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USSR: Problems in Financing Hard Currency Trade Deficits

Key Judgements

The USSR incurred a hard currency trade deficit of $6.~~4~~3 billion in 1975 and is expected to run a deficit on the order of $4 billion to $6 billion this year. While Moscow had no problem covering the 1975 deficit, and is still an excellent credit risk, it is encountering difficulties in doing so this year.

Financing of 1975 Deficit:

- In addition to its normal heavy use of government-backed credits, the USSR was forced to borrow $4.3 billion from Western commercial banks in 1975 and to sell as much as $1 billion in gold. In addition the USSR received at least $500 million in loans directly from Middle Eastern OPEC countries.
- Soviet medium- and long-term debt is estimated to have risen to $7.5 billion and total indebtedness to over $10 billion.

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<u>Outlook for 1976</u>:

- The USSR will be able to make continued heavy use of government-backed credits in 1976. However, last year's heavy Eurocurrency borrowing will limit Moscow's ability to secure similar financing in 1976. Moscow will probably increase its gold sales, but its earnings from these sales will be limited by lower, probably declining gold prices.
- Moscow has taken several steps to minimize the amount of commercial borrowing required in 1976. These steps have included delays in payments due some Western suppliers and requests to others for financing of orders originally contracted for on a cash basis.
- The Soviets have yet to demonstrate a willingness to significantly cut back on orders for Western equipment [redacted]
- Moscow will probably be able to finance a deficit of as much as $6 billion without having to request debt rescheduling, but in

so doing will almost certainly exhaust its remaining ability to tap Western commercial banks for untied financial credits.

<u>Legacy for 1977</u>:

- The USSR undoubtedly is counting on a vastly improved trade picture for late 1976 and beyond. In fact, Moscow would probably be forced to take severe measures to counter any threat of a substantial trade deficit in 1977. This could occur, for example, if the USSR has another poor harvest this year.
- Should the Soviets incur a large deficit again in 1977, the need for debt rescheduling would be a distant possibility. With access to Eurodollar funds severely limited, Moscow might also try and tap funds from the Middle East more heavily.

Hard Currency Trade

The USSR incurred a hard currency trade deficit of $6.~~4~~3 billion in 1975 and is expected to run a hard currency deficit of $4 billion to $6 billion this year. Much of the 1975 deficit was caused by higher imports of Western equipment ($4.5 billion) and grains ($2.4 billion) at a time when recession in the West kept Soviet export growth to a negligible level. Prospects for 1976 are more favorable. Recovery in the West should allow the USSR to increase export earnings (up 32% to $2 billion in the first quarter), but imports, particularly of Western equipment and grain, are also expected to rise. Soviet imports rose 10% in value to $4 billion in the first quarter, leaving Moscow with a $2 billion hard currency trade deficit for this period.

The Role of Government-Backed Credits

The USSR relies heavily on government-backed, long-term, low-interest credits to finance a major share of its capital goods imports from the West.[1/] The Soviets undoubtedly regard such credits as a relatively low cost means of accelerating the pace of acquiring Western equipment and technology.

1. With the exception of West Germany, government backed export credits include interest rate subsidies as well as guarantees. Although the West German government does not subsidize the interest rates, government guarantees allow West German banks access to more preferential market rates and provides for a significant expansion of the volume of credit these banks are willing to extend to the USSR. In the case of the US, less than 20% of 1975 US equipment exports to the USSR was financed by Eximbank credits arranged for in 1972-1973.

The USSR not only is able to stretch repayments over a long period, but also to make these payments in Western currencies which have been inflated even further. The USSR also has used government-backed credits to finance a major share of its purchases of large-diameter pipe from the West. In 1975, an estimated $900 million in pipe imported as part of various Soviet gas-for-pipe deals has been financed in this manner.

As a result of its increased reliance on medium- and long-term credits -- private as well as government-backed -- the USSR's medium- and long-term debt has risen in recent years from an estimated $3.6 billion at the end of 1973 to an estimated $7.5 billion at the end of last year (see Appendix 1).[2] Because of the extended repayment periods involved, including grace periods on at least some credits, Soviet debt service remains relatively low -- roughly 20% in 1975.

Most Western countries feel that long-term credits are a necessary evil associated with doing business with the USSR and are quite willing to extend large lines of credit in hopes of securing substantial Soviet contracts. Since mid-1974, the USSR has received over $11 billion in credit lines from Western Europe, Japan, and Canada (see Appendix 2).

2. Including the commercial supplier's credits which take the form of Soviet promissory note financing.

The USSR is expected to continue receiving large government-backed credits to finance a major share of its capital goods and pipe imports. The Soviets have yet to obligate a major share of the credit lines extended earlier by France, the UK, and Canada. Japan and West Germany are expected to continue to finance major deals on a case-by-case basis. Italy is the major exception. Although the Italians feel that low-interest credits are crucial to obtaining badly needed Soviet business, domestic economic difficulties severely limit the amount of credits the Italian government can extend. For this reason, the Italian government in May 1976 refused a Soviet request for $600 million in credits to cover the purchase of Italian equipment.

Medium- and long-term credits drawn to finance equipment and pipe imports covered only a portion of the Soviet 1975 hard currency trade deficit. Once allowances are made for the repayment of principal and interest on past debt, only $2 billion was available to offset the $6.3 billion deficit. The USSR was forced to finance the remaining $4.3 billion from other sources. Moscow sold gold and relied heavily on the Eurodollar market in doing so (see Table 1).

