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Eastern Europe: Facing Up to the Debt Crisis

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An Intelligence Assessment

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This paper was prepared in the Office of European Analysis by [redacted] with a contribution from [redacted] Comments and queries are welcome and may be directed to the Chief, East-West Regional Issues Branch, EURA, on [redacted]

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Eastern Europe: Facing Up to the Debt Crisis

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Summary

Information available as of 1 September 1983 was used in this report.

Most of Eastern Europe has withstood the severe credit crunch that began in 1980, but the region remains financially vulnerable. The peak of the crisis occurred in the first part of 1982, when it seemed that several countries were on the brink of default. The regimes responded by imposing austerity, mostly in the form of severe import reductions. With the incipient economic recovery in the West and signs of some easing in creditors' attitudes, the worst of the crisis is probably over. Some countries may yet have to reschedule their debts, however, and most will continue to look to the West for financial assistance. For the longer run, all will need to rely more on their own resources, which will increase pressure for more systemic solutions to economic problems. The adjustment process almost certainly will increase the risk of internal instability and will present problems and opportunities for the USSR and the West.

The Credit Crunch. While Western bankers showed some unease about Eastern Europe as early as 1980, the credit crunch intensified the following year when Poland's inability to service its debts gave bankers second thoughts about continuing to lend to other East European countries. Banks initially refused to provide more medium-term loans. As a result, the East Europeans had to resort to more official financing, activate undisbursed credit lines, seek costly short-term borrowing, and draw down their reserves. By yearend, all the East European countries faced liquidity problems. The crunch thus hit Eastern Europe well before Latin America and other developing countries.

The squeeze grew particularly severe in the first half of 1982. The imposition of martial law in Poland and difficult rescheduling talks with Poland and Romania led bankers to withdraw short-term credits from the entire region in addition to refusing to roll over maturing medium-term loans. For the year as a whole, Western banks reduced their short-term exposure by 30 percent and rolled over only \$3.6 billion of \$9.1 billion in maturing medium- and long-term obligations. Western government–backed credits did not offset the loss of private loans; the region as a whole contracted new government-backed loans in roughly the same amount that it owed in repayments.

Adjusting to the Credit Squeeze. Lack of credits and inability to expand exports because of Western recession forced the East Europeans to slash imports by 30 percent in 1981-82. Planners focused the cuts on those items that would have the least immediate impact on their economies and

populations. Purchases of capital equipment were generally denied because the loss of these items would not jeopardize current production. For political reasons, most regimes have been cautious about reducing purchases of consumer goods and foodstuffs although last year's good harvest permitted cutbacks in grain imports. Despite attempts at insulation, the reduction in Western imports has been a key factor in the decline of GNP which fell by 0.5 percent annually in 1980-82 for the six CEMA countries compared with an annual average growth of 2.5 percent in 1976-79. For Yugoslavia, growth slowed from a peak of 7.0 percent in 1979 to only 0.3 percent last year.

The East European countries reacted to their financial problems in varying ways. *Poland,* after Western governments refused to reschedule its 1982 debt or extend new credits, secured de facto debt relief simply by not making repayments. Warsaw was able to negotiate debt relief from commercial banks, and Western bankers report that Warsaw met the repayment schedule. Altogether, Poland managed to cover less than half of its $11 billion financing requirement last year. The need to deal with the resulting arrearages continues to delay and complicate Warsaw's economic recovery.

Doubts about Bucharest's creditworthiness brought the credit crunch to *Romania* in early 1981. After arrears reached $1.1 billion at the end of the year, Bucharest gained breathing room through agreements with Western banks and governments to reschedule 1981 arrears and principal payments due in 1982. By mid-1982 there were signs that Bucharest was addressing its financial problems. By the end of the year, it had cut imports by one-third, enough to earn a current account surplus of $655 million, but was still left with arrears of nearly $400 million. The import cuts intensified shortages of food, gasoline, and other consumer goods. Data presented to the IMF show that consumption fell for the first time since World War II and that the rate of growth of industrial production fell to a new low.

The problems of Poland and Romania had a spillover impact on Hungary, East Germany, and Yugoslavia—countries also dependent on new credits to meet debt obligations. In *Hungary,* the withdrawal of $1.3 billion in short-term credits by Western, OPEC, and CEMA banks and inability to roll over medium-term credits brought Budapest to the brink of a liquidity crisis in early 1982. The Hungarians parlayed their good relations with the West and reputation as sound managers into enough emergency support from Western governments, the Bank for International Settlements (BIS),

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and the International Monetary Fund (IMF) to avert rescheduling. After temporizing for some months, Budapest imposed import controls and tougher austerity on consumers. Hungary consequently was able to slash its current account deficit by more than $600 million and stabilize its financial position.

East Germany, despite suffering the region's largest cutback in credits—$1.9 billion, was the only heavily indebted country in the region that did not require debt relief or emergency loans in 1982. The East Germans apparently managed last year's credit crunch through tough adjustment measures and skillful cash management. Trade adjustments offset more than 80 percent of the cutback in bank credits, but the measures exacted a stiff price from the domestic economy. We estimate that GNP growth fell from 2.4 percent in 1981 to 0.5 percent last year.

Yugoslavia did not suffer as severe a reduction in Western bank lending as Hungary or East Germany, but the impact on its financial position proved more damaging. The country's financial crisis stemmed as much from failure to reduce the current account deficit and poor cash management in the banking system as from fewer credits. Belgrade's current account deficit reached $1.4 billion in 1982 instead of the planned $500 million, and emergency measures to strengthen the Yugoslav National Bank's liquidity position failed. IMF credits of $600 million could not offset the shortfall in current earnings and capital flows, and Yugoslavia had to draw down its reserves by $1 billion. By yearend, with arrears of $500-600 million, the country technically was bankrupt.

Because of their conservative trade and borrowing policies, *Czechoslovakia* and *Bulgaria* did not face as severe financial problems in 1982 as the other East European countries. The Czechoslovaks nonetheless slashed hard currency imports by 19 percent. The import curbs flowed from President Husak's pronouncement in 1981 that Czechoslovakia would not live on "credit." With shrinking export earnings, Prague's planners had to make deep cuts in purchases to meet the leadership's goal of reducing external indebtedness.

Bulgaria's low debt and comfortable maturity schedule freed it from onerous repayment obligations. Its conservative trade policy yielded surpluses on the hard currency trade account. Although some firms reported problems with payments from Sofia last year, we believe these were not the result of any serious financial deterioration.

