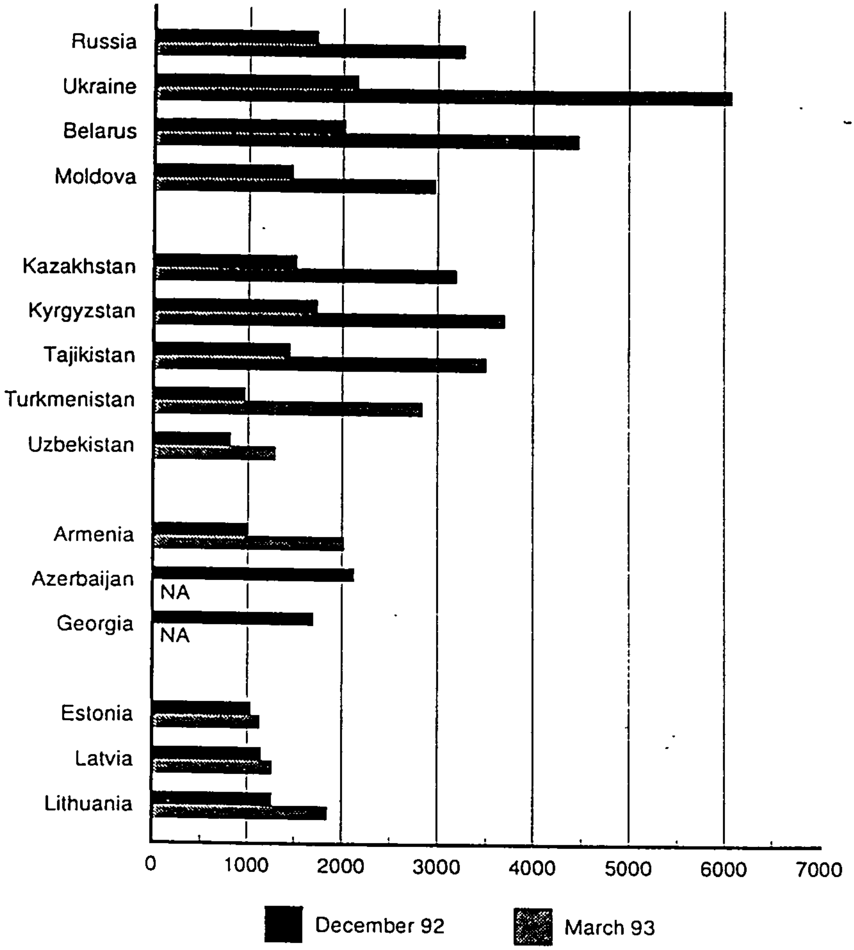
[a] Gross domestic product.
[b] As compared with 1st quarter 1992.

Source: Official statistics of the Commonwealth of Independent States and individual countries.

Figure 2

Russia and Eurasia: Inflation in Retail Prices of Consumer Goods, 1992-93

Index: December 1991=100



Unemployment began to rise as output fell but so far has remained low by Western standards. Nonetheless, unemployment probably is markedly higher in all of the Eurasian countries than official statistics indicate. In Russia, for example, official statistics imply that only about 1 percent of the work force was unemployed at the end of March 1993, while our estimates suggest an unemployment rate of at least 4 percent—not counting underemployment, which reportedly is widespread. The degree to which official statistics understate actual unemployment probably is greater in Central Asia than in Russia but less in the Baltic states (table 1).

Table 1

Russia and Eurasia: Registered Unemployment, 1992-93

	Registered Unemployment *(percent of workforce at end of month)*		
	December 1991	December 1992	March 1993
Russia	0.08	0.8	1.0
Ukraine	0.03	0.3	0.3
Belarus	0.04	0.5	1.0
Moldova	0.00	0.7	0.6
Kazakhstan	0.05	0.5	0.5
Kyrgyzstan	0.01	0.1	0.1
Tajikistan	0.00	0.3	0.4
Turkmenistan	NA	NA	NA
Uzbekistan	0.00	0.1	0.2
Armenia	0.00	3.4	4.6
Azerbaijan	0.13	0.2	NA
Georgia	NA	NA	NA
Estonia	NA	1.9	2.5
Latvia	NA	2.4	4.0
Lithuania	NA	1.0	1.5

Source: Official statistics of the Commonwealth of Independent States and individual countries.

Sharp Cuts in Investment and Defense

Although statistics on total investment are available for only a few countries, almost all of the Eurasian states probably experienced sharp declines in investment last year. In part, these drops reflected tight limits on budget funding of investment as governments placed top priority on social spending. The reluctance of banks and enterprises to tie up funds in long- term projects when soaring inflation and uncertain property rights made future benefits highly uncertain also played a role.

The collapse of the Soviet Union left its successor states with a huge military burden that none can afford; most of the responsibility for attempting to manage the orderly reduction of that burden has fallen to Russia. According to our independent estimates, total Russian defense outlays in real terms last year were less than one-half of what the USSR spent in 1991, and about one-third of what total Soviet spending reached in the late 1980s. Within these totals:

- Russian outlays for military hardware were roughly two-fifths of what the USSR spent in 1991, and about one-fourth of the peak amount Soviet procurement outlays reached in 1988. Procurement slowed markedly in all weapons categories (table 2).

Table 2

Weapons Production in the Soviet Union and Russia

	Soviet Union		Russia
	1990	1991	1992
Tanks	1300	1000	675
Armored combat vehicles	3600-3900	2100	1100
Artillery	1900	1000	450
Bombers	35	30	20
Fighters and fighter-bombers	575	350	150
Attack helicopters	70	15	5
Submarines and major surface combatants	20	13	8
Strategic ballistic missiles	190-205	145-165	45-75

Source: CIA and DIA estimates.

- Russian (R&D) also fell sharply, and many weapons development programs were either canceled or stretched out.
- Russian outlays on wages, pensions, housing, and other support for personnel were cut somewhat less drastically to minimize the chances of military unrest.

With a total personnel strength of about 1.5 million, the Russian military is suffering from a drastic shortage of conscripts, while the officers corps is far over strength. Because of the breakup of the Soviet Union and recent changes in conscription laws, Russia in 1993 can draft only 10 to 20 percent of the conscripts available to the USSR in the late 1980s. Attempts to recruit new volunteer enlisted men are underfunded, and the military has used the lack of civilian housing to limit the pace of reductions in the officer corps.

Plummeting External Trade

The Eurasian states have experienced sharp declines in trade with each other and the outside world. The dissolution of the Soviet Union in December 1991 and Russia's liberalization of trade in January 1992 seriously disrupted traditional interstate trade flows. In addition, the development of new market-oriented arrangements has been hindered by rapid inflation, slow clearing of interstate payments, and continuing direct intervention in trade by many governments. The ruble zone has shrunk from 15 countries to 10 in response to these problems as well as to national desires for separate currencies. The Baltic states and Ukraine left in 1992, and Kyrgyzstan followed in May 1993.

Trade between the Eurasian states and the outside world also fell (table 3). Trade with Eastern Europe and most developing countries continued to be hit hard by the adjustment to world prices and the lack of hard currency. The decline in trade with developed countries was milder because of their willingness to pay cash for exports and provide credit for many imports.

Table 3

Russia and Eurasia: Exports and Imports, 1991-92[a]

	Exports (billion $US)		Imports (billion $US)	
	1991	1992	1991	1992
Russia	51.0	38.0	44.0	35.0
Ukraine	5.0	4.0	7.0	6.0
Belarus	1.7	1.1	2.0	0.7
Moldova	0.2	0.1	0.6	0.1
Kazakhstan	0.8	1.5	1.7	0.5
Kyrgyzstan	0.05	0.08	0.6	0.1
Tajikistan	0.3	0.1	0.4	0.1
Turkmenistan	0.1	0.1	0.4	0.1
Uzbekistan	0.7	0.9	1.3	0.9
Armenia	0.1	0.03	0.8	0.3
Azerbaijan	0.3	0.8	0.8	0.3
Georgia	NA	NA	NA	NA
Estonia	0.1	0.4	0.3	0.5
Latvia	NA	0.8	NA	0.9
Lithuania	NA	0.5	NA	0.4

Source: Official statistics of the Commonwealth of Independent States and individual countries.

[a] Excluding trade among the Eurasian states.

The drop in exports by most of the Eurasian states reflected declining domestic production and continuing government restrictions, including Russian delays in issuing export licenses. Some countries managed to increase their exports to the outside world, however, probably by diverting goods from trade with other Eurasian states. The fall in imports would have been much greater in the absence of foreign grants and credits that helped maintain supplies of essential goods, such as food and medicine. Nonetheless, domestic production of food, medicine, textiles and apparel, and chemicals reportedly suffered from the loss of imported supplies on which Eurasian industries had come to depend.

Responsibility for the debt left behind by the former Soviet Union has fallen almost entirely on Russia. At the beginning of this year, Russia's total foreign debt (including obligations incurred by Russia itself as well as those inherited from the USSR) amounted to some $77 billion. In late March, Moscow negotiated an agreement with the Paris Club rescheduling the bulk of payments due in 1993 on official debt—that is, credits extended directly by foreign governments or covered by official export credit insurance programs. Under the terms of this agreement, Moscow formally accepted liability for the entire foreign debt of the former Soviet Union. Payments due this year on debts incurred before 1991 are to be rescheduled over 10 years, with a 5-year grace period. Western banks are now expected to grant a rescheduling along broadly similar lines of Russia's commercial—or nonofficial—debt, but a final agreement is not likely until later this year.

Mixed Progress on Economic Reforms

All of the Eurasian states have signed the death warrant of Soviet central planning, and all have taken important steps toward market economies. At the grass roots level, too, private farmers, traders, and entrepreneurs are also developing new ways of doing business. Nonetheless, progress varies greatly among and within these countries, and many problems need to be resolved before the current stage of reforms can be deemed irreversible.

One of the main obstacles is that pressures to run substantial budget deficits and provide easy credit for inefficient firms have proved irresistible for most countries. As a result, high inflation is impeding progress toward markets in a variety of ways. With all prices rising rapidly, changes in relative prices cannot serve as clear signals of supply and demand. Because interest rates remain far below inflation, moreover, incentives to save are minimal, and few funds are available for investment—which is particularly detrimental to the development of the private sector. In addition, the rapid depreciation of the ruble is encouraging the "dollarization" of domestic economic transactions and worsening capital flight—that is, the transfer of assets abroad to avoid potential financial loss arising from potential domestic economic or political instability.

Developing Market-Oriented Behavior

Movement from direct state intervention in economic activity to reliance primarily on market signals is a crucial part of the move away from central planning. All of the Eurasian states, with Russia and the Baltic countries in the lead, have reduced government orders for output and accompanying allocations of inputs and have liberalized prices to a considerable extent. The Baltic countries lifted most price controls by late 1991, Russia freed roughly 90 percent of prices in January 1992, and the other Eurasian states followed suit, although most left more extensive price controls in place.

Many factory managers, moreover, are changing product lines, searching out new markets and sources of supplies, and spearheading the reorganization of state enterprises into private firms of various kinds (see inset). And market-oriented wholesale and retail trade are expanding rapidly—encouraged in Russia by the dissolution of the once powerful State Committee for Supplies and its replacement by two contract organizations charged with managing state purchases on a commercial basis.

The changeover to market-oriented behavior is just beginning, however. Decades of central planning have left many workers and managers ill prepared to assume responsibility and exercise initiative, and incentives to improve efficiency and develop new technology remain limited. Moreover, institutional vestiges of the old system, such as industrial ministries, continue to function, and many officials of the former Communist Party and government "nomenklatura" are using their remaining powers to stake early claims on privatized government property.

Russian Industrial Managers Starting To Adapt to Reform

Economic reform is beginning to take hold at the enterprise level, according to monthly surveys of over 100 Russian industrial enterprise directors during 1992:

- As the year progressed, fewer enterprises were building up inventories of unsold goods: 63 percent had rising inventories in February, but only 25 percent did in December.
- Most of the enterprises managed to locate new suppliers or buyers during the past 2 to 3 years: 14 percent reported a greater than 50 percent change in business partners, while only 15 percent experienced no change in business relationships.
- Fifty-five percent of the directors reported production innovations over the past 3 years, including the introduction of new technologies at 24 percent of the enterprises and new products at 33 percent.
- Roughly half of the directors were aware that lack of demand for their traditional products was a primary reason for their production slump.

Although many directors indicated awareness of the need to develop new products and find new markets, they reported that obtaining investment funds to accomplish needed changes was a major obstacle. Privatized firms—31 percent of the sample by the end of 1992—were the most likely to desire restructuring in order to respond to market forces but the least likely to receive financing from the banking system, which is still largely state-run.

Restructuring Output

Russia and the other Eurasian states have begun to shift output away from heavy industries, especially goods produced for investment and defense, toward goods and services for the consumer, but much work remains to be done on this front. Russia, which inherited the vast majority of facilities of the Soviet military-industrial complex, faces the most daunting challenges in this respect. Despite the steep cuts in Russian spending on investment and defense last year, substantial further reductions in output of metals and machinery are needed.

Moreover, Russia has made little progress in converting the defense industry to the production of civilian goods. Although Russian officials claim that two-thirds of defense enterprises and over one-half of military R&D facilities are engaged in some form of conversion, increases in output of highly sought-after consumer goods and equipment for consumer-oriented industries have been limited so far. Defense plants continue to confront problems developing and marketing new products, establishing new supply links, securing resources for retooling, and attracting foreign aid and investment. In addition, a July 1992 decree requiring defense plants to retain weapons production capacity in case of future mobilization has made managers uncertain whether military production lines can be closed permanently. A government decree to clarify this issue has been repeatedly delayed.

Reorienting trade toward world markets will be a particularly important part of restructuring for the smaller Eurasian states. Although most of these countries have shifted some of their trade to hard currency partners, they have barely begun the long process of improving the competitiveness of manufactured goods and reducing reliance on exports of raw materials, such as cotton from Central Asia.

Moreover, Russia and the other Eurasian states have made only minimal progress in the most painful aspect of restructuring—the large-scale shutdown of inefficient factories and layoffs of unneeded workers. In Russia's coal industry, for example, where miners have been an important source of political support for Yel'tsin, the government agreed to large wage increases last year and continues to pour in huge subsidies in an effort to prevent mine closings. In the Russian defense industry, moreover, most government funds for conversion have been diverted to meet payrolls, and many financially strapped factories have averted large-scale layoffs by running up debts to other enterprises and relying on bank credits, often on preferential terms. Underemployment is widespread, however; according to Russian press reports, more than 400 defense plants were operating only 3 or 4 days per week late last year.

Improving the Social Safety Net

Although the Eurasian states n further work to do in redesigning their social safety nets to meet the needs of a market economy. All have boosted pensions, welfare payments, and the wages of workers paid from government budgets in partial compensation for inflation in consumer prices. Nonetheless, most countries are under intense pressure to provide more generous increases for the higher cost of living—which would add further fuel to inflationary fires.

Despite price liberalization, subsidies on basic consumer goods and services, such as bread and housing, still take up substantial shares of budget expenditures in most countries. These subsidies provide some relief for consumers, but they complicate efforts to reduce budget deficits, partly because they are not limited to the neediest social groups.

Moreover, state enterprises still provide many social services, including housing, clinics, day care for children, and recreation. In many Russian cities, about one-half of all housing is owned by local enterprises. Because these services are expensive, many are likely to be dropped when enterprises are privatized, although some could be privatized separately. Local governments could take over, but their funds are limited.

Unemployment compensation and retraining for workers who lose their jobs will become increasingly important as economic restructuring proceeds. Layoffs of excess workers should ease budgetary strains to some extent. In Russia, for example, Deputy Premier Boris Fedorov has estimated that the cost of keeping inefficient state enterprises operating is three times as great as that of paying the workers to produce nothing. The task of retraining workers and helping them find skilled jobs is likely to prove difficult, however. Many workers already have found new jobs in the private sector, and more will do so, but those who experience permanent setbacks in their socioeconomic status will be a large source of potential discontent.

Privatization

Most of the Eurasian states have encouraged or at least accommodated the establishment of private small businesses and farms; the privatization of small state enterprises, especially in trade and services; and the transfer of state housing to private owners (tables 4 and 5). Armenia and the Baltic countries have made the most progress in setting up private farms, while Russia and again the Baltic countries are the leaders in promoting other kinds of small-scale private business. Tajikistan and Turkmenistan are clear laggards.

Table 4

Russia and Eurasia: Small-Scale Privatization During 1992

Russia	47,000 enterprises, mostly small shops, restaurants, and service establishments, transferred to private hands, about 8 percent of total. Sales spurred late in year by distribution of vouchers to 96 percent of Russian citizens. Significant share purchased by former employees.
Ukraine	No enterprises auctioned during period, but some privatized through worker buyouts and leasing agreements. Government plan approved by parliament, but implementation blocked by bureaucratic foot-dragging.
Belarus	About 100 small stores and restaurants sold off, less than 1 percent of total. Strong political opposition to notion of privatization.
Moldova	No enterprises privatized during period. Key legislation put on hold because of civil unrest.
Kazakhstan	3,000 stores, restaurants, and consumer service establishments, or a little over 3 percent of such facilities, transferred to private hands. Significant number purchased by worker collectives.
Kyrgyzstan	11 percent of state-owned small enterprises privatized. Properties sold mostly for cash; program tainted by charges of corruption.
Tajikistan	Privatization barely begun, largely because of civil war.
Turkmenistan	Handful of retail shops and restaurants sold. Conservative leadership seeks to retain control over bulk of economy.
Uzbekistan	More than 1,000 small businesses privatized, including about 10 percent of consumer service establishments. Numerous restrictions placed on new owners.
Armenia	Some 200 to 400 small businesses privatized, less than 5 percent of total. Sidetracked because of Nagorno-Karabakh conflict. First priority to sales of agricultural land and housing.
Azerbaijan	No properties sold during period. Key legislation remained blocked in committee.
Georgia	Privatization program of former Gamsakhurdiya government nullified. New legislation drafted, but little progress due to civil strife.
Estonia	Some 4,000 small businesses privatized, about 60 percent of total. Some property returned to descendants of prewar owners, rest auctioned for vouchers, which were distributed to adults according to length of employment.
Latvia	136 small businesses privatized, less than 1 percent of total. Problems in defining eligibility to buy property, especially in relation to citizenship rights.
Lithuania	1,600 retail stores, restaurants, and service establishments privatized, or about 20 percent of total. First Eurasian state to issue vouchers. Property sales slowed by new Brasauskas government in response to charges of corruption on part of former privatization officials.

Table 5

Russia and Eurasia: Peasant Farms, 1992-93

	1 January 1992		1 April 1993[a]	
	Number of Farms	Percent of Agricultural Land	Number of Farms	Percent of Agricultural Land
Russia	49,770	0.9	230,000	4.5
Ukraine	2,098	0.1	20,655	1.0
Belarus	739	0.2	9,400	2.0
Moldova	5	0.0	500	0.1
Kazakhstan	3,333	0.4	11,100	3.0
Kyrgyzstan	4,070	3.2	16,700	12.0
Tajikistan	4	0.0	8	0.0
Turkmenistan	100	0.0	100	0.0
Uzbekistan	1,868	0.1	5,800	0.2
Armenia	164,542	15.0	246,000	29.6
Azerbaijan	92	0.1	219[b]	0.2[b]
Georgia[c]	NA	NA	NA	NA
Estonia	7,227	13.2	8,500[b]	15.2[b]
Latvia	17,500	13.0	48,900[b]	32.0[b]
Lithuania	8,500	3.9	25,000[d]	11.1[d]

Source: Official statistics of the Commonwealth of Independent States and individual countries.

[a] Except as noted.

[b] Date of last report is 1 October 1992.

[c] Georgia has not reported on peasant farms since 1 July 1991, when it reported 20,750 farms, which would account for 0.5 percent of its farmland.

[d] Date of last report is 1 April 1992.

The privatization of large state enterprises generally has been more controversial than the development of small-scale private activity. Russia, Estonia, and Lithuania have begun to sell shares in large enterprises, while Ukraine, Moldova, Latvia, Kazakhstan, and Kyrgyzstan plan to start doing so this year. In Belarus, the legislature rejected a voucher privatization program in April.

The transfer of state property to private hands will not necessarily bring prompt changes in the behavior of workers and managers, however, for two main reasons. First and foremost, property rights are not clearly defined, and almost all of the Eurasian states place significant limits on private ownership, especially of land. The Baltic countries have established the most far-reaching laws on private property, but actual transfers of firms and land have been slow, partly as a result of disputes over restoring property seized by the Soviet Union to pre-World War II owners. In addition, workers and managers who hold the majority of shares in privatized firms may promote their own interests—for example, by paying themselves generous wages and salaries—at the expense of other shareholders. Of the large Russian firms privatized so far, most are under the majority control of workers and managers.

Redesigning the Budget and Banking Systems

All of the Eurasian states have improved their budget systems by introducing value added taxes, which provide more stable revenues than the turnover taxes they replaced, and all have raised the priority of social spending relative to outlays on investment and defense. Budget implementation remains difficult to monitor, however, largely because of complicated subsidy schemes, numerous off-budget funds, and inexperience on the part of the government personnel and organizations charged with this responsibility.

The Eurasian states also have taken steps to establish central banks as separate institutions from the "commercial" banks that lend to firms, but their banking systems remain rudimentary and encumbered by legacies of the Soviet era. Commercial banks continue to be owned primarily by governments or state enterprises, although most countries permit privately owned commercial banks to operate. Loans are not based on reliable assessments of the ability of borrowers to repay, and, as a result, many loans carry a high risk of default. In addition, firms still are required to pay each other by transferring bank deposits that cannot be converted freely into cash—and that often take several weeks to clear.

Building a Legal and Commercial Framework

All of the Eurasian states have made some progress in building the legal and commercial framework for market economies. In Russia, for instance, markets for privatization vouchers, stocks, commodity futures, and dollar futures have been established since January 1992. A growing number of commercial banks are offering quicker deposit transfers than the Russian Central Bank provides and handling transactions in new national currencies. In addition, Western countries and international financial institutions have begun to provide training for government officials and business managers from almost all of the Eurasian states.

Most of the Eurasian states have adopted laws on the tax and banking systems, support for small-scale private economic activity, and the framework for government regulation of monopolies. Only a few countries have enacted laws on bankruptcy, however, and only Estonia and, more recently, Russia have begun to enforce such laws. Moreover, courts and other legal institutions are only beginning to adapt to the post-Soviet environment, although the Russian system of arbitration courts is starting to work. Commercial and contract law is in its infancy, and violations of contractual agreements are widely reported in the press.

Liberalizing External Trade

Most of the Eurasian states have taken important steps toward market-oriented trade with the outside world. Since July 1992, Russia has used a single ruble-dollar exchange rate, determined by auctions on the Moscow Interbank Currency Exchange, in all accounting for exports and imports. The volume of currency traded at these auctions has grown and is now approaching one-third of imports. Most countries still in the ruble zone are setting exchange rates consistent with Russia's, and the Baltic states also adopted single exchange rates when they separated their currencies from the ruble.

Russia and the Baltic countries have led the way in reducing direct government participation in trade, abolishing import quotas and licenses, and reducing the number of goods subject to export quotas and licenses. Russia still requires export licenses for fuels and other major earners of hard currency, however, and restrictions and high taxes are likely to persist until the domestic prices of these commodities get much closer to world levels.

Almost all of the Eurasian states have passed foreign investment laws that offer generous tax breaks and protection against repatriation. Kazakhstan and Belarus have been most accommodating to foreign firms seeking investments in their countries, while the Baltic countries are openly encouraging Western participation in privatization. Nonetheless, doing business in these countries remains difficult. Repatriation of profits is either not permitted or difficult, largely because of the weakness of the ruble and new national currencies, and protection of intellectual property rights is weak. Potential investors also are faced with an inadequate banking system and bureaucratic obstacles in negotiating deals, registering joint ventures, and obtaining export licenses.

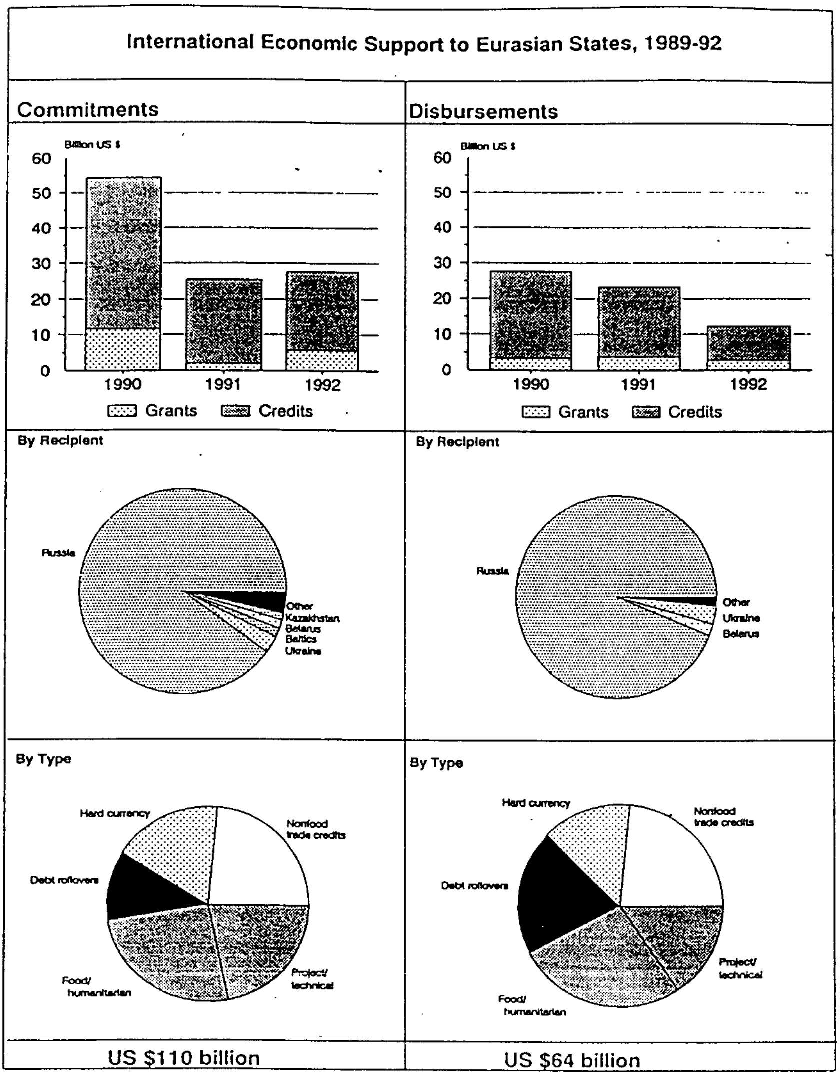
Foreign Economic Assistance Vital

Although most of the effort required for the transition to market economies will have to come from the Eurasian states themselves, foreign assistance can play an important supporting role. To date, such assistance has met critical humanitarian needs but otherwise has had little economic impact on the receiving countries. International commitments of economic support to the Eurasian states in 1990-92 exceeded $100 billion, but only about 60 percent of this amount was delivered (figure 3). Most of the support disbursed consisted of credits rather than grants, and much of it went for deferments and refinancing of debt inherited from the USSR—such as Germany's assumption in 1990 of $10 billion worth of Soviet trade debt to East Germany. Nonetheless, foreign credits and grants accounted for more than one-half of Russia's food imports in 1992, and Russia also received technical assistance in areas such as energy conservation, transportation, and nuclear safety.

Russia—by far the largest beneficiary of foreign support— received about $60 billion worth of assistance during the 1990-92 period, but disbursements fell to a low of about $12 billion last year. Reasons for this decline in disbursements included bureaucratic snags, the wariness of creditors as a result of Moscow's failure to meet repayment schedules, and Russian reluctance to draw on some bilateral trade credits that were tied to unwanted or expensive goods. The major problem, however, was Moscow's failure to meet conditions set by the International Monetary Fund (IMF)—including strict limits on the budget deficit and domestic inflation—for a permanent standby arrangement. This prevented the disbursement of many bilateral credits that were contingent on IMF conditions, as well as of standby loans.

More recently, Russia received additional pledges of support as part of a $43 billion package of assistance announced at the G-7 meetings in April and July. This total includes about $18 billion in old and new aid from multilateral $10 billion in bilateral credits and grants, and $15 billion in Paris Club rescheduling of official debt. Russia's difficulty so far in meeting IMF terms for a standby agreement has prompted easier terms and fewer conditions for much of the new assistance—including nearly $4 billion in grants with no conditions attached. In addition, Russia was offered up to $3 billion from the IMF under a new Systemic Transformation Facility, which is designed to provide cash loans that can be used for any purpose and that are subject to weaker conditions than traditional IMF standby credits. The G-7 package also includes pledges of increased project and technical assistance in areas such as support for small business, energy conservation, improvements in the safety of nuclear reactors, environmental cleanup, and destruction of nuclear weapons.

Figure 3


International Economic Support to Eurasian States, 1989-92
Commitments
Disbursements
Billion US $
60
50
40
30
20
10
0
1990
1991
1992
Grants
Credits
By Recipient
Russia
Other
Kazakhstan
Belarus
Baltics
Ukraine
By Type
Hard currency
Nonfood trade credits
Debt rollovers
Food/ humanitarian
Project/ technical
US $110 billion
US $64 billion

Corruption in Russia: Potential Roadblock to Foreign Assistance

Little Trouble So Far ...

Only a small portion of Western food and medical aid deliveries have been stolen, despite claims to the contrary by Vice President Rutskoy and other opponents of Yel'tsin. Investigations by the Russian Ministry of Internal Affairs and Western donors show that total losses have been only about 2 percent of overall deliveries. Although thefts have occurred at ports and airfields, at warehouses, during transport, and at the point of distribution, careful monitoring by donors and aggressive investigation of losses have prevented more serious problems. Local officials, who can use their position to falsify documents, steal goods, and misdirect aid funds, pose the greatest threat.

Medical aid is most vulnerable to theft because Russia's medicine shortages are widespread and the potential for lucrative resale is huge. In contrast, corruption has had little negative impact on Western technical assistance and credit programs. Bilateral and multilateral technical assistance funds are paid directly to the Western contractors working on specific projects and face minimal exposure to corruption in Russia. Grain bought with Western credits enters Russian Government stocks, and Russian officials are distributing it according to set procurement and distribution plans. Funds for balance of payments support go directly to the Central Bank to finance imports. The Russian press claims, however, that some Russian officials are misappropriating loans to the Russian Government and hiding the funds in personal bank accounts.

... But Potential Problems Loom

New bilateral and multilateral loan programs aimed at stimulating private Western investment could encounter growing problems with corruption. Foreign businesses say corruption, bribery, and Mafia activity have become obstacles to investing in Russia. Requests from Russian business partners and government officials for bribes to ease negotiations and secure required permits are common. Some Western joint ventures have been roped into their Russian partners' capital flight schemes. Illegal exports of raw materials, sometimes with the help of Western firms, are widespread and substantial—about 10 percent of oil exports and about 25 percent of metal exports.