<u>Eurodollar Borrowing</u>

Fortunately the USSR entered 1975 with a net liability of only $74 million vis-a-vis its position with Western

Table 1

USSR: Financing the 1975 Deficit

	Millions US $
Merchandise trade 1/	-6,335
Medium- and long-term credits net of principal and interest payments	2,000
Other invisibles and hard currency trade N.E.S. 2/	500
BALANCE FINANCED of which:	-3,835
Eurocurrency syndications	800
Gold sales	750 to 1,000
Reduction in Eurocurrency assets	371
Increase in Eurocurrency liabilities, N.E.S.	2,800
Errors and Omissions 3/	-886 to -1,136

1. Official Soviet Foreign Trade Statistics.
2. Includes revenues from arms sales, hard currency expenditures under clearing agreements, and net receipts from tourism and transportation.
3. Includes loans from the Middle East.

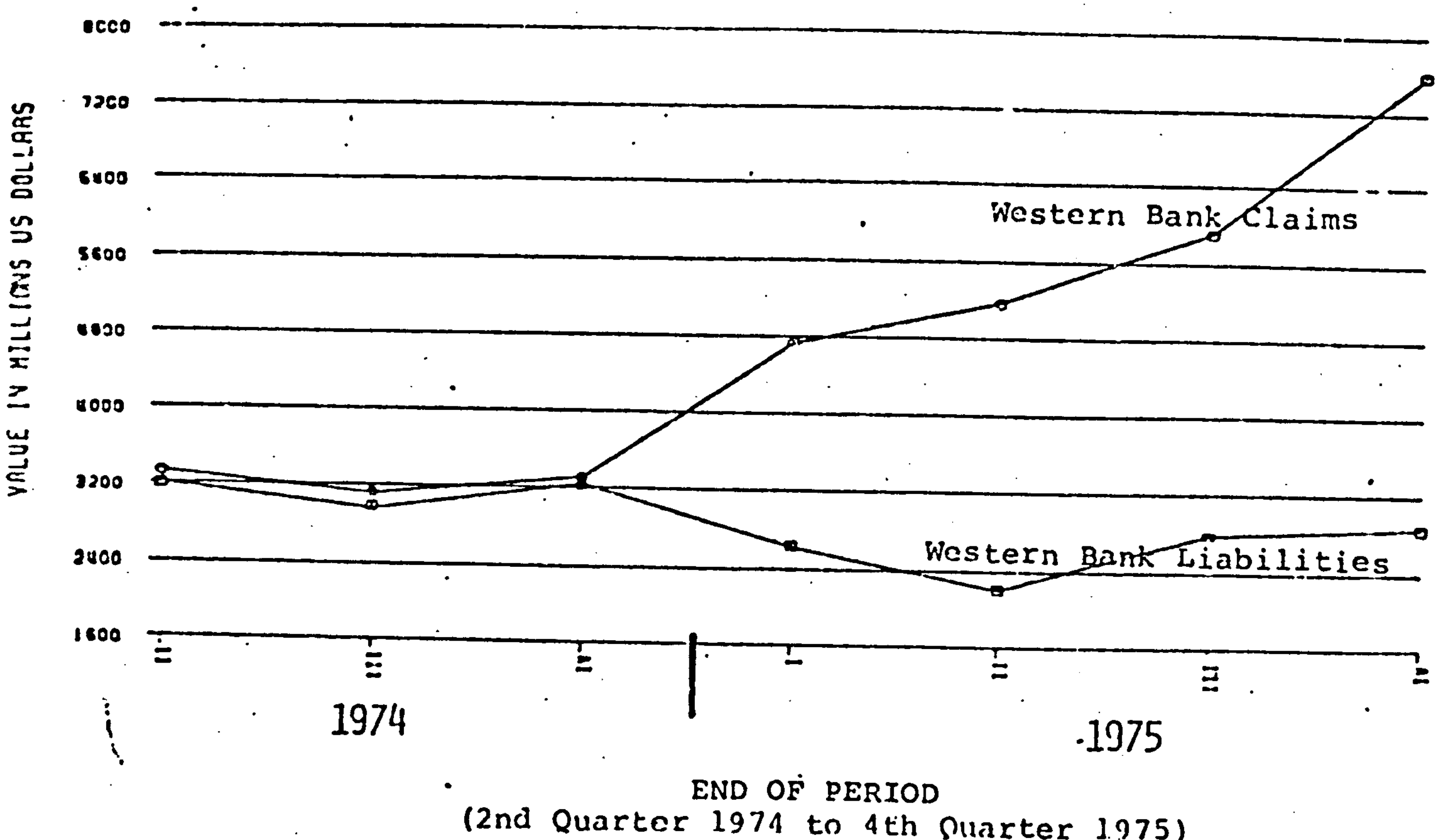
commercial banks[3] (see the chart). While Moscow was believed to have made use of the Eurocurrency market to help finance its 1973 grain purchases, a portion of this amount was repaid and assets rebuilt during the following year. Soviet assets with UK banks, for example, rose by $500 million in 1974.

During 1975, the USSR borrowed roughly $4.3 billion from Western commercial banks while at the same time reducing its holdings by $371 million. At year's end, total Soviet liabilities stood at $7.6 billion and net-liabilities (subtracting out Soviet assets held by Western banks) at $4.7 billion.[4] Much of this borrowing was done on a direct bank-to-bank basis whereby the USSR obtained time deposits and other short- and medium-term credits simultaneously from a great number of banks. Borrowing was heaviest during the first ($1.4 billion) and fourth ($1.7 billion) quarters of the year. The USSR also drew heavily on its deposits in Western banks during January-June of 1975, only to rebuild them during the third and fourth quarters.