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Lender Attitudes. Lender attitudes toward Eastern Europe have eased slightly since last year's rush to reduce exposure, in part because their worst fears proved exaggerated. Poland did not default and Romania has improved its relations with banks. BIS and IMF involvement in Hungary's and Yugoslavia's crises has encouraged, and to some extent compelled, continuing banker involvement in these countries.

Continuing wariness among bankers and closer governmental supervision of commercial bank exposure will restrain the pace and extent of new loans. Major Eurodollar syndications will be much rarer than in the late 1970s; a far greater share of lending will be short term and trade related. The cost of credit will be higher, and the debt maturity structure will remain unfavorable for most countries. Commercial banks, furthermore, are likely to insist on more Western government backing for their loans or demand security from the borrowers, including gold collateral and offsetting deposits.

As a prerequisite for increasing lending, bankers are looking for evidence that the East Europeans are addressing their payments imbalance through structural changes to improve export performance. Creditors regard the draconian import reductions of the past two years as a short-run expedient with little positive impact on long-term creditworthiness. Some bankers remain skeptical that the East Europeans will or can do as much as the financially troubled LDCs to correct their fundamental problems. To assure long-term economic discipline, they are putting more weight on IMF membership, while urging the East Europeans to provide more complete economic and financial data.

Outlook for 1983-85. In 1983 we estimate the region (excluding Poland, because of the uncertainties regarding rescheduling terms) will experience another large outflow on the capital account of more than $2.4 billion. Yugoslavia will probably be the only net gainer, thanks to the Western financial rescue package. An expected slight improvement in borrowing conditions and a pickup in Western demand for East European exports should enable a few East European countries to ease the import cuts of the past two years, but we still anticipate a 1- to 2-percent decrease in Eastern Europe's (excluding Poland's) hard currency imports this year. Import gains seem likely in 1984-85, assuming continued growth in the West and continuing improvement in creditor attitudes. Only under the most favorable lending assumptions, however, would the absolute level of imports in 1985 exceed the level reached in 1980. With a modest revival of lending, imports in 1985 would be about 4 percent below the 1980 peak, while continued lending shortfalls would keep 1985 import levels some 8 percent below 1980 levels.

Even if lending revives, some countries—notably Bulgaria, Czechoslovakia, and Romania—may be unwilling to expand imports at the rates our projections suggest, opting instead to continue reducing hard currency debt or building up reserves. Most regimes will give preference to goods needed for consumption and current production. Some economists and planners, however, are arguing more strongly that their economies need a revival of investment, using Western resources to lay the foundation for long-term growth. This may have some greater impact down the road.

The prospect of slow export growth and at best small credit inflows means that financial problems will continue to beset nearly all the East European countries. In the near term, Poland—and very likely Yugoslavia—simply cannot generate enough debt servicing capacity on their own to meet obligations. Most regimes will have to restrain consumption and investment in order to lower demand for imports and free goods for export. Pressure will build to produce more output with fewer inputs. This will highlight the necessity of attacking the systemic flaws that contribute to low productivity.

Poland and *Yugoslavia,* caught in a medium- to long-term financial crisis, seem least able to impose effective adjustment measures and to attack structural problems. Poland's insolvency and lack of progress in dealing with debt problems have locked it into a continuing economic crisis. Merely to stem the increase in its debt, Poland must generate net exports equal to annual interest payments, an effort requiring large current account surpluses and, thereby, a commitment by the regime to revive economic growth and by the populace to make large sacrifices.

Even with completion of this year's financial rescue package, we believe that Belgrade will need more help in 1984. Yugoslavia's position entering 1984 will be very similar to that at the beginning of this year—stocks of imported goods and foreign exchange reserves will be at minimal levels and few credits will be in the pipeline to bridge the seasonal financing gap in the first half of the year. Adjustment policies and structural reforms needed for recovery may impose a higher price than regional politicians and the population are willing to accept.

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Romania, East Germany, and *Hungary* show signs of financial recovery, but their positions remain fragile. East Berlin and Bucharest have squeezed their economies much harder than Budapest, while the latter seems further along in addressing structural problems. Bucharest has passed the peak in its debt maturity structure, but is having problems in satisfying IMF targets and in obtaining credits. Even if it meets its goal of avoiding rescheduling next year, another test of its external adjustment efforts will come in 1985 when Bucharest must begin to repay obligations rescheduled in 1982. Next year's expiration of the current IMF standby arrangement also will add to pressures for large current account surpluses.

East Germany probably can avoid a rescheduling, but the country continues to face a serious liquidity problem. The recent decision of the West German Government to guarantee a $400 million five-year credit from West German commercial banks should improve prospects for covering this year's borrowing requirement. East Berlin can also draw on new government-guaranteed trade credits from France, Canada, and Austria. Over the medium term, the country will have to live more within its means, implement measures that improve export competitiveness, and promote economic growth without heavy reliance on Western imports and credit.

Hungary is still on a financial tightrope despite some successes in raising credits in the first half of 1983. Budapest faces a rising level of debt repayments through 1985 and has requested a second IMF standby credit. The Hungarians must tighten adjustment policies, as well as continue to forge ahead with measures to improve efficiency and competitiveness. Fortunately for Budapest, many Western bankers believe they should support Hungary's reform program as an example for other East European countries.

Due to their small debts and generally good standing with Western banks, *Czechoslovakia* and *Bulgaria* enjoy the luxury of choosing whether to continue paying off their debt or to lift self-imposed restraints on imports from the West.

The Greater Implications. Our forecast of continuing serious financial problems for some countries (Poland and Yugoslavia) and, at best, slow improvement for the rest implies that the leaderships will face difficult decisions in the next few years. The problems are not new ones, but are now more severe than in the past. Muddling through—tinkering, temporizing, and relying on help from the USSR and the West—has become less of an

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option. More than ever, the East European countries will be forced to rely on their own resources and on the ability of their economic managers and systems to adjust. Continuing financial and related problems will influence East European policy on a wide range of issues:

- Relations with the USSR, the West, and each other.
- Allocation of resources to investment, consumption, and defense.
- Economic reform—along with its political and ideological implications.

The East European regimes are likely to draw some sobering conclusions from the financial crisis of the past two years and from the past decade of expanded economic ties with the West. While the Polish situation is abhorred by the rest of the region, most of the countries made some of the same mistakes, albeit to a lesser degree. In retrospect, the regimes overborrowed—at first to purchase Western capital goods with which to modernize their economies and later to buy grain and other supplies to support consumption.