Corruption also could hurt Western projects designed to help fund Russia's privatization program. Reports of back-door deals and special access for former Communist officials have damaged the Russian program's image. In a few cities the Mafia has scared off competing bidders for attractive lots, thereby ensuring it gets the property it wants at below-market prices. Mafia thugs in Chelyabinsk, reportedly in league with conservatives opposed to industrial privatization, have attempted to delay the process through beatings, burglaries, and threats aimed at local privatization officials.

This package is unlikely to be fully disbursed this year; Russia has said it will use only about half of the $10 billion in bilateral credits. However, the first installment of the Systemic Transformation Facility has been granted, following the statement of intent to curb inflation signed by the Russian Government and Central Bank on 24 May. Disbursement of the second installment, however, will be contingent on the implementation of at least some of the promised measures to promote reform and financial stabilization. A full standby arrangement will require still stricter conditions, and a stabilization fund, which could be drawn as needed to support a fixed exchange rate for the ruble, is an even more distant dream. If Russia does manage to lower domestic inflation enough to qualify for such a fund, the main benefit would be a reduction of the financial risks associated with sharp fluctuations in exchange rates. This, in turn, would encourage exports, imports, and foreign investment—which reached only about $300 million last year.

Proliferation Concerns Growing

The economic difficulties facing the Eurasian defense industries as a result of the steep drop in military orders are increasing the potential for the proliferation of special weapons and related technologies. At the same time, the ability of the Eurasian states to maintain control has weakened somewhat under the stresses and strains of the Soviet breakup. Most reports of transfers of nuclear materials appear to be scams, hoaxes, or exaggerations. Similarly, we have no credible reporting that nuclear weapons have left the territory of the former USSR, and we do not believe that nuclear weapon design information has been sold or transferred to foreign states. Some black market transactions in Western Europe have included radioactive material from the former Soviet Bloc, but, so far, we have detected no transfers of weapons-grade material in significant quantities.

The Eurasian states have publicly opposed illegal transfers of technology that would lead to the proliferation of weapons of mass destruction, and we consider it highly unlikely that Moscow would willingly transfer warheads to any outside state. Nevertheless, Russia's growing dealings with Iran and China are of concern regarding proliferation. Moscow is holding civilian nuclear cooperation discussions with Iran, and China is aggressively pursuing agreements with both Russia and Ukraine covering increasingly more sensitive areas of missile technology. Such agreements, besides advancing Chinese missile development, would present China with the opportunity to pass more advanced Russian and Ukrainian technology to other countries, as Beijing has done previously with its own technology.

Despite some indications of high-level political support for effective export controls among the Eurasian states, Moscow's efforts have not yet produced solid results. Legal problems and shortages of personnel and funding are slowing progress. For example, inadequate funding has constrained the hiring of customs officials and limited the training programs that would better enable them to identify sensitive materials and enforce controls. Corruption and the lure of large profits also are hampering efforts to prevent the transfer of sensitive weapons technologies. As a result, unauthorized transfers of weapons of mass destruction technologies and materials could occur.

Economic and nationalist pressures have made questionable Russian and Ukrainian membership in the Missile Technology Control Regime (MTCR). Russian officials now contend that national laws, rather than the MTCR, will govern their exports of missile technology. Despite Russian claims, their regulations are not entirely consistent with the MTCR. Washington and Moscow recently concluded an agreement intended to terminate a Russian transfer of rocket engine technology to India that is inconsistent with the MTCR guidelines. In recent arms shows, the Russians have also advertised a new SCUD warhead with improved accuracy, as well as a derivative of the old SS-23 SRBM for sale as a civilian sounding rocket, raising potential missile proliferation concerns.

Severe economic hardships among individuals with military and scientific expertise could lead many to be tempted by more lucrative work abroad. Tens of thousands of former Soviet scientists were involved in sensitive weapons, and the current emigration and customs bureaucracies cannot monitor more than the most critical personnel. Moreover, a substantial number of former Soviet scientists involved in weapons of mass destruction R&D are of Ukrainian origin, so the risk of leakage and brain drain is not isolated to Russia.

Prospects for More Turmoil

The economic transition on which Russia and the other Eurasian states have embarked will be long, difficult, and complicated by simultaneous political and institutional transformation. Economic hardships already have contributed to changes in government in several countries, and conditions will remain difficult in the near future. Output will continue to decline this year, unemployment will rise, and inflation will remain dangerously high in many countries. These economic troubles will contribute to political controversy over the speed and scope of the transition process and to recurring crises and periodic setbacks for political and economic reform. It is also true that economic ills could erode support for political leaders and form the basis for critical disputes between players jockeying for power.

Russia

Russia has been a leader in economic reform, but the outlook for further progress is guarded. On the political front, the vote of confidence that Yel'tsin won in the 25 April referendum has strengthened his position, and he has begun to move ahead on a new constitution and new legislative elections. Under the existing constitution, however, he is required to obtain the approval of the Congress of People's Deputies for both. But Yel'tsin's proposed constitution would dissolve the Congress in its present form, and many of its members, who won their seats in 1990, probably would not be elected to a new legislature. As a result, hard-liners in the Congress are opposed to the changes Yel'tsin wants. A democratic, peaceful solution to this impasse will be complicated at best, and, as the 1 May protests in Moscow showed, the possibility of violence by elements of the hard-line opposition to Yel'tsin cannot be ruled out.

Continuing Economic Hardship. Even if peace and democracy prevail, no quick economic turnaround is in sight, and controversy over the social consequences of economic reforms will continue to play a key role in Russian politics. The main economic danger at present is inflation, which has been running at rates of 15 to 30 percent per month since last fall. The statement of intent to reduce inflation that the government and Central Bank signed last month as a condition for IMF assistance promises to implement tough austerity measures—including quarterly limits on the budget deficit and Central Bank credit and increases in Central Bank interest rates to near market levels. But previous promises to curb inflation—including promises made to the IMF—have fizzled, and Yel'tsin may well be reluctant to impose austerity if new elections are scheduled soon.

Indeed, Yel'tsin faces a tough dilemma. If austerity measures are implemented, inflation would begin to fall within a few months, although it could rise initially as a result of cuts in subsidies. But the social costs—including widespread bankruptcies and a sharp jump in unemployment—would be high. The resulting increase in the ranks of people who have suffered losses as a result of economic reforms would heighten the political dangers confronting Yel'tsin. In addition, the privatization of large state enterprises, which is likely to lead to further bankruptcies and unemployment as competition begins to increase, probably would become more controversial.

Without austerity measures, inflation would at best continue at roughly its current rate. In this case, output and living standards would continue to decline, although probably more slowly than last year, and unemployment would continue to rise, although not as much as under an austerity program. Moreover, the threat of hyperinflation—price increases of 50 percent per month or more for a prolonged period—would remain high. Unless decisive government action reversed this process, money would lose value so rapidly that ruble payments would be replaced by hard currency and barter transactions, shortages and hoarding would worsen, flows of supplies would diminish, and output and living standards would plummet.

Whatever policies the government pursues, staying the course of economic reforms will be difficult. International economic assistance can ease the burden a little, however, in several ways. Debt rescheduling and offers of new credits will provide additional financing for vital imports, although imports are likely to remain depressed in the near future because of Moscow's concerns over its ability to repay. Rescheduling also will relieve pressure on the Russian budget deficit by freeing hard currency for purposes other than payments on the foreign debt. Perhaps most important, foreign assistance will provide longer term support for economic and political reforms such as privatization and the development of democratic institutions.

Impact on Defense Sector. Political uncertainties and delays in approving a military don protect or increase each of this budget's major components. Defense industry leaders are warning of massive layoffs and losses of production capacity if procurement is not protected, for example, and the published budget includes military procurement in a list of items that are guaranteed full funding. Military officers, whose loyalty is critical, are seeking personnel funds to provide housing and other social amenities and to mitigate the shortage of conscripts by enlisting more volunteers. Nonetheless, the need to curb the budget deficit probably will lead to cuts in Russian defense spending this year.

Top Russian officials, including Yel'tsin, have stressed the continuing importance of arms exports as a means to keep defense plants active, finance conversion, and support military R&D programs. Moscow has stepped up its marketing efforts—for example, during the February 1993 arms show in Abu Dhabi, where Russia displayed close to 370 pieces of its most advanced military equipment. Further efforts to promote arms sales could include cutting prices and licensing more exporters.

Weapons Procurement in the 1990s: A Russian Official's view

Despite the lack of an approved military doctrine, First Deputy Defense Minister Andrey Kokoshin has plunged ahead with setting priorities for weapons procurement and R&D in the 1990s. To better focus limited procurement funds, his strategy concentrates on dual-use technologies and high-technology improvements for systems already fielded, while de-emphasizing production of major new weapons. In addition, the variety of weapons purchased is to be sharply reduced; this is already occurring in almost every major category of weapons system. Kokoshin has also indicated that Russia will sharply reduce the number of plants producing armaments. Implementation of this strategy will be strongly contested by these defense industrialists who stand to lose military orders, but fiscal constraints may force even larger cutbacks. Moreover, the growing diversity of interests within the defense sector—stemming from the varying prospects for defense orders, exports, conversion, and privatization—will complicate, if not derail, the pursuit of a coherent defense industrial policy.

Nonetheless, arms exports have fallen far short of expectations and will continue to be limited by the shrinking global arms market, fierce international competition, and concerns about Moscow's reliability . Hard currency sales of arms brought the Soviet Union about $5 billion annually in the mid-1980s, but Russia probably earned only about $1 billion in hard currency from arms sales last year. As in recent years, China, India, and countries in the Middle East are likely to be the biggest buyers of Russian arms. China, for example, received 26 Su-27 Flanker fighter aircraft last year and this year is receiving SA-10 SAMs; Iran received a Kilo-class diesel submarine last year and is slated to receive another this year.

Pressure on defense plants to convert to civilian production will continue to grow this year as low military orders and poor prospects for arms sales provide few alternatives. The government's recently approved conversion program for 1993-95, along with decisions to grant preferential loans and tax breaks to promote conversion, should facilitate the process. A major thrust of this program is to channel defense plants to support 14 priority civil areas, including energy, civil aviation, and production of processed food and other consumer goods. Progress on conversion is likely to remain slow, however, because of the lack of adequate funding and the difficulty of managing the process from the center.

Nonetheless, privatization of medium and large state enterprises will boost conversion by loosening the state's grip on production and by encouraging firms to become more efficient and responsive to customers. Following his victory in the April referendum, Yel'tsin has redoubled his efforts to push privatization of the defense sector. Russian officials have announced that 90 to 95 percent of defense enterprises will either be privatized or begin the process by 1995. Many old-line defense industrialists, however, fearing that privatization will weaken their power and perhaps force their firms into bankruptcy, are still seeking to slow implementation of the voucher privatization program.

Defense Conversion Outside Russia

The Ukrainian leadership lacks both a coherent strategy and the financial resources needed to implement conversion. Because the leadership has not yet decided which weapons programs and plants it wants to retain, most defense enterprises lack military orders but are unable to convert production. Meanwhile, Ukrainian defense plants have been hit hard by deep cuts in Russian weapons orders and disruptions in supplies and components previously provided by Russian defense enterprises. Ukraine's efforts to support conversion through arms exports and attracting foreign investment have met with little success.

Conversion efforts in other countries have lower priority to their governments and have progressed even more slowly than in Russia and Ukraine. Belarus is hoping to develop a high-tech civilian economy around converted defense industries that specialized in computers and electronics. Outmoded designs, poor quality, and antiquated production facilities, however, have limited the appeal of Belarusian products. Kazakhstan, while publicly endorsing conversion, has devoted far greater attention to the development of its abundant natural resources, such as oil, gas, and nonferrous metals.

Ukraine and Belarus

Prime Minister Kuchma of Ukraine recognizes the need for tough austerity measures, including clamping down on credits and reducing subsidies to inefficient enterprises to rein in inflation, but his government lacks the authority to implement such policies. With a referendum on the legislature and the president scheduled for September, it is likely that the conservative legislature and President Kravchuk will not only resist any austerity measures but will continue to pursue inflationary policies such as Kravchuk's decision in early July to issue sizable new credits to state-owned farms.

The economic and political consequences of hyperinflation would be severe. Tax revenues would be difficult to collect, forcing the government to continue creating money in order to finance its deficit, economic output would plummet, and barter trade would proliferate. As living standards erode, support for the current political system would evaporate. Prospects for large-scale social unrest would increase and could bring new threats of regional separatism. In the russified east, the movement to form an economic union with Russia would gain strength. The combination of unrest and regionalism resulting from a long period of hyperinflation would ultimately jeopardize Ukraine's viability as an independent state.

Belarus continues to take a slow approach to economic reform, maintaining the extensive state orders for output and generous credits that have limited the decline in production so far. The legislature has approved a program for small-scale privatization but voted down a program for the voucher privatization of larger enterprises. Nonetheless, Belarus has attracted some foreign capital on the strength of its liberal foreign investment law and stable political environment. Economic hardship is likely to increase this year, as imports of Russian fuel decrease in volume and increase sharply in price.

Baltic States

The Baltic states are leaders in most aspects of political and economic reform. All three countries have held post-Soviet elections, all liberalized most prices in 1991, and Estonia and Latvia have reduced inflation to monthly rates below 3 percent. Private ownership of small business and housing has expanded rapidly in all three countries—with Lithuania in the lead—although land privatization has been bogged down by conflicting claims of prewar owners. The new government in Lithuania placed privatization on hold in December 1992, largely in response to charges of corruption, but has promised to resume it soon. Meanwhile, Estonia, with the help of the German Treuhand agency established to sell off East Germany's State Enterprises, began to auction off large businesses in December 1992.

Thanks to their progress so far—including the reorientation of much of their external trade toward the West—all three Baltic states are likely to see some relief from the sharp declines in output that they suffered last year. Unemployment is likely to rise substantially, however, especially among the ethnic Russian populations of Estonia and Latvia.

Kazakhstan and Central Asia

Kazakhstan and Kyrgyzstan continue to lead economic reform efforts in the Central Asian region, but both lag behind Russia. Both countries have liberalized most prices and launched relatively ambitious programs for the privatization of small-scale business, agriculture, and housing. To date, Kazakhstan has been more successful than Kyrgyzstan in limiting its budget deficit and attracting foreign investment, including the recently signed agreement with Chevron to develop the Tengiz oil field. In May, Kyrgyzstan became the first Central Asian country to reach a standby agreement with the IMF and, as part of that agreement, to introduce a separate national currency.

Turkmenistan and Uzbekistan, in contrast, have made clear their intentions to approach economic reform gradually. Both appear to be counting on relatively abundant natural resources— such as gas in Turkmenistan and nonferrous metals and cotton in Uzbekistan—to provide exports and attract foreign investment. Nonetheless, Uzbekistan has made some progress in privatizing housing and retail stores and in encouraging the formation of small private farm plots. Tajikistan, after nearly a year of armed conflict, has just begun to turn more attention to economic matters.

Kazakhstan and the Central Asian countries will continue to face declining output and begin to experience rising unemployment this year. These troubles will be complicated by the relatively high degree of poverty and underemployment in all countries except Kazakhstan. Nonetheless, all of these countries have made some progress in reorienting their trade to the outside world. All but Tajikistan increased their hard currency exports last year, and all but Kyrgyzstan are now registering export surpluses in their hard currency trade.

Moldova and Caucasian States

After several months of preoccupation with armed conflict over the status of the Dniester region, Moldova has begun to move forward with economic reform. The privatization of state enterprises for vouchers is slated to begin this year, and collective farms are to be reorganized, with provisions for members who choose to leave the collectives to receive separate plots of land. Moldova is likely to face a continuing decline in output this year, albeit at a slower rate than last year if peace prevails. This small country remains highly dependent on energy imports, mainly from Russia, and sharp increases in energy prices will be damaging.

The economies of the Caucasian states continue to suffer greatly from the undeclared war between Armenia and Azerbaijan and from civil strife in Georgia. Armenia and Georgia have managed nonetheless to make considerable progress in privatizing agriculture and housing. With foreign investment, Azerbaijan could develop a successful oil industry, but substantial investment is not likely until the conflict with Armenia is resolved and the internal political situation stabilizes.

Percent change

Appendix Table 1

Russia and Eurasia: Growth of National Income Produced by Country, 1981-91

	Average Annual	Annual						
	1981-85	1986	1987	1988	1989	1990	1991	1992 Preliminary
Russia	3.0	2.3	1.4	4.5	1.6	-4.0	-11.0	-20
Ukraine	3.4	1.5	3.7	2.0	5.0	-3.6	-11.2	-16
Belarus	5.3	4.3	2.7	1.2	8.2	-2.4	-1.9	-11
Moldova	2.8	7.9	1.2	1.8	8.8	-1.5	-18.0	-21
Kazakhstan	0.9	1.7	-0.2	8.6	-0.1	-0.9	-10.3	-14
Kyrgyzstan	3.7	0.9	1.4	12.9	4.5	4.8	-5.2	-26
Tajikistan	2.6	3.5	-1.2	13.9	-6.5	0.2	-8.4	-31
Turkmenistan	2.2	4.5	4.0	10.8	-7.0	1.8	-4.7	-15
Uzbekistan	3.0	-0.2	0.5	9.7	3.1	4.3	-2.4	-13
Armenia	5.5	1.9	-3.3	-2.4	8.4	-8.2	-11.4	-43
Azerbaijan	4.4	1.9	4.4	4.4	-8.9	-11.3	-0.4	-28
Georgia	4.8	-0.8	-0.6	6.0	-2.4	-12.1	-23	-46
Estonia	2.8	3.4	2.0	4.6	7.0	-10.4	-11	-32
Latvia	3.3	4.3	-2.4	6.8	7.1	-1.5	-8	-33
Lithuania	4.3	5.8	-0.1	9.2	3.3	-5.5	-10	-35

Sources: Statistical Committee of the Commonwealth of Independent States, Strany-chleny SNG: Statisticheskiy yezhegodnik (Moscow, Finansovyy inzhiniring, 1992), p. 538; and reports of individual countries.

Percent change

Appendix Table 2

Russia and Eurasia: Growth of Industrial Output by Country, 1981-91

	Average Annual	Annual						
	1981-85	1986	1987	1988	1989	1990	1991	1992 Prelim-inary
Russia	3.3	4.5	3.5	3.8	1.4	-0.1	-8.0	-19
Ukraine	3.4	4.2	3.9	4.1	2.8	-0.1	-4.5	-9
Belarus	5.3	6.7	6.7	6.3	4.6	2.1	-1.5	-9
Moldova	4.4	2.6	5.0	3.3	5.7	3.2	-7.0	-22
Kazakhstan	3.4	5.1	4.3	3.7	2.5	-0.8	0.7	-15
Kyrgyzstan	4.6	4.3	1.4	6.8	5.2	-0.6	0.1	-27
Tajikistan	3.7	1.7	5.0	5.5	1.8	1.2	-2.0	-24
Turkmenistan	2.6	4.8	3.1	4.3	3.3	3.2	4.1	-17
Uzbekistan	4.5	5.6	2.5	3.3	3.6	1.8	1.8	-6
Armenia	5.7	4.5	4.7	-1.1	-8.3	-7.5	-9.6	-53
Azerbaijan	4.4	-2.0	3.7	3.4	0.7	-6.3	3.8	-24
Georgia	4.0	2.3	2.5	3.2	0.7	-5.7	-19	NA
Estonia	2.8	3.8	3.0	3.1	0.7	0.1	-9.0	-39
Latvia	3.3	3.7	4.2	3.5	3.1	-0.2	0.0	-35
Lithuania	4.5	4.8	4.6	5.7	4.2	-2.8	-1.3	-52

Sources: Statistical Committee of the Commonwealth of Independent States, Mir v tsifrakh (Moscow, Finansovyy inzhiniring, 1992), p. 152; and reports of individual countries.

Percent change

Appendix Table 3

Russia and Eurasia: Growth of Agricultural Output by Country, 1981-91

	Average Annual[a]	Annual						
	1981-85	1986	1987	1988	1989	1990	1991	1992 Prelim-inary
Russia	1.0	6.7	-1.2	3.2	1.7	-3.6	-5	-8
Ukraine	0.5	2.2	2.2	-1.6	5.1	-3.7	-12	-11
Belarus	1.6	6.9	0.1	-7.3	8.9	-8.7	-3	-6
Moldova	1.3	10.1	-4.3	0.6	5.2	-12.8	-11	-18
Kazakhstan	0.1	12.6	-2.6	4.4	-7.3	6.8	-8	-0.2
Kyrgyzstan	1.7	7.9	1.5	4.1	2.5	1.3	-8	-14
Tajikistan	1.7	3.7	-7.0	9.4	-10.8	2.8	-10	-45
Turkmenistan	2.2	-1.8	5.0	8.6	0.3	7.0	-2	-5
Uzbekistan	2.0	-2.0	0.3	8.8	-4.3	6.3	-5	-5
Armenia	2.6	3.3	-6.9	1.4	-18.7	-11.4	11	-10
Azerbaijan	5.2	-2.0	-1.0	-3.2	-8.9	1.0	0	-30
Georgia	2.5	4.5	-6.8	3.5	-15.5	6.9	NA	NA
Estonia	0.8	7.1	-2.6	-3.7	7.6	-13.1	-16	-23
Latvia	2.3	5.5	-1.7	-1.5	3.9	-10.2	-4	NA
Lithuania	1.3	4.6	0.0	2.4	1.8	-9.0	-4	-40

[a]Average annual increase in sum of output during 5-year period shown over sum during previous 5-year period.

Sources: Statistical Committee of the Commonwealth of Independent States, Mir v tsifrakh (Moscow, Finansovyy inzhiniring, 1992), p. 312; and reports of individual countries.

PREPARED STATEMENT OF CHRISTINE WILLIAMS

The Economies of Russia and the Former Republics: Progress and Pitfalls

Good morning, Mr. Chairman. Let me begin by saying what a pleasure it is to be here on this twentieth anniversary of our first JEC testimony. We are proud of our record of supporting the work of this committee and the Executive Branch during the years of the Cold War; we alerted you to the growing decay of the command economy, the widening technological gap with the West, and the heavy burden of the defense sector that relegated Soviet citizens to third-world status.

Now we are analyzing the dramatic changes underway in Russia, Ukraine, and the other new states as they undergo three simultaneous revolutions—the turn away from the command economy toward the creation of markets, the repudiation of their totalitarian political system and the construction of new political institutions, and the disintegration of the Soviet empire and the creation of new relationships among successor states.

Since Gorbachev set this process in motion, Russia and its neighbors have seen dramatic changes for the better. These have had a great and favorable impact on US interests and hold substantial promise for creating a more secure and stable world order.

But these revolutions will take years and possibly decades to unfold. Instability will be commonplace and there is considerable uncertainty about the outcome. While we hope to see democratic governments and market economies evolve from these major changes, the West remains concerned about the dangers inherent in this transformation process. At present, it is the weaknesses of the new states that present worrisome threats.

- The four nuclear States—Russia, Ukraine, Kazakhstan, and Belarus—retain nuclear weapons, and the danger of proliferation will be substantial in the face of continuing political and economic instability. The risk associated with the possible sale of nuclear materials, as well as Russia's open marketing of arms to earn much-needed hard currency, further complicates the quest for a more secure world.
- Crises and dangers abound around Russia's periphery and in its relations with the 14 former Soviet republics. Conflict and violence in all three Caucasian states, Moldova and Tajikistan bear careful monitoring, and there are dangers in tensions between Russia and Ukraine. The breakaway republics are inevitably forming new alliances with neighbors and like-minded states that might strengthen regional powers unfriendly to U.S. interests.
- Economics will play a major role in this process of change—affecting struggles for political power, the creation of stable governments, the staying power of political leaders, the military capabilities of the new states, and the attitudes of the people toward their leaders.
- A key question is whether aid—and in what amounts and in what forms—will have a positive impact. In any case, aid will absorb U.S. and Western resources at a time when many of these economies are in recession.

In last year's testimony we focused on the first steps that Russia and the other new states had taken on the long and painful road to marketization and democratization. This year we want to look at how far they have come along this road and how much farther they have to go. We also want to emphasize that our assessment of the economic situation is inextricably linked with the outcome of political power struggles and the creation of new sovereign bodies.

Let me say a word first about how the new situation presents new analytical challenges. The virtual collapse of the old command economic system requires us to track both the dismantlement of old institutions and the building of new ones. And we will continue to ask about what is really happening in these economies. For example, to what extent are they pushing ahead with reforms? What remnants of the old bureaucracy and other impediments to efficiency are getting in the way? What impact are reforms and stabilization programs having on economic performance and the welfare of the people? To what extent is Western aid and support making a difference?

These issues require us to adopt new approaches—some of which have been applied to the study of less-developed countries engaged in reform and structural change. And we can benefit from the explosion of new information on these countries as they have begun to publish more information and statistics and have joined international institutions.

Now let me begin recounting the tremendous strides that Russia has made over the past year and a half in reforming its economy:

— Prices have been freed on more than 90 percent of its goods and services, allowing them to provide for the first time a valid guide to investment, production and consumer decisions.

— The old centralized distribution system has been virtually eliminated, forcing enterprises to seek suppliers and customers through the market.

— Reduced demand for the products of heavy and defense industries have heralded the beginning of a reorientation toward consumer needs and export markets.

— The explosion of free enterprise has resulted in an emerging private sector that we estimate now constitutes almost one-quarter of all goods and services produced.

— The privatization of large industrial plants has just gotten underway, and is off to a good start- -shares in some 1800 factories have now been sold. The issuing of 10,000-ruble vouchers to every man, woman and child gives all Russian citizens a stake in this process.

The death of the old system and the birth pains of the new had a severe impact on economic performance last year that has continued into the present. Industrial output declined by about 19 percent in 1992 and by 19 percent again the first quarter of this year compared with last, leaving industry at about 60 percent of its peak size in 1989.

— First, the collapse of the old state supply system and the breakup of the union—that had been by design tightly integrated- -was devastating. The volume of trade among Eurasian states declined by as much as one- third in 1992 compared with the previous year.

— Second, Russia's trade with the outside world, particularly with East European countries that were finding more profitable markets, fell by some 25 percent in 1992. The decline in imports was held to manageable levels only by foreign grants and credits.

— Third, government orders for military hardware were reportedly down by as much as 70 percent last year. Investment spending by the government also plummeted by half. The decline in demand for these two categories of goods was responsible for a large part of the industrial decline.

— Lastly, living standards clearly deteriorated as consumer prices increased much faster than wages and other personal incomes. Average real wages were about one-third lower last year than in 1991, placing 35 percent of all Russians below the official poverty line.

Concern over poor economic performance and the threat of unemployment and social unrest led the legislature and the government to loosen the reins on spending in the second half of 1992. This resulted by yearend in a budget deficit of about 10 to 15 percent of GDP and massive credit extensions to enterprises and the former republics that boosted inflation to about 30 percent a month. Fear of hyperinflation resulted in some spending cutbacks, reducing inflation to about 17 percent in April and May. But government spending began to rise sharply in the spring in part due to pre-referendum promises made by Yel'tsin and the legislature. Inflationary pressures remain high, and the rate could easily climb back up to 20-25 percent or beyond.

The non-Russian states have suffered similar economic fates over the last year, with most fighting a losing battle against inflation and production declines. The Baltic countries are the exception, with all of them making major progress in promoting the development of the private sector, creating market-oriented laws and institutions, and restructuring their foreign trade toward Western markets. Estonia and Latvia have introduced stable currencies and are bringing inflation under control. At the other end of the scale, ethnic and civil strife have severely disrupted economic performance and reform in Armenia, Georgia and Tajikistan, while conscious policy decisions have been made to go slow on reforms in Turkmenistan and Uzbekistan.

Economic progress in Ukraine, because of its strategic position, the status of nuclear weapons there, and its resource base, has great import to US interests. Resistance from old-guard forces in industry and parliament and social costs have kept Ukraine from wholeheartedly embracing reform. Now its constitutional crisis, which is on the scale of Yel'tsin's, has brought gridlock in economic decisionmaking that is pushing it closer to hyperinflation than in any other former republic. Recently, the factionalized legislature increased the minimum wage by 150 percent, tripled minimum pensions, asked the government to index savings accounts, and initially refused to raise prices to meet rising energy costs-thereby fueling inflation that was already rising by an average monthly rate of 41 percent during the first quarter of this year. The extent of the populace's concerns about economic conditions is demonstrated by this week's strikes to protest food and fuel price hikes.

Looking ahead, we see great dangers and challenges: economics and politics remain inextricably linked. In Russia, for example, critical economic decisions await some resolution of the constitutional crisis that has wracked the country for months. The current impasse between President Yel'tsin and a congress dominated by old-guard legislators may be resolved, at least partially, at the constitutional conference now meeting in Moscow. If the conference approves a draft constitution that enhances the President's powers and comes up with a ratification method that has the clear support of most of the delegates, Yel'tsin may be able to get a new constitution in place and hold a new legislative election this year. Even then, however, newly-elected deputies will be reluctant to vote for tough austerity measures that will take the country to the next stage of reform and its associated higher unemployment.

If Yel'tsin fails to bring the constitutional convention to a successful conclusion, this would prolong and deepen the political crisis. If power shifts in favor of the legislature, the wrangling between centrists and hard-liners over personnel appointments and overlapping responsibilities would make policy decisions erratic and even contradictory. Reformers in the cabinet almost certainly would be replaced, and progress on privatization and other economic reforms would be slowed.

The economic choices will not get easier. The two major options look equally unpalatable. The first, often characterized as "shock therapy," would combine rapid movement toward a market economy with strict monetary and financial discipline. This option would lay the best foundation for an eventual resurgence of economic growth in the longer term, but the short-term impact would be a sharp rise in unemployment. To choose this option would risk a political confrontation with old-guard industrialists who favor more gradual reforms, as well as major social protests from those adversely affected by reduced social spending and increased unemployment. The alternative—more likely if Yel'tsin is pushed aside—is a more gradual approach to reform combined with a continuation of subsidies to inefficient firms and increased social spending. This would mean less unemployment in the short run but increasingly high inflation rates, raising the specter of hyperinflation and eroding chances for a return to stable and positive growth.

This dilemma is the one now sharply posed by the strings the IMF has attached to releasing the first tranche of the $3 billion systemic transformation loan. In order to qualify, the Russian government and Central Bank have signed an accord that promises to reduce inflation to single digits per month by yearend by phasing out credits to enterprises and regions and by holding the 1993 budget deficit to under 10 percent of GDP. This will be accomplished by reducing subsidies on grain, coal, and imports and by abolishing tax exemptions. Political pressures will obviously make it difficult to live up to many of these promises. Thus far neither the government nor the parliament have been willing to accept the consequences of such an austerity program that would bring bankruptcies and a sharp rise in unemployment.

The difficulties facing a reform-minded Russia will be great even in the best of circumstances, but they are unavoidable if progress is to be made. We emphasize that there is some light at the end of the tunnel, and it is not an approaching train.

— 1. A necessary corollary of economic transformation is wrenching, painful change. The late Sovietologist and former NSC Director Ed Hewett often said that an economic downturn can be proof that good things are happening.