3. Bank of International Settlements data which includes reporting from the commercial banks of Belgium-Luxembourg, France, West Germany, Italy, the Netherlands, Sweden, the United Kingdom, Canada, and the United States. The USSR was probably a net debtor vis-a-vis Swiss banks which do not report their positions with the USSR to the BIS.
4. According to US Treasury and Federal Reserve statistics, US-based banks and their major foreign branches held $1 billion in claims against the USSR at the end of 1975. Almost 60% of these claims were held by the foreign branches.

CHART

Western Commercial Banks[1]: Claims and Liabilities vis-a-vis USSR



1. Banks of Belgium-Luxembourg, France, West Germany, Italy, Netherlands, Sweden, the United Kingdom, Canada, and the US since the second quarter of 1974 and offshore branches of US banks beginning in the fourth quarter of 1975. The USSR is also believed to be a significant net debtor with Swiss banks.

Syndicated medium- and long-term loans accounted for only $800 million of total Soviet Eurodollar borrowing in 1975. In all cases, the USSR was able to obtain relatively favorable terms and management fees (see Appendix 3). Lead Western banks had little trouble in arranging the syndications.

Well over $500 million of Soviet Eurodollar borrowing was indirect, resulting from the discounting of private supplier's credits by Western firms with their banks. In such instances, the USSR paid for Western equipment with a series of negotiable notes which were guaranteed by the Soviet Bank for Foreign Trade and which carried a fixed interest rate of 6.5% to 7.5%. In most cases the notes matured over a period of five years or more, and were discounted on a non-recourse basis at 8% to 9%.5/ The value of such transactions rose significantly in 1975, accounting for $500 million to $1 billion of total Soviet Eurocurrency borrowing. The total medium- and long-term component of Soviet 1975 Eurodollar borrowing was thus probably in the range of $1.3 billion to $1.8 billion or more.6/

5. US banks discounting such notes often required a percentage, usually on the order of 1.75%, over the prime US interest rate.
6. This amount is included in Soviet medium- and long-term indebtedness as discussed on the previous page and shown in Table 1..

Gold Sales

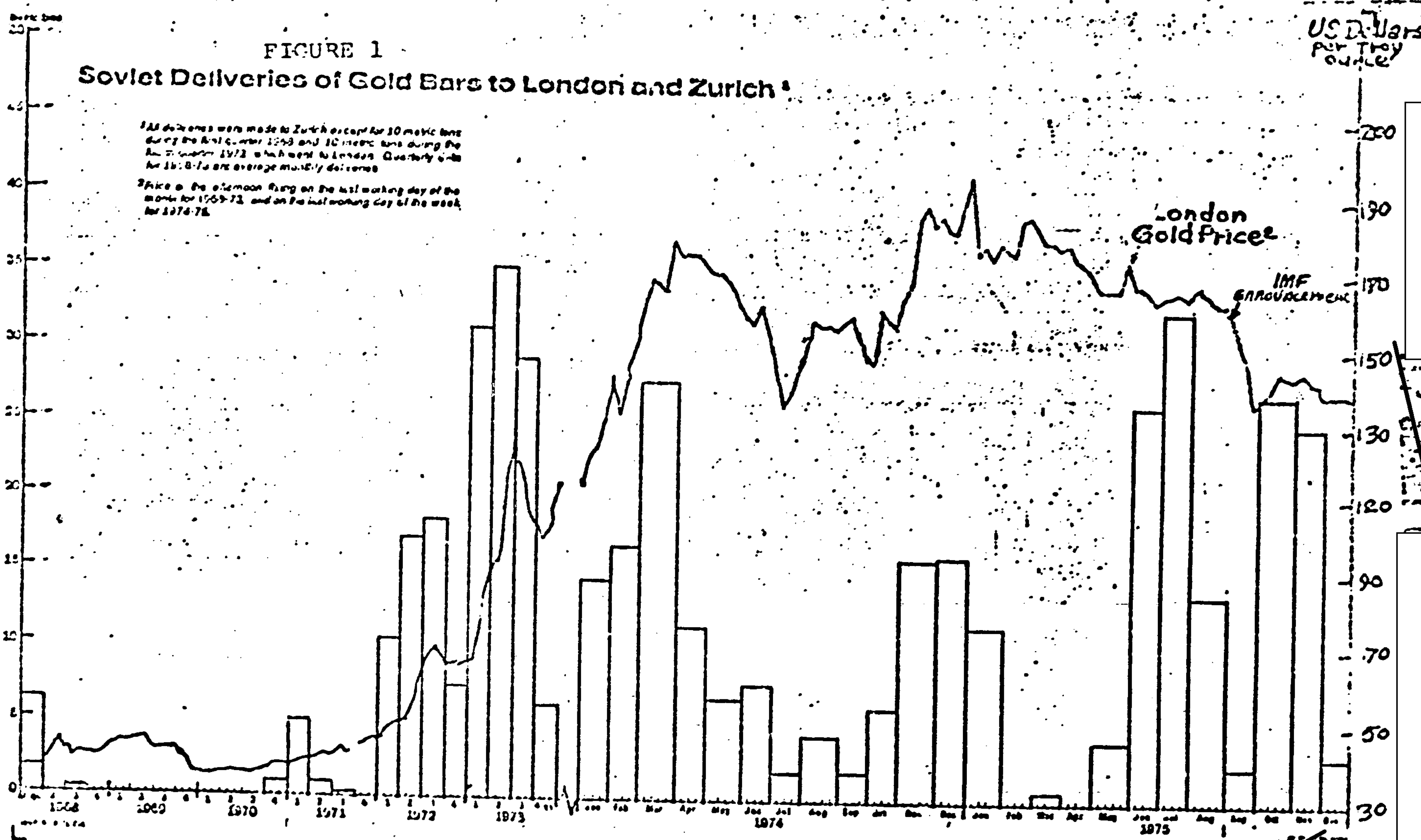
The Soviets were frustrated in their efforts to sell gold in 1975 by market developments -- such as the August 1975 IMF announcement of gold sales -- which helped to push the gold price down from $165 per ounce to below $130 per ounce. Nonetheless, heavy Soviet sales were resumed in June when Soviet planners became aware of the need to import massive amounts of Western grain and recognized the persistency of the recession in the West. During June-December, the USSR sold $650 million worth of gold in Switzerland, bringing total 1975 sales on this market to $744 million (see Figure 1). In addition to selling gold on the Swiss market, the USSR has also acknowledged direct sales to Middle Eastern buyers, notably Kuwait and Saudi Arabia. Some 50 tons, worth an estimated $250 million, were reportedly sold last summer.