Although East European officials instinctively blame the West for their problems, they must also recognize that their own shortcomings made them more vulnerable to the credit cutoff. At a minimum, they probably will try to be more certain that they can repay loans and will build more caution into their forecasts of the potential impact of Western economic performance on their external accounts. At the same time, the East Europeans probably will conclude that they now need the West more than ever. The problems that led them to seek Western trade and credits a decade ago are now even more pressing.

Economic relations with the USSR will still figure heavily in their decisionmaking; and Bulgaria's relative economic success in recent years will stand as an example of the advantages of less dependence on the West and strong Soviet ties as well as, perhaps, increased CEMA integration. The leaderships realize that one of their chief assets is their borderline position between the USSR and the West, and they will try to play off East against West.

The long-talked-about CEMA summit, if and when it is held, should provide some clues as to which of these conflicting pulls is predominant. The USSR has been pressing for more balanced and possibly less subsidized trade, as well as for increased integration. The East Europeans have seen these aims as burdening their economies still more and threatening their relations with the West and have delayed the convening of the summit.

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The increased need for efficiency and the priority of boosting sales in hard currency markets is likely to give fresh impetus to reform advocacy in most countries. The problem is that reforms take a long time to implement and can be politically unsettling, threatening the privileges of the bureaucracies and challenging the ideological underpinnings of these regimes. The prospect of greater Soviet economic demands, continued stringency in economic relations with the West, and sharp domestic adjustments to the credit squeeze are likely to heighten tensions within the leaderships and between the leaderships and the led.

Although the populations have accepted recent austerity reasonably placidly, their patience may not survive the period of austerity ahead. The regimes will have to decide whether to use more repression (as in Romania) or to explain the problem and enlist public support (as in Hungary).

The Soviets will want to provide the minimum sustenance necessary to assure stability in Eastern Europe. With economic constraints of their own, the Soviets will want to avoid doing much more than is necessary.

Eastern Europe's economic difficulties may also persuade Western governments that they have new opportunities to weaken Moscow's influence in the region. To pursue these opportunities, however, would require a revival of willingness to take financial risks and to use new policy tools, such as including more East European states in the IMF, and pursuing agreements between them and the EC or assuming politically motivated aid burdens of indefinite duration and return.

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Preface

This paper is an assessment of the financial situation and outlook of the East European countries, including Yugoslavia. [redacted] 25X1 The study reviews the evolution of the crisis through August 1983 from a regional perspective, considers how the countries have used various financial options in dealing with their problems, and projects prospects through 1985. The regional focus is complemented by appendixes that provide statistical and analytic details on individual countries. We also consider the broader impact of debt problems in terms of adjustments in foreign trade and projections of future import capacity. Finally, the paper analyzes the implications of the debt crisis for East European decision makers as they formulate policies to overcome their financial problems and try to get their economies back on track, and the consequences for their partners in the West and East.

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Table 1
Net Financing Flows From Western Banks [a]

Million US $

	1975	1976	1977	1978	1979	1980	1981	1982	1983 [a]
Eastern Europe	**5,877**	**6,048**	**5,824**	**10,715**	**11,252**	**5,342**	**−1,513**	**−6,685**	**−2,122**
Bulgaria	628	407	428	556	−86	−495	−489	−320	−170
Czechoslovakia	5	609	510	485	950	541	−224	−473	71
East Germany	1,164	1,170	715	1,494	1,760	1,375	805	−1,874	−389
Hungary	892	892	1,413	1,747	1,058	64	−305	−940	−457
Poland	2,427	2,550	1,327	3,167	3,393	339	−890	−1,373	−720
Romania	133	−163	470	1,406	1,552	1,362	−707	−826	−206
Yugoslavia	628	583	961	1,860	2,625	2,156	297	−879	−251

[a] Net financing flows equal changes in the stock of bank claims as reported in the Bank for International Settlements (BIS) statistics. This reflects new credits less repayments.

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Table 2
Syndicated Loans for Eastern Europe, 1976-82 [a]

Million US $

	1976	1977	1978	1979	1980	1981	1982
Total	**1,120**	**1,696**	**4,549**	**6,914**	**5,037**	**3,026**	**935**
Poland	425	186	739	901	1,089	106	0
Romania	0	50	453	1,100	458	337	0
Yugoslavia	100	323	1,415	2,291	1,972	1,371	439
East Germany	65	542	916	782	481	627	62
Hungary	150	350	600	1,047	550	573	434
Czechoslovakia	260	0	150	461	487	4	0
Bulgaria	120	245	276	332	0	8	0

[a] Source: *Euromoney*.

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Eastern Europe: Facing Up to the Debt Crisis

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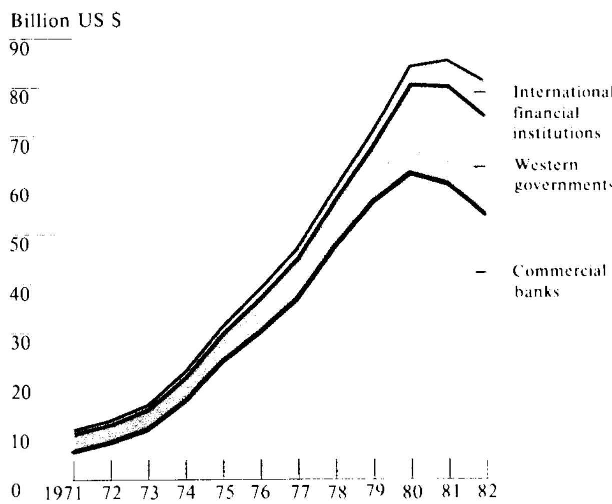
The Credit Crunch Begins

Eastern Europe's credit crunch began in 1980, well before the onset of LDC financing problems, following a decade of growing reliance on Western credits to finance mounting payments deficits (figure 1). Net credit flows from Western banks (new credits less repayments) slowed to $5.3 billion in 1980, less than half the 1979 level (table 1).[1] Most of the decline can be attributed to Poland and reflected growing concern that Warsaw was headed for insolvency. The other countries continued to raise credits, but the net inflow was less than in 1979. Fears about Poland were beginning to give bankers second thoughts about lending to other East European countries. Other factors that contributed to the slowdown in lending were the Soviet invasion of Afghanistan and subsequent Western sanctions, Tito's death in 1980 and growing doubts about the prospects for stability in Yugoslavia, and the adjustment efforts leading to less borrowing by a few regimes (notably Hungary and Bulgaria).