— 2. Such a major transformation will take at least a generation to complete because of the need to develop the kind of psychology and commercial infrastructure under which a market system can flourish.

— 3. Despite the hardship on the Russians' lives created by this transitional phase, the April referendum has proven that the Russian people believe they are on the right track and are willing to tolerate even more.

— 4. Overall, we can expect the reform process to move in fits and starts. At the same time, the chances for a return to the old political and economic systems are becoming increasingly remote because of growing power at the local level, coupled with the reduced ability of the center to impose its will, and a greater stake by workers, managers and the elite in the new system.

— Finally, although most of the resources for the transition must come from the countries themselves, the West can make a difference. The political support for change shown by Western nations has been of incalculable value to the morale and steadfastness of Russian democrats and reformers. Technical assistance is helping them to move further

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along the learning curve. And the credits and other aid provided have allowed for greater imports and at least some easing of the plight of many Russians.

Thank you.

PREPARED STATEMENT OF WILLLIAM GRUNDMANN

It is my pleasure to offer a defense intelligence assessment of military-economic developments in Russia and the new states of Eurasia after their first full year of independence. As in past defense intelligence testimony, I will focus my attention on mtlitary dimensions of the economy. In particular, I will address the formation of new militaries, defense spending, weapons production, conversion, arms sales and proliferation.

The governments of the USSR successor states are still struggling to define national priorities, build new political institutions, and reform and revitalize their weakened economies. Inherent in all these processes are uncertainties about the future role of the military. The fundamental question facing the new governments is what kind of military and defense industrial structures are compatible with new geopolitical conditions, threat perceptions, and economic capabilities.

Forming New Militaries

I will begin with our assessment—a survey—of efforts by the successor states to form new militaries:

Russia, heir to the lion's share of the Soviet armed forces, faces the greatest challenge in transforming the military into an institution compatible with new geostrategic realities. Russia's immediate security concern is the potential for internal and regional conflict. Russian forces are involved to varying degrees in conflicts in Tajikistan, Georgia, Moldova, and the Russian Federation itself. The Russian Ministry of Defense (MOD) is developing forces for these new security concerns, including rapid reaction and peacekeeping troops. A fundamental debate continues among radical reformers, moderates, and conservatives over the degree to which Russia needs to retain and further develop large-scale warfare capabilities. The Russian MOD continues to consider the U.S. and Nato as benchmarks for planning and evaluating force development.

One of Moscow's first tasks is to consolidate its forces onto Russian territory. some 250,000 military personnel remain outside the country. Russia is committed to returning all troops by 1995, and withdrawals are proceeding on or ahead of schedule. In the Baltic states, Russia signed an agreement to withdraw forces from Lithuania by this August. Negotiations with Latvia and Estonia, however, have been complicated by Moscow's concern over the status of ettnic russians in both countries as well as insufficient housing in Russia for returning troops. Nevertheless, forces are actually continuing to leave all three Baltic states. To the south, Azerbaijan last month became the first former republic to secure total withdrawal of Russian forces.

A major hurdle in returning the forces is a shortage of housing, motor parks, and support facilities. Even with Western help, housing construction is not keeping pace. Defense Minister Grachev has said it will take until 1997 to alleviate military housing shortages. Withdrawals are but one component of three ongoing processes—reductions, reorganization, and restationing.

Russia is making deep reductions in weapons and personnel strengths in response to economic constraints, a reduced manpower base, CFE treaty limits and changing force requirements. Manning has declined to less than 2 million. The Russian legislature capped military manpower at 1 percent of the population—about 1.5 million—by 1995. Indeed, Defense Minister Grachev said recently that manning will fall below 1 million.

Forces are being reorganized as they are reduced. Ground forces, for example, are evolving from the heavy army and division structure to smaller, more efficient and flexible corps and brigades. At the same time, the most modern weapons and equipment are being consolidated in remaining units. for instance, all Western border military districts now possess modern T-80 tanks.

Russian forces are also being restationed to compensate for the loss of forward bases, airfields, and logistics networks in the forward area of the former Warsaw Pact and Western USSR. For example, the north Caucasus military district, once a military backwater, will see an increase in ground forces by more than 50 percent this year. The buildup, including upgrades of air defense, combat strike aircraft' and internal troops, reflects Russia's intense concern with instability to its south and strained relations with Ukraine in the West.

A complex of problems has caused the readiness of conventional forces to fall dramatically. These include acute shortfalls of conscripts and junior officers; low morale and worsening corruption in the officer corps; lack of funds, supplies, and spare parts; and inadequate training and infrastructure. Readiness is expected to reach its ebb about mid-decade. There could be gradual improvement in military readiness with the completion of ongoing force redeployments and the potential beginnings of economic recovery. To alleviate manning problems, the Russian MOD is attempting to accelerate the introduction of a mixed conscript and contract manning system, thus far achieving limited success.

Despite low readiness overall, Russia is trying to develop a core of combat-ready units. For example, the MOD is attexpting to maintain about one-third of its units—the historic norm—at a ready level with at least 50 percent manning. The military has also completed its most ambitious training cycle since the summer of 1991. While no large-scale field exercises have been held since 1991, the forces are practicing missions that emphasize smaller, more mobile units capable of reacting to crises in the former Soviet Union.

In the strategic arena, Russia is maintaining potent capabilities while streamlining the force to dramatically reduce treaty-accountable and obsolete weapon systems. Strategic nuclear forces will continue to be a high priority into the next century as weapons are consolidated in Russia. Although these forces belong nominally to the commonwealth of independent states, the Russian General Staff continues to exercise effective command and control, notwithstanding Ukraine's assertion of ownership over strategic forces on its soil.

Now turning to **Ukraine's** military force developments, Kiev took control of some of the most modern ground and air forces from the dissolving USSR. The Ukrainian MOD is moving to restructure and redeploy its forces to reflect new security concerns over Russian intentions and instability in Moldova. Ukraine's mod is facing conscription shortfalls, tensions between Russian and Ukrainian officers in its units, and discontent over lack of housing. The armed forces, numbering more than 400,000, are expected to be reduced to 200-250,000 over the next several years.

Ukraine and Russia have a full agenda of political-military disagreements to settle. These include disputes over division of the Black Sea fleet and ownership and ultimate control of strategic nuclear forces. The latter dispute is fed by Ukrainian anxiety over Russia's conditional recognition of its borders and calls by some Russian Government officials for reexamination of the status of Crimea. Economic differences—for example, over the level and price of Russian oil and gas exports to Ukraine—also are clouding relations.

In **Belarus**, the other significant military power of the newly independent states, the government has neither the desire nor capability to maintain an inherited force of about 145,000. It is currently downsizing and restructuring the military. In contrast to most successor states, Belarus has agreed on a new military doctrine, which states an intention to be neutral and nuclear free. Mensk signed the start treaty and the nuclear nonproliferation treaty, agreeing to return nuclear forces on its territory to Russia. Despite declared neutrality, significant actors in the government favor closer military ties with Russia. Mensk has entered into a 5-year agreement with moscow on coordinating military activities.

To the south, the **Central Asian States** have all claimed jurisdiction over former Soviet forces on their territory. Lacking resources and experience, they are moving slowly to form independent militaries. Russia retains de facto and in many cases de jure control of former Soviet forces in the region. The Central Asian States envision continued defense cooperation with Russia.

Other successor states also have established only rudimentary militaries:

— **Moldova's** efforts are hindered by the conflict in the breakaway eastern dnestr region, as well as financial constraints and a shortage of officers.

— The **Baltic States'** fledgling forces possess only a limited capability to secure the borders and provide some police functions.

— The militaries of the three **Transcaucasus States** are small, poorly organized, and focused on ethnic and territorial disputes such as the conflict over the Nagorno-Karabakh region.

DEFENSE SPENDING

After peaking in 1988, Soviet defense spending fell about 25 percent through 1991. Following the breakup of the USSR, Russia continued to reduce military outlays. Cuts were concentrated in weapons procurement, affecting virtually all weapon types. Spending on research and development (R&D), personnel, and other activities also fell. Russian defense spending in 1992 was roughly half the 1991 total for the Soviet Union.

About half the 1992 decline represented the loss of the other republics, which began to take over funding of their own militaries at much reduced rates. Most of their budgets are directed toward personnel-related costs, with very little spending for procurement or R&D. In the Caucasus and Tajikistan, however, increased defense spending on the conflicts in those regions is further straining fractured economies.

For 1993, Russia plans to hold its defense budget at the 1992 level in real terms. procurement is slated to rise 10 to 30 percent. The exact increase is unclear from Russian data. This increase represents a victory for the persistent arguments, especially by industrialists, that cuts have gone too deep too fast, threatening massive unemployment and loss of manufacturing capabilities. The 1993 state budget published last week includes military procurement in the list of protected items for which full funding is approved regardless of revenues.

Military R&D budget outlays will fall again in 1993; however, the large science budget as well as off-budget funds to preserve scientific capabilities and develop dual-use technologies could offset much of the R&D decline. Military leaders are more concerned with R&D for future weapons and system improvements than with procuring large numbers of current weapons. The main thrust of military-technical policy is toward creating forces with greater mobility, firepower, and improved command, control and communications systems. This strategy calls for protecting the R&D structure to ensure development of core technologies and programs necessary to meet future military requirements

WEAPONS PRODUCTION

The pattern of declining military production continued during 1992. Output in many weapon categories dropped 50 percent or more last year. (This trend is indicated in the accompanying table.) Even with these large declines, some weapons—tanks and certain fighter aircraft, for example—were produced in excess of domestic or foreign orders. While some plants idled military production lines and furloughed workers, other factories continued to produce arms to keep plants running and workers occupied, sometimes at plant managers' initiative and sometimes with government orders.

Some cooperation continues between Russia and the other new states. Belarus and the Central Asian states, in particular, are trying to preserve their supplier role to Russia. In mid-January, Ukraine and Russia signed agreements to restore cooperation in virtually all areas of military production. These agreements, despite the tensions between the two countries, reflect concessions to the reality of the integrated, mutually dependent defense industrial sector in the former Soviet Union. as long as antagonisms exist in the political sphere, however, Ukraine and Russia will attempt to lessen their mutual reliance over the long run. Ukraine, for example, is seeking to expand defense industrial contacts with Eastern Europe.

DEFENSE INDUSTRY CONVERSION

The USSR successor states have made only limited progress in converting defense plants to civilian production. In Russia, which inherited about three-fourths of the former Soviet defense industrial base, many plants used the state's limited conversion assistance last year to meet payrolls and avoid unemployment. Some Russian officials claim about 600,000 defense workers were released in 1992. As in the previous year, however, a large portion probably remained on the payrolls, accepting shorter workweeks and extended leave at reduced pay.

Regional leaders are increasingly questioning Moscow's ability to manage and fund conversion. Some regions and cities are developing their own programs, a trend that is likely to continue. Many managers and officials have concluded that arms exports are the best answer to defense plants' financial problems.

Last week the Russian Government unveiled a new conversion plan for 1993 to 1995 which provides for a significant level of funding, both from the state budget and bank lending. The key, however, will be how the funds are used. For 1993, more resources appear to be allocated to preserving production capacities than to actual conversion. Last year's experience showed that even funds targeted for real conversion often were redirected to other uses.

Privatization of defense industries is in its infancy. In Russia, defense enterprises have begun to incorporate as joint stock companies, but in most cases the government or existing management will retain controlling interest at least for 3 years. Much remains to be settled in terms of what plants will be allowed to privatize, the degree and forms of state involvement, and the allowance for foreign ownership or partnership.

The intention over the longer term to downsize and restructure the defense sector is a widely shared policy goal. Nevertheless, few of the necessary hard choices have been acted on regarding which defense industries to retain and which to convert or close. Nor is there agreement on the kind of defense industrial structure Russia can realistically expect to support in the future. Among Russian industrialists' more ambitious visions is the creation of large holding companies, adapted from the model of Asian market economies, that can diversify into a range of civilian and military products and serve as "locomotives" for economic growth.

Ukraine and Belarus, representing respectively some 15 percent and 5 percent of the defense industrial base, have developed ambitious conversion programs that count heavily on Western assistance and funding from military exports. Ukraine offers tax advantages and other incentives to foreign investors, but still has some way to go to create an attractive investment climate and business infrastructure. Belarus wants to develop a high-tech economy centered abound computers and electronics. Both countries are farther along than russia in some respects but still face daunting problems.

ARMS EXPORTS

The value of the former USSR's arms exports plummeted from a high of over 20 billion dollars in the late 1980s to some 6 billion dollars in 1991. In 1992, arms exports from all the former Soviet republics fell to 2.5 billion dollars, with about 1 billion in hard currency earnings. Russia accounted for more than 90 percent of the total. Ukraine was the only other state to export major equipment, and that was in cooperation with Russia to fulfill existing Soviet contracts.

Much of the decline results from discontinuing the Cold War motivated arms deliveries to poor Third World client states, such as Afghanistan, Angola, Ethiopia and Nicaragua, which in the past received weapons free or at deep discount. In addition, generous loan and barter programs with major recipients such as India and Syria were replaced by demands for cash payments. Some of the lost trade came from compliance with UN arms embargoes, particularly against Iraq and Libya. Russia and Ukraine now view arms sales as a means to avoid unemployment and to fund imports, military housing, and defense industry conversion as well as the development of new weapons. They simply can no longer afford to subsidize clients.

Russia and Ukraine are making concerted efforts to find new cash-paying customers, particularly in the Middle East and Asia. They have begun to market variants of their most advanced weapon systems. In addition, both countries have high hopes of commercially exploiting their strategic ballistic missile know-how to penetrate the space launch vehicle/booster market, in some cases in partnership with each other.

China is now Russia's most important arms customer. Beijing received 26 SU-27/flanker aircraft last year, signed a contract for SA-10 air defense missile systems, and is negotiating for other weapons. Iran's another important customer, received the first of three kilo submarines in 1992 and will probably accept a second later this year.

The arms sales push has had only limited success. The sale of 450 BMP-3 infantry combat vehicles to Abu Dhabi was Russia's only successful breakthrough against Western suppliers. One obstacle is the poor image of Soviet- or Russian-made weapons after the Gulf War, which Russian exporters are trying hard to dispel at international arms exhibits. The problem, however, stems more from russia's reliability as a supplier. Many potential buyers are concerned that they will not be able secure spare parts and after-sales support.

Moscow is now willing to include the transfer of production technology for key components to boost sales. However, exports will not return to the high levels of the past with the current decline in international demand for arms. new orders, particularly for hard currency, will be crucial to the survival of some plants. Nevertheless, foreign sales alone cannot sustain the current size of the defense industrial sector.

Foreign military sales have become a highly sensitive issue for russian leaders, who are unlikely to curtail conventional arms exports in current economic conditions. Moscow is expected to attempt to restrain trade with international pariah states—most of whom are short of hard currency anyway—while trying to expand sales with countries such as China, Iran and India. Government regulation of arms sales is hampered, however, by conflicts in the bureaucracy, the emergence of many independent arms export organizations, and by President Yeltsin's grants of special permission for selected plants to enter arms markets directly.

PROLIFERATION

Poor government export controls and the difficult internal situation in the successor states have raised apprehension in the West about the possible proliferation of materials, technologies, or expertise related to weapons of mass destruction. We have no convincing evidence of significant transfers thus far, but remain concerned that the current environment increases their likelihood.

Russia and Ukraine increasingly are authorizing export of sensitive dual-use space launch, chemical, and biological technologies as they attempt to save their weapons facilities and prevent unemployment. Some countries are establishing substantial bilateral exchanges with Russia, Ukraine and the other new states that will increase the danger of nuclear technologies being transferred. Facilities that once were isolated in closed cities are increasingly open to international contacts. Organized crime in the region may also view materials and technolgy relating to weapons of mass destruction as lucrative new commodities.

The Russians have declined to sign the missile technology control regime, claiming it is an effort by the west to squeeze them out of a market in which they believe their aerospace industry can successfully compete. Russia has said that it will not sell nuclear-capable missile systems, and the government has developed its own missile export control legislation. Even with consistent government commitment and Western assistance, law enforcement organizations and new export control bureaucracies will need several years to implement effective licensing and enforcement regimes. The concern is that organizations and individuals—facing enormous pressure to survive financially—will try to evade government controls over export activities.

OUTLOOK

As we noted in our testimony last year, the dissolution of the Soviet Union has irrevocably changed the context in which we assess military-economic developments. Economic resources of the former USSR no longer can be mobilized as an aggregate to develop and sustain military forces. The outcome of current political struggles over economic and defense policies will hold important implications for the future military capabilities of the Soviet successor states.

To the extent Russia, Ukraine, and the other new states push ahead with market reforms and reductions in the resources devoted to the defense sector, their economies are likely to recover more quickly, perform more robustly in the future, and ultimately better support smaller, modern militaries appropriate to new geopolitical conditions. To the extent the successor states slow economic reforms, retain more of the current defense industrial structure, and devote more resources to the military, economic recovery is likely to be slowed and domestic prosperity postponed. The latter path would likely result in larger armed forces, but economies that ultimately are far less capable of meeting the military requirements of the 21st century.

The transitions taking place in Russia and Eurasia will be long, contentious, subject to recurring crises, and marked by large downside risks. While the military threat to the West has been dramatically reduced, the potential for local and regional conflicts as well as the proliferation of sensitive weapon-related technologies remains high. Both can have adverse impacts on Western security interests. The questions we are now being asked are more complex and difficult because of the breakup of the Soviet Union and the current political, economic, and military turmoil. In this uncertain environment, defense intelligence considers its mission to assess the militaryeconomic indicators of change, continuity, and conflict to be a first-order priority.

WEAPONS PRODUCTION IN THE SOVIET UNION & RUSSIA			
Weapons Categories	1990 (USSR)	1991 (USSR)	1992 (Russia)
Tanks	1,300	1,000	675
Infantry Fighting Vehicles and Armored Personnel Carriers	3,600 - 3,900	2,100	1,100
Artillery	1,900	1,000	450
Bombers	35	30	20
Fighters/Figher Bombers	575	350	150
Attack Helicopters	70	15	5
Submarines and Major Surface Combatants	20	13	8
Strategic Ballistic Missiles	190-205	145-165	46-75

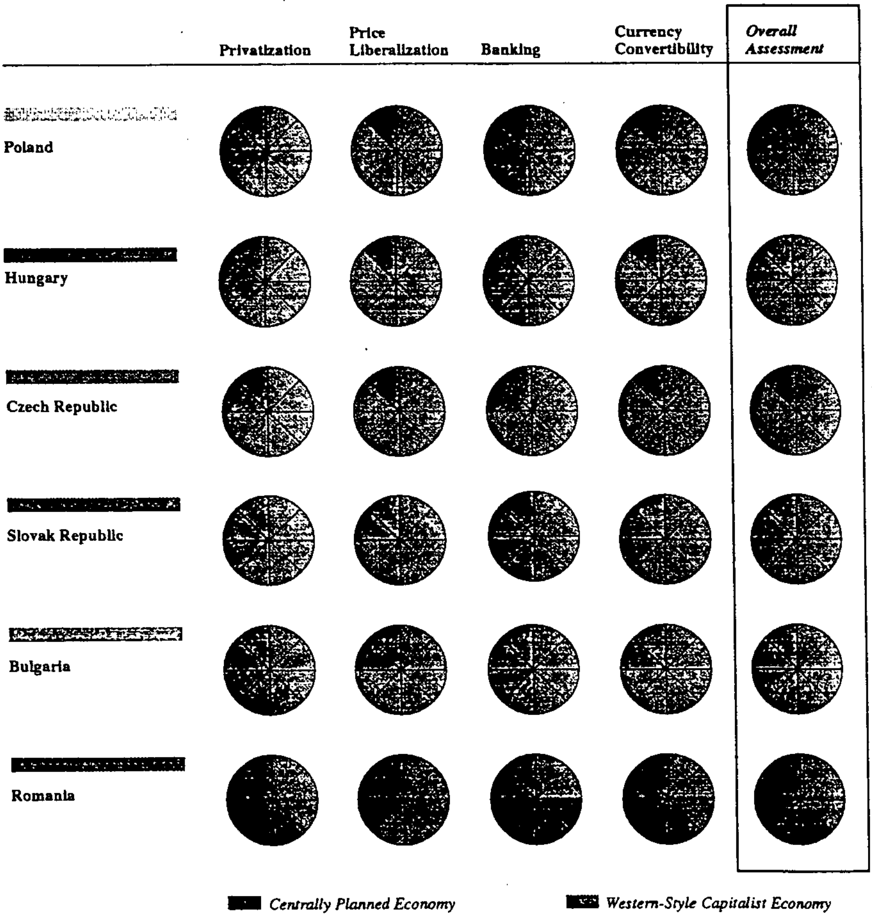
PREPARED STATEMENT OF ROBERT BLACKWELL

EASTERN EUROPE REFORMS ABOUT TO PAY OFF

Our message today is basically a positive one.

Eastern Europe has made great strides in the transition to a market economy. Progress has been greatest in the Northern Tier—Poland, Hungary, and the Czech Republic—but even in Bulgaria and Romania, overall trends are more positive than a year ago. Although the region will continue to suffer economic hardship as part of the transition, several of these countries have reached the point of no return on the road to a market economy.

Eastern Europe: Scorecard on Reforms



REFORMS ADVANCE UNDER THE CAUTION FLAG

The reform process is moving forward throughout the region, albeit now more slowly than previously. Although leaders and publics reject a return to socialism, East Europeans are increasingly wary of full exposure to market forces. In the past year, pressures have grown throughout the region to proceed more cautiously to ease the economic pain of reforms. Leaders in Bulgaria, Romania, and Slovakia in particular have taken heed and talk increasingly of slowing the pace of reform.

Still, economic reforms have moved ahead in the past year, and market forces are well established in the Northern Tier. The shift of ownership from the state to private owners continues throughout the region. The private sector now represents nearby half of output and employment in Poland and Hungary, thanks largely to the initiative of small entrepreneurs. The private sector also has grown in both Bulgaria and Romania to 15 percent of the economy, compared with virtually nothing three years ago. Although implementation has lagged, most countries have established mass privatization schemes to sell off large state enterprises. Moreover, many of these enterprises already have dramatically slashed employment and changed their product mix in response to market forces.

The East Europeans have made progress on other reforms as well.

- Most countries have passed agricultural land restitution laws to redistribute land seized by the Communists after World War II.
- The Northern Tier countries have begun buying up bad debts by issuing government-guaranteed bonds to clean up bank balance sheets.
- East European governments now set very few prices, although the prevalence of subsidies, wage indexation, and monopoly influences from state-owned enterprises undermine the impact to some degree.

The next year will be pivotal for the key reform issues of privatization and banking. Czechoslovakia's head start on privatization will be tested by the actual transfer of shares, its new bankruptcy law, and Slovakia's apparent lack of faith in the market. Poland will have to grapple with an uncertain political situation that threatens to delay the sale of large state-owned firms. Bulgaria has sold only one large enterprise in the year since its privatization program was approved. And Romania, which has distributed privatization vouchers, still needs to identify the companies it intends to sell.

In addition, a robust banking sector will be critical to the selection process that nourishes promising firms and weeds out the weak and inefficient ones. While many banks will have stronger balance sheets after being relieved of bad loans, they will face the challenge of making good lending decisions—opening the flow of credit without incurring another load of bad debts.

ECONOMIES NEAR THE BOTTOM

Economic performance projections are finally starting to look better. Although Eastern Europe registered its fourth consecutive year of economic decline in 1992, the rate was less steep and some signs of growth were evident at the end of the year. The region's GDP fell less than 5 percent in 1992, compared with 13 percent in 1991. Poland recorded the first positive growth in the region since the late 1980s, and others look poised for an upturn within the next year.

Inflation, meanwhile, continued to go down, although the rate of descent was slowed by the lifting of remaining price controls, rising food prices, and budget deficits. Inflation ranged from 11 percent in Czechoslovakia as Prague held to tight monetary and fiscal policies, to 200 percent in Romania, where the growth of inter-enterprise credits fueled price rises.

Unemployment remains the most troublesome side effect of reforms. By the end of 1992, more than 5 million East Europeans—11 percent of the work force—were out of work. Rates in rural areas and in one-company towns hit hardest by the shakeout in manufacturing were well over 20 percent.

The outlook in the Northern Tier for 1993 is for a modest upturn of industrial production and a boost in farm output with the return to normal weather. Poland should be able to meet its 2-percent growth target, and Hungary, which had to revise its earlier, rosier forecast after a plunge in first quarter exports, is projecting zero or low negative growth. For the Czech and Slovak Republics, near-term prospects are gloomier because of uncertainty following the breakup of the federation, the collapse of a common currency, and the fall-off of bilateral commerce. Despite some recent signs of life in manufacturing, Bulgaria and Romania also probably will not grow for another year. At the same time, the East Europeans must still deal with rising unemployment, high levels of inflation, and substantial budget deficits in 1993.

LOOKING WEST FOR TRADE AND AID

East European trade patterns are adjusting to the new post-cold war environment.

Since the fall of Communism in 1989, Eastern Europe has directed its commerce toward the European community and away from the former Soviet Union. The East Europeans now see their economic future as tightly linked to the west.

— More than half of Northern Tier exports in 1992 went to the European Community, and only 10 percent went to the former Soviet Union, compared to around 30 percent in 1989.

— Even Bulgaria, traditionally the most tightly wedded to the Soviet market, reduced its share of exports to the USSR's successor states from 30 percent in 1991 to 10 percent in 1992.

Export growth is likely to slow or stagnate this year because of weak West European demand despite additional market access granted by the EC under association agreements. Sales of agricultural goods—where Eastern Europe has a comparative advantage—will increase only slightly at best because of continued EC and EFTA restrictions, lagging agricultural reforms, and the lingering effects of the below-average 1992 crop. Eastern Europe's increased ties with the west and the hard currency shortages in the former Soviet Union will hold down sales to Russia and other successor states.

The East Europeans will remain eager for Western investment, which has totaled about $7.5 billion in the last three years. Hungary has attracted around $4 billion because of its reputation for political and economic stability.

PROGRESS LIKELY BUT PITFALLS LOOM

The East Europeans will continue to make progress over the longer term, but the region has entered a stage where dramatic breakthroughs on the scale of those of 1990-91 are not likely. The Northern Tier countries must still grapple with economic restructuring of their state-owned enterprises. Modernizing plant and equipment will require massive amounts of capital. The East Europeans also will need to continue to develop the managerial and marketing skills to overcome an entrenched socialist work ethic. Romania and Bulgaria probably will take years to reach the stage that most of the northern tier countries have already achieved.

There will se some other significant pitfalls along the way as well.

— Unemployment will rise even after output begins to grow and will tempt the east europeans to increase social spending at the risk of widening already high budget deficits.

— To ease the pain, governments are also likely to consider further stretching out of reform timetables. Putting off the inevitable makes political sense to leaders astride fragile coalitions, but it also slows the transition and delays the onset of strong economic growth.

— Fiscal problems will remain a major hurdle in meeting the requirements of IMF programs. Proponents of restraint will have to answer critics who will complain that governments are selling out to foreign interests.

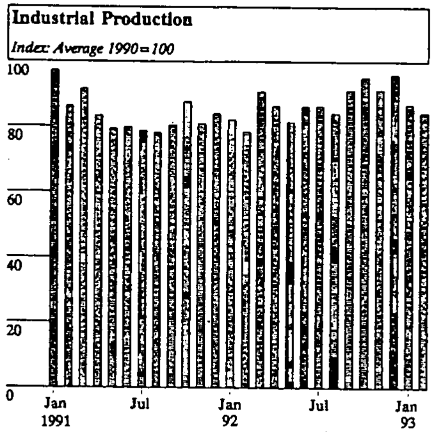
At the same time, the East Europeans, with the possible exceptions of Slovakia and Romania, have reached the point where backtracking on reforms is unlikely. The momentum generated by completed reforms and the lack of coherent alternatives make it unlikely that they will reverse course—by nationalizing newly privatized enterprises or reimposing price controls, for example —despite occasional antireform statements by their leaders.

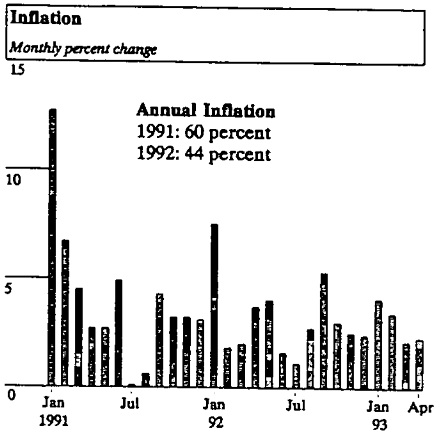
In short, the past year has strengthened our confidence that by the mid-1990s, the region will achieve the successes we projected in our testimony last year. Most will:

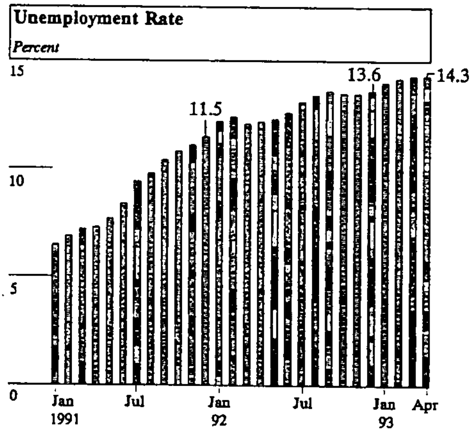
- register economic growth;
- make substantial progress in selling off state enterprises;
- become more integrated with the EC;
- benefit from increased foreign investment.

To be sure, the East Europeans are still likely to turn to the West for help in reaching these goals. Many now view increased market access, especially from West European trade partners, as the favored form of assistance. The East Europeans also will continue to press for loans from international financial institutions and for technical assistance. More generally, the East Europeans will want reassurances that increased attention toward Russia is not at their expense.