Other Sources of Hard Currency Revenue

The USSR also benefited from net revenues from its transportation and tourism and from direct lending from OPEC nations. An expanding merchant marine allowed the USSR to net an estimated $411 million in revenues last year, and net 1975 earnings on tourism are estimated at $140 million. [redacted] indicate that the USSR received at least $500 million in direct loans from the Middle East, principally from Iran and Kuwait. Arms sales to the less developed world, primarily to Iraq and Libya, are estimated to have earned the USSR $600 million or more.

FIGURE 1

Soviet Deliveries of Gold Bars to London and Zurich[a]



[1] All deliveries were made to Zurich except for 10 metric tons during the first quarter 1968 and 10 metric tons during the fourth quarter 1972 which went to London. Quarterly data for 1968-73 are average monthly deliveries.

[2] Price at the afternoon fixing on the last working day of the month for 1969-73, and on the last working day of the week for 1974-75.

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Strategy for Financing the 1976 Trade Deficit

Around the end of last year, a major effort was instituted to control hard currency expenditures in an apparent move to minimize additional Eurocurrency borrowing. In November 1975, [redacted] was informed that the USSR planned few requests for financial credits in 1976, and as late as mid-April 1976 high officials in the Soviet Bank for Foreign Trade told [redacted] that the USSR would probably not be in the Eurodollar market for such credits for several months, perhaps for the balance of the year.

Several steps were taken to minimize hard currency outlays in 1976. Hard currency disbursements on previously signed contracts were limited to the specific period for which they had been budgeted. Moreover, in several instances the USSR has been late in payments due to Western suppliers. In early April, for example, [redacted] reported that the USSR was three months overdue in its payments and was citing as the cause of the delay "administrative and documentation problems." Moscow is also known to have attempted to refinance orders previously signed on a cash basis. Two [redacted] companies reported in April that they had been asked to arrange one-year credits for sales which had originally been concluded for cash. US firms, [redacted]

[redacted] have met with similar requests.

The Soviets are also insisting that new contracts signed in 1976 not entail cash disbursements (including downpayments and progress payments) before the beginning of 1977. In negotiations with [redacted] producer of automotive equipment, Soviet officials claimed that no payments could be made this year and insisted on long-term financing. [redacted] agreed to accept Soviet promissory notes as payment for 80% of the contract with the initial Soviet payment of 5% to be deferred until January 1977. The USSR is also known to be attempting to find a way to circumvent French credit regulations, which require a minimum 10% downpayment before credit can be approved for the remaining amount.

Moscow has also delayed the placement of some orders, including contracts for computer systems, testing equipment, and gas turbines for power plants. Some previously committed hard currency allocations for equipment purchases were revoked because of the need to buy Western grain. Although such paring seems to be concentrated in non-priority areas or areas where Soviet-produced equipment can be substituted, the USSR has also deferred some projects in acknowledged high-priority sectors such as the oil industry.

Tight controls over hard currency outlays and a deferment of some orders for equipment will not significantly reduce the hard currency deficit for 1976. It may, however, allow Moscow to reduce substantially that portion of assets held in Western banks to cover day-to-day financial needs. There is little to suggest a more major cutback on imports and Moscow's ability to do so is constrained by contracts previously signed for equipment, steel products, and grains. Expansion of exports appears to be the most feasible approach to cutting the deficit over the short run. Moscow, in fact, is known to have become more aggressive in its export sales efforts during the latter part of 1975, including the offering of additional amounts of oil to Western nations.

Financing the 1976 Deficit

The USSR's hard currency trade deficit for 1976 is expected to be substantial -- on the order of $4 billion to $6 billion. The USSR is again expected to obtain medium- and long-term credits to cover a major share of the estimated $4.5 billion to $5 billion in machinery and equipment which will be imported from the West this year. As in the past, a major portion of such credits will again be backed by Western governments. Approximately $1 billion in government-backed credits are expected to be advanced in support of Soviet large-diameter pipe imports. The USSR also is expected to make heavier use of promissory note financing in 1976, possibly to the detriment of concomitant attempts to obtain pure financial credits on the Eurocurrency market. Total medium- and long-term credits associated with equipment and pipe imports will thus probably reach $3.7 billion. Allowing for principal and interest repayments on past medium- and long-term credit drawings, new drawings will net the USSR roughly $1.4 billion which can be applied against the 1976 trade deficit (see Table 2).

As in 1975, other invisibles and earnings from arms sales should net the USSR $750 million, leaving roughly $2 to $4 billion to be covered by gold sales and additional financial credits from the West. In both of these areas the USSR is facing constraints.