The credit squeeze tightened in 1981 when bank claims on Eastern Europe fell by $1.5 billion. The Poles and Romanians shouldered the largest reductions in bank exposure and were forced to reschedule, but Hungary and Czechoslovakia also paid debts more quickly than planned. East Germany and Yugoslavia—with the largest financing requirements aside from Poland—managed to obtain a net inflow of credit, but at substantially reduced levels from previous years. Only in Bulgaria did the reduction in debt to banks probably reflect regime intentions.

The slowdown in bank lending to Eastern Europe in 1980-81 involved medium-term commercial credits, particularly syndicated Eurodollar loans. Data compiled by *Euromoney* show that, after peaking at $6.9 billion in 1979, syndicated loans slowed to $3.0 billion

Figure 1
Eastern Europe: External Debt, by Type of Lender



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by 1981 with no major loans arranged after midyear (table 2). This type of lending was very sensitive to worsening banker attitudes because syndicated loans generally involve a lengthy commitment without a Western government guarantee and usually do not finance sales made by banks' clients. 25X1 25X1

trading in promissory notes, which had come to a halt for Poland in 1979, stopped for the other East European countries in late 1981. Although a relatively small source of credit, the collapse of the *a forfait* 25X1

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[1] The financial and trade data presented in this paper are in nominal terms. We have not adjusted for price and exchange rate movements because we lack adequate price indexes and data on the currency composition of trade and credit flows

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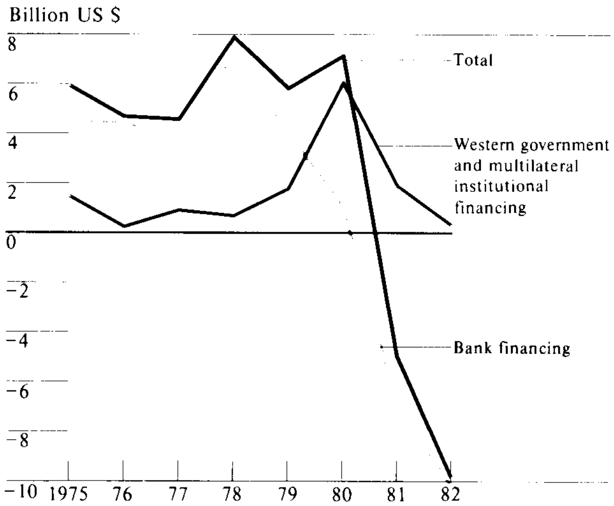
Figure 2
Net Resource Transfer to Eastern Europe From Western Financing[a]



[a] New credits minus repayments of principal and interest.

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market for Eastern Europe indicated that banks were becoming increasingly wary about extending medium-term trade financing as well.[2]

The falloff in unguaranteed commercial lending increased the importance of credits from Western governments and international financial institutions.[3]

[2] The *a forfait* market or nonrecourse market trades in promissory notes that generally have maturities of three to five years and do not carry Western government guarantees. A Western exporter sells notes obtained from the East European buyer to a bank which can either hold the notes until maturity or resell them to another bank. The holder of the notes bears the full risk of collecting payment from the importer and has no recourse to intermediate parties. For this reason the *a forfait* market's assessment of a borrower is a very good indicator of bankers' underlying perceptions of creditworthiness.

[3] An undetermined share of bank credits guaranteed by Western governments is included in BIS statistics on bank lending to Eastern Europe. Data on official and officially backed credits collected by NATO, the OECD, and the Berne Union of Credit Insurers indicate that Eastern Europe's debt on these credits continued to rise through 1981; therefore, the amount of bank loans guaranteed by Western governments appearing in BIS data presumably increased as well. This would mean that the reductions in unguaranteed bank exposure were even greater than the overall slowdown in lending shown in table 1. 25X1

Data from official Western and East European sources indicate that Eastern Europe's officially backed debt grew in 1980 and 1981 while Yugoslavia and Romania increased their borrowings from the IMF and the World Bank. By yearend 1981, Eastern Europe owed nearly 30 percent of its debt to official institutions compared with 20 percent at yearend 1978. Large disbursements of official and officially backed loans maintained a strongly positive net resource transfer from the West to Eastern Europe in 1980 despite the slowdown in commercial lending; however, new government-backed loans were insufficient in 1981 to reverse fully the net resource outflow resulting from the reduction in Western bank exposure with Eastern Europe (figure 2). 25X1

Although Eastern Europe's debt on disbursed government-backed credits continued to rise, outstanding commitments from Western official credit agencies—guarantees pledged for both disbursed and undisbursed credits—declined in 1981 (table 3). The apparent cancellation of some unused credit lines for Poland accounted for most of the decrease. Western 25X1 official data, nonetheless, indicate a slowdown in new commitments to most other countries. This may have resulted partly from reduced East European demand for new credit lines. Some regimes, concerned over worsening debt management problems, cut back orders for capital goods in particular. A sizable share of 25X1 these goods typically is financed by government-backed credits. On the other hand, the supply of new credits was probably becoming more constrained. According to Western press reporting, some Western official credit agencies began taking a harder look at Eastern Europe's credit rating following Poland's rescheduling request in early 1981. 25X1

The slowdown in new government-backed commitments lowered Eastern Europe's stock of undisbursed official credit lines from $12.6 billion in 1979 to $6.5 billion in 1981 (table 4). Poland and Yugoslavia accounted for over three-fourths of the decline al- 25X1 though East Germany and Romania also drew down their commitments. Statistics published by the Bank for International Settlements (BIS) show a similar

Table 3
Commitments of Major Western Government Credit Insurers to Eastern Europe [a] [b]

Million US $

	1975	1976	1977	1978	1979	1980	1981	1982
Total	**10,028**	**10,392**	**13,020**	**17,997**	**31,457**	**33,744**	**31,017**	**27,699**
Bulgaria	737	649	688	675	722	1,034	863	1,314
Czechoslovakia	848	762	899	1,306	1,451	1,762	1,710	1,713
East Germany	987	947	1,204	2,939	4,647	4,512	5,358	5,487
Hungary	244	173	129	212	430	828	844	1,069
Poland	5,575	6,563	8,696	10,181	12,852	13,679	12,137	8,704
Romania	1,637	1,298	1,404	2,684	3,728	4,027	3,737	3,207
Yugoslavia	NA	NA	NA	NA	7,627	7,902	6,368	6,205

[a] Commitments are pledges by official credit agencies to insure payment of principal and interest on credits extended by banks and suppliers. Commitments refer to both disbursed and undisbursed credits.
[b] Sources: Berne Union of Credit Investment Insurers.