Poland: Economic Trends





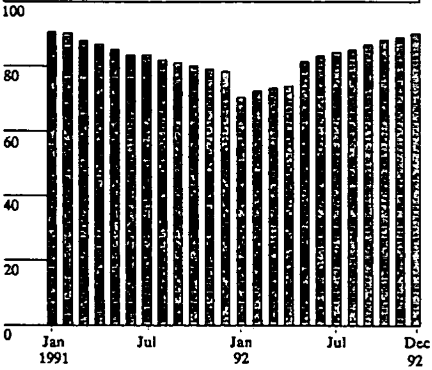


GDP Growth
1990: -12 percent
1991: -8 percent
1992: 1 percent
1990-1992: -18 percent

Hungary: Economic Trends

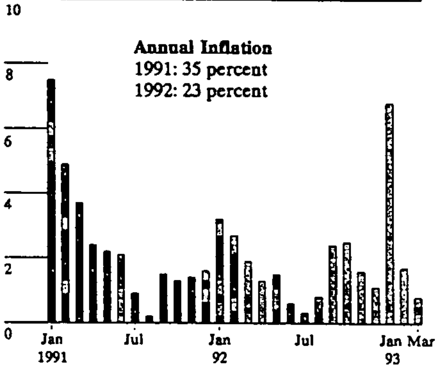
Industrial Production

Percentage of production in the same month of the previous year



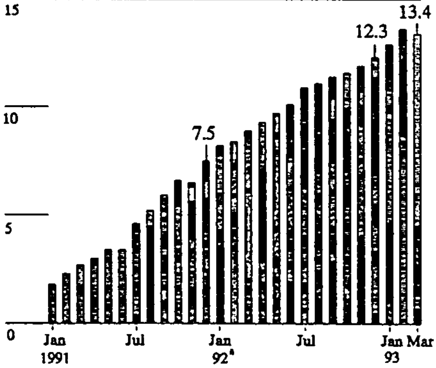
Inflation

Monthly percent change



Unemployment Rate

Percent

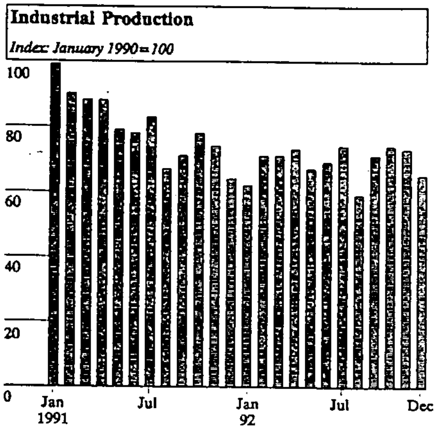


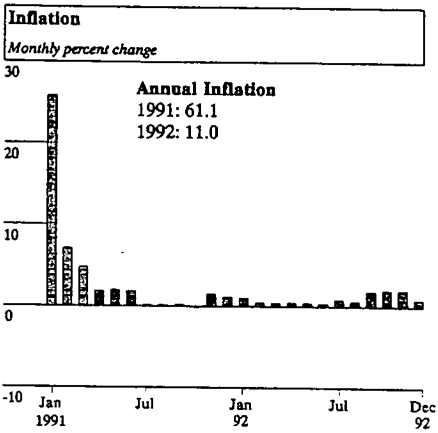
[a] The labor force on which the rate is calculated has been defined more broadly; the revision reduced the reported rate by about one percentage point.

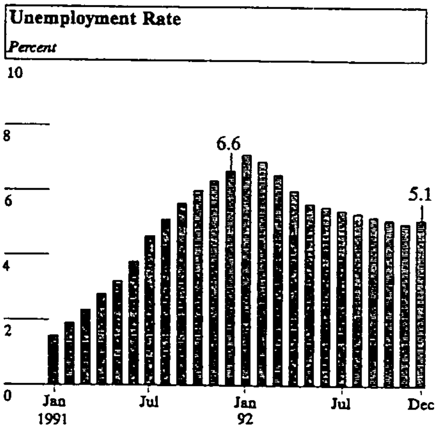
GDP Growth

1990: -3.3 percent
1991: -10.2 percent
1992: -50 percent (est.)
1990-92: -18 percent

Czechoslovakia: Economic Trends





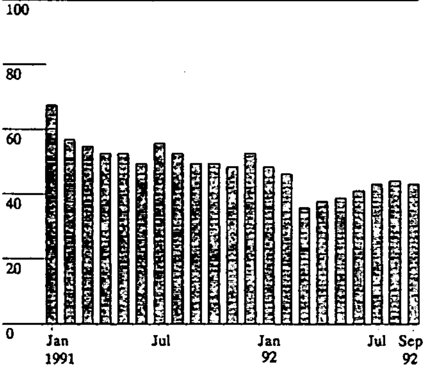


GDP Growth
1990: -1.8 percent
1991: -15.1 percent
1992: -7.1 percent
1990-92: -24.8 percent

Bulgaria: Economic Trends

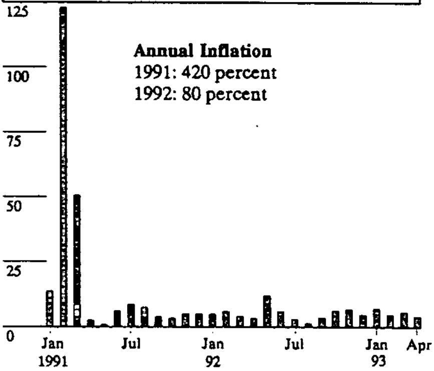
Industrial Production

Index: January 1990=100



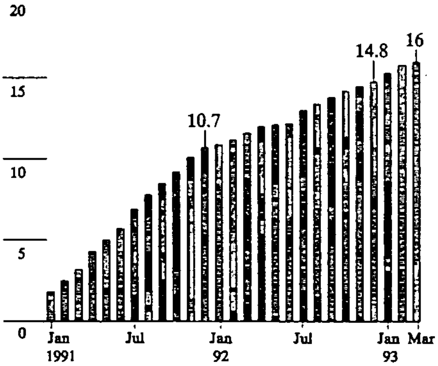
Inflation

Monthly percent change



Unemployment Rate

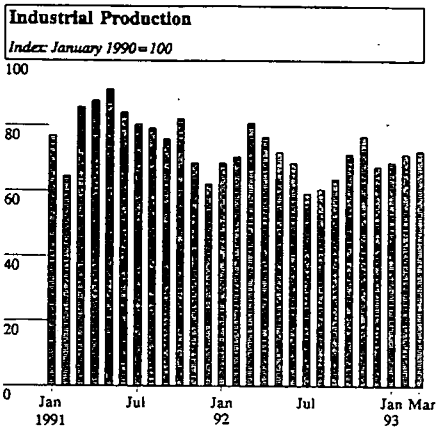
Percent

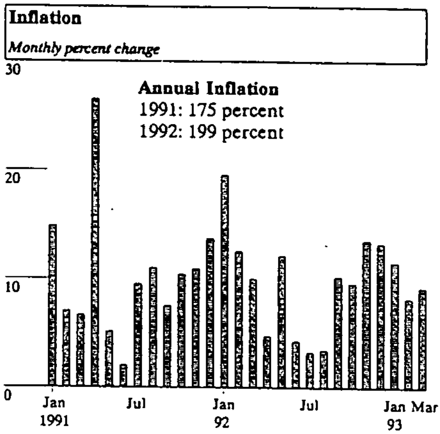


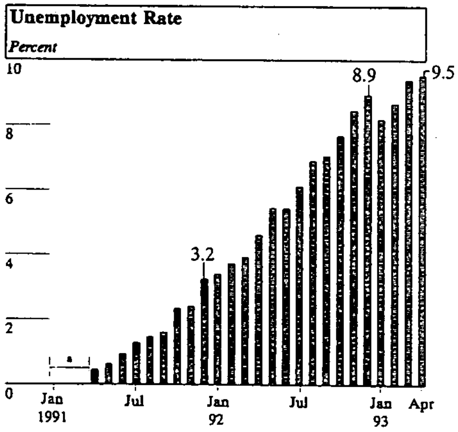
GDP Growth

1990: -11 percent
1991: -22 percent
1992: -10 percent
1990-92: -37.5 percent

Romania: Economic Trends







GDP Growth
1990: -12.1 percent
1991: -16.1 percent
1992: -12.3 percent
1990-92: -35.3 percent

[a] Data not available.

CHINA'S ECONOMY IN 1992 AND 1993: GRAPPLING WITH THE RISKS OF RAPID GROWTH

FRIDAY, JULY 30, 1993

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The Committee met, pursuant to notice, at 9:00 a.m., in room SD–628, Dirksen Senate Office Building, the Honorable Jeff Bingaman (Member of the Committee) presiding.

Present: Senator Bingaman.

Also present: Richard F Kaufman, General Counsel.

OPENING STATEMENT OF SENATOR BINGAMAN, MEMBER

SENATOR BINGAMAN. Today, the Joint Economic Committee is holding it's annual hearing on China's economy. We've done this now for many years.

During the Cold War, there was an obvious reason for monitoring developments in the large Communist and nuclear armed country that shared a border with the Soviet Union.

Today, we still have a very strong interest in the changes taking place in that country. We need to be paying close attention to them.

According to the International Monetary Fund and the World Bank, China is now the world's third largest economy, behind only the United States and Japan.

And we'll get a chance, perhaps, in the questions and answers, to discuss whether that is a reasonable estimate of the size of China's economy.

The IMF estimates China's gross domestic product at $2.35 trillion, nearly the same as Japan's.

China now occupies an important place in the world economy, and her role can be expected to continue to grow. According to the latest figures, she is now the world's eleventh largest trading nation.

Of course, China is one of our major trading partners and, frankly, one of our major trading problems. Our bilateral trade deficit with China is our second largest. It grew again in 1992. It appears that it is still growing, and today we'll get an estimate of what it will perhaps be in 1993.

Many would argue that Beijing's trade policies, which have had the overall effect of promoting exports and restricting imports, are largely responsible for our unfavorable trade balance.

China has been promising to reform its trade policies and to become less protectionist. Clearly, that has not happened. The trade deficit with China, as we'll hear today, is soaring out of sight.

I remember a discussion with former President Bush and Secretary of State Baker, and others in the Bush Administration, Carla Hills, about the size of the trade deficit with China the first year they were in office. It was about $3 billion, which seemed to me excessive.

The last year that President Bush was in office, according to the figures we are getting today, it exceeded $18 billion. And I gather it's on its way up, rather than on its way down..

So this is clearly an unacceptable situation, and one that, in my view, requires a major change in policy. If the Chinese won't change their policy, then we need to change ours. One way or another, we need to begin to bring some balance to our trade relationship with China.

And I hope that today's testimony will give us some good information with which to make that case.

Testifying this morning is Martin Petersen, who is the Director of the Office of East Asian Analysis of the Central Intelligence Agency.

Mr. Petersen, we have your full statement and the new CIA report on China's economy that you've submitted to the Committee.

If you wish, introduce your associate and then take 10 to 15 minutes and summarize your findings in any way you prefer.

Thank you for being here.

[The *Paper* presented to the Committee by the Central Intelligence Agency starts on p. 97 of Submissions for the Record:]

STATEMENT OF MARTIN PETERSEN, DIRECTOR, OFFICE OF EAST ASIAN ANALYSIS, CENTRAL INTELLIGENCE AGENCY: ACCOMPANIED BY LEE ZINSER, DEPUTY DIRECTOR, CHINA DIVISION

MR. PETERSEN. Thank you, Senator.

With me today is Mr. Lee Zinser, the Deputy Chief of our China Division.

I do have an opening statement that I would like to make, to summarize the report that you have in front of you.

Let me start by saying, good morning. It's a pleasure to be here again today to present our assessment of the current state of China's economy.

The main text of our report, I think, focuses on Beijing's efforts to control inflation and the other unwanted side effects of the nation's rapid economic expansion.

As usual, the paper includes a chronology of major economic events in China over the last year, and a discussion of China's bilateral trade relations.

This year, we've added a short discussion of China's progress in state enterprise reform, and an explanation of the discrepancies between Chinese and U.S. trade statistics.

I'd like to cover three broad areas in my remarks this morning.

I'm going to briefly recap some of the characteristics of China's economic reform program.

I'm then going to focus on the current economic situation in China.

And finally I'm going to conclude with some observations on the direction that we expect China's economy to take in the coming years.

As we've reported in past meetings with this Committee, China's 14-year economic reform program has basically followed a pragmatic trial and error approach to building China into a modern economic power.

Indeed, some prominent Chinese reform proponents have described the process as feeling their way across a river by feeling for the stones. In other words, rather than following a systematic blueprint, Beijing has proceeded step by step, introducing measures in selected areas and expanding implementation when the results seemed favorable.

At the same time, Beijing has sought to balance the benefits of reform against the risks and costs.

One of the results of this approach has been the gradual expansion of market forces in the economy. Chinese officials claim that roughly 80 percent of the commodities in China today are distributed through market channels at prices largely set by market forces.

Another characteristic of China's reform strategy has been the reliance on decentralized decisionmaking. Giving local officials a much greater day in economic matters.

Prior to reforms, many economic policies were dictated from Beijing or from provincial capitals, but reforms have given local officials far greater leeway to adapt policies to fit their own conditions.

These reforms have also allowed officials to benefit from the fruits of their economic initiatives. For example, Beijing has made revenue sharing deals with provinces that allowed many localities to retain additional tax revenue generated by development.

This combination of economic decisionmaking autonomy and incentives is the key to the success of the economic reform effort.

Since the early eighties, China's economy has grown an average of nearly 9 percent a year in real terms. At that rate, the size of the economy more than doubles every decade.

In stark contrast to many of the states of the former Soviet Union, who are also struggling now with reform, living standards in much of China have continued to improve steadily. And consumer goods and food supplies are abundant throughout the nation.

But Beijing's trial and error approach to reforms is not without its drawbacks, and we see shortcomings in four broad areas.

First, in many cases, the regime has had to delay the hardest reform steps, such as trimming surplus workers from bloated state enterprises, out of fear of sparking social unrest.

Second, reforms have widened the gap between the rich and poor areas of the country. In most cases, coastal areas, particularly in southern China, have been better positioned to capitalize on economic opportunities, while the interior provinces have found it much harder to take advantage of the opportunities that reform presents.

Third, the reforms have not removed all wasteful bureaucratic interference from the market. Local officials may make better on-the-spot decisions than central planners in Beijing, but they still skew economic development, create new layers of red tape, and occasionally erect inter-provincial trade barriers, and perhaps most damaging, raise corruption to new levels.

And finally, Beijing has been slow in building a legal and institutional framework needed to support more sophisticated markets.

Reform of the financial sector is especially needed, and the reliance on revenue sharing deals negotiated with local authorities undercuts Beijing's ability to use fiscal policies to regulate the economy.

A weak central bank and reliance on policy-directed low-interest loans similarly reduces Beijing's control over monetary policy.

This last shortcoming, in particular, has hampered Beijing's ability to guide economic development by using indirect macroeconomic levers. Despite substantial reform progress over the past decade and a half, the regime still has problems in fine-tuning China's economy to achieve stable, long-term growth.

As a result, economic cycles in China tend to be accentuated. Beijing relaxes controls to spur growth, but then must step in with blunt measures when inflation and other unwanted side effects start to soar.

The last such boom and bust cycle ended in 1991, when China's economy began to shake off the effects of the retrenchment of 1988 to 1990.

At that time, we saw Beijing relying on policies that led to earlier cycles of overheating. In 1991, we warned that inflation would be difficult to control if the regime relied primarily on loose credit policies to spur growth.

And last year, with the economic expansion picking up steam, we warned that local development initiatives were adding to the dangers of economic overheating.

As figure one indicates, this is precisely what has happened over the last year. China chalked up an impressive 12.8 percent growth rate last year, even when much of the rest of the world was in the economic doldrums.

And this growth was stimulated by three broad factors.

First, they intervened in the spring of 1992 to spur a new round of economic reform. And local officials took advantage of this greater autonomy to pursue their own economic development plans.

For example, they established thousands of small economic development zones last year, modeled on those in South China.

Second, informal capital markets developed rapidly last year, which helped fund many of these investment products. Not only did lending from the banking system expand by over 20 percent, but localities also turned to nonbank funding sources, such as issuing local bonds and shares to finance local enterprises.

Foreign investors contributed as well, with paid-in foreign investment increasing by 160 percent, to reach nearly $11 billion.

Third, entrepreneurial activity increased dramatically. Last year in China, a number of companies nearly doubled. This was largely because the regime strongly endorsed the expansion of the service sector last year, encouraging surplus workers in the state factories and government organizations to set up their own service ventures to meet the demands of growing markets.

With reforms picking up speed, many new services forms were established to trade in securities or to cash in on booming trade.

By the end of the year, China also had over four thousand real estate companies. As a result, investment in fixed assets increased by nearly 38 percent last year; in turn, creating new demand for construction materials and producer goods, such as steel and production machinery.

In response, China's industrial output grew by nearly 22 percent. This was the main driver in the rapid GNP growth that China registered last year.

As we detailed in our report to this Committee, the rapid growth in the money supply last year, coupled with surging investment by local authorities, has triggered renewed inflation.

Again, as figure one indicates, urban inflation increased by more than 13 percent last year, but reached nearly 16 percent in the first quarter of this year, compared to the same period last year. This inflation rate has continued to rise.

These inflation rates, of course, are far below those in many other countries, but they're still shocking to a leadership that has always feared inflation. Furthermore, despite the rapid expansion in bank lending, some key sectors were starved for cash, primarily because funds were channeled into higher profit and more speculative ventures. Cash shortages in rural areas forced many grain stations to pay farmers for their crops in IOUs last year, and some key state infrastructure projects could not obtain loans.

Beijing has also seen its trade balance dip into the red since late last year. In part, because reforms have modestly liberalized access to China's markets, Chinese consumers now have greater access to high quality imported goods. Chinese local officials also have greater discretion in importing items as part of their development efforts.

Although Chinese exports increased by nearly 18 percent last year, imports were up by 26 percent.

In the fourth quarter, China registered a trade deficit, and that deficit has continued to grow in the first half of this year.

Let me comment, for a moment, on the U.S. trade relations with China.

Despite its eroding global surplus, Beijing's surplus with the United States is continuing to grow, as indicated by figure two.

U.S. exports to China increased by 19 percent, to reach almost $7.5 billion last year. But U.S. imports from China jumped by 35 percent, to reach $25.7 billion. This growth pushed our trade deficit with China to $18.2 billion, up 43 percent compared to 1991.

Chinese trade gains with the United States are continuing this year. And if we take the trends of the first five months of 1993 and project them through to the end of the year, then we're looking at a trade deficit with China between $23 and $24 billion.

As figure three indicates, China was an important source of U.S. export growth last year. Indeed, U.S. exports to China grew three times faster than overall U.S. exports.

Some of China's key trading partners, however, experienced even faster export growth in 1992. This caused the United States' share of the China market to shrink slightly to about 11 percent, according to Chinese statistics, which is roughly the same level the United States had ten years ago.

By contrast, Japan claimed 17 percent of China's import market last year. This is a slight increase over its 1991 share, but far less than the 25 percent share it had ten years ago.

Turning back to China's domestic economy, as we meet today, China's in the midst of a new effort to cool the economy and slow growth to levels that can be sustained over the long term. And in July, Beijing unveiled details of a 16-point program to try and combat inflation and economic overheating.

The plan incorporates administrative measures, such as ordering localities to stop constructing new development zones, and ordering government banks to recall loans that were made without authorization or without adequate guarantees.

Beijing hopes that this new 16-point program will prove to be a measured response that will reduce inflation, but allow the continued growth of the economy at a roughly 10 percent rate.

Central leaders do not want to stop expansion as their austerity program did in late 1989. Without continued growth, Beijing would be unable to generate the jobs needed to soak up massive surplus labor or to fuel development in the interior provinces.

In other words, China's leaders probably will judge their program a failure if it either fails to reduce inflation, or if it over-shoots the mark by reducing growth substantially, or if it triggers an economic contraction.

As I noted earlier, Beijing has not had much success in the past in achieving such an ideal economic soft landing. Retrenchment programs have often been far too harsh.

To their credit, however, Chinese policymakers appear to be learning from their past mistakes, and so far they've avoided slamming on the brakes.

The new 16-point program was formulated because these earlier efforts have been unsuccessful. We take this as a sign that Beijing is attempting to find a balance between control and growth.

The 16-point program also demonstrates Beijing's intent on relying on a wider mix of policy instruments than just administrative measures to slow the economy. Indeed, the program is largely based on credit rationing and ordering loans to be granted only to priority sectors.

But Beijing is also raising bank interest rates to reduce savings and reduce the demand for state loans.

How well this program succeeds will depend largely on the response of local officials. With many more channels available to them to raise funds, localities may be able to circumvent most of Beijing's directives and continue their own local development drives.

This could be particularly true in the coastal provinces. The plan could end up hurting the hinterland the most, which is what Beijing does not want to happen.

If local authorities continue to ignore Beijing's directives to cool overheated growth, the regime could be forced to take sterner measures later on this year. If so, the anti-inflation program could threaten growth in some of the very sectors that Beijing is depending on to absorb surplus labor, including the emerging service sector.

And this could also force the regime to shelve reforms designed to trim surplus labor.

These economic and social uncertainties are occurring during a time of persistent rumors that China's paramount leader, Deng Xiaoping, is dying or incapacitated. And they appear to be fueling regime concerns about popular unrest.

The Hong Kong press, in recent weeks, has been filled with often-conflicting reports about the state of Deng's health. These rumors come at a time when the current economic strain and party discipline problems seem to be on the rise.

The reports of rural unrest in 13 of 30 provinces are sparked by low-crop prices, excessive local taxes, or ad hoc levies and government payment for crops with IOUs. And some factory workers in some cities have staged strikes over wages and working conditions.

Since the Tiananmen incident, Beijing has concentrated on upgrading its internal security capabilities and has not hesitated to use these forces in dealing with public disturbances.

82-717 - 94 - 4

Given the rumors about Deng and the social situation, the annual leadership conclave at the resort town of Beidahe later this month probably could be particularly contentious.

I'd like to close my remarks with some points about Beijing's longer-term prospects.

Clearly, China has substantial potential for further growth. It has natural resources, the human capital, and the access to technologies that are essential to sustaining the growth rates of the past decade well into the next century.

Furthermore, China's at the geographic center of the world's most dynamic economic region. And considering that we're talking about a nation of more than a billion people, China's economic growth carries substantial implications for East Asia and the rest of the world.

We focused today on China's difficulties in managing the complex challenges that accompany this growth. Many Chinese leaders and their advisors understand the limits of managing their economy through the on and off measures of credit rationing, and they recognize that further reforms are needed to give the regime improved market-based levers to regulate economic growth.

Taxation, banking, finance and labor reforms all are on Beijing's agenda, even while central leaders must employ administrative controls to deal with the immediate problems of overheating.

As you're aware, Deng has been the chief architect of China's reform since the late seventies. But he turns 89 next month, and his ability to continue to guide the reforms that are still needed is undoubtedly waning.

Nonetheless, we expect Beijing will continue to experiment with pragmatic economic measures to enhance growth and economic efficiency. Even during the height of the 1989 retrenchment, when orthodox leaders were threatening to chip away at market reforms, we predicted they could not turn back the clock.

In our view, opposition to future reforms will come primarily from interest groups that these reforms threaten, rather than from ideological opponents.

Although local bureaucrats welcome measures that enhance their decisionmaking powers, they bridle at reforms that will return direct taxation powers to Beijing or limit their ability to direct local lending for their own purposes.

Consensus for reform is building in China as the fruits of economic development are increasingly evident. Not only is there an increasingly sophisticated economic class emerging in China, but foreign influences are also contributing to reform and making China's economic system more compatible with international standards.

China's drive to absorb foreign investment and to join such international bodies as the General Agreement on Terrorists and Trade are encouraging the regime to adopt Western-style accounting and management practices.

As we stated last year, the Chinese economy is evolving through continued cycles of reform and retrenchment. This is going to continue to be a very bumpy process. And we expect temporary setbacks.

But what is also clear, however, is that China cannot return to the policies of the pre-reform era.

That concludes my statement, Mr. Chairman. We'll be more than happy to take any questions you might have.

SENATOR BINGAMAN. Thank you very much.

First, I'd like to ask about Chart 2, to be sure that I understand it.

What you said in your testimony and what the chart reflects is that China's trade imbalance with the rest of the world has really corrected itself. In fact, China is running a deficit with the rest of the world, beginning this year, for the first time, in a long time.

MR. PETERSEN. Yes. There's a couple of things that need to be said about that, and then I'm going to ask Mr. Zinser to amplify my remarks.

The EC, the United States, and Japan all have trade deficits with China. Taiwan, Hong Kong, parts of the third world and former states of the Soviet Union all are running surpluses in China.

But, Lee, maybe you can expand on that.

MR. ZINSER. Yes. The yellow bars reflect very well the macroeconomic cycles that China has gone through.

When they get into the overheated phase of the macroeconomic cycle, their imports tend to surge, their exports tend to slow, and as you can see, they go into deficit.

I would like to caution you. The dotted line is there to indicate that the numbers for 1993 are the actual numbers. They're not our projections, as Mr. Petersen said in his remarks.

The red bar shows that the U.S. trade deficit with China has not really been affected by China's macroeconomic cycles. It has continued to grow in a fairly straight line way since the mid-1980s.

SENATOR BINGAMAN. So, while Chinese imports have surged, imports from the United States not kept up with exports to the United States?

MR. ZINSER. That's correct.

SENATOR BINGAMAN. By any means.

MR. ZINSER. That's correct.

SENATOR BINGAMAN. Why, for example, what is Japan doing that is different from the policy we're pursuing. Japan, I gather from your statement, has essentially seen its deficit with China decrease, or?

MR. ZINSER. Slightly.

SENATOR BINGAMAN. Slightly. And what about the European Community?

MR. PETERSEN. It's stayed about the same, sir. I think they had about a 1 percent decline in their deficit last year. Japan had about an 11 percent decline in their deficit last year.

SENATOR BINGAMAN. And that's when we had our deficit.

MR. PETERSEN. Ours grew by 43 percent.

SENATOR BINGAMAN. Ours grew by 43 percent. What are they doing that we're not doing?

MR. PETERSEN. There are two elements to the story.

The first element is the fact that the U.S. has a very open market and a very strong demand for the light industrial goods that China is producing now. And part of what we're seeing is the result of the Chinese correcting 30 years of very poor policies under a Stalinist central planning system.

From the 1950s to the late 1970s, they were emphasizing a capital-intensive industry, which is not to their comparative advantage. Since then, the reforms have increased the share of labor going to labor-intensive industries. There's been a tremendous flow of resources and labor and funding into the labor-intensive products that they're exporting to the United States.

So that's the import side of the equation. They're becoming much more competitive because they're focusing on the comparative advantage.

The export side of the equation is a little more complicated. The United States has a very different export mix than Japan. Japan concentrates on selling semi-finished goods and machinery to China. Now,, as China's macrocycle has gone into the overheating phase, demand for those products has surged. And last year, Chinese imports from Japan grew about 39 percent.

Now, if you look at our export pattern, it's a combination of raw materials, fertilizer, wheat, cotton fibers, and also very high-tech products. Some of our high-tech industries have done very well in China in the last year. Aircraft sales, for instance, accounted for about a quarter of total U.S. exports to China.

On the other hand, our sellers of these raw material products saw very steep declines in their sales, partly because China's shifting to other markets for those imports.

So our growth of exports to China has been slowed because their imports of our raw materials have slowed, while their exports to us have continued unabated because of the economic reforms and also the joint ventures that are setting up in Southern China to take advantage of those most skilled workers.

SENATOR BINGAMAN. Has some of the limitation on the size of the trade deficit with China a result of policies that Japan and the European Community have adopted? Have they begun to tighten up or restrict access into their markets?

MR. PETERSEN. I know last year, sir, EC, Mexico and Japan all, at one time or another, initiated anti-dumping actions against the Chinese, so they are protecting their markets.

SENATOR BINGAMAN. What were they claiming that China was dumping?

MR. PETERSEN. Steel-related products, I believe, in the case of Japan. Lee?

MR. ZINSER. I think a wide range of products. In the EC countries, they have on the order of 20 to 30 anti-dumping suits underway, I believe.

SENATOR BINGAMAN. Do we have any anti-dumping actions?

MR. PETERSEN. We do.

SENATOR BINGAMAN. On what items?

MR. ZINSER. I think the Commerce Department might be a better source of information than we, right now. I'm not exactly sure which are still underway.

But, as Mr. Petersen said, some of it, I think, relates to steel products, some hand tools; things of that nature.

MR. PETERSEN. There's another aspect here too, sir, and that's the Europeans, the Japanese generally offer more concessionary financing than the United States does, and makes those products more competitive, more attractive, to the Chinese, in some instances. And that's a factor in this too.

SENATOR BINGAMAN. Okay. Your estimate is that this year our trade imbalance with China will be about $23 to $24 billion.

MR. PETERSEN. It could be higher too, sir.

SENATOR BINGAMAN. Could be higher?

MR. PETERSEN. Yes. It depends on what happens with this effort to cool the economy.

If, as sometimes happens in the past, it leads China to hold down imports later in the year, and to shift resources to export industries, it could be higher than $23 or $24 billion.

SENATOR BINGAMAN. Is there any way to look beyond the next six months and into 1994, and say where this thing is headed? I mean, we have about a $49 or $50 billion trade deficit with Japan. We now have a trade deficit with China that's half that size. Where is this thing headed?

MR. PETERSEN. I'm going to ask Mr. Zinser to amplify what I'm going to say here.

Basically, we see it continuing to go up. And there's a couple reasons for that.

One, getting back to what Mr. Zinser said earlier about the export mix, there tends to be very sensitive swings in demand in the Chinese economy. There tends to be a lot of competitors for some of those markets out there. That's one element.

Another element is that a lot of our exports tend to be very big-ticket items, like aircraft, and if you do that once or twice, you're going to have pretty good numbers, but they're not going to be buying those numbers of aircraft every year, so you're going to see those kinds of dropoffs.

Meanwhile, the Japanese and others are putting in a lot of semi-finished goods, production-related equipment, into the growing areas in the south—doing more than we're doing there in those exports. And that's one reason why I think our trend is going to continue along the lines that we see here.

MR. ZINSER. Well, I think Mr. Petersen makes a very good point when he cautions that the degree to which the Chinese leadership is successful in slowing their economy will have a big impact on our specific projection for 1994, but it's very likely to continue to go up.

If you look at a ten-year pattern, our import growth from China has averaged about 26 to 27 percent per year. Our export growth to China has been on the order of 13 to 14 percent. And we don't see anything happening in the next couple of years that would throw that trend-line way off.

So, in other words, the deficit is likely to continue to expand in 1994. I don't think we're ready to put an actual number on it, but if the deficit reaches, as Mr. Petersen said, $24 billion in 1993, then it's likely to be in the mid-to upper-20s in 1994.

SENATOR BINGAMAN. Let me ask a couple of questions about the current estimates on the size of the Chinese economy.

In earlier hearings, we've discussed this. I guess, back in 1990, we had a hearing, and I asked this question at that time.

I said that the CIA estimate, I gather, is in line with the World Bank and other authorities in that they estimate the size of the economy at $425 billion, per capita income of $360 per person annually. Are these accurate figures? This strikes me as an amazingly low figure.

Now, I guess the World Bank or IMF says that it's the third largest economy in the world. And that's been three years.

It makes you wonder if these figures are worth anything.

What is your explanation, or what do you estimate the size of the economy is at this point, and how does that square with what you were telling us three years ago?

MR. PETERSEN. Well, I believe that we cautioned readers about the report that that was not an estimate *per se*. That was simply using an exchange rate method to convert.

And we went to considerable lengths to explain that that's not really a scientific way to do it. So I don't think we were projecting this as our estimate.

And then two years ago, if you'll remember, we included a lengthy appendix discussing the GNP issue in some detail. And we pointed out that, depending on the methodology you choose, the range could be four hundred to maybe four trillion dollars for China's economy.

Our sense is that the World Bank and the IMF estimates are in the ball park, are reasonable estimates, for the size of China's economy.

We've done some work privately on the issue, but we decided that there's so much imprecision involved in using a purchasing power parity method to come up with an estimate, because China's economy is changing so rapidly that we have not published our own estimate.