<u>Eurocurrency Borrowing</u>

Although still an excellent credit risk, heavy borrowing in 1975 has placed the USSR in a tight situation for borrowing this year. By the end of 1975, many major European and US banks had reached their self-imposed credit limits which govern the share of a bank's assets which can be loaned to a given borrower. Moreover, bankers able to continue to lend were beginning to insist on higher interest rates and fees for new

Table 2

USSR: Financing the 1976 Deficit

	Millions US $
Merchandise trade 1/	-4,000 to -6,000
Medium- and Long-term credits net of principal and interest payments	1,400
Other invisibles and hard currency trade N.E.S. 2/	600
BALANCE FINANCED of which:	-2,000 to -4,000
Eurocurrency syndications	1,000 to 500
Gold sales	1,000 to 800
Reduction in Eurocurrency assets	1,000 to 0
Errors and Omissions 3/	-1,000 to 1,000

1. Estimated
2. Includes estimated revenues from arms sales, hard currency expenditures under clearing agreements, and net receipts from tourism and transportation.
3. Will possibly include borrowing from the Middle East and where possible, additional bank-to-bank borrowing on the Eurocurrency market.

Soviet loans. The extent of Soviet problems is exemplified by Moscow's recent effort to secure a $250 million consortium loan to help finance its payments deficit.

In late April, the USSR approached several West European and US banks for a $250 million general financial credit for balance of payment financing. Only one US bank, which had never before led a syndication on the USSR's behalf, agreed to syndicate such a loan at this time. The terms of the loan called for an interest rate spread of 1.25% above LIBOR and a management fee of 0.5%. The funds were to be drawn down quickly and were to be repaid over five years with a three-year grace period on principal repayments.

The lead bank has found syndication of the loan exceedingly difficult. Although a syndication is 90% complete and final details should be wrapped up soon, it probably will not be on the terms the US bank would have liked. Many Western banks, including the big three Swiss banks, have reached their self-imposed credit limits vis-a-vis the USSR and have refused to participate in the syndication. Banks able to lend cited the relatively low return from the spread and management fees as unrealistic in view of heavy recent Soviet borrowing. These latter banks prefer the high returns obtainable from rediscounting Soviet promissory notes. Because of problems cited above, it seems unlikely that the USSR could raise more than $1 billion in syndicated financial credits this year and will probably have to pay higher rates in doing so. Additional credits would have to be raised on a bank-to-bank basis.

<u>Gold Sales</u>

With Eurocurrency borrowing apparently limited in 1976, the USSR seems forced to market large amounts of gold this year. Unlike past years when Soviet decisions to sell gold depended mainly on market conditions, balance of payments requirements now appear to be the predominant factor. After selling small amounts in January and February, in March the Soviets reportedly resumed heavy sales on the Swiss market. Moscow can also be expected to market gold outside of traditional markets. Press reports recently included an example whereby the USSR used gold to cover a $7 million progress payment due a Swiss firm.

The Soviet need to maximize earnings from gold comes at a time when the market is already depressed. A substantial increase in the rate of Soviet gold sales would likely drive prices down later this year. Gold prices have already slumped because of weak demand and the prospects for an increase in supply. Industrial consumption of gold, although beginning to recover, is running roughly 30% below its peak level in 1971. The speculative demand for gold, which accounted for slightly over half of Free World demand last year, is down sharply because of a moderation in inflation, a decline in currency unrest, and an upturn in real interest rates. On the supply side, South Africa -- the world's major producer -- hopes to increase production this year. In addition, the IMF, which began auctioning monetary gold last week, will increase the supply of gold to Free World markets by roughly 15%-17% in second half 1976 comapred with the same period last year.

If the Soviet Union increases sales to a monthly rate of 20 to 30 tons compared with last year's pace of slightly over 12 tons, the supply of gold to the Free World market would be increased by an additional 7% to 17% in the second half of this year. Assuming the supply of funds to the speculative market does not increase from the current level, such a move could depress prices by another $10 to $30 an ounce. Soviet earnings from the sale of this amount would thus vary between $800 million and $1 billion. The price impact of the Soviet action probably would be somewhat offset by price-induced increases in speculative and industrial purchases. There is also the possibility of additional gold purchases by central banks to support the market price.

Borrowing Directly from the Middle East

Pressure on the USSR to sell gold and/or to pay higher interest rates to attract additional Euro-currency credits will be lessened to the extent that Moscow is able to borrow directly from the Middle East. Knowledge on such lending is limited. Iran is known to have placed roughly $500 million directly with the Soviet Bank for Foreign Trade last year and may be a source for additional Soviet borrowing in 1976. The Iraqis, for their part, regularly keep some $300 million in time deposits with the Soviet Bank for Foreign Trade.

Increased Soviet interest is perhaps best expressed by the March 1976 visit of a Soviet financial delegation to Kuwait. The Soviets were interested in obtaining Kuwaiti time deposits for project financing both in the USSR and in third countries and Kuwaiti participation in a joint Soviet-Arab bank. The Kuwaiti response to these requests is unknown; however, they will probably step up their lending activity at least somewhat.

Financing Scenarios

Barring a deficit in excess of $6 billion, it thus appears that the USSR will be able to meet its financial obligations in 1976 without having to request debt rescheduling from Western governments. This estimate is based on the assumptions that the USSR will be able to:

- obtain roughly $4 billion in medium- and long-term credits from Western governments and Western exporters of equipment and pipe.
- sell upwards of $1 billion in gold in 1976 despite the low prices currently prevailing and the adverse effect of Soviet sales on these prices.
- arrange for the syndication of Euro-currency credits -- up to $1 billion if the deficit should reach $6 billion -- from Western banks and/or directly from Middle East depositors.
- draw down as much as $1 billion of its assets held in the West without severely restricting its day-to-day financial needs.