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reduction—by $2.7 billion—in undisbursed credit lines with commercial banks during 1981.[4] By yearend, the ratio of undisbursed credits to outstanding debt to banks stood at less than 12 percent, a low ratio in comparison with other borrowing countries. This drawdown of commercial and official funds in the pipeline left Eastern Europe with a diminishing reserve of credit lines available to finance imports and to cover debt service payments. [redacted]

With fewer medium-term loans available, the East Europeans had to draw down reserves and rely on more short-term borrowing. This placed growing strains on the liquidity positions of most countries. In the words of one commercial banker, the East Europeans cut corners and they soon got caught. During the first half of 1981, the East Europeans reduced their cash holdings in Western banks from $9.3 billion to $7.8 billion. Between July and December, the East Europeans shifted toward more short-term borrowing to cover their financing requirements and to stem the loss of reserves, which compressed the maturity structure of debt and raised interest costs. At yearend 1981, Eastern Europe's ratio of reserves to debt maturing within one year—a measure of liquidity—stood at only 26 percent (table 4). [redacted] 25X1

By yearend 1981, the East European countries showed differing degrees of financial vulnerability (table 4): 25X1

- Poland and Romania already were in a financial crisis requiring rescheduling.
- Hungary's position was very shaky. Budapest could cover from its reserves less than one-fourth of its bank debt maturing in 1982 and had few undisbursed credit lines available with Western banks and export credit agencies.

[4] There undoubtedly is some overlap between the BIS statistics on undisbursed credit bank lines and our estimates of undisbursed government-guaranteed credits. [redacted] a sizable share of reported undisbursed bank credit lines represent commitments backed by official guarantees, but not all such commitments are reported to the BIS. [redacted] 25X1 25X1

Table 4
Eastern Europe: Selected Financial Indicators [a] [b]

	Proportion of Bank Loans With Less Than One-Year Maturity (*percent*)				Reserves as a Share of Debt Maturing in One Year (*percent*)			
	1979	1980	1981	1982	1979	1980	1981	1982
Eastern Europe	**39.9**	**36.3**	**37.0**	**34.0**	**28.8**	**29.0**	**26.3**	**22.1**
Bulgaria	41.1	36.3	48.1	51.7	31.0	53.5	55.4	68.7
Czechoslovakia	47.1	43.1	37.6	31.2	46.8	65.3	55.7	53.4
East Germany	42.7	38.6	42.6	39.0	46.7	45.2	40.7	42.5
Hungary	47.4	42.9	40.4	33.2	27.2	34.0	23.6	32.0
Poland	39.1	33.1	36.1	32.8	14.7	7.5	9.7	9.0
Romania	50.5	42.7	35.3	38.9	9.6	9.4	8.9	9.5
Yugoslavia	22.6	28.1	28.4	26.7	46.3	36.9	35.5	15.9
Developing countries excluding Middle Eastern countries	42.7	45.6	46.2	45.7	119.8	100.6	91.4	78.2

	Undisbursed Bank Commitments as a Share of Outstanding Debt (*percent*)				Undisbursed Government Commitments (*million US $*)			
	1979	1980	1981	1982	1979	1980	1981	1982
Eastern Europe	**16.5**	**17.4**	**11.7**	**8.4**	**12,564**	**10,723**	**6,497**	**4,883**
Bulgaria	8.4	16.7	24.5	15.5	129	341	157	390
Czechoslovakia	9.7	8.3	6.7	10.4	494	579	493	510
East Germany	16.5	15.2	16.2	13.3	1,918	1,206	1,344	1,025
Hungary	5.2	8.4	4.6	7.2	191	398	314	378
Poland	24.6	23.9	11.8	4.8	4,152	3,579	1,682	Negl
Romania	18.3	18.2	9.4	9.8	1,891	1,270	953	980
Yugoslavia	23.8	19.0	11.9	7.5	3,789	3,349	1,554	1,600
Developing countries excluding Middle Eastern countries	26.6	23.2	20.5	11.8				

[a] Source: BIS, IMF, CIA estimates.
[b] At yearend.

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- Yugoslavia and East Germany could cover only 35 to 40 percent of maturing obligations from their foreign exchange assets. While both still had reasonably large undrawn commitments, Yugoslavia's lines had been declining since 1979. East Germany, on the other hand, had been better able to maintain its reserve of undisbursed bank and government-backed commitments.
- Czechoslovakia and Bulgaria enjoyed the most secure financial positions. Both had relatively low debt service ratios and could cover over half of maturing credits out of their hard currency deposits in Western banks. Bulgaria also had the highest ratio of undisbursed commitments to outstanding debt among the East Europeans. 25X1

Debt Service Burden Increases

Growing debt service payments contributed to the deterioration in Eastern Europe's financial position (see table 5). The rapid accumulation of debt in the early-to-mid-1970s saddled most countries with interest and repayment obligations that mounted more quickly than earnings from exports and services. This trend was aggravated by the upward march of international interest rates in 1980-81 and by the growing reluctance of banks to lend at longer maturities. The increase in debt service ratios meant that most East European countries were becoming increasingly dependent on borrowings to meet their debt obligations. [redacted]

The significance of debt service ratios in assessing the financial situation of Eastern Europe is ambiguous. The steady climb of Poland's debt service ratio reflected the country's slide into insolvency. The moderately high and rising debt service ratios of both Hungary and East Germany—while not necessarily indicators of imminent insolvency—warn that these countries will need continued sizable inflows of credit in order to meet debt service payments without large drawdowns of reserves and import cuts. Romania, however, encountered debt servicing problems in 1981 despite having one of the lowest debt service ratios in Eastern Europe. Interest payments on gross debt and repayments of medium- and long-term debt were less than 30 percent of current account earnings through 1981. The more telling indicator in Romania's case was the rapid buildup of short-term debt in 1978-80 that resulted from burgeoning trade deficits caused mainly by skyrocketing oil import bills. This left Bucharest with reserves equal to only 9 percent of maturing debt by yearend 1980 and, hence, put it in a vulnerable position once banks began to cut back lending. [redacted]

Table 5 *Percent*
Eastern Europe: Debt Service Ratios [a]

	1975	1979	1980	1981	1982
Bulgaria	29	35	30	32	29
Czechoslovakia	13	20	18	18	19
East Germany	19	46	44	52	58
Hungary	16	31	32	37	37
Poland	28	80	89	176	53 [b]
Romania	19	20	24	27	45
Yugoslavia	14	19	20	26	25 [c]

[a] Repayments of principal on medium- and long-term debt plus interest payments as a share of earnings from exports and services. 25X1
[b] Reflects debt service paid. Ratio based on amounts owed equals 213 percent.
[c] Excludes $400-500 million in arrearages.