But my sense is that both of those estimates are reasonable, which leads to the conclusion that China has a very large economy.

The other implication you draw from that, if you take the IMF estimate, which I think is in the low $2 trillion, for example, then China's total trade as a share of GNP is only about 7 percent, which is small even for a continental economy.

Of course, that reflects the 30 years of central planning approach and the disincentives to export. But the important implication for that is that if China's economy is in the range of somewhere around $2 trillion, then China hasn't reached anywhere near its export potential. And I guess that's the second important conclusion that comes from those studies.

SENATOR BINGAMAN. So what you're telling me is that while our largest trade deficit is with Japan today, it might well be with China here in a few years?

MR. PETERSEN. I won't tell you the exact year, but it's very likely those trends will lead the deficit to continue to expand fairly rapidly.

SENATOR BINGAMAN. It does seem that if China is the third largest economy in the world—you say 2 percent of their gross domestic product?

MR. PETERSEN. Seven percent.

SENATOR BINGAMAN. Seven percent is now traded.

MR. PETERSEN. Yes.

SENATOR BINGAMAN. How does that compare with, for example, Japan's gross domestic product? What percent of that is in trade?

MR. PETERSEN. Japan is 25 percent. Brazil is about 15 percent. The United States is about 17 percent. So, if China approaches the average of continental economy, then it's still got a long ways to go.

SENATOR BINGAMAN. Okay.

Let me ask a couple of questions about military spending in China.

From a untutored perspective, you would think that the decline in capability and military power in the Soviet Union would have caused a reduction in military spending in China, just as it has caused a reduction in military spending here.

And yet, I guess what you're telling us in your report is that the opposite has occurred. That they are continuing to expand their military purchases and their military buildup. Could you elaborate on that a little?

MR. PETERSEN. That's correct, sir.

I think they're basically two sets of factors that are driving Chinese military spending.

On the domestic and internal side, the PLA, Peoples Liberation Army, is a very important political actor, and was key to maintaining the regime in the Tiananmen incident. And therefore, China's political leadership has rewarded the PLA by pumping a lot of money into the PLA since then.

As a matter of fact, defense spending, since about 1988, has grown something like 60 percent in real terms.

SENATOR BINGAMAN. Since what year?

MR. PETERSEN. Since 1988.

And basically what we've seen is double digit increases in budget-line items for defense expenditures since then.

Perhaps, our best guess as to the actual defense spending last year is in the range of $16 or $17 billion.

Anyway, they're a very important domestic political force. They have a claim on resources. The leadership believes it's important to satisfy that claim on the resources.

The second set of factors that are driving it is the international situation. And indeed, on the surface, you would think that the collapse of the Soviet threat and the rest of it would lead to the sorts of conclusions that you articulated here.

I think what has happened in China's mind is that they see a far less certain world. They're concerned about the prospects of instability along that northern border, particularly with some of the new states of Central Asia.

I think they're very concerned about U.S. willingness and commitment to remain forward deployed in East Asia. They see our military presence there as perhaps the best guarantee of stability in the region.

They look at what's happening with our defense budget and that sort of thing, and it's an element of uncertainty in the equation.

Added to this is that this is a regime that is interested in building China into a great power, and indeed has had border disputes and disagreements with any number of its neighbors.

It's a China that is also very concerned about Japan's prospects over the longer term, not in the immediate term. But I think there's some genuine concern on their part that Japan's great economic power someday will be translated into political and perhaps military power.

So I think there's elements of all of that behind their growth in military spending.

SENATOR BINGAMAN. What are they putting this money into? Are they increasing the number of people in uniform? Are they modernizing their forces? What are they doing?

MR. PETERSEN. Basically, Mr. Chairman, I think they're doing the following:

One, they're drawing down the number of people in uniform. They want to reduce their ground forces by about a million men by the year 2,000. They have largely drawn down the forces along the border with the Soviet Union. They're trying to make them more mobile, more flexible. They're trying to draw some of the lessons from the Gulf War and apply them to the Chinese Army, which looks an awful lot like the Iraqi Army, in that sense.

What they are doing is building a force projection capability. We've seen money going into the air force. I'm sure aware that they've acquired Soviet Fighters SU-27s; acquired service-to-air missile systems, the SA-10. We think that they would like to develop a new fighter aircraft. They would like to develop an in-flight refueling capability.

We've seen money going into the navy, as well. Seven new classes of frigates, better anti-submarine capabilities. We're also seeing them put money into their strategic forces. Those forces are still relatively small, but we would expect them to continue to make developments in that area.

What the Chinese are doing is not so much buying equipment, if you will, although there are some significant examples of that, as they are trying to acquire the technologies that will allow them to develop their own systems and to increase their own capability to produce those systems.

So a lot of the defense expenditures that we saw initially went into personnel costs, improving the standard of living of the PLA. Increasingly, we've seen more money going into the acquisition of either technology or weapons systems.

SENATOR BINGAMAN. What about the effect of this in the region? Do we have a sense as to whether this expansion of their military capability, or improvement of their military capability, is a stabilizing factor or a destabilizing factor?

MR. PETERSEN. Let me preface my remarks with two statements.

Number one, everyone in the region watches everyone else's defense expenditures.

And number two, the greatest force for stability in the region is the U.S. presence. As long as the United States remains there, most states in the region are fairly relaxed.

That said, there is an increase in weapons flowing into the region. I think we're seeing evidence of that in Southeast Asia. I think there is nervousness about China's growing capabilities, particularly as they relate to force projection capability.

And so, in that sense, it's an issue of concern in the region.

SENATOR BINGAMAN. What about efforts to restrict the export of sensitive military technologies by China? That's been a major factor in debates here in Congress, as to whether they were doing what they should do to restrict the export of missile technology, in particular.

MR. ZINSER. Could I interject something for just a second?

SENATOR BINGAMAN. Sure.

MR. ZINSER. Going back to your previous question, sir, I'm sure when Mr. Petersen was talking about how stabilized the U.S. forces are in the region, he was reflecting the views of a lot of Asian governments and the official statements from them.

MR. PETERSEN. That's right.

SENATOR BINGAMAN. Okay. What about restrictions on exporting military technologies? Have they done any better in that area than they had a year ago or two years ago, or is that still a major problem area?

MR. PETERSEN. As you know, sir, it's very difficult for us to say anything about this at an unclassified level. But let me say this.

The Chinese Government continues to maintain, publicly and privately, that they are abiding by all the agreement assurances that they have signed.

That said, we remain very concerned about Chinese activities in this area and continue to monitor their behavior in this area very closely.

I think this is still an issue of concern.

SENATOR BINGAMAN. Okay.

You had one reference in your statement that I just didn't understand very well. This talk about increased present discontent throughout the country. What's that about and is that a serious factor that we need to be aware of, or is this just a blip on the radar screen?

MR. PETERSEN. I think it's an indicator that there are problems with the way the reform program in economic development is occurring.

This is not surprising. Any time you undertake this sort of massive program, some people are going to benefit and some people are going to be hurt.

I think what's happened in the case of the peasantry is that they benefited from the program early on. They were the big gainers. But what has happened, I think, in recent years, is a number of things.

One, their incomes have tended to stagnate a bit, particularly viz a viz the more dynamic coastal areas.

Two, they've been subjected, I think, by local officials to a lot of ad hoc taxes and levies. The regime has been forced, on a number of occasions, to pay for grain with IOUs. And I think there have also been complaints about the level of corruption.

So, as I look at these incidents and reports of present discontent, I don't think they can be ignored. I think they have to be taken as an indication that something is happening out there.

Lee, can you add to that, or would you care to?

MR. ZINSER. Well, the main focus of the discontent does seem to be against local officials or local grievances.

What the reforms have done have really eroded the old way of managing much of the peasants' lives. And it's really reduced the central government's and the party's control over how rural officials interact with the peasants.

So a lot of the discontent is focused on very local issues. For instance, disputes over who has the right to farm a particular piece of land, whether it goes into industrial use or agricultural use.

Some of the disputes have to do with how local officials try to collect funding for social services.

It doesn't seem to be, as best we can tell at this point, focused at the central government. But these are very much bread and butter issues, and it's hard to measure just how much of that's going on.

SENATOR BINGAMAN. Let me ask one other question about Hong Kong. The date for turning over Hong Kong to China is 1997?

MR. PETERSEN. That's correct.

SENATOR BINGAMAN. Is there anything that's occurred in the last year or so that sheds new light on how that process is going to play out, and whether Hong Kong is going to be able to remain the trading leader that it has been historically under that new relationship?

MR. PETERSEN. Well, I'm sure you're aware that Governor Patton, the Governor of Hong Kong, has put a number of proposals on the table to democratize, if you will, the institutions in Hong Kong that will remain in place after 1997.

Beijing has some major problems with his proposals. As Beijing looks at Hong Kong, I think they are of two minds. One, they very much want to maintain the economic vitality of Hong Kong. They see it as important to their overall economic development procedures.

At the same time, they're very wary and very concerned that Hong Kong could become somehow a base of subversion—shipping democratic ideas into larger Chinese mainland.

I think they are very concerned about the support in Hong Kong for the demonstrators at Tiananmen.

I think that they were very concerned about the results of local elections in Hong Kong, where the Beijing slate didn't do very well at all.

The British and the Hong Kong Governments are now in a series of negotiations and talks over Governor Patton's proposals.

And so we're going to have to see how that plays out, because that will have a major impact on what happens in Hong Kong after 1997.

SENATOR BINGAMAN. All right. I think that concludes my questions.

Let me also say, for the record, Richard Kaufman is going to be leaving the Joint Economic Committee. He's been the person that's organized these hearings for many years now, and has got a good tradition going. We will try to carry it on in spite of his absence, but he's moving on to bigger and better things, which we all compliment him on.

I appreciate your testimony today. I think it's very useful testimony and I hope we can use it, as we have in previous years, to help enlighten and improve the debate over U.S.-China relations.

Is there anything more if you wanted to add?

MR. ZINSER. If I could just add one more point, sir?

When we're talking about the trend in the U.S. deficit, there are some factors that also could come into play down the road. And those specifically are how carefully China implements the Market Access Agreement, which they signed last October with the United States.

And also, as you know, they're very interested in getting into the GATT and the process that could lead to GATT accession. Both those things could liberalize their import sector significantly, projecting a few years down the road.

That's an uncertainty, and it could temper the estimate of how wide the deficit with China could become. It probably won't impact on their exports to the United States, but it could impact significantly on the access that U.S. firms will have to the China markets.

And it's an uncertainty that I think we need to take cognizance of.

MR. PETERSEN. Thank you, Mr. Chairman.

SENATOR BINGAMAN. Thank you very much.

[Whereupon, at 9:50 a.m., the Committee adjourned, subject to the call of the Chair.]

SUBMISSIONS FOR THE RECORD

CHINA'S ECONOMY IN 1992 AND 1993: GRAPPLING WITH THE RISKS OF RAPID GROWTH

This paper was written by the Central Intelligence Agency for submission to the Joint Economic Committee, Congress of the United States.

July 30, 1993

Summary

Information available as of 28 July 1993 was used in this report

China's economic performance over the past year has highlighted again the risks of decentralizing decisionmaking authority to spur growth when the fiscal and monetary policy levers needed to keep growth within sustainable limits are only partially in place. The economy has grown at a 13-percent annual pace since Deng Xiaoping's January 1992 visit to southern Chin a that gave the green light to local authorities to speed up their own development initiatives. Spending by local authorities helped boost investments in fixed assets by nearly 38 percent in 1992, and the output of China's industrial sector jumped 22 percent, as demand for producer goods and construction materials soared. Foreign commercial ties also increased; the country's total trade grew almost 22 percent in 1992, and foreign investment jumped 160 percent as foreign businesses pumped over $11 billion into China to take advantage of the rapid growth and new investment opportunities. Over 85 percent of foreign investment came from other Asian nations in 1992, helping to weave tighter regional economic bonds.

While the economic expansion is good news for Beijing—creating new job opportunities for many Chinese and adding to Beijing's clout as an emerging economic power—it is threatening to spiral out of control in a repeat of 1988's economic overheating, which forced the government to undertake a costly retrenchment program. Inflation is now running at a four-year high, with urban living costs increasing by nearly 20 percent between May 1992 and May 1993. The economic expansion is also straining the nation's transportation and energy infrastructure and creating numerous supply bottlenecks. And, although China's exports continue to increase, surging domestic demand for imported goods contributed to a global trade deficit of $3.54 billion in the first half of 1993.

In response, Beijing has recently stepped up its efforts to cool the economy. Earlier this year, Beijing restricted local officials from establishing economic zones or issuing local bonds that compete with national treasury bond sales and state bank deposits for funds. In an effort to fine-tune the economy, Beijing in May raised interest rates on deposits and loans for the first time in two years to help boost flagging bank deposits and slow investment spending.

Escalating inflation and other indicators have forced the regime to take even tougher steps; Beijing has ordered state banks to halt loans for local real estate developments, for example, and to call in loans that have been made to

unauthorized recipients or without sufficient guarantees, according to Hong Kong press accounts. These and other anti-inflation measures were folded into a new 16-point program unveiled in early July to combat overheating. Underscoring its determination to deal more effectively with economic overheating—particularly by cracking down on problems in the financial sector—Beijing installed Vice Premier Zhu Rongji as governor of the central bank in early July, a move that bolsters Zhu's authority in guiding the anti-inflation effort.

The effectiveness of these measures remains to be seen. In the past, Beijing has been able to temporarily regain control of overheated growth with similar retrenchment steps. China's economy, however, is now more diverse and less subject to direct central control. Furthermore, local officials have become adept at sidestepping orders from Beijing that run counter to their interests.

Central authorities themselves are still hoping to avoid stronger retrenchment measures that could threaten growth in some of the most dynamic, market-oriented sectors of the economy and damage prospects for further reforms. if the economy continues to overheat, however, the regime will face the difficult choice of applying even tighter controls despite the additional risks they would entail. The 16-point program already calls for a suspension of price reforms for the remainder of the year. If the program slows growth of services and rural enterprises— sectors the regime depends on to create new jobs—Beijing may have to delay reforms to trim surplus workers from state enterprises and government bureaus. Efforts to reduce the trade deficit by tightening administrative controls on imports—the 16-point program bans some auto imports for the remainder of 1993—could increase frictions with China's trading partners and complicate China's efforts to join the General Agreement on Tariffs and Trade.

These economic challenges face central leaders—many installed in their new positions during the past year—at a time when China is approaching a political watershed; elders of the revolutionary generation are now in their late 80s and are succumbing to poor health and old age. Despite these challenges, however, the past year has demonstrated the impressive growth potential of the Chinese economy, as well as the impact of the growing pressure for reform measures. Support for reform is no longer coming primarily from a limited number of central policy visionaries and reformist officials in some coastal areas, but increasingly from a growing entrepreneurial class and from foreign businesses and governments. This broadening base of support—along with the obvious fruits of rapid economic development—may bolster Beijing's reform commitment during the uncertainties of the transition to a post-Deng Xiaoping era. Although reforms will almost certainly encounter setbacks in the 1990s, pressures from these quarters will be a powerful force urging the regime to press ahead.

China's Economy Surges ...

China in 1992 chalked up its strongest economic performance in six years as real GDP increased by 12.8 percent. Following a 7-percent increase in real GDP in 1991, the economic expansion is boosting living standards and creating new job opportunities for many Chinese residents and adding to Beijing's clout as an emerging economic power. The sharp acceleration in growth last year followed Deng Xiaoping's visit in January 1992 to southern China—including a high-profile visit to the Shenzhen Special Economic Zone—that helped reinvigorate economic reforms:

-- Deng's reformist statements during his tour—including attacks on "leftists" who place political orthodoxy ahead of economic construction—gave the green light to local authorities to speed up their own development initiatives. Investment spending on fixed assets surged by 37.6 percent last year, led by aggressive spending by local authorities. To cash in on the economic expansion, for example, local authorities established thousands of "economic zones" in an effort to emulate the success of prominent coastal zones such as the Shenzhen Special Economic Zone. Local spending and the need to prop up inefficient state-owned enterprises helped push total bank lending up by roughly 20 percent last year, contributing to an over 30-percent jump in the money supply.

-- The reform resurgence also spurred a dramatic increase in entrepreneurial activity. The number of companies in China nearly doubled last year to reach 480,000, in part because Beijing is encouraging existing firms and government units to set up new business ventures to provide jobs for surplus workers and government functionaries. A growing number of Chinese are also abandoning secure but dead end jobs in the state sector to "swim in the sea" of the market-based economy, while many others are moonlighting at entrepreneurial ventures to augment their salaries.

-- China's foreign commercial ties increased substantially last year; not only did China's total trade increase by almost 22 percent, but foreign utilized investment jumped by 160 percent. Meanwhile, Beijing's efforts to ease frictions with trading partners and gain membership in the General Agreement on Tariffs and Trade (GATT) spurred reforms designed to improve foreign access to China's domestic market and to bring Chinese commercial practices closer in line with international standards.

Major Communist Party and government meetings over the past year helped cement important elements of Deng's economic reform vision. Personnel appointments at the 14th Party Congress in October 1992 and at the Eighth National People's Congress (NPC) in March 1993, for example, installed a new economic policy making team largely made up of pragmatic reformers in their sixties. These meetings also enshrined Deng's vision of a "socialist market economy" in party and state constitutions. Despite caveats that China's economy must remain dominated by "socialist public ownership," Beijing has made a significant public commitment to further expanding the role of market forces in its economy. An article published in a January 1993 edition of *People's Daily*—the Communist Party's flagship newspaper—argued that the market is "much more powerful than the government' in regulating economic activity—a view that is probably shared by an increasing number of China's policymakers. As an indication of Beijing's outlook, the NPC in March approved a substantial reorganization of the economic bureaucracy designed to transform key elements of the interventionist planning apparatus into either commercial ventures or into organizations to provide advice and market information to manufacturers.

How Accurate Are China's Statistical Yardsticks?

We rely on published Chinese statistics—except where noted—to provide key benchmarks for economic performance. in many cases, Chinese statistics are easily accessible time series data that generally track well with observed economic trends. Beijing is also making efforts to improve and upgrade its statistical yardsticks, recognizing that economic information is a vital requirement for market development.

Nevertheless, some statistics do not correlate with Western measures, or are flawed by weak collection or other problems. Furthermore, economic reforms themselves have complicated Beijing's statistical measurements because rapid growth of the nonstate sector—including booming rural enterprises—has increased the segment of the economy that is most difficult to measure. Some statistical series need to be handled with particular care:

- Unemployment statistics are questionable because they count only registered urban residents and exclude unregistered migrant workers that are an important part of the work force in many localities. Unemployment figures also do not capture the extensive underemployment among state enterprise workers or in rural areas where over three-quarters of the population still resides.
- The commonly used gross value of industrial output (GVIO) series—a holdover from Soviet-style statistical measures—tends to overstate somewhat growth in industrial output because of double counting and because some enterprises report output in current rather than constant prices. Furthermore, because GVIO statistics report all output—even unusable or unmarketable goods— they overstate the real contribution of China's industries to national income.
- China's monthly inflation statistics—which compare price levels for each month with levels for the same month in the previous year—in fact report the entire previous year's inflation. These figures obscure current inflation trends and cause many misunderstandings. Beijing has begun sporadically releasing inflation figures on a month-to-month basis—as is common in Western countries—but complete series of month-to-month figures that would be needed to calculate seasonal adjustments are not yet available.

Restructuring the Economic Bureaucracy

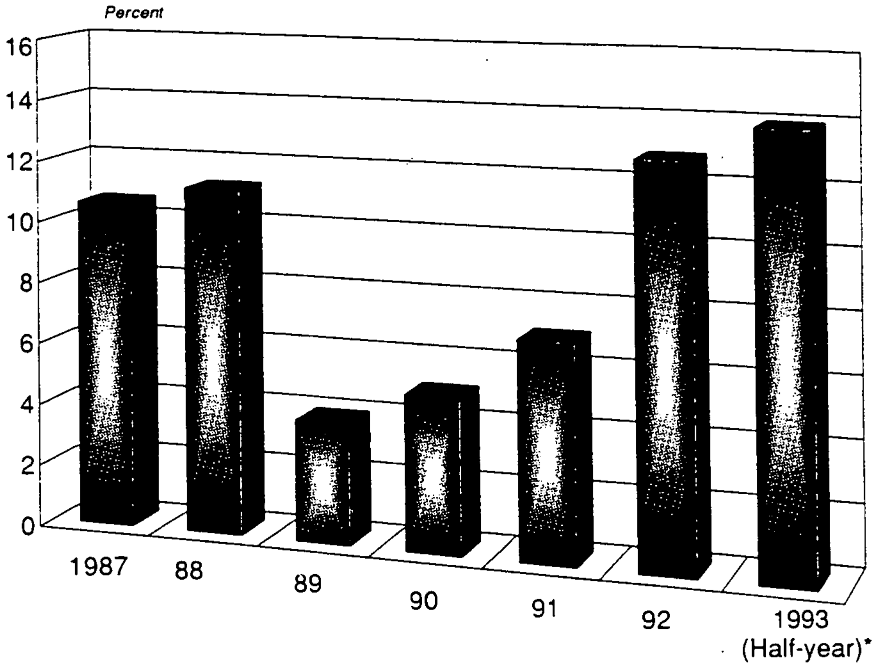
In March 1993, the National People's Congress (NPC) approved the first steps in a new plan to streamline China's massive economic bureaucracy and to reduce interference in enterprise commercial operations. A key element in the plan is the new Economic and Trade Commission—formed by upgrading an existing office to full commission status—which some reform proponents hope will eventually become China's version of Japan's Ministry of International Trade and Industry. The commission will oversee the nation's industrial sector by absorbing a number of functions from other elements of the economic bureaucracy.

The plan also rearranged a number of economic line ministries:

- Three ministries were abolished: the Ministry of Aerospace Industry, the Ministry of Textile Industry, and the Ministry of Light Industry. Each will be replaced with business-oriented corporations or "trade federations" that will provide policy guidance and supervision over these sectors but ostensibly without the administrative ties that the ministries enjoyed.
- The Ministry of Commerce and the Ministry of Materials and Equipment have merged into a single Ministry of Internal Trade.
- In an apparent step back from Beijing's streamlining objectives, two ministries that had been formed by mergers during a 1988 reorganization will be split; the Ministry of Machine Building and Electronics Industry will divide into separate ministries for machine building and electronics, and the Ministry of Energy Resources will split into separate ministries for coal and electric power. These shifts probably reflect Beijing's belief that separate ministry level organizations are needed to oversee the strategic electronics and coal mining sectors.

Although these shifts reduced the total number of ministries and commission by only one, the plan also calls for cuts of up to 25 percent of government functionaries at all levels over the coming three years, a move that could affect millions of bureaucrats. Beijing has also demanded that remaining ministries and commissions reduce their interference in the management decisions of business enterprises.

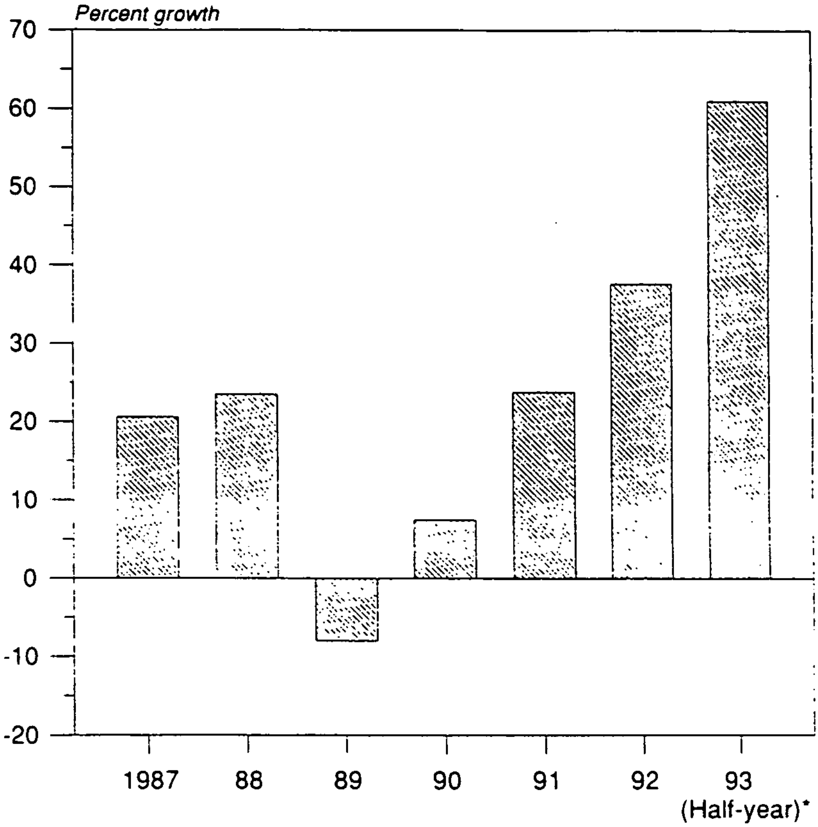
China's Real GNP Growth, 1987-93



*Compared to same period in 1992.

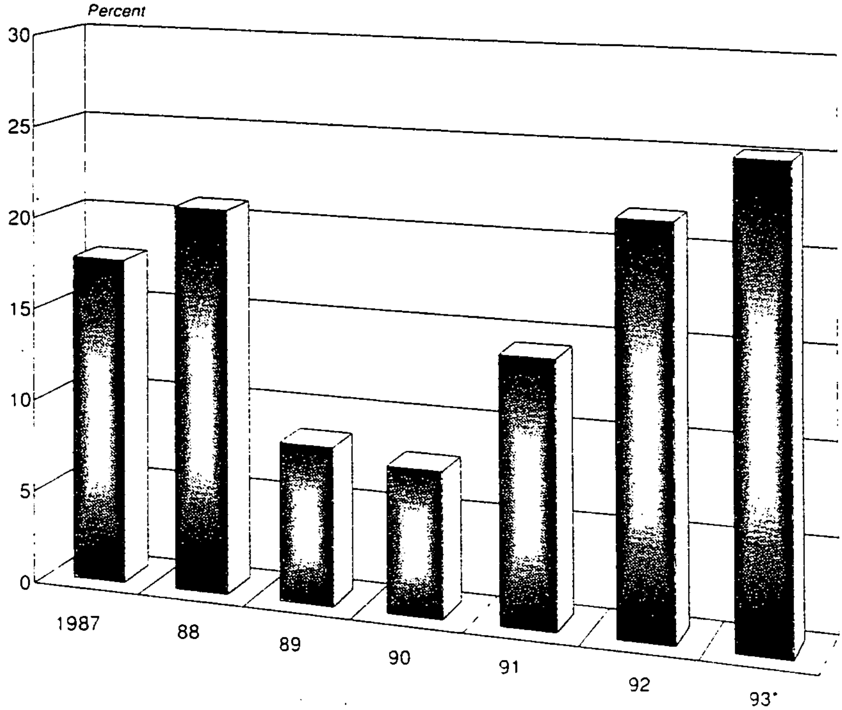
Source: Official Chinese statistics.

Growth in Nominal Investment in Fixed Assets



*Compared to same period in 1992.
Source: Official Chinese statistics.

China's Industrial Output Growth, 1987-93

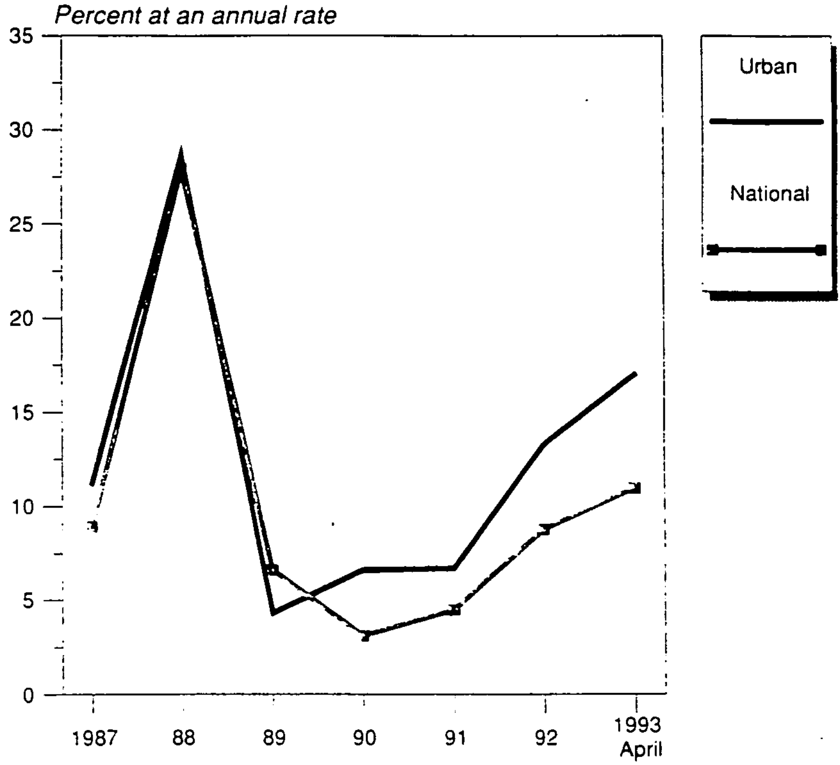


Gross value of industrial output (GVIO) calculated using constant prices

*1993 first six month GVIO growth compared with same period in 1992

Source: Official Chinese statistics

China's Inflation, 1987-92



Values are for December of each year compared to December of preceeding year.
April 1993 inflation compared to April 1992. National cost of living index for April is estimate.
Source: Official Chinese statistics.

... Amid Concerns of Renewed Economic Overheating

Central policymakers are grappling with the problems of rapid growth, which continued into the first half of this year as GNP increased by 13.9 percent compared with the same period last year. The expansion is threatening to spiral into the kind of overheated growth that forced the government to undertake costly retrenchment programs three times during the 1980s. Inflation—a key measure of overheating and a politically charged issue as well—is rising steadily; the cost-of-living index for urban workers increased by 13.3 percent during 1992, nearly twice 1991's level.[1] As economic decision making powers are increasingly decentralized, frictions are also escalating between central leaders and local authorities who are anxious to take advantage of new opportunities. Despite repeated warnings from central authorities to avoid "rash" development schemes, for example, investment spending on fixed assets jumped 51 percent in the fourth quarter of last year compared to the same period in 1991, and surged by 61 percent in the first half of this year compared to the same period in 1992.

Despite these indicators, Chinese press commentaries and official statements early this year generally claimed that economic growth was within acceptable bounds. Officials pointed out, for example, that a resurgence of consumer anxiety over escalating prices and shortages that contributed to panic buying in 1988 is not likely in the near term because consumer markets are well stocked with goods and because wage increases have generally kept pace with inflation. They also noted that some inflation resulted from long-overdue measures to lift artificially low prices. Deng Xiaoping himself spoke out for continued reforms and high growth rates at a public appearance in Shanghai in January 1993.