The Legacy for 1977

The USSR is undoubtedly counting on a vastly improved trade picture for late 1976 and beyond; the above conditions in fact make this a necessity. Should export performance fail to pick up as expected and/or a poor 1976 harvest necessitate massive grain imports in 1977, the USSR will be forced to take severe measures to bring its hard currency trade into balance.

These steps could include diverting easily marketable exports from soft currency trading partners to Western markets; requesting delays in deliveries of goods not covered by medium- and long-term credits; or, if necessary, cancelling contracts outright.

On the financing side, the USSR could be forced to expand gold sales even further regardless of world market conditions. Moscow could also be expected to insist that imports financed by government-backed credits be 100% financed. Debt rescheduling with commercial banks is also a possibility, although steps in this direction would have an adverse impact on the credit rating the USSR has continually tried to maintain.

APPENDIX 1

USSR: Estimated Drawings and Scheduled Repayments on Medium- and Long-term Credits

	Million US $					Percent[1]
	Drawings	Scheduled Payments to Principal	Scheduled Payments to Interest	Amount Available to Offset Trade Deficit	Outstanding Debt at Yearend	Debt Service Ratio
1970	715	310	79	326	1,722	18
1971	682	374	103	204	2,029	18
1972	1,030[2]	451	122	457	2,608	20
1973	1,690[2]	657	157	875	3,641	17
1974	1,710	890	220	600	4,461	15
1975[3]	4,300	1,272	276	2,752	7,489	20
1976[3] [4]	4,450	1,760	509	2,181	10,179	N.A

1. Scheduled repayments of principal and interest as a percent of hard currency exports.
2. Including drawings on three-year Commodity Credit Corporation credits.
3. Includes $800 million in known consortium loans drawn down in 1975 and an estimated $750 million in consortium loan drawdowns for 1976.
4. Projected.

USSR: Major Government-Backed Credit Agreements with the West

Date	Country	Type of Credit[1]	Value of Credit[2]	Value of Contract	Downpayment	Interest Rate(s)	Length of Credit (yrs)	Deferments or Grace Period	Description
Dec 1974	France	CL	2,800	3,500	20%	7.2 to 7.55	to 8½		For purchases during 1975-1979.
Nov 1975	France	PA	295	368	20%	7.2	to 8½	N.A.	For French share of Iran natural gas project.
Oct 1974	West Germany	PA	293	375	20%		6	1 yr.	For trucks.
Oct 1974	West Germany	PA	577	700	15%	6.75	8½		For pipe.
Jan 1976	West Germany	PA	464	546	15%	7.35	8		For pipe.
Feb 1975	United Kingdom	CL	2,270	2,838	20%	7.0 to 7.35	to 8½		Matches terms of French CL.
Jan 1975	Italy	PA	560	650[3]	15%[3]	7.45	5		35% of $1.5 billion pipe order.
Apr 1975	Italy	PA	257	320	20%	7.345	8		For chemical plants.
Sep 1975	Italy	CL	900	1,058	15%	7.55	8		
Jan 1976	Italy	PA	200	235[3]	15%[3]	7.55[3]	5[3]		Additional credit for January 1975 pipe order.
Feb 1976	Japan	PA	160	200	20%	7.55	5		For pipe
Feb 1976	Japan	PA	221	260	15%	7.55	8.5		Ammonia plant.
Mar 1976	Japan	PA	25	—	--	6.375	—		Yakutsk exploration.
Feb 76	United States	PA	25	—	--	N.A.	—		Bank of America loan for Yakutsk exploration.

1. CL stands for general purpose credit line, PA for project associated.
2. Millions of current US dollars.
3. Estimated.

APPENDIX 3

USSR: Publicized Consortium Eurocurrency Credits

Date	Value[1/]	Interest Rate	Length of Credit (yrs)	Grace Periods
Jan 1975	100	1% over LIBOR[2/]	5	N.A.
May 1975	250	1.125% plus .125% utilization fee	5	3 yrs.
Jul 1975	50	1.13% over LIBOR	5	N.A.
Dec 1975	400	1.125% over LIBOR	5	3 yrs.
Jun 1976[3/]	250	1.25% over LIBOR	5	3 yrs.

1. In millions of US dollars.
2. London interbank offered rate.
3. Syndication not yet completed.

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East European Hard Currency Debt Soars

Key Judgements

A record $6.4 billion trade deficit incurred in 1975 boosted Eastern Europe's hard currency debt to $19 billion. Another $6 billion deficit is expected this year. Poland, by far the heaviest East European borrower, could rack up a trade gap surpassing the $3 billion incurred last year. The East Europeans had little difficulty in obtaining the necessary financing in 1975, but Poland is now encountering some difficulty in doing so.

Financing of 1975 Deficit

- In addition to their normal heavy use of government-backed credits, the East Europeans were forced to borrow $3.7 billion from Western commercial banks.
- The major creditors were the United Kingdom, West Germany, and France.

Outlook for 1976

- All of the East Europeans except Poland appear willing to keep the growth of imports well below that of exports. Poland continues to place large orders for Western technology and equipment and is committed to sizeable grain purchases.
- Although the East Europeans will be able to draw heavily on government-backed credits, they will require another large infusion of Western bank credits.

- Poland will continue to be the largest Eurocurrency borrower but, because of banker concern over its large debt, probably will be forced to accept higher interest rates and/or management fees to get the financing it requires.