[redacted] 25X1

The Crash of 1982

The cutback in bank lending to Eastern Europe accelerated at the beginning of 1982. Concerns about the region's creditworthiness were heightened by bankers' rescheduling experiences with Poland and Romania and by the chill in East-West relations following the imposition of martial law in Poland. 25X1
[redacted]
Commercial banks reduced their gross claims on Eastern Europe by $6.7 billion or by 12 percent of their yearend 1981 exposure. In percentage terms, the reductions in bank exposure ranged between a high of 18 percent for East Germany; 12 to 16 percent for Hungary, Bulgaria, Czechoslovakia, and Romania; and less than 10 percent for Yugoslavia and Poland.[5] [redacted] 25X1

[5] The strengthening of the dollar in 1982 overstates the decline in bank exposure to the extent credits are denominated in currencies other than the dollar. The BIS estimates that roughly one-third of last year's decrease in Eastern Europe's debt to Western banks—when measured in US dollars—resulted from exchange rate movements. [redacted] 25X1 25X1
Since Poland paid off a very small portion of its obligations to banks, most of the reduction in Polish liabilities reflected bank writeoffs of loans and payments of claims on bank loans insured by Western governments. [redacted] 25X1

Table 6
Western Bank Claims, by Region [a]

Million US $

	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983 First Quarter
Total bank claims	**326,987**	**441,667**	**547,569**	**689,660**	**902,979**	**1,110,909**	**1,321,919**	**1,549,440**	**1,687,522**	**1,689,147**
Eastern Europe	11,644	17,521	23,569	29,393	40,108	50,236	55,835	54,322	47,637	45,515
Developing countries [b]	77,488	124,289	163,707	197,800	243,695	309,315	379,121	464,253	512,563	518,592
Developed countries	215,268	273,971	323,599	401,614	531,515	652,791	780,518	909,911	996,329	996,457
Other	22,587	25,886	36,694	60,853	87,661	98,567	106,445	120,954	130,993	128,583

[a] Source: Bank for International Settlements.
[b] Excludes oil-exporting countries.

[redacted] 25X1

The credit squeeze was comparatively more severe for Eastern Europe than for the developing countries. Whereas Eastern Europe suffered an outright reduction in credit lines, banks continued to provide a net flow of loans to developing countries, albeit at a much slower annual rate of increase in 1982 (10 percent) than in preceding years (24 percent annually in 1979-81) (table 6). Even the most financially troubled developing countries, such as Mexico, Brazil, and Argentina, increased their debt to Western banks last year. Consequently, the East Europeans were under even greater pressure for adjustment than the Third World. [redacted]

The crisis was most severe in the first half of 1982 when Western banks reduced their short-term exposure in addition to refusing requests for new medium-term credits. This dealt a severe blow because most countries had become dependent on short-term borrowings to cover their financing requirements after the halt in medium-term lending. Using BIS data on the maturity structure of East European debt, we estimate that Western banks reduced short-term claims on Eastern Europe from $11.3 billion to $8.2 billion with the entire reduction occurring in January-June. For the year as a whole, Western banks rolled over only $3.6 billion of the $9.1 billion in maturing medium- and long-term debt. A sizable share of the medium-term credits Eastern Europe obtained from banks presumably came from continued drawdowns of undisbursed commitments, which fell from $6.4 billion at yearend 1981 to $4.1 billion at the end of last year. Some of the decline probably reflected cancellation of unused credit lines as well. [redacted] 25X1

Unlike 1980-81, government-backed credits did not offset any of the cutback in commercial loans last year. We estimate that the region as a whole drew down new government-backed loans at roughly the same pace as repayments, leaving government-guaranteed debt stable at just over $20 billion. Total Western government commitments (encompassing both disbursed and undisbursed credits) continued to decline largely because of cutbacks to Poland and Romania. For most of the other countries, guarantees of short-term credits increased while medium- and long-term commitments stagnated or fell. Banks and suppliers evidently were more likely to seek official guarantees for short-term trade financing than they had in the past. In terms of medium-term credits, the Berne Union reported that Western governments were willing to pledge new guarantees to all East European countries except Poland and Romania. Reporting from US Embassies [redacted] indicates that some governments turned down East

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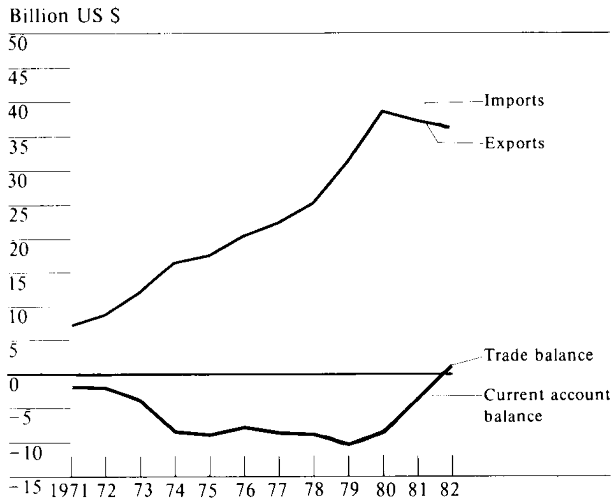
25X1

Figure 3
Eastern Europe: Trade and Current Account Balance



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European requests for new credits and tried to reduce their exposure by holding new commitments below repayments. Even when governments were willing to insure new credits, commercial banks often refused to assume the 15- to 20-percent unguaranteed portion of the loans.

With other financial options running out, the East Europeans reduced substantially their deposits with Western banks early in the year. With cash holdings at or near minimal levels needed for day-to-day trade transactions, most regimes slashed imports. This enabled the region to run its first hard currency trade surplus in more than 20 years and to bring its current account into balance (figure 3). This helped the East Europeans to pay off $2 billion to banks in the last three quarters of 1982 and to rebuild their reserves by $1.5 billion. The East Europeans placed a higher priority on rebuilding their financial strength over more imports, perhaps out of fear that they would be subjected to renewed withdrawals of short-term credits.