Hong Kong press reports, however suggest that some leaders were privately urging early this year that growth rates should be dampened before signs of overheating became more visible. More orthodox leaders in particular argued that latent inflationary pressures were building because of the rapid growth in the money supply and the increasing costs of producer goods that forms would eventually need to pass along to consumers. Rising inflation—April's cost-of-living index for urban workers stood at 17 percent above April 1992's level, the highest increase in four years—undoubtedly fueled these concerns. Moreover, Beijing's eroding control over local development efforts, coupled with speculation in real estate, stocks, and foreign exchange, probably added to leadership concerns. Throughout the past year, authorities have also been faced with sporadic local demonstrations in both urban and rural areas, which are a constant reminder of the potential for inflation, corruption, and other economic problems linked to overheating to spark wider protests. Even reformist leaders realize that their own political futures could be jeopardized by social unrest if economic overheating is not checked.

Sectors Showing Gains, Strains of Rapid Expansion

The combination of rapid growth and mounting signs of economic overheating can be seen in virtually all sectors of the economy. The output of China's *industrial sector* surged by almost 22 percent last year, fueled by heavy

[1] We have elected to use Chinese price statistics for December of the year in question when reporting annual inflation rates in this report. Because these indexes each use December of the previous year as a base, they report inflation for the entire twelve month period. In contrast, Chinese annual inflation figures are derived using a monthly averaging method that under estimates inflation when prices are rising and over estimates inflation when prices are falling. Using this method, China reports a 5.4-percent increase in inflation in 1992.

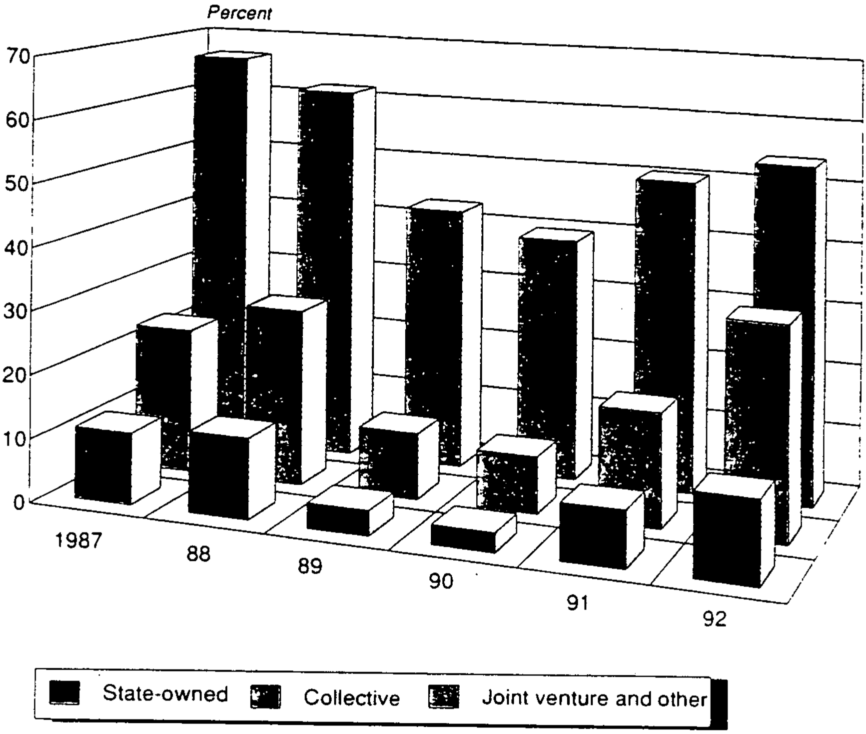
investment spending that boosted demand for producer goods and construction materials. The sales volume of major capital goods, for example, increased by more than 40 percent last year. Buoyant demand, shortages, and gradual reductions in artificially imposed price ceilings pushed prices of these goods up substantially last year, with coal prices climbing by 20 percent, steel prices increasing 40 percent, and cement prices jumping 47 percent, according to one Chinese press account. In contrast, sales of retail goods increased by only 15 percent at current prices and at less than one-half that rate when discounted for inflation in national retail prices. Some consumer products, including refrigerators, watches, some textiles, and other durables, are still heavily overstocked, and firms in these sectors continue to be hampered by excessive inventories and unpaid debts.

The economic expansion is straining the nation's transportation and energy infrastructure, creating supply bottlenecks that are another key indicator of overheating. The heavily used railways, for example, are failing to keep up with the demands of the expanding economy, and energy production lagged far behind the overall industrial output gains last year as well. As one indicator of the gap between burgeoning demand and lagging supply, in the fourth quarter of 1992 China became a net oil importer for the first time in 15 years. China has since resumed its status as a net oil exporter, but production and demand trends indicate China will again become a net oil importer by mid-decade.

China's state-owned enterprises are continuing their often painful transformation from being appendages of the government's economic planning apparatus to becoming market- oriented producers. State factories that are economically viable—probably accounting for fewer than one-third of all state-owned industrial firms—are taking advantage of enhanced market opportunities and increased freedom from government interference to diversify their operations and shed some of their nonprofitable operations. A handful of leading enterprises, for example, are restructuring their operations along Western lines in preparation for listing shares on Hong Kong-s stock exchange.[2] Beijing has also succeeded in cutting the proportion of state enterprises that are running in the red to under one-third, in part because of gradual price reforms. Indeed, by lifting some artificially low state-set prices for energy and raw materials, the regime actually trimmed budgeted subsidy payments to deficit state enterprises, such as coal mines, by roughly 12 percent last year.

[2] In June 1993 the Qingdao Brewery became the first Chinese state enterprise to list shares directly on the Hong Kong bourse. Eight other state-owned firms have received permission to list as well.

China's Industrial Output Growth by Sector, 1987-92



Source: Official Chinese statistics.

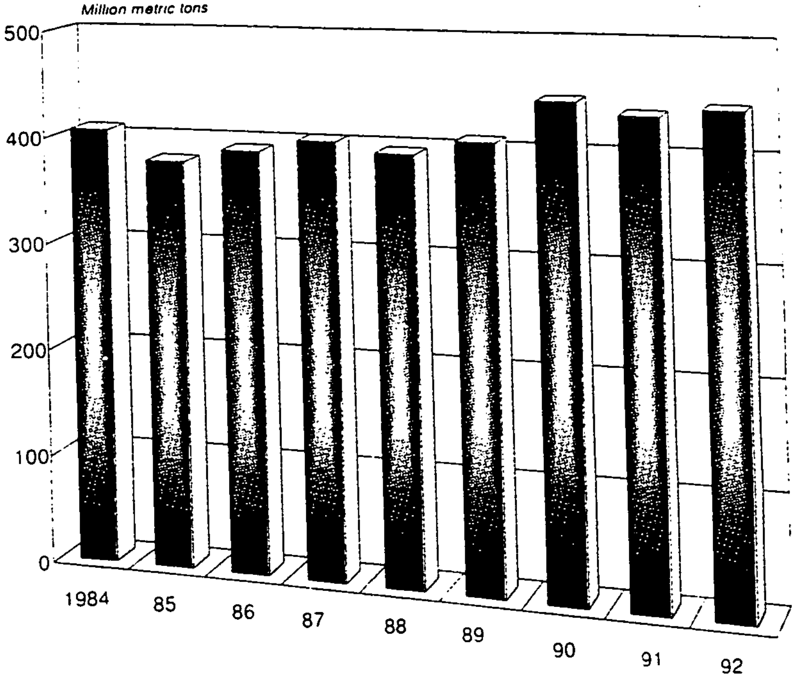
The majority of state firms, however, remain overstaffed and continue to face difficulties adjusting to the demands of the marketplace. Although fewer than one-third are reporting deficits, many firms are counting bank loans as part of their earnings, delaying needed equipment maintenance, or using other techniques to hide their losses, according to Chinese press reports. Reforms to cut surplus state enterprise workers and force deficit-ridden firms into bankruptcy are progressing slowly because of concerns over social unrest and the costs of writing off unredeemable bank loans. Chinese courts ordered 45 state firms to declare bankruptcy last year, according to a Chinese press report, but many of these cases probably remain unresolved.[3] Because of the buoyant economy, output from state-owned industrial enterprises grew by 12.6 percent last year, but gains from non-state owned firms—which are often more adept at

[3] State enterprise reforms are discussed in greater detail in appendix D: "Beijing Wrestling With State-Sector Woes."

responding to changing market conditions—continued to erode the proportion of industrial output from state factories. Collective firms scored a 33.2-percent increase in production value and output from other types of enterprises—including foreign-funded firms—jumped by 54 percent last year.

In the *rural sector,* China's farmers reaped the second-largest grain harvest in history—at 442.5 million metric tons the crop nearly matched 1990's record—and fisheries and animal husbandry registered gains as well. Cotton production, however, dropped by 20 percent from 1991's record to 4.53 million tons, in part because of insect damage. Rural enterprises-including collective firms run by town and village authorities and individual household-run businesses—continued their strong growth; rural enterprise employment increased by nearly 10 percent to reach 105 million, and output from rural industrial firms increased by roughly 40 percent.

China's Grain Harvests, 1984-92



Source. Official Chinese statistics

Beijing Scrapping Grain Rationing

Beijing has taken substantial steps to dismantle the system of quota grain procurement and rationing in place since the 1950s. Under the old system—established to help shield urban residents from rising priced—farmers were obligated to turn over a portion of their grain harvest to state grain-purchasing stations at low state-set prices. Urban residents then used ration coupons to purchase this grain at state stores at even lower, subsidized prices.

Over the past two years, Beijing has adjusted food prices and changed subsidy arrangements to help phase out the rationing system in many localities:

-- Reforms in 1991 and 1992 raised the price paid to farmers for grain and also increased the urban selling price roughly to parity with the purchasing price. Cuts in grain subsidies saved local governments nearly 15 billion yuan (or roughly $2.6 billion) in the first 11 months of 1992, according to a Chinese press report.

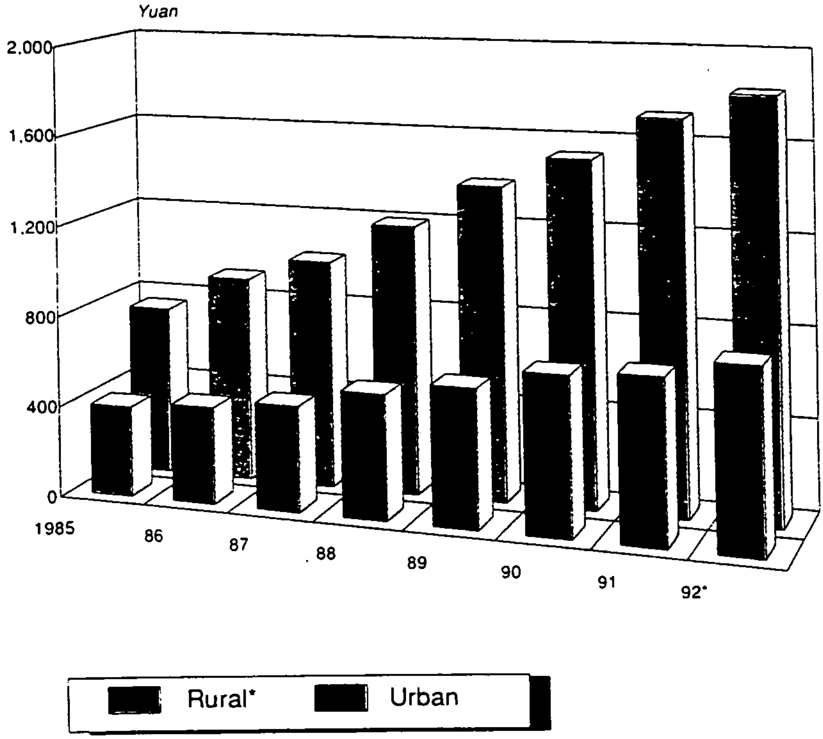
-- Localities began phasing out grain and edible oil ration coupons last year, paying urban workers an additional monthly food allowance to offset the loss of the ration coupons. Many urban residents had already stopped using the coupons because they preferred to pay higher prices for better quality free market staple foods. As of this spring, virtually all provinces have reportedly eliminated the grain rationing system.

-- The regime this year stopped supplying farmers with subsidized fuel and fertilizer. Instead, localities are supposed to make cash subsidy payments to farmers when they sign procurement contracts.

Elements of the state grain-purchasing system—such as state grain station s—remain in place, but they increasingly work through emerging grain wholesale markets where grain importing regions arrange for large-scale *purchases of grain. Grain pricing is partially determined by market forces, although Beijing still uses a system of guidance prices and protection prices to keep price movements within limited parameters. The government has indicated that in the future it will rely more heavily on a state grain reserve system to help stabilize prices through market intervention—buying grain when prices are low and selling grain when prices are high—to protect both farmers and consumers.

Despite the good harvest, the rural sector has become a focus of leadership concern because of rising peasant discontent. Thousands of farmers in Sichuan Province demonstrated against local officials and police this May, protesting rising taxes and stagnant incomes, according to Hong Kong press reports, and other localities in key grain-producing provinces are probably experiencing similar disturbances. Central authorities have blamed much of the-unrest on local officials who have charged peasants excessive fees and taxes and diverted funds earmarked for crop purchases to higher profit development schemes, which in turn forced many grain purchase stations to issue IOUs to farmers instead of paying cash for their crops last fall. Beijing in December 1992 ordered localities to redeem IOUs within two months—in part to ensure peasants would have cash to purchase seeds and fertilizer—but Chinese press reports indicated that some areas failed to meet this deadline.

Average Annual Per Capita Income for Urban and Rural Residents,1985-92



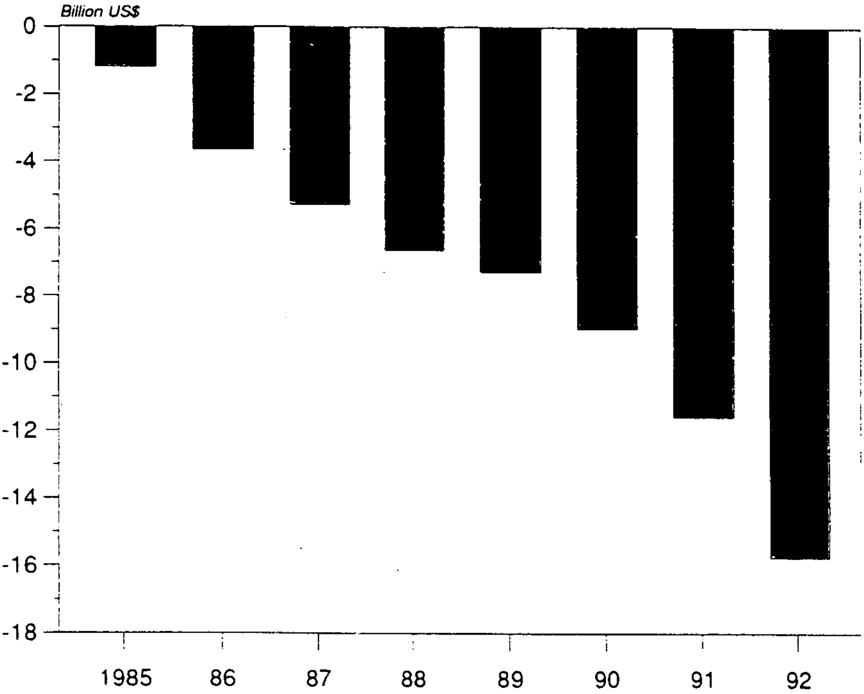
*Rural income is net of farming and business expenses.

Source: Chinese statistics based on survey.

Peasant discontent has highlighted the unequal distribution of the benefits of economic reforms that is at the root of many rural problems. While coastal regions are developing rapidly, many rural hinterland residents have been hit with stagnant grain prices, escalating input costs, and losses caused by inadequate systems for storing and shipping grain. Furthermore, many of these areas have not experienced rapid growth in their rural industries, which is largely a coastal phenomenon. Although Beijing has made substantial progress recently in dismantling the quota grain system that forced many farmers to turn a portion of their crops over to the government at artificially low prices, rural market mechanisms have failed to boost incomes in many inland grain-producing areas that are still burdened with substantial unemployment and underemployment.

As a result, many focal officials in inland provinces believe that they have no alternative in funding local development efforts—including roads, schools, and extension services—but to tax peasants and divert funds earmarked for crop purchases. Indeed, central authorities have admitted that dozens of taxes and fees assessed against peasants have been authorized in central and provincial documents in order to boost the services village and township officials provide for peasants. Beijing's new directives to limit peasant taxes and ensure that farmers receive cash for their crops have not resolved the fundamental causes of lagging rural development and may actually be inflaming tensions between peasants and rural authorities in many areas.

China's State Budget Deficit



Source: Derived from Chinese budget statistics. converted at \$1.00=5.74 yuan.

In the *financial sector,* rapidly escalating capital construction expenditures by both central and local authorities—in part to help modernize China's infrastructure and upgrade industries—pushed the government's "hard" budget deficit up by over 35 percent to 90.45 billion yuan (the equivalent of nearly $ 16 billion at the official exchange rate), or nearly 4 percent of total GNP.[4] Beijing was forced to boost sales of government bonds by over 60 percent and to step up borrowing from its central bank and from foreign sources last year to help cover the deficit, despite the regime's success in trimming budgeted subsidies for deficit state enterprises and subsidies for underwriting urban grain rationing. This year Beijing is facing a tougher time financing the deficit; sluggish treasury bond sales forced the regime to extend the bond selling period this spring; as of early June, more than 70 percent of 1993 treasury bonds remained unsold, primarily because of low interest rates.

Pressure on the state banking system to provide credit to finance the economic expansion and to help prop up inefficient state-owned enterprises pushed total lending up in 1992 by nearly 400 billion yuan (or nearly $70 billion), a jump of roughly 20 percent over the total outstanding loans at the beginning of the year. Buoyant bank lending—along with Beijing's reliance on the central bank to help cover a portion of the government s deficit— helped boost currency in circulation by 36 percent and cash plus demand and time deposits by almost 31 percent, adding further to inflationary pressures. However, bank savings deposits grew substantially last year as well, increasing by 26.8 percent to reach 1,154 trillion yuan, or the equivalent of over $200 billion. But the regime's reluctance to raise deposit interest rates despite rising inflation last year—primarily because banks would need to increase loan interest rates to offset higher returns paid to depositors, which in turn would push heavily indebted state enterprises further into the red—encouraged many Chinese to look for other investments that would yield real gains. The rate of growth in bank savings deposits slowed throughout last year, and in March 1993 bank deposits fell in only the second monthly decline in 15 years.[5] In response, Beijing raised interest rates on savings deposits and loans in May—the first adjustment in nearly two years. The modest increase, however, failed to bring interest rates above effective inflation levels, and real returns for Chinese savers remained negative.

China's officially sanctioned capital markets developed far slower than the burgeoning demand for investment alternatives and financing. According to one recently published estimate, Chinese individuals now hold the equivalent of over $315 billion in capital assets—including cash, savings deposits, and various types of investment instruments—but few legitimate options are available to help them shield most of these holdings from the effects of inflation. The number of enterprises issuing stocks for sale to the public increased last year from 89 to 123, about one-half of which were listed on China's two operating stock exchanges. In addition, over 3,000 state-owned enterprises have issued stocks to employees that cannot legally be traded outside the firm. The search for alternatives nevertheless encouraged speculation in these "internal shares." Highlighting the intensity of speculative demand for new investment options, disturbances broke out in Shenzhen in August 1992 after tens of thou-

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[4] In Chinese budget accounting, domestic bond sales and foreign borrowing by the government are counted as revenues. To arrive at the "hard" budget deficit, we follow Western accounting practice by not including these items as part of government revenues; as a result, our figure is higher than the Chinese Government's.

[5] The other decline was in August 1988 when many Chinese residents withdrew savings deposits to purchase consumer durables in anticipation of price hikes.

sands of hopeful investors flocked to participate in a lottery for purchasing a new stock listing, but found they could not even obtain lottery forms.

Beijing Turns Spotlight on Service Sector

China markedly stepped up efforts last year to promote service industries, including real estate, financial, legal, tourism, and trading endeavors. These services have been neglected for years, in part because of Marxist-inspired theories that considered them "unproductive" or "capitalist." A key party document issued in the spring of 1992, however, reflected Beijing's new, reformist view of the service sector as a vital link in the development of China's market economy. Beijing has called for growth in the service sector—often called the "tertiary" sector in Chinese commentaries—to outstrip growth in China's agriculture and industry in coming years.

Beijing is embracing services both because it recognizes they are vital to smooth market development and because they offer a low-cost way to provide jobs for millions of redundant state enterprise workers and government functionaries. Of the 226,000 new companies registered by Chinese authorities last year, nearly 75 percent were service-sector undertakings, according to Chinese press accounts.

Beijing's new support for services also extends to foreign investors. China has permitted limited operations by foreign-owned bank branches in the special economic zones since the mid-1980s, and in 1991 allowed selected foreign banks to open branches in Shanghai. In 1992 Beijing added seven more cities to the list where foreign bank branches could operate. In addition:

-- China has opened its domestic market wider to foreign retail operations. In October, for example, Japan's Yaohan Department Store chain and its Chinese joint-venture partner broke ground for a major shopping center development in Shanghai.

-- In October 1992 the American Insurance Group obtained Beijing's permission to open the first foreign insurance office to operate in China since 1949.

Beijing's sudden embrace of service industries faces a number of potential stumbling blocks. Many newly formed service companies have been established by state enterprises and government units, and these companies will be prone to trade on official connections as they begin business, leading to a surge in corruption and influence peddling. Many other firms will undoubtedly fail, stranding new employees and creating pressure on the government to provide unemployment support or to let them return to state sinecures. Finally, the surge in services has been accompanied by rapid price increases for items that many Chinese residents have long taken for granted—prices for services are the fastest rising component of cost-of-living increases— which could trigger a popular backlash against this new entrepreneurism.

The *military* is also learning to "swim in the sea" of the market, capitalizing on its defense-industrial base and political clout to take advantage of expanding economic opportunities. China's budgeted defense expenditures increased by nearly 14 percent last year to 37 billion yuan (or $6.4 billion at the official exchange rate), the fourth consecutive year of nominal double-digit increases. Budgeted expenses, however, are only one source of income for the defense sector. Profits from commercial enterprises run by the People's Liberation Army (PLA) totaled roughly 30 billion yuan last year, according to Hong Kong press reports. Other sources of income include transfers and subsidies the PLA receives from local governments to cover some of the expenses of conscription, demobilization, maintenance of reserve forces, and military pensions. Income from extra budgetary sources almost certainly surpassed budgeted allocations.

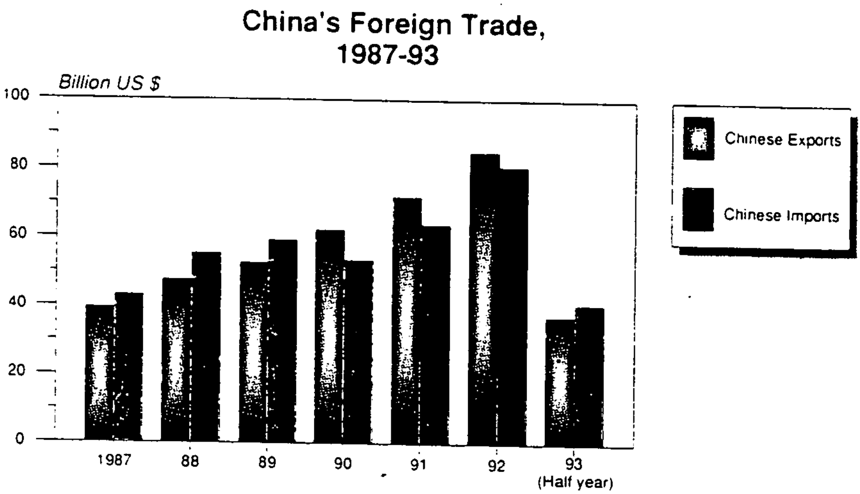
Trade and Investment Forging Stronger International Links

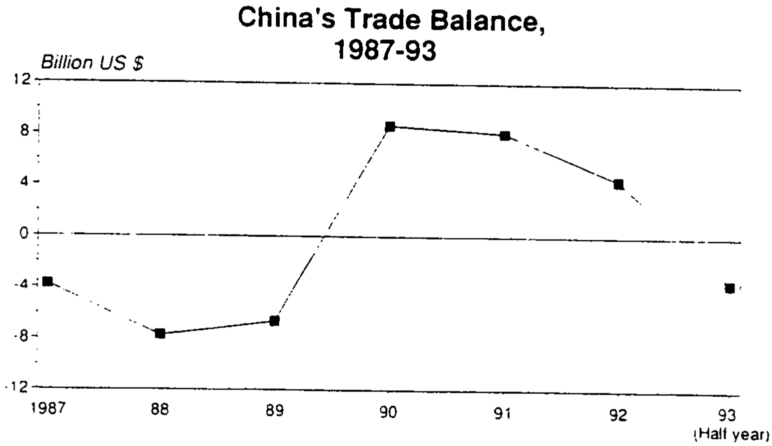
China became the world's 11th-largest trading nation last year—up from 15th in 1991—as total foreign trade reached $ 165.6 billion. China's 1992 global trade surplus of $4.4 billion was down substantially from 1991's $8.1 billion, however, as imports surged as a result of burgeoning demand and relaxed trade controls:[6]

-- Total Chinese imports grew 26.4 percent to reach $80.6 billion last year. The rapid growth in domestic investment is boosting imports of industrial and infrastructure goods, such as machinery and transportation equipment, and such raw materials as steel, which collectively accounted for over one-half of all imports last year. Increasing urban wages have resulted in a growing demand for higher quality consumer goods, which contributed to import growth as well. More imports or brands produced domestically with foreign materials and equipment are becoming available on market shelves, particularly in dynamic coastal urban areas.

-- China's exports also increased sharply last year, growing by 18.2 percent to reach $85 billion. Although low-technology, labor-intensive goods, such as toys and textile products, continue to dominate China's exports, Beijing had some success last year in boosting exports of more sophisticated products. The proportion of electrical and mechanical products in China's total exports, for example, increased from 19.6 percent in 1991 to 23 percent in 1992. Exports of machinery and transportation equipment jumped by nearly 85 percent over 1991 levels.

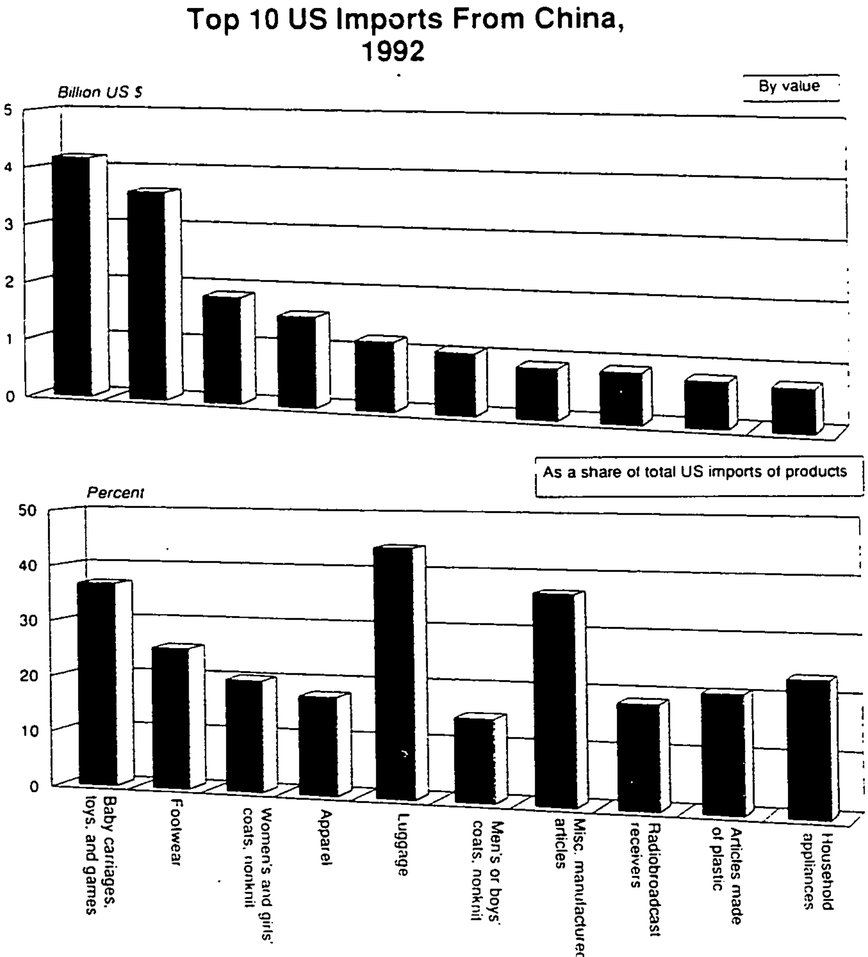
[6] Beijing late last year revised the method used to calculate China's foreign exchange reserves to include only foreign exchange holdings in the People's Bank of China, special drawing rights, and the country s reserve position in the International Monetary Fund. Chinese officials claim the new accounting method meets international standards. Beijing no longer includes in its official definition those foreign exchange deposits in other elements of the state banking system, including the Bank of China, arguing that these deposits are not really under state control. Thus, China's reported foreign exchange holdings of only $23.3 billion in December 1992 were roughly one-half the amount that would have been reported under the old formula.