Discussion

The Debt

Eastern Europe's net hard currency indebtedness hit $19.0 billion at yearend 1975 -- up from $4.6 billion at yearend 1970 (see Table 1).* Poland led the pack with a yearend 1975 indebtedness of $6.9 billion, followed by East Germany and Romania, which stacked up debts of $3.8 billion and $3.0 billion, respectively. In recent years, Poland -- eager for advanced Western technology and equipment -- has permitted the fastest growth in indebtedness. Romania, on the other hand, reacted to the escalation of its debt in the 1960's by cutting back on the growth of new borrowing in the 1970's.

Except for Romania, East European imports from the developed West grew considerably faster than exports during 1971-75 (see Table 2). Most of the $16.9 billion cumulative trade deficit was incurred in 1974-75. Export growth began to fall in the second half of 1974 due to lower Western demand and EEC restrictions on meat and live animal purchases. The East Europeans, however, underestimated the depth of the Western recession and did not begin to cut back on imports until the spring of 1975. Thus, in 1975, East European deficits on

* The estimates of East European hard currency indebtedness used in this paper represent net liabilities with the developed West adjusted for hard currency assets and liabilities with other areas, including CEMA.

Table 1

Eastern Europe: Estimated Net Hard Currency Liabilities

(Billion US $)

	1970	1973	1974	1975
Bulgaria	.70	.77	1.19	1.83
Czechoslovakia	.34	.79	1.12	1.45
East Germany	.99	2.14	2.80	3.77
Hungary	.60	.94	1.52	2.10
Poland	.77	1.89	3.94	6.87
Romania	1.23	2.00	2.59	2.97
TOTAL	4.63	8.53	13.16	18.99

TABLE 2

EAST EUROPEAN TRADE WITH THE DEVELOPED WEST

Million US $

	1970	1971	1972	1973	1974	1975 1/
Bulgaria	584	623	659	883	1,331	1,536
Imports	324	338	349	480	928	1,139
Exports	260	285	310	403	403	397
Balance	-64	-53	-39	-56	-525	-742
Czechoslovakia	1,626	1,786	1,985	2,779	3,670	3,887
Imports	880	966	1,056	1,513	2,031	2,157
Exports	746	820	921	1,266	1,639	1,730
Balance	-134	-146	-135	-247	-392	-427
East Germany	2,408	2,549	3,335	4,650	6,186	6,375
Imports	1,350	1,415	1,929	2,735	3,540	3,725
Exports	1,058	1,134	1,406	1,915	2,646	2,650
Balance	-292	-281	-523	-820	-894	-1,075
Hungary	1,181	1,339	1,590	2,220	3,083	2,939
Imports	623	790	851	1,135	1,862	1,843
Exports	558	549	739	1,085	1,221	1,096
Balance	-65	-241	-112	-50	-641	-747
Poland	1,864	2,172	3,169	5,494	5,830	9,155
Imports	901	1,075	1,772	3,431	5,233	6,096
Exports	962	1,099	1,397	2,063	2,865	3,059
Balance	61	24	-375	-1,368	-2,368	-3,037

TABLE 2

EAST EUROPEAN TRADE WITH THE DEVELOPED WEST

Million US $

	1970	1971	1972	1973	1974	1975 1/
Romania	1,306	1,484	1,869	2,654	4,338	4,250
Imports	756	815	1,043	1,451	2,436	2,300
Exports	550	669	826	1,203	1,902	1,950
Balance	-206	-146	-217	-248	-534	-350
Total	8,969	9,953	12,607	18,680	24,438	28,142
Imports	4,834	5,399	7,000	10,745	16,030	17,260
Exports	4,134	4,556	5,599	7,935	10,676	10,882
Balance	-700	-843	-1,401	-2,789	-5,354	-6,378

1. Partially Estimated.

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trade with the developed West totaled an estimated $6.4 billion, topping the previous record of $5.4 billion incurred in 1974. There was a notable slowdown in the growth of the deficit in the second half of 1975, however..

Length Structure Improved

Between 1970 and 1975, all the East European countries except Poland realized an improvement in their debt structure as long-term liabilities rose much faster than medium- and short-term. As a result, the share of long-term in total net liabilities rose from 20 percent to 32 percent. Thus, although there was not much movement toward longer maturities for individual credits, average maturities lengthened.

Romania has met with the most success in spreading out its debt and now has the most favorable debt structure of all the East European countries. Long-term indebtedness stood at 48 percent of the total at yearend 1975 as compared with 20 percent at end 1970. Poland, on the other hand, has had to dip heavily into short- and medium-term financing in order to help offset unexpectedly large trade deficits and meet sharply increased debt servicing obligations. As a result, long-term liabilities -- although more than quadrupling -- dropped from two-thirds of total net liabilities in 1970 to one-third in 1975. Poland still, however, has more of its debt in long-term than do Czechoslovakia or East Germany.

Sources of Financing

Eurocurrency financing and credits guaranteed by Western governments provide the major sources of hard currency financing for Eastern Europe. Other sources include direct Middle East placements and CEMA banks.*

Net liabilities on the Eurocurrency market have grown much more rapidly than on government-guaranteed credits. This trend mainly reflects the major change in the composition of Poland's debt. For the area as a whole, known net liabilities on Eurocurrency markets, which account for about one-half of total debt, came to an estimated $8.9 billion at yearend 1975 (see Table 3). Poland is the largest user of Eurocurrency financing, followed by East Germany, Hungary, and Bulgaria. Ultraconservative Czechoslovakia has gone hardly at all into Eurocurrency financing. Bucharest, surprisingly, has also not borrowed much in Eurocurrency markets.