Impact on Trade

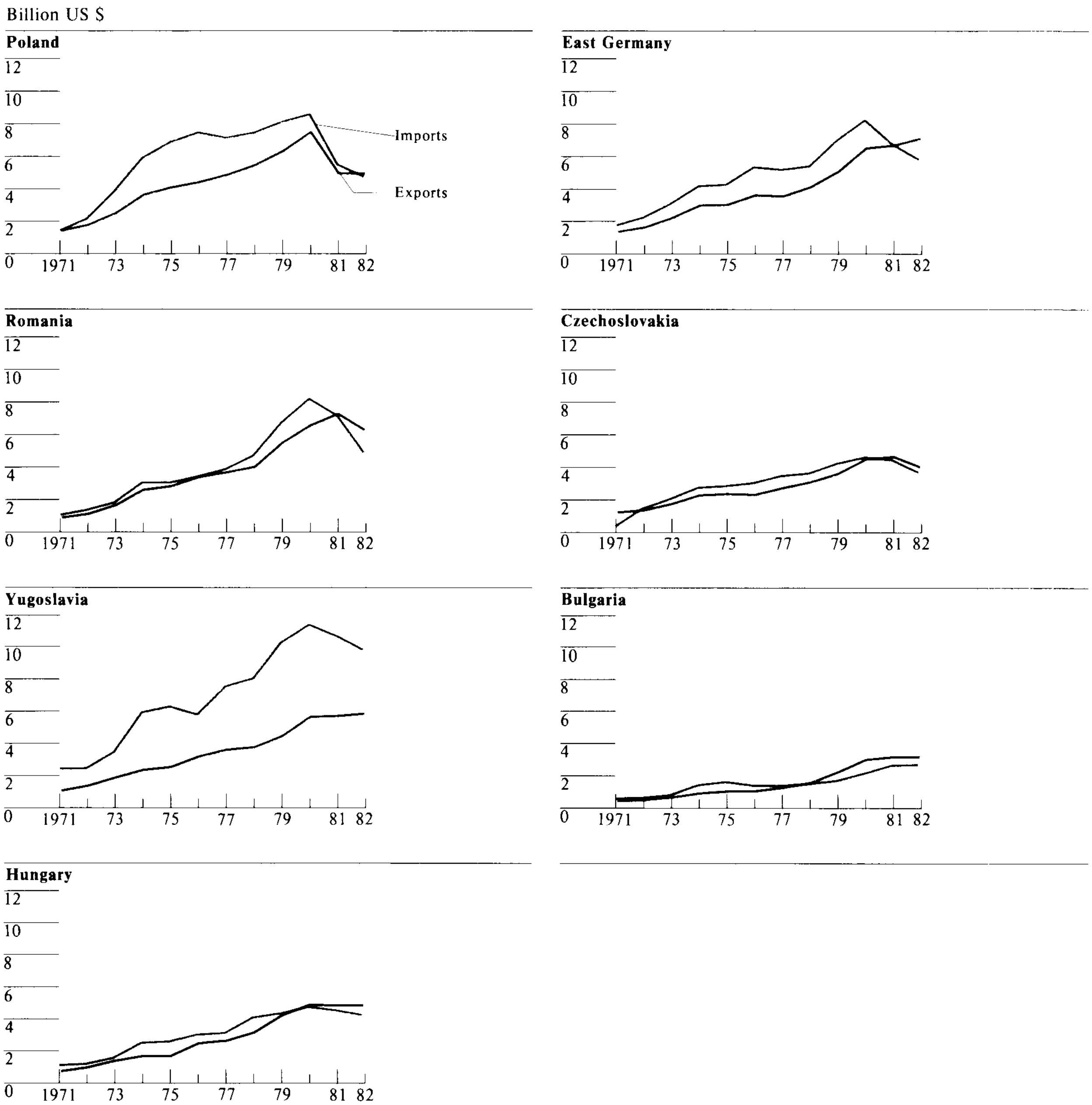
The credit crunch of 1980-82 produced a dramatic shift in Eastern Europe's hard currency trade. In marked contrast to the record deficit of $10.3 billion in 1979, the region attained a surplus of $2.6 billion by 1982. In 1980 trade adjustment had focused on both increases in exports and slower growth of imports. But as credits dried up and exports sagged in 1981-82, almost all countries had to impose sharp reductions in imports. The abrupt turnaround in the trade account has contributed to slow growth and has confronted regimes with increasingly difficult trade-offs between sustaining consumption and investment. 25X1

The first signs of a shift toward living on less credit had appeared in the late 1970s when Bulgaria and Hungary moved to reduce their trade deficits. Sofia's actions—prompted by a close scrape with insolvency in the mid-1970s—were supported by strong growth in exports and paid off in a nearly $700 million surplus by 1979 (see figure 4). In the same year, Budapest cut its deficit by more than $600 million as 25X1
a result of a jump in exports and a reduction in imports. 25X1

The slowdown in lending in 1980 helped bring about a reduction in the region's trade deficit of $1.9 billion. All countries except Romania improved their trade positions, although the gains were small for East Germany and Yugoslavia. Eastern Europe's imports 25X1
continued to climb to a record of $47.2 billion, but the 13-percent increase was little more than half the 1979 rate. Buoyant growth of exports helped boost import capacity despite fewer new credits. The 24-percent surge in hard currency sales did not reflect improved competitiveness, but rather windfall gains from booming world prices for energy and raw materials. Exports of petroleum products—in large part refined Soviet oil—increased sharply, and the East Europeans possibly diverted other goods from domestic supply or sold from stocks. The spending spree of less developed countries, particularly oil producers, also increased export earnings for several countries. 25X1