Source: Official Chinese statistics

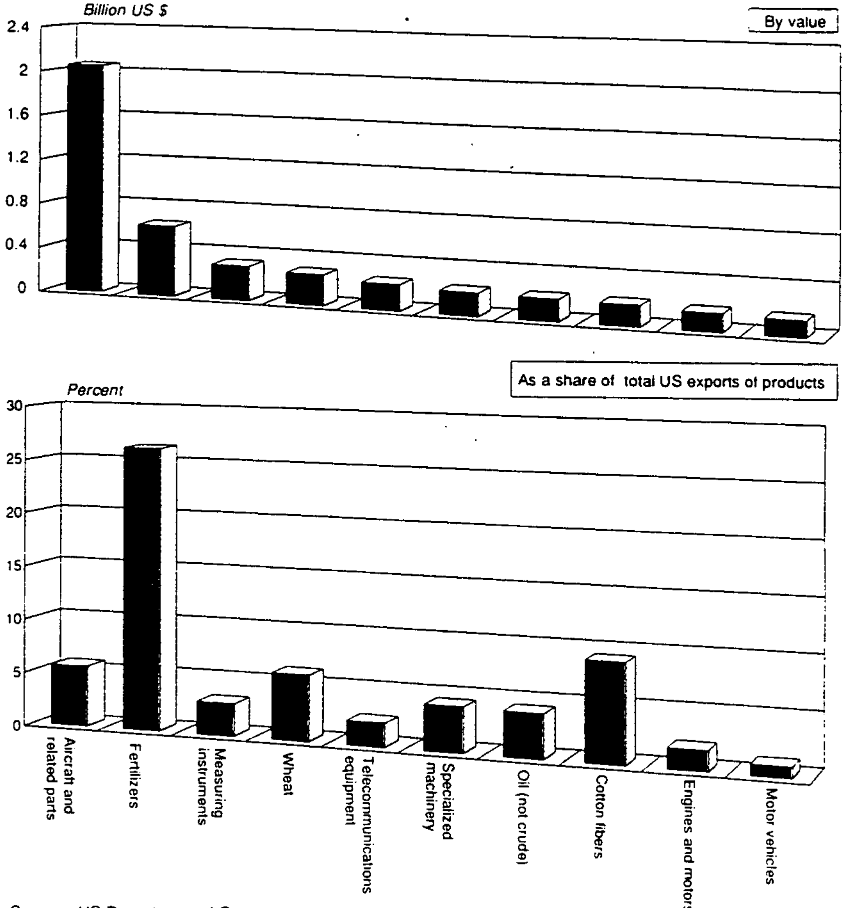
Despite its eroding global trade surplus—China in fact reported a $3.54 billion global trade deficit in the first six months of 1993—Beijing's trade surplus with the United States continues to mount. It increased by over 43 percent last year to reach $ 18.2 billion, according to US Department of Commerce statistics. US exports to China increased by 19 percent to reach $7.5 billion, led by aircraft, fertilizer, measuring instruments, and wheat But US imports from China—concentrated in low-technology, labor-intensive products, such as textiles, footwear, and toys—jumped by 35 percent to $25.7 billion, boosting China's share of total US imports from 3.8 percent in 1991 to almost 5 percent last year. China has gained US market share in part because manufacturers in Hong Kong, Taiwan, and other rapidly developing Asian nations are shifting their labor-intensive, export-oriented industries to China, which drives up the US trade deficit with China while deficits with these other Asian nations stabilize or even decline. Over one-half of China's footwear exports to the United States, for example, are produced in Taiwan-invested farms. This trend is likely to continue, and the US trade deficit with China—which is second only to the US trade deficit with Japan—could reach more than $23 billion this year if current trends continue.[7]



Source. US Department of Commerce statistics

[7] For a fuller treatment of China's trade patterns, please see appendix B: "The Chinese Market: How Different Suppliers Are Faring."

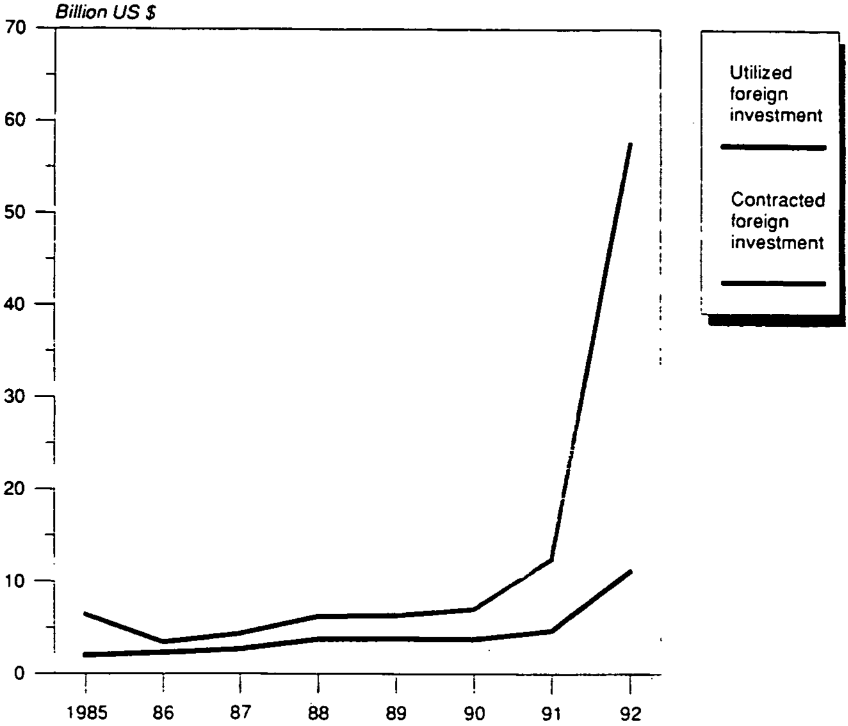
Top 10 US Exports to China, 1992



Source: US Department of Commerce statistics

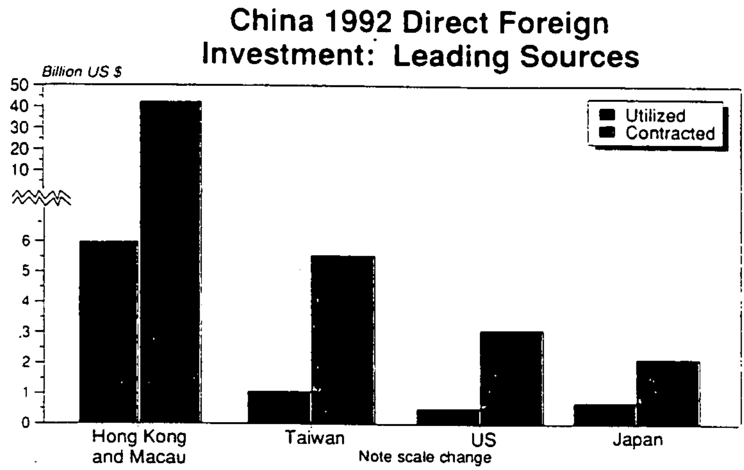
Foreign investment in China surged last year, with utilized direct investment exceeding $11 billion—an increase of 160 percent over 1991—and contracted direct investment more than quadrupling to reach nearly $58 billion, according to Chinese figures. Asian investors led the charge, with roughly 70 percent of both utilized and contracted investment coming from Hong Kong or from third-country investors channeled through Hong Kong firms. Taiwan became the second-largest source of foreign investment in 1992—providing roughly 10 percent of both utilized and contracted direct investment—as Taiwan businesses capitalized on increasingly open economic links with China. The US ranked fourth—after Japan—in utilized direct investment, supplying over $500 million in investments to China last year.

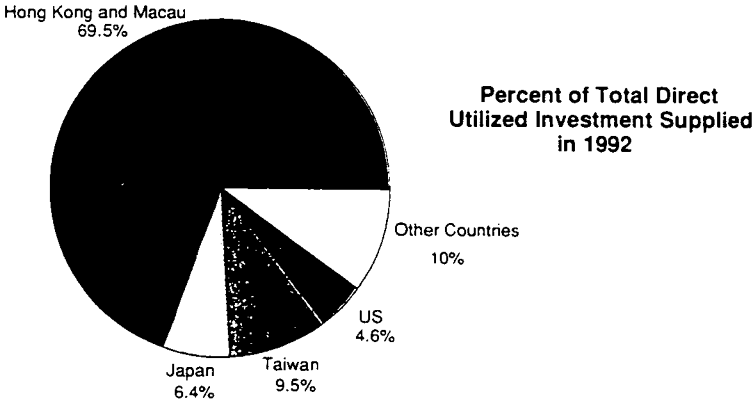
Direct Foreign Investment in China, 1985-92



Source: Official Chinese statistics.

These figures—particularly contracted investment amounts—are almost certainly inflated by overly enthusiastic local officials, and by the practice of funneling domestic funds through false-front foreign operations to obtain the preferential treatment—such as lower tax rates and easier access to imports—that Beijing reserves for foreign-invested enterprises. Nevertheless, the increase in real foreign investment going into China is notable, and reflects mounting foreign confidence in China's economic growth, as well as specific policy measures Beijing implemented to open the country wider to foreign commercial links:





Source. Official Chinese statistics

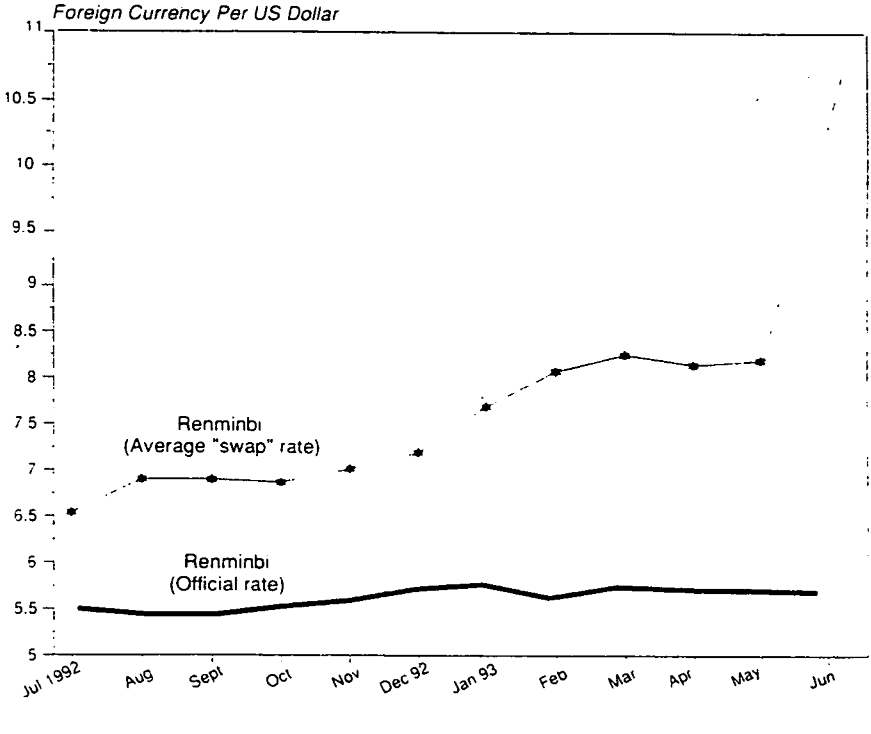
-- Beijing decentralized some aspects of the foreign investment approval process and dropped prohibitions against foreign majority ownership in joint ventures formed with state-owned enterprises. Several dozen hinterland cities were also opened for foreign investment last year.

-- Foreign investors purchased $711 million worth of land use rights—private land ownership is still prohibited—more than three times 1991's figure. Real estate investments accounted for over 6 percent of all utilized direct investment last year, and the proportion of land leasing agreements in contracted investment may be even higher.

-- Beijing has promised that foreign-funded enterprises will be able to sell more products domestically, hoping that competition from these products will help improve efficiency at moribund state-owned enterprises. Pledges of greater access to the domestic market contributed to increased investor interest in establishing joint-venture and wholly owned production facilities in China.

Beijing has recently stepped up appeals to investors to help finance basic infrastructure projects in energy, transportation, and communication, promising that foreign firms can build and operate such facilities for up to 15 years before turning them over to China. Recently Beijing touted an eight-year project to develop the strategic Yangtze River region—stretching from Shanghai to Sichuan Province—with an estimated investment of one trillion yuan (the equivalent of $ 175 billion), announcing that foreigners will be able to invest in many of the development projects.

China's Foreign Exchange Rates, 1992-93



Dashed line is CIA estimate.

Volatile exchange rates have created headaches for foreign investors, however, and highlighted the shortcomings in China's complex exchange rate system. China does not allow free convertibility of its currency, but pegs the "official" exchange rate—which Chinese banks offer to tourists and use for some other currency dealings—at an artificially high rate, currently roughly 5.7 yuan to the dollar. Individuals anxious to hold hard currency as a hedge against inflation and foreign exchange speculators who expected that Beijing would eventually devalue the official exchange rate helped push the black-market exchange rate up to nearly 10 yuan to the dollar by early this year. China's government-run swap centers—here authorized firms can exchange domestic currency for foreign exchange at "negotiated" rates—proved inadequate to meet the surging demand; Chinese authorities apparently attempted to cap swap center rates at roughly 8 yuan to the dollar, but few hard currency sellers were willing to trade at these rates. In early June, authorities relaxed controls on swap center rates, which quickly jumped to nearly 11 yuan to the dollar.

Pressure for wider access to foreign exchange is eroding China's nonconvertible currency system. The regime now allows individual Chinese travelers to take up to 6,000 yuan out of the country, and the Hong Kong branch of the Bank of China is helping individuals convert these limited amounts into foreign exchange. Some stores in Hong Kong are also openly accepting Chinese currency at rates similar to those in China's swap centers. A growing number of Chinese organizations are trading in foreign exchange futures—which businesses need in order to protect themselves against exchange rate fluctuations —although many reportedly lack official authorization. Even the People's Liberation Army has established unauthorized foreign exchange futures markets in southern China, according to Hong Kong press reports.

China's drive to gain greater stature as an internationally recognized trading nation—including its GATT membership bid—contributed to a series of measures by Beijing to reform its trade sector. China concluded an Intellectual Property Rights (IPR) Memorandum of Understanding (MOU) with the United States in January 1992 that commits China to improve protection of copyrights, patents, and trade secrets. As part of the agreement, Beijing has established bilateral copyright relations with the United States, acceded to several international IPR conventions, and adopted a revised patent law. In October 1992, China and the United States signed a Market Access MOU that commits Beijing to further reduce barriers to trade. Beijing has already taken a number of steps to improve access to its domestic market. At the end of 1992, Beijing unveiled a new round of tariff cuts on 3,371 imported items—covering a broad range of products including raw materials and high-technology equipment —claiming that the average overall tariff rate would be reduced by 7.3 percent Beijing has also taken steps to reduce nontariff barriers; it has announced the elimination of import substitution policies, and has promised to reduce the use of arbitrary testing and certification requirements. Beijing also claims that licenses will no longer be required to import over 3,000 kinds of goods. Finally, China has agreed to publish all trade regulations currently in use by the end of this year; the Ministry of Foreign Trade and Economic Cooperation has already begun publishing documents that were previously limited to "internal" use only.

Despite these efforts, many of China's trade partners are pressing for even wider access to its domestic market and for improvement in other trade practices. Japan, Mexico, and the European Community each initiated antidumping actions against China earlier this year. Japan for example, boosted tariffs against Chinese products in an antidumping move, and Mexico raised tariffs on three-quarters of Chinese imports into its market.

Trade partners hope that China's desire to gain membership in the GATT will help reduce trade barriers further. For its part, Beijing probably hopes to move bilateral trade disputes into the GATT forum, as well as enhance its international stature by becoming a GATT member. Recent Chinese press articles have noted, however, that domestic industries will face tougher competition from imports as trade barriers are reduced. Beijing is undoubtedly facing internal political pressures to maintain some barriers to protect uncompetitive state-owned producers and such emerging "infant industries" as the automobile sector. With China's trade balance slipping into deficit, Beijing may be more resistant to demands from trading partners for further trade liberalization, despite its desire to gain GATT membership.

Beijing's Prescription for Overheating

Chinese policymakers hope that inflation can be capped without resorting to draconian measures—such as a repeat of the 1988-91 retrenchment program—that would doom the economic expansion. Beijing may still have an opportunity to achieve this goal: while urban residents are nervous over inflation, many apparently feel reassured by well-stocked shops and markets and welcome the growing economic opportunities available to them. Even though retail sales of some formerly stockpiled items—such as TV sets—picked up substantially this spring because of anticipated further price hikes, a repeat of the panic-buying episodes of 1988 has not occurred.

Beginning early this year, therefore, central leaders targeted specific causes of overheating without resorting to wholesale retrenchment measures. Central banking officials, for example, indicated in January that they would allow new lending from the state banking system in 1993 to grow at roughly the same rate as last year but would "strictly" prevent more rapid credit growth.[8] Central government officials have stated that they hope to cap growth in investment spending at roughly last year's level as well. Meanwhile, Beijing unveiled measures to clamp down on economic "irregularities," trimming some local economic decision making autonomy in the process:

-- In December, Premier Li Peng announced a freeze in establishing new local economic development zones that in many cases have destroyed cropland and committed the regime to fund billions of yuan in infrastructure development projects with little hope of economic success. The State Council followed up with regulations that denied sub-provincial-level authorities the power to set up local economic zones and forced them to rescind many of the new zones they had established in 1992. Beijing has also tightened central control over preferential investment terms localities can offer to foreign investors.[9]

-- In early January, a senior Chinese banning official ordered a halt to the issuance of "internal enterprise shares" by state firms to workers. A State Council directive subsequently called on local officials to take steps to halt the issuance of these internal shares without proper authorization.

-- Central authorities in April clamped down on local financing efforts such as issuing unauthorized local bonds. Beijing apparently is particularly vexed at local officials and enterprises that issue bonds at high interest rates that compete with state bonds and deposits in state banks for investment funds.

-- This spring Beijing moved to crack down on unauthorized dealers in foreign exchange, including foreign exchange futures markets. The

[8] In past years, authorities set an internal unpublished target for new bank lending that was usually far below real needs and then boosted the target through the year as pressures for additional lending mounted. Beijing adopted a different strategy this year by publicly announcing in January that the annual lending target is roughly equal to last year's final credit growth figure.

[9] The leadership, however, has not reversed itself on zone development across the board: central authorities granted "state-level" status to some more promising local zones this spring.

leadership believed that speculation was helping the value of the Chinese yuan plummet in swap centers and on the black market, which could drive up import costs and add to inflation. Government circulars ordered that all foreign exchange futures transactions must be handled by agents specifically authorized by central bank officials and licensed by the State Administration of Exchange Control.

Central Versus Local Control: Beijing's Problems in Finding A Balance

Beijing's difficulty in forcing local officials to curb excessive investment spending that is fueling overheating highlights the problem of central control under partially completed economic reforms. One of the key elements of Deng's reforms is the decentralization of economic decision making power to lower levels to stimulate development, but central leaders are often frustrated by their inability to set limits on local prerogatives or to command immediate obedience when pressing problems are identified. Indeed, many local authorities have become adept at subtly ignoring Beijing's directives or responding with counter measures that appear to comply with orders but in fact undermine their intent.

Beijing's problems in managing local officials are intensified because, unlike in a federal system, there is little distinction between the powers and functions of the central government and local authorities. Instead, each layer of the bureaucracy—including provincial and municipal governments—mirrors the organization of the central government, carrying out many of the same duties on a local scale. While the center reserves the right to intervene in any local issue, Beijing cannot monitor everything, and therefore broad powers fall to local officials.

The fuzzy distinction between bureaucrats, bankers, and entrepreneurs also encourages undisciplined development. Bureaucrats can lean on local bank managers—whom they may appoint—to fund projects that are under their supervision and that will pay taxes into local coffers when completed. Even unsuccessful projects can enrich localities; local authorities can collect product taxes on goods that are never sold, and Beijing may have to help bail out banks that are stuck with the losses. Such "soft budget constraints" help localities undertake projects of dubious economic value, or that duplicate industrial facilities already constructed in other areas.

Frictions between central and local officials probably do not threaten the political unity of China. Virtually no state functionaries at lower levels question Beijing's ultimate political authority; most influential bureaucrats are party members subject to the party's internal methods of command and discipline. And, unlike in the former Soviet Union, ethnic rivalries are not a major factor in central-provincial disputes except in some strategically important but relatively sparsely populated hinterland areas. Nevertheless, economic localism is an important factor in China's repeated cycles of economic overheating and retrenchment.

Beijing Takes Further Anti-Inflation Steps

Despite these steps—and the modest boost in bank savings and lending interest rates in May—evidence indicates that Beijing has not yet turned the corner in its struggle with overheating. Inflation is continuing to mount, and investment in fixed assets in May jumped 70 percent compared with May 1992, underscoring Beijing's difficulties in controlling local fund raising and development efforts. Localities have also been dragging their feet in implementing central directives to deal with problems in the industrial and rural sectors; Beijing was forced to dispatch special inspection teams this spring to check up on local compliance with directives designed to grant state enterprises more operational autonomy and to reduce peasant taxes.

Responding to these indicators, Beijing boosted its anti-inflation efforts by unveiling a 16-point austerity program in early July, according to Hong Kong press accounts. The regime, for example, is pressuring localities to sell this year's quota of treasury bonds despite their unappealing interest rates, and workers in some areas are receiving bonds instead of salary checks, according to Hong Kong press reports. Beijing has also ordered state bank branches to call in loans that have been made to unauthorized clients—including loans to fund real estate development projects—to ensure that funds are available to support key state projects and for purchasing this year's grain harvest from peasants. In July the regime also again raised interest rates on bank deposits and loans.

Additional measures in the new 16-point program include a freeze on new price reforms to avoid fueling inflation. Beijing is also demanding that officials cut government spending by 20 percent, probably to spur reductions in administrative staff. To reduce speculative pressures on real estate, the plan calls for a new tax on the appreciation in real estate values and orders that real estate firms sell 20 percent of their residential holdings to Chinese residents at low profits. And the plan bans some auto imports for the second half of 1993 to cut the spiraling trade deficit.

Underscoring its determination to deal more effectively with economic overheating-particularly by cracking down on problems in the financial sector—Beijing installed Vice Premier Zhu Rongji as governor of the central bank in early July. The new appointment appears to establish Zhu—who already holds policy portfolios for industry and agriculture—as "first among equals" in implementing economic policy for the leadership.

These measures have already apparently affected demand for foreign exchange in China. Tighter credit restrictions and orders that funds be returned to banks have boosted demand for Chinese currency and encouraged some speculators to sell their foreign exchange holdings, helping strengthen Chinese currency on swap markets where exchange rates dropped to roughly 8.2 yuan to the dollar in early July.

It remains to be seen, however, how effective the new austerity program will be in controlling overheating. In the past Beijing has been able to temporarily regain control of overheated growth with similar retrenchment steps. China's economy, however, is now more diverse and less subject to direct central control. Furthermore, local officials have become adept at sidestepping orders from Beijing that run counter to their interests.

As the impact of the new program becomes evident, Beijing will probably attempt to fine-tune its strategy to minimize the use of administrative controls to combat economic overheating. Central leaders almost certainly still hope to avoid the costs that a full administrative retrenchment would entail:

-- Strictly controlling the issuance of new loans—one of the few direct levers Beijing has at its disposal—could lead to shortages of funds in Beijing's priority areas. Beijing has pledged that farmers will not be forced to accept IOUs again this year, for example, but localities may not have funds available to purchase crops without turning to banks for new loans. Furthermore, tighter credit controls could exacerbate the problems of state firms; state enterprise indebtedness, for example, could rise as customers are unable to pay their bills. Unpaid debts in the state sector—which is still the largest source of government revenues—could hold up tax collection efforts later this year, adding to Beijing's fiscal problems.

-- Intensive credit rationing—ordering banks to make loans only for crop procurement and selected state projects—threatens growth in some of the most dynamic, market-oriented sectors of the economy, such as rural industries and services. A slowdown in the creation of new job opportunities in these sectors would probably force Beijing to delay reforms aimed at cutting bloated state enterprise and government employment.

-- Attempts to limit local development efforts—such as banning new construction projects—are likely to trigger fresh local countermeasures. Many localities will almost certainly seek new fundraising channels to circumvent spending restrictions, further eroding Beijing's ability to monitor and regulate the economy.

-- Should Beijing seek to protect foreign exchange reserves by limiting imports—banning some categories such as luxury consumer goods, for example, or tightening import licensing requirements—frictions with major trading partners would probably escalate, which in turn could hurt Beijing's application for membership in the GATT.

In view of these costs, if inflation and other signs of overheating begin to ease, Beijing may step back from some of the administrative controls in the 16-point program and turn to market-based measures—such as further interest rate adjustments—to help keep the expansion within bounds. If overheating continues to intensify, however, the regime may face the difficult choice of applying tighter credit controls as the fall approaches—risking this year's crop procurement and revenue collection work—or delaying further efforts until next year when inflation and other symptoms of overheating could be even more intense.

China's Economic Cycles

China has experienced three cycles of economic expansion and retrenchment since the beginning of economic reforms in the late 1970s. In each case, Beijing's reforms helped to harness local initiatives and boosted living standards, but also created undesirable side effects that forced Beijing to temporarily retrench.

To ease popular discontent over decades of stagnant living standards, Beijing boosted incomes in the late 1970s by allowing factories to pay incentive bonuses and by increasing the prices peasants received for grain and other commodities. Government subsidies to underwrite these price hikes contributed to a sharp jump in budget deficits in 1979 and 1980. Meanwhile, surging import demand created a trade deficit beginning in early 1980.

-- *Central leaders responded in 1980 and early 1981 by cutting budget expehditures—which trimmed investment spending—and by tightening foreign exchange controls to help curtail imports.*

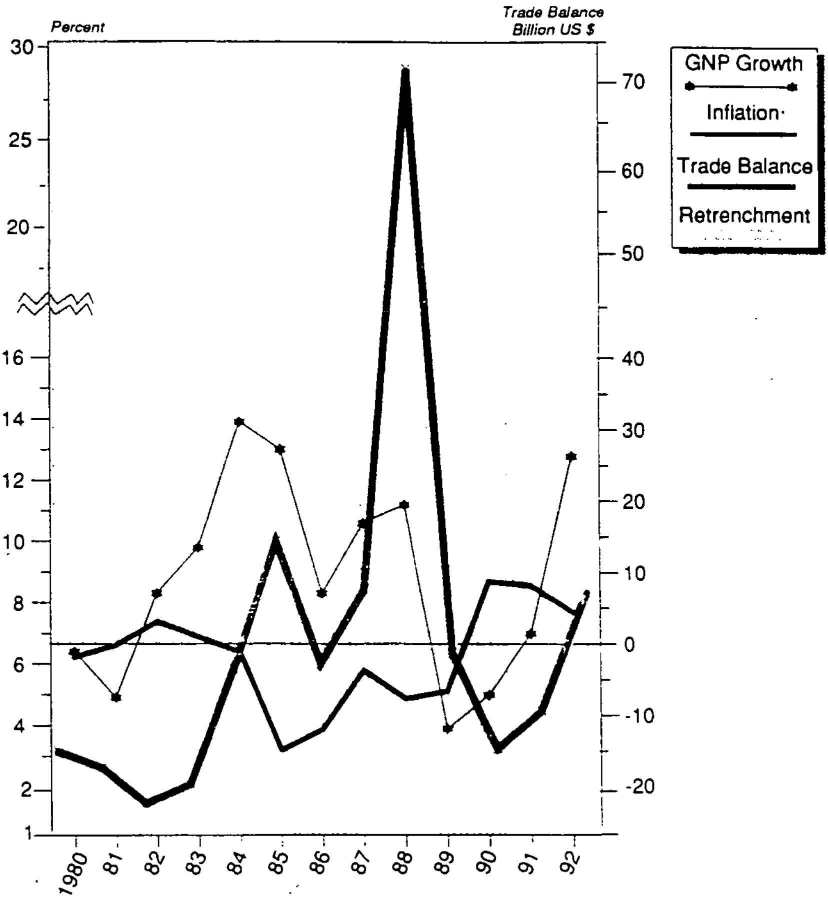
By late 1982, favorable trade balances and productivity gains prompted the regime to relax its retrenchment effort. With growth accelerating to record levels, banking reforms that loosened central controls over specialized banks led to a surge in new lending in 1984 and early 1985, boosting the money supply and adding to inflation pressures. Meanwhile, loosened central control over foreign trade again spurred imports, driving the trade balance far into deficit, and foreign exchange reserves fell 35 percent between September 1984 and June 1985.

-- *After a series of partial measures to dampen overheated growth beginning in mid-1985—including tightened controls over new credit—Beijing declared a temporary period of consolidation and retrenchment in early 1986.*

By 1987 the effects of the retrenchment had worn off, and rapid growth resumed. Beijing's plan to introduce new price reforms—announced in the spring of 1988 when inflation was already heating up—contributed to outbreaks of consumer panic buying, which pushed prices up even faster.

-- *Beijing responded with a severe retrenchment effort beginning in September 1988 that was originally scheduled to run for three years. Inflation dropped substantially in 1989, but stagnant economic performance forced the regime to begin easing controls by late 1990.*

China's Economic Cycles, 1980-92



Note scale change.

Inflation based on national overall retail price index; December over December figures.

Source: Derived from Chinese statistics.

Reform Horizons in the 1990s

Beijing's experience over the past year has highlighted again the limitations of relying on decentralizing decisionmaking authority to spur growth while indirect macroeconomic controls—including fiscal and monetary policy levers—are only partially in place. This prescription can generate rapid short-term economic gains but sets the stage for repeated bouts of economic overheating and retrenchment.

Central leaders almost certainly recognize that, to ensure longer term sustained growth, Beijing must strengthen its ability to guide a rapidly changing economy by developing more sophisticated macroeconomic levers:

-- Authorities have announced that banking laws will soon be promulgated that will strengthen the People's Bank of China as an independent central bank and help transform the state's specialized banks into commercial operations. These measures should improve the ability of the banking system to allocate credit on the basis of potential return and risk rather than functioning simply as a "teller window" for central and local bureaucrats.

-- Tax reforms are also under way. Enterprises of all ownership types will be placed under a single unified tax rate by the end of the year, according to central tax officials. At the same time, central authorities hope to boost the proportion of taxes they collect directly, helping improve Beijing's control over fiscal policy.

Furthermore, Chinese leaders probably recognize the need to erect a legal and supervisory foundation to support China's increasingly complex economy. China has made substantial progress in introducing market forces to the distribution of commodities, over 80 percent of which are now distributed through market channels, according to estimates by Chinese economists. But the experiences of the past year have focused attention on the need for more sophisticated markets to meet the demands of economic growth. China needs legitimate capital markets, for example, to give investors a wider range of investment options that link returns to risk and broader foreign exchange markets to meet the needs of the growing global economic links. Responding to these pressures, China recently established a Securities Regulatory Commission to help improve the supervision over nascent stock exchanges, and also promulgated regulations that attempt to spell out conditions and obligations for enterprises that issue shares to the public. Beijing has also announced that a comprehensive real estate law will be promulgated later this year to help set ground rules for the burgeoning real estate industry.

These and other commitments to continue the reform process do not promise smooth sailing ahead. In many cases the toughest reform measures—such as revamping the entrenched economic bureaucracy and cutting the labor force at bloated state enterprises—still lie ahead. Even if the regime succeeds in slowing the economy without resorting to draconian measures, Beijing must still wrestle with sectorial bottlenecks and recurring speculative bubbles as domestic and foreign investors seek to take advantage of rapidly changing—but poorly regulated—economic opportunities. Beijing is also likely to encounter resistance from provincial authorities as it tries to strengthen the central banking system and overhaul the revenue collection system—steps that would erode some of the powers local officials now enjoy.

These challenges face central leaders—many installed in their new positions during the past year—at a time when China is approaching a political watershed; senior elders of the revolutionary generation are now in their late 80s and are succumbing to poor health and old age. The capabilities of the new leaders—and their ability to work together effectively in the absence of senior patrons—are as yet unproven. And, despite nearly 15 years of reforms under the guidance of Deng Xiaoping, Beijing has not fully articulated a vision for the role of the Communist Party that is compatible with modernization trends under way in China.

Despite these uncertainties and challenges, China enjoys strong prospects for further growth. indeed, vast areas of the country are still at early stages of development. The development gap between coast and hinterland is a potential source of friction, but it is also an opportunity for wider dissemination of the benefits of reform. Improved transportation infrastructure, coupled with more efficient national labor and capital markets, could help Beijing promote faster inland regional development, creating new markets that could become an engine of growth in the decades ahead.