Part of the Eurocurrency financing consists of medium- and long-term consortium loans. Of the total increase in Eurocurrency borrowing in 1975, some $1.3 billion -- or about one-third -- consisted of publicized Eurocurrency syndicated loans. Poland received $500 million; East Germany, $250 million; Hungary, $350 million; and Bulgaria, $106 million. In addition, Czechoslovakia received its first consortium loan -- $60 million for deliveries of grain.

* Large gaps, however, remain in out knowledge about the sources of financing, especially in the cases of Czechoslovakia and Romania.

TABLE 3

External Positions of Western Commercial Banks with Eastern Europe[1]

Million US $

	31 December 1974		30 June 1975		31 December 1975	
	Bank Assets	Bank Liabilities	Bank Assets	Bank Liabilities	Bank Assets	Bank Liabilities
Bulgaria	1,098	253	1,396	222	1,569	282
Czechoslovakia	275	315	283	220	288	250
East Germany	1,665	422	2,195	496	2,550	556
Hungary	1,497	468	1,878	429	2,107	748
Poland	2,067	407	2,935	321	3,723	308
Romania	755	135	914	168	867	40
Total	7,357	2,000	9,601	1,856	11,104	2,184

Source: Bank of International Settlements Data.

1. Banks of Belgium-Luxembourg, France, West Germany, Italy, the Netherlands, Sweden, and the United Kingdom. Switzerland Canada, Japan, and the United States do not report separately on their position with Eastern Europe. The East Europeans are believed, however, to be net debtors.

Major Creditors

By yearend 1975, the United Kingdom was the single largest creditor, accounting for just under one-fourth of total East European indebtedness. About three-quarters of the debt to the United Kingdom consisted of net liabilities on the London Eurocurrency market. West Germany came next with about 18 percent of total debt and led in government-guaranteed credits outstanding with about one-third of the total. East Germany accounted for almost one-third of net East European liabilities to West Germany. France followed with about 15 percent of the debt.

Other West European countries accounted for 27 percent of the East European debt; Japan, the United States and Canada for about 9 percent; and the Middle East, CEMA banks, and the IMF (Romania only) for the remaining 7 percent. Notable shifts by creditors since 1970 have been a decline in the West German share; a rise in the Uk and French shares; and the appearance of the Middle East Countries and CEMA banks as significant creditors.

Kuwait and Iran have become active lenders to Eastern Europe in the past year and a half. Known credits from the two countries total nearly $1 billion. Iran provided $420 million to Romania, $160 million to Bulgaria, and --

reportedly -- $200 million to Poland in loans, and Kuwait handled $200 million in Romania and Hungarian notes and bonds. In addition, there are some short-term Middle East deposits placed in Eastern Europe.

Most of the CEMA bank funds so far have come from IBEC; with the greater part probably going to Czechoslovakia, East Germany, and Romania. Romania, the only East European country that is a member of the IMF, drew $135 million against two IMF tranches and an IMF standby credit.

Outlook

Eastern Europe will again have to borrow heavily in 1976. Even with some recovery in exports, the deficit on trade with the developed West could approach $6.0 billion, not much lower than the $6.4 billion incurred last year. All but Poland are expected to keep the growth of imports well below that of exports. Poland is committed to large orders of machinery and equipment and of grain. Romania -- concerned about its high debt burden -- is expected to try especially hard to reduce the trade gap.

Eastern Europe's net borrowing to cover the projected $5.5 billion current account deficit would bring the total debt up to $24.5 billion by yearend 1976. Poland's debt could well hit almost $10 billion. In addition, the East Europeans will have to borrow to cover their repayments obligations. Thus, total financing required may approach $9 billion.

The East Europeans, especially Poland, will be able to draw heavily on Western government-backed credits to finance the major share of their equipment imports from Western Europe and Japan. And they have received some credits for grain purchases. In addition, Poland will receive this year $300 million in West German credits and payments to the Polish pension fund and Romania has available $175 million under two IMF standby arrangements.

Even so, the East Europeans will once more be forced to borrow heavily on the Eurocurrency market -- perhaps as much as the $3.7 billion taken last year. Poland will continue to be the largest Eurocurrency borrower -- perhaps requiring close to $2 billion -- followed by East Germany, Hungary, and Bulgaria. Part of the borrowing will again consist of syndicated loans, of which the East Europeans already have raised $660 million in this type of loan and are seeking another $600 million.

Eastern Europe's soaring hard currency debt is causing Western bankers to reexamine their lending policy, especially in the case of Poland. As a result the East Europeans probably will have to pay higher interest rates and/or fees. Given the large supply of funds expected in the money markets, however, they should be able to borrow what they need. Even Poland is still preferred over many LDC borrowers and should be able to meet financing requirements, though probably at a higher cost.

A heavy borrower in 1974-75, Poland generally must pay the highest rates -- at least 1.5 percent above London Interbank Offered Rate -- of any East European country in obtaining commercial loans. Poland seems to be encountering difficulties in arranging for credits on the terms it desires. Earlier this year, for example, Poland's request for a three-year, $30 million credit to finance grain purchases was turned down by US banks because of the low interest rate Poland offered to pay. Alternatively, Warsaw refused a syndication offered by US banks to help cover the purchase of a color television plant because of the high interest rate demanded by the banking consortium. Financial necessity will ultimately force Warsaw to accept higher interest rates and/or more costly management fees in its 1976 Eurocurrency borrowing.

Bankers for the most part appear willing to meet the financial needs of Hungary, Bulgaria, and East Germany on reasonably favorable terms. Romania and Czechoslovakia are not expected to tap the Eurocurrency market extensively this year. With a heavy overall debt burden, Romania could encounter some difficulties if it tries to borrow large amounts on the Euromarket.