Furthermore, the past year has witnessed a rapid increase in demands for further reform measures. Support for reform is no longer coming primarily from a limited number of central policy visionaries and reformist officials in some coastal areas but increasingly from a growing domestic entrepreneurial class and from foreign businesses and governments. This broadening base of support for reforms—along with the obvious fruits of rapid economic development—may bolster Beijing's reform commitment during the uncertainties of the transition to a post-Deng Xiaoping era. Although reforms will almost certainly encounter setbacks in the 1990s, pressures from these quarters will be a powerful force urging the regime to press ahead.

Appendix A

A Chronology of Economic and Political Developments, January 1992-June 1993

January 1992

Senior leader Deng Xiaoping tours southern China and visits the Shenzhen Special Economic Zone, where he calls for speeded up reforms to create a "socialist market economy." Chinese media initially fail to report Deng's remarks.

China Southern Glass—a Shenzhen-based firm—issues the first state enterprise shares offered specifically to foreign investors.

The United States and China conclude an Intellectual Property Rights Memorandum of Understanding that commits China to improve protection of copyrights, patents, and trade secrets.

March 1992

The National People's Congress amend s the work report submitted by Premier Li Peng to include a reference to guarding against "leftism"" a code phrase aimed against reform opponents.

April 1992

Beijing abolishes the "import adjustment tax" on most commodities as part of efforts to cut market access barriers. Beijing boosts tariffs on imported autos, video equipment, and some other items to compensate.

Vice Premier Tian Jiyun delivers a hard-hitting pro-reform speech at the Central Party School in Beijing. Although official media do not carry the speech, Hong Kong press accounts and black-market video tapes of the speech circulate widely within China.

Beijing boosts the selling price of government-allocated grain and edible oil to roughly equal the prices paid to farmers for these commodities; authorities promise that many urban workers will receive cash subsidies to offset the price hikes.

May 1992

Deng Xiaoping visits Capital Iron and Steel Mill in Beijing—a leading state-owned industrial enterprise and a reform model—and calls for faster state enterprise reforms. Deng authorizes the firm to open the first bank directly affiliated with a state-owned firm.

The Production Office—an organization formed in 1990 under the State Planning Commission to help state-owned industrial enterprises achieve their production targets—is upgraded to independent status, and renamed the Economic and Trade Office. Vice Premier Zhu Rongji heads the office.

The nation's first metals futures market opens in Shanghai.

July 1992

Beijing publishes regulations on changing management mechanisms at state-owned enterprises that promise state firms greater business autonomy in 14 areas.

A Hong Kong firm purchases a controlling interest in a Wuhan textile enterprise in the first case of a foreign investor gaining the majority ownership of a state-owned firm.

Beijing opens additional hinterland cities to direct foreign investment and trade links, including all hinterland provincial and regional capitals.

August 1992

Thousands of investors applying to purchase stock on the Shenzhen stock. exchange become disorderly, damaging property and scuffling with authorities.

A railroad passenger car factory in Sichuan Province becomes the first large-scale state-owned firm to be leased to foreign investors.

A knitting mill in Sichuan Province becomes the largest state-owned enterprise to date to be declared bankrupt.

September 1992

Premier Li Peng signals that Beijing is willing to allow direct foreign investment to help develop some oil fields in northwestern China.

Beijing announces that price controls are lifted on nearly 600 types of producer materials, including some steel, electrical, and machinery products.

October 1992

The 14th Party Congress—party congresses are held every five years—elects a new Central Committee, endorses Deng Xiaoping's reform theories, and revises the party constitution to include Dengist phrases such as establishing a "socialist market economy" in China.

The American Insurance Group gains approval to open an office in Shanghai, becoming the first foreign insurance firm to operate in China in over four decades.

A Bermuda-based holding company that represents 51 percent ownership of a major Chinese state-owned automobile producer lists stock on the New York Stock Exchange.

November 1992

The Leading Group on Finance and Economy—the regime's top economic policy coordination body—is reestablished under the leadership of party chief Jiang Zemin, according to Hong Kong press reports. Premier Li Peng and Vice Premier Zhu Rongji are deputies.

December 1992

Beijing announces tariff cuts on 3,371 imported items.

January 1993

Deng Xiaoping calls for faster reforms during a visit to Shanghai.

The State Council Securities Committee is established to improve the regulation of stocks and securities markets.

March 1993

The Eighth National People's Congress—held March 15-31—raises the annual GNP growth rate targets for the 1991-1995 period to between 8 and 9 percent and revises the state constitution to endorse Deng Xiaoping's reform ideas.

April 1993

The State Council issues a circular banning the issuance of high interest rate bonds by local officials to raise funds.

May 1993

The interest rates on state bank savings deposits and loans are raised on May 15. Beijing promulgates interim regulations on issuing and trading enterprise stocks.

Appendix B

The Chinese Market: How Different Suppliers Are Faring

Many countries intensified their efforts to gain a foothold in the Chinese market in 1992 to capitalize on China's rapid economic growth and on Beijing's steps to open its market as part of its bid to join the General Agreement on Tariffs and Trade. Competition in the Chinese market will almost certainly heat up further this year, and foreign suppliers are increasingly likely to find themselves pitted not only against their foreign competitors but also against domestic Chinese producers. Imports could become tighter in the second half of 1993, moreover, if Chinese efforts to slow economic overheating through credit controls translate into fewer imports.

Mixed Year for US Sales

The 19-percent increase in US sales to China in 1992 was swamped by a 35-percent expansion of Chinese exports to the United States, which propelled the US deficit with China to a record $ 18.2 billion.[10] Although the growth in Chinese exports to the US market through the first five months of 1993 has slowed somewhat—up 25.5 percent over the same period in 1992—growth in US exports to China has slowed to 15 percent, and another record deficit appears likely this year. Indeed, if the bilateral trade trends through the first five months of 1993 continue, the US shortfall by yearend will reach more than $23 billion.

US suppliers did score some notable gains in the Chinese market last year. Despite a 20-percent decline in overall Chinese imports of transportation equipment, for example, US suppliers more than doubled their share of this segment of the Chinese economy, supplying 40 percent of total Chinese imports. US firms sold over $2 billion in aircraft and related equipment, making China the fastest-growing market for this US industry. US sales of computers also vastly outpaced the increase in overall Chinese purchases of these goods, and industry experts estimate that the United States now supplies over 40 percent of personal computers—both domestic and imported—sold in China. US car sales surged in 1992 following a well-publicized Chinese buying mission that purchased 7,000 US automobiles, giving the United States an 11-percent share of China's still highly restricted import market for automobiles.

US exporters, however, fared less well in other product lines. The US share of the fast- growing Chinese market for specialized industrial machinery deteriorated, despite a 60-percent increase in total Chinese imports of these goods in 1992. Many of these sales went to Asian suppliers as a result of their expanding direct investment in China; as firms in neighboring countries relocate their manufacturing facilities to China, related sales of equipment to outfit these factories have grown. Japanese sales to China of textile and leatherworking machinery, for example expanded over 160 percent last year while US exports of these items dropped nearly 17 percent. Moreover, US sales of wheat, cotton, textile fibers, plastics and chemicals dropped by between 19 and 39 percent last year, resulting in US market share declines. In some cases, these losses came despite strong overall growth in Chinese imports of these items; Chinese purchases of plastics grew by nearly 76 percent last year, and chemical imports expanded at an 18-percent clip.

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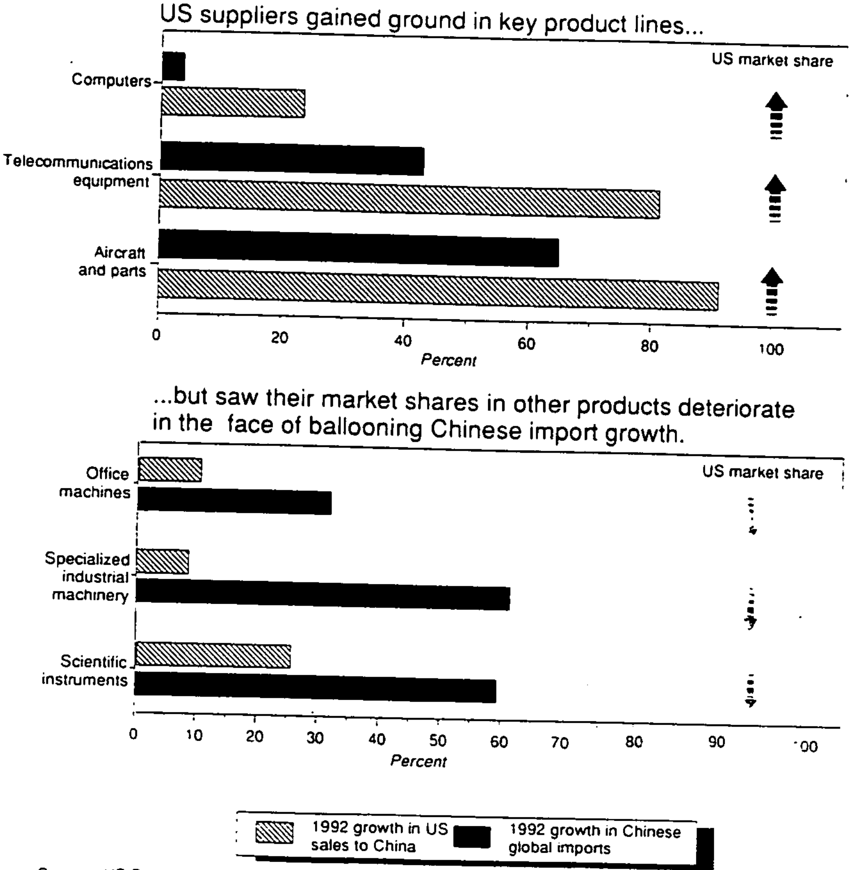
[10] Unless otherwise noted, all statistics are derived from data provided by China's trading partners rather than from Chinese Customs data.

Mixed Results for US Exports to China, 1992

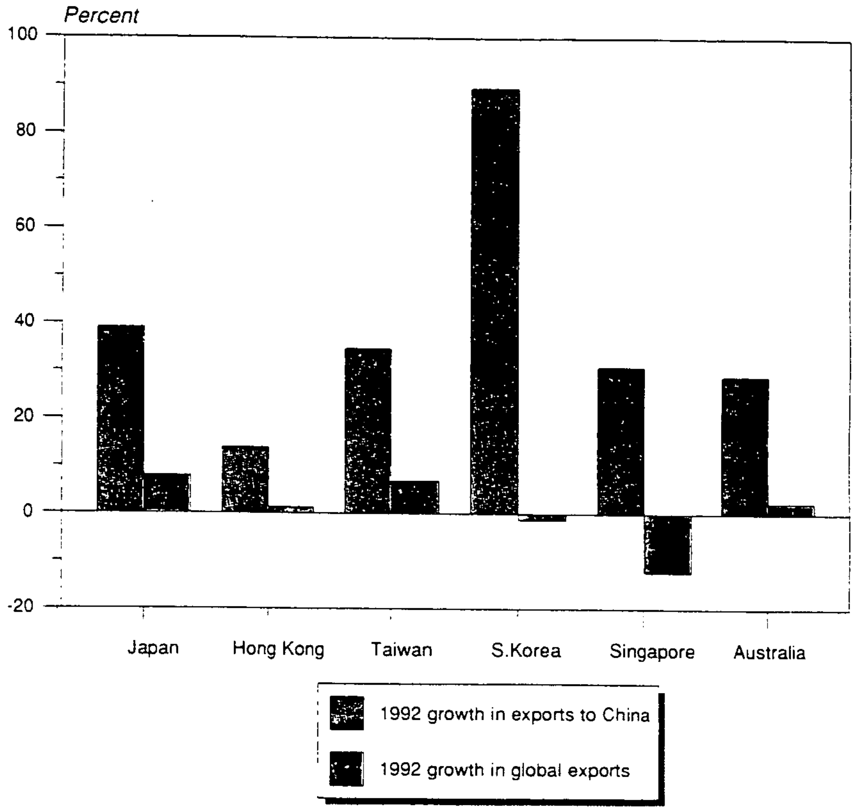


Source: US Department of Commerce statistics

Asian Countries Step Up Presence in China

China's economic ties to its Asian neighbors continued to deepen in 1992. For most of the countries in the region, rapid growth iii their exports to China last year stood in sharp contrast to more sluggish sales to the rest of the world. China's Asian neighbors increasingly view continued economic growth in China as vital to their own economic well-being. Hong Kong, Taiwan, and Japan were leading sources of the record $11 billion in new investment dollars that flowed into China in 1992—a tangible sign of China's closer economic links to other Asian economies.

Asian Exports to China Boom in 1992



Source: Partner country statistics

Japan turned in a strong performance in the Chinese market last year, boosting sales by 39 percent over 1991 levels—a pace that outstripped overall Chinese import growth by nearly 13 percentage points—to reach about $12 billion. Japanese businesses supplied 17 percent of all goods imported by China in 1992, making it the largest supplier to the Chinese market.[11] Purchases from China, however, also increased sharply in 1992, resulting in a Japanese bilateral trade deficit of $5 billion. Machinery sales continued to dominate Japan's exports to China, accounting for 40 percent of total Japanese sales in 1992. Japa-

[11] Despite the growth in Japanese exports to China in 1992, Japanese sales have still not matched their 1985 record of $12.5 billion, when Japanese goods accounted for 30 percent of total Chinese imports.

nese businesses supplied nearly one-third of all telecommunications equipment imported by China in 1992, for example, outselling their US competitors by nearly a two-to-one margin. Japan also continues to dominate Chinese consumer electronics imports.

Changes in Japan's investment strategy over the past year suggest that Japanese goods will continue to be competitive both in China and in third-country markets. Japanese businesses signed almost $2.2 billion worth of agreements for new investment projects in 1992, almost 2.5 times the level in 1991, and many of Japan's largest corporations—such as NEC, Mitsubishi, C. Itoh, and Sony—are taking a harder look at the Chinese market. These large firms, which have previously taken a relatively small stake in projects in China, now appear more willing to engage in projects producing more technologically sophisticated goods. Japan's NEC, for example, announced this spring that it would become the first Japanese firm to produce dynamic random access memory (DRAM) chips in China, following investments it made last year in the production of integrated circuits and computer-controlled telephone exchanges. Increasingly, Japanese subcontractors to these large Japanese firms are also relocating to China to escape high wages and an appreciating yen at home. Over time, they will probably become strong forces in both the electronics and automotive parts sectors of the Chinese economy.

Signs that Beijing is allowing greater access to the domestic market are also encouraging these firms to step up their China-based investments. Japanese firms have been quick to respond to new opportunities for investment in retail operations in China, part of a broader Chinese initiative unveiled last year aimed at attracting foreign investment into the service and real estate sectors. Although retail investments still remain highly circumscribed—limited primarily to larger urban centers—Japanese firms probably hope to eventually duplicate in China the success they have had elsewhere in Asia. Japanese department stores, for example, have captured about 40 percent of Hong Kong's retail market, a base that has paved the way for continued sales of Japanese products in the territory.

Taiwan enjoyed the largest bilateral surplus with China last year of any economy—$5.2 billion. China was Taiwan's fastest growing export market in 1992, according to Hong Kong statistics, with sales increasing at a 35-percent clip. Taiwan trade officials claim that sales to China were fueled by orders for machinery and components used in Taiwan-funded factories in southern China, an assertion that is borne out in Hong Kong statistics for indirect trade between Taiwan and China. Taiwan's exports of plastics to China climbed by a third in 1992, sales of textile yarns and fabrics expanded by nearly 22 percent, and specialized industrial machinery exports jumped 82 percent over 1991 levels. Taiwan's gains in these categories probably came largely at the expense of Hong Kong suppliers, who saw their share of Chinese imports of these goods decline in 1992.

South Korean exports to China grew 10 times faster than imports from China in 1992—up nearly 90 percent—reversing the bilateral deficit Seoul ran in 1991. The establishment of diplomatic ties last year paved the way for expanded South Korean sales, with Korean products for the first time enjoying most-favored-nation tariff treatment in China, a change that significantly boosted the price competitiveness of South Korean products. Indeed, South Korean exporters picked up market share in many of the categories where US sales declined, including chemicals, plastics, and textile fibers. Lower transportation costs probably also helped South Korean exporters win some sales at the expense of US and other foreign suppliers. South Korea's market share advances appear to be continuing this year; in the first two months of 1993, for example, South Korean exporters sold 1,400 cars to China, double the number of automobiles sold for all of 1992.

EC Sales Make Some Inroads

Although overall *European Community* exports to China grew almost 25 percent in 1992, the EC's share of the China market declined slightly. Only *Germany, Ireland, the Netherlands*, and the *United Kingdom* increased their shares. Germany led EC trade with China last year, boosting its sales to China by 50 percent. Based on data for the first nine months of 1992, we estimate that German sales of heavy industrial machinery, scientific instruments, and apparel all outpaced the growth of US and Japanese exports of these goods. German exports were almost certainly boosted by Bonn's decision to ease its remaining post-Tiananmen economic sanctions in June of last year.

Other key EC exporters to China did not fare as well. France and Italy fell from being the sixth and seventh largest exporters to China to being the tenth and ninth. We estimate that Italy nevertheless saw large gains in its exports of engines and road vehicles, while France showed dramatic growth in aircraft sales.

Trade With Former Soviet Republics Accelerates

China's trade with the former Soviet republics last year grew 70 percent over 1991 levels, according to Chinese trade statistics. Chinese imports grew faster than Chinese sales to the former republics, resulting in a Chinese trade deficit with these states of $ 1.2 billion. Beijing sought to speed diversification of its trade last year, signing bilateral economic and trade cooperation agreements with 13 of the 15 former Soviet republics. In addition, China opened 13 cities in border regions for the first time to foreign investment and trade opportunities. Trade with Russia, however, continues to dominate Chinese exchanges with the former Soviet republics. accounting for 88 percent of total trade last year.

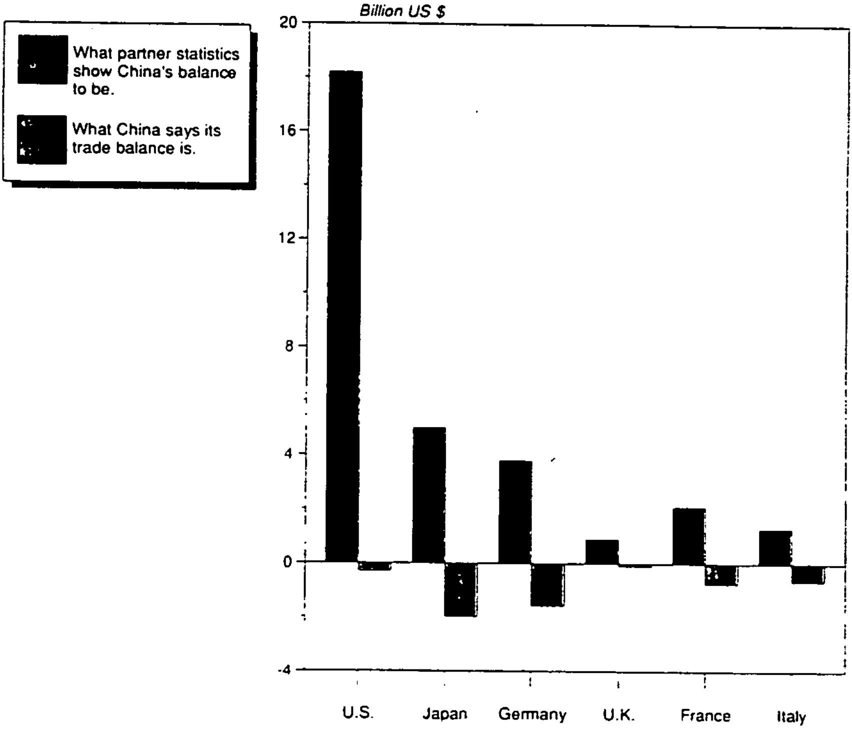
The structure of Chinese trade with the former Soviet republics also remains highly specialized. Foodstuffs and textile articles accounted for nearly 44 percent of total Chinese exports to Russia in 1992, for example, while Russian sales of fertilizers alone accounted for over one-quarter of all exports to China. Problems with overburdened transportation links, the dumping of shoddy goods in each other's market, and failing to live up to contractual agreements also continue to dog bilateral exchanges.

Appendix C

Comparing US and Chinese Trade Statistics

Chinese Customs trade statistics differ substantially from those of some of its key trading partners. These problems are evident in its reporting of trade with much of the developed world—including the European Community and Japan. China's largest trade accounting discrepancies in absolute terms are with the United States, reflecting the importance of the US market for Chinese exports and the large proportion of Chinese exports to the United States shipped through Hong Kong. Beijing claims that the US enjoyed a $306 million trade surplus with China last year, whereas the US Government reports that the United States ran an $ 18.2 billion trade deficit with China during the same period.

China: Statistical Discrepancies With Key Trading Partners, 1992



This transshipment or re-exporting of goods—particularly through Hong Kong—is the key source of discrepancies. The United States, for example, records imports according to the country of origin and exports according to the final destination of the goods. China, on the other hand, counts goods transshipped through Hong Kong as exports to or imports from Hong Kong. This leads to a Chinese figure for exports to the United States in 1992 of $8.6 billion, substantially lower than the US Government's figure of $25.7 billion.

Less significant factors behind the discrepancy in trade figures are:

-- *Goods valuation*. The U.S. Department of Commerce reports exports in terms of free alongside ship (f.a.s.) value, which sets the cost of exported goods as the price just prior to loading on the ship. Chinese import statistics are reported on a cost, insurance, freight (c.i.f.) basis, which includes all the costs associated with shipping. The inclusion of shipping costs accounts for about $700 million of the discrepancy between China's reported imports from the United States—which it estimates were $8.9 billion last year—and the US Commerce Department's figure of $7.5 billion.

-- *Reporting inaccuracies*. Some Chinese exporters may underreport the value of their exports and understate hard currency earnings, allowing them to hold larger amounts of foreign exchange abroad. Some importers may underreport trade to avoid paying duties and to hide transactions using illegally obtained foreign exchange. Given the high volume of Chinese exports to the United States, the net impact of these reporting inaccuracies may be to undervalue the US trade deficit when calculated using Chinese trade statistics.

-- *Time lags and differences in statistical coverage and accounting practices*. Although these differences exist between the statistics of any two trading partners, they exacerbate already large discrepancies in Sino-US trade.

-- *Recording system*. Some items—such as leased products—may be counted as traded goods by one partner but listed in a separate category by the other.

The discrepancy between Chinese and US trade statistics has grown in recent years as China has shipped larger shares of its exports to the United States via Hong Kong. China has reportedly taken steps toward greater accuracy in reporting trade since the beginning of 1993. China appears to be focusing primarily on goods bound for the EC or the United States that were transshipped through Hong Kong. For the first three months of the year, China recorded substantially larger increases in exports to the United States and EC than its partners, and this was nearly matched by a reported drop in exports to Hong Kong.

Appendix D

Beijing Wrestling With State Sector Woes

Inefficient state-owned enterprises still loom as one of Beijing's biggest headaches, impeding further economic reforms, draining government coffers, and burdening the state banking system with demands to grant loans to keep many state firms afloat. State enterprises—particularly 13,000 large-and medium-sized firms—still turn out roughly half of China's industrial products and are key sources of state revenues. Although the proportion of these firms registering losses dropped slightly last year to under one-third, total losses in 1992 were roughly the same as in 1991, according to Chinese press reports. More recently, the proportion of money losing enterprises has been increasing, in part because of stricter accounting practices. Beijing's efforts to tighten controls over credit is also creating new debt "chains" in the sector as firms are unable to pay suppliers because they have not received payment from customers.

Beijing has made progress over the past two years in addressing some of the tough problems that contribute to state enterprise losses. By gradually lifting artificially low state-set prices on some commodities, for example, Beijing has cut red ink at state-owned energy producers—including coal mines—that have been forced by state plans to sell their output at below their production cost. Furthermore, the rapid economic expansion has created opportunities for many state enterprise employees to moonlight—a phenomenon that has helped augment their incomes and may reduce resistance to labor cutbacks.

Nevertheless, reforms to cut surplus state enterprise workers and to force deficit-ridden firms into bankruptcy—key measures needed to enhance state-sector efficiency—are progressing slowly because of concerns over social unrest and the costs of writing off unredeemable bank loans. In the spring of 1992, for example, the Chinese press briefly touted the benefits of "smashing the iron rice bowl" of guaranteed lifetime employment until rising labor unrest forced Beijing to tone down the campaign. Beijing still hopes to cut the state-sector work force—cutbacks have continued at some state firms, falling hardest on women workers and temporary contract employees—but local authorities are probably adjusting the pace of layoffs to keep labor unrest under control.

Other problems—such as antiquated equipment, outmoded designs, and low-quality standards—plague the sector, the result of years of management practices geared to achieving output targets and increasing worker bonuses, rather than upgrading technology and developing new products. When output was allocated according to plan, managers had little need to worry about finding buyers for their products. As Beijing has scaled back planning controls, however, the hidden costs of years of neglect has become apparent in mounting stockpiles of unwanted goods from state enterprises, and in firms where production has halted because their products are unmarketable.

New Reforms Under Way ...

As part of his reform drive, Deng Xiaoping has demanded that state enterprises be pushed "toward the marketplace" to expose state firms to real competition while being given greater operational autonomy to respond to the demands of the marketplace. Chinese leaders insist that, over time, state enterprises that fail to adjust to these new conditions will in fact be liquidated or merged with more successful partners.

The centerpiece of Beijing's new state-sector reforms is a set of regulations promulgated in July 1992 that promises firms greater operational autonomy.

The regulations build on previous enterprise laws but provide greater details on the types of decisionmaking authority state enterprises should enjoy, including greater independence to import and export, to make investment and production decisions, and to set total work force numbers and wages.

Nevertheless, these new regulations are still guidelines and Beijing has ordered localities to draft specific plans to help implement them.

Beijing is also pressing with other reforms to help sort out thorny issues of state sector assets and accounting methods. State firms are to adopt a new, uniform accounting system this summer that Chinese authorities claim will be compatible with international standards. Many state firms now blend operational and capital budgets, for example, either to obscure losses or to shift funds to uses that authorities discourage, such as excessive bonus payments for workers. Western accounting practices—if combined with careful accounting regulation—should help clarify the extend of hidden enterprise losses.

Furthermore, central tax officials have announced that a new business tax system will be in place by the end of the year that will unify tax rates between state-owned, collective, and private firms. A key element of the new plan is the elimination of the negotiation of effective tax rates between enterprises and local financial bureaus that reform proponents claim ties firms to local bureaucrats.[12]

Stock ownership experiments are going forward as well. Beijing now claims some 4,000 state enterprises have issued shares, most of which are internal shares issued to workers and not legally tradable. About 130 enterprises are listed on China's two operating over-the-counter stock exchanges in Shanghai and Shenzhen. Proponents of stock ownership experiments claim that shareholding can help clarify ownership rights while injecting capital for enterprise renovations. To ensure that the stock experiments are compatible with orthodox demands to preserve "socialist public ownership" in China, however, in most cases the government holds majority ownership in enterprises that issue shares.

Beijing is also promoting a broad range of social welfare reforms to provide a "safety net" for workers as the system of cradle-to-grave lifetime security is scrapped. Management of state-sector pension funds is shifting from specific enterprises to citywide and even province-wide systems, in part so that pensioners will continue to receive benefits even if their original firms shut down. Meanwhile, workers are under pressure to contribute a portion of the costs of these services in an effort to make consumers more cost-conscious and to provide additional funding.[13]

[12] The tax rate on state enterprise profits is ostensibly set at 55 percent, but negotiations between firms and local financial authorities often result in lower effective rates on a case-by- case basis.

[13] The most ambitious and complicated "social safety net" issue is the reform of the urban housing system, designed to turn heavily subsidized housing—which many state workers receive virtually rent free from their workplaces—into a commercial commodity. Urban authorities have mapped out strategies that combine gradual rent increases with salary hikes to eventually encourage residents to purchase their housing. This would cut enterprise and government housing subsidies and help ensure that workers who lose their jobs will not be deprived of housing now provided by their employers. Workers, however, are likely to resist rent increases even when they are offset by higher wages. Furthermore, the reform will require the formation of a residential real estate market that is only beginning to emerge in most areas.

Replacing Output Targets With New Efficiency Yardsticks

Beijing is developing new statistical methods to measure state enterprise performance in hopes of replacing the gross value of industrial output (GVIO) series that encourages firms to turn out outmoded, shoddy, and in some cases unsalable products just to achieve output targets. Beijing has formulated a new "index of industrial efficiency," for example, that factors in labor productivity, sales, tax payments, and profit along with output. The index has not been in use long enough to determine whether it will be a reliable indicator for Chinese efforts to boost state-sector efficiency, but the factors that it includes suggest it will be of only limited value. Because state firms tend to retain surplus employees, for example, labor productivity primarily reflects changes in overall enterprise output rather than improvements in labor utilization.

Finally, Beijing is continuing to promote "enterprise groups"—state-sector conglomerates often formed around a key state enterprise or developed from long-standing foreign trade corporations—to achieve economies of scale and to help cross-fertilize management methods and production techniques. China's industries have historically been isolated by provincial and bureaucratic boundaries, but groups can draw firms in different regions and different sectors together, including research institutes and banks. Beijing has focused attention on 55 large-scale groups formed with central backing that are becoming flagships of China's emerging "cadre capitalism." Not all groups are successful, of course: thousands have been formed at lower levels but many are simply paper exercises with no real clout or influence. And most prominent groups owe their success to high-level leadership patronage that helps them gain preferential treatment and access to scarce credit and materials.

... But Progress Likely To Be Slow

Despite these reform initiatives, turning around moribund state enterprise performance is likely to be a long-term process of overcoming entrenched obstacles to state enterprise reforms. Beijing, of course, remains concerned that shutting down state firms or cutting surplus staff will trigger urban unrest, and most areas are proceeding cautiously with these difficult steps. Even the new enterprise regulations do not give managers carte blanche to cut bloated work forces to optimum levels. The process of adopting Western accounting practices in enterprises will probably be slowed by the lack of independent trained accountants. State firms may adopt Western-style accounting methods to meet Beijing's demands, but continue to use their old system for taxation and bonus purposes until forced to do otherwise.

Recent developments have also highlighted the difficulties that reformers face as they attempt to free state enterprises from bureaucratic supervision and interference. Many localities have responded slowly to Beijing's orders to draft implementing regulations to grant state firms greater autonomy; Beijing early this year was forced to send work teams out to speed up the process. Furthermore, some areas renamed administrative bureaus "enterprise groups," and then argued that autonomy should be vested in the groups, rather than the subsidiary enterprises—an arrangement that, contrary to the intention of reformers, leaves the power of local officials to meddle in enterprise affairs virtually unchanged.

These ploys highlight the close connection between state enterprises and bureaucrats. In many cases, government officials see the enterprise autonomy drive as a threat to their bureaucratic turf, while enterprise managers—particularly at less efficient firms—are anxious to obtain preferential government treatment in negotiating taxes and other performance targets.

These government-enterprise links—which are proving hard for Beijing to overcome—ultimately discourage the kind of efficiency-enhancing competition that some reform proponents argue is the only way to extricate state enterprises from their economic woes.

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