25X1

Figure 4
Eastern Europe: Hard Currency Trade



25X1

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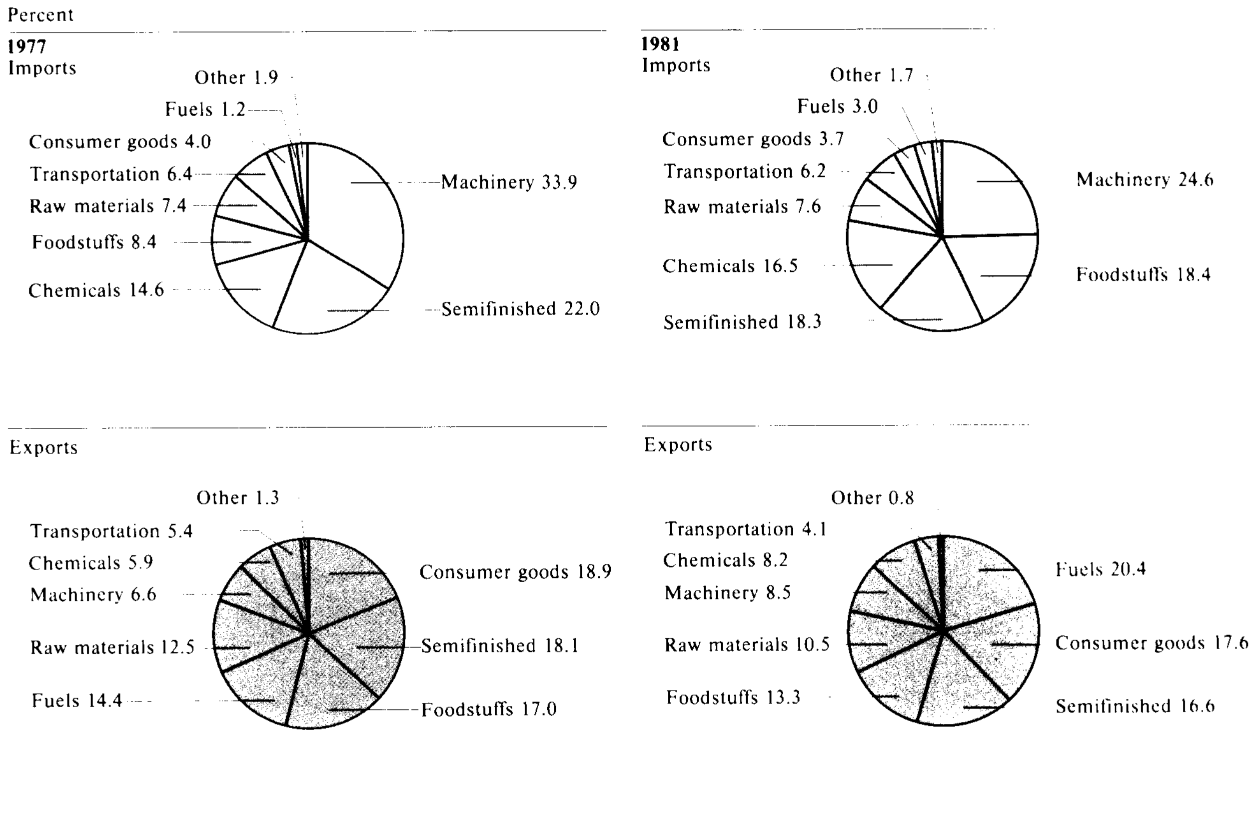
Figure 5
Eastern Europe: Trade With the Developed West, 1977 and 1981



Source: Official Western country (OECD-19) data.

25X1

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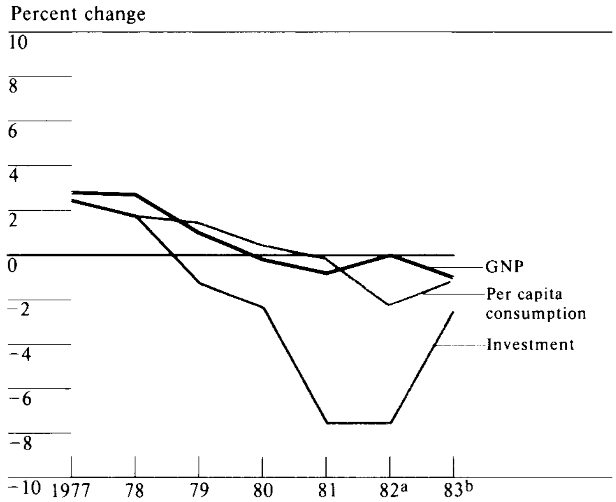
The collapse of lending forced an improvement in the trade balance of $4.6 billion in 1981 and $6.4 billion last year. With a simultaneous slump in exports as a result of recession in the West, the East Europeans had little choice but to slash imports by 30 percent over the two-year period; the deepest cuts were made by Poland, Romania, and East Germany. The $12.8 billion reduction in imports lowered the region's financing requirement by about 15 percent.

Planners focused import cuts on those items that would have the least immediate impact on their economies and populations. Purchases of capital equipment were put off, wherever possible, because their loss would not jeopardize current production. The share of machinery and transportation equipment in imports from the developed West fell from 40 percent in 1977 to 31 percent in 1981 (figure 5). Restrictions were less severe on imports of raw materials, chemicals, and other semifinished goods needed for production, which together maintained their 45-percent share of imports from developed countries. 25X1

Figure 6
Eastern Europe: Domestic Economic Indicators



[a] Preliminary.
[b] Projected.

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Most regimes were cautious about reducing purchases of consumer goods and foodstuffs; the share of these goods in imports rose from 12 to 22 percent between 1977 and 1981 but may have declined somewhat last year because the good harvest permitted substantial cutbacks in imports of grain.

The net resource outflow—excess of exports over imports—needed to cope with the financial crisis has been a key factor in the region's deteriorating economic performance (figure 6). For the six CEMA members, real GNP fell by 0.5 percent annually in 1980-82 compared with 2.5-percent annual growth in 1976-79. For Yugoslavia, growth slowed from a peak of 7.0 percent in 1979 to only 0.3 percent last year. Investment in the CEMA members fell by 1.9 percent annually in 1980-82 and by 5.7 percent in Yugoslavia. Per capita consumption, on the other hand, dropped by only about 0.5 percent annually on average throughout the region.

Varying Impact, Differing Responses

The financial problems of the individual East European countries varied in terms of their timing and severity, and evoked differing responses from the regimes. 25X1

Poland and Romania: Coping With Rescheduling

Poland. Unable to cover their 1981 financing requirements, Poland and Romania were forced to reschedule. As 1982 began, *Poland* was $400 million in arrears on interest payments necessary to conclude the 1981 bank rescheduling agreement; payments were completed in March 1982 and the agreement was signed in April. In January, Western governments protested the imposition of martial law by refusing to reschedule 1982 debt and by not extending new government-guaranteed credits. This decision and Poland's failure to repay debt service to governments did not result in default, however, and Warsaw secured de facto debt relief simply by not making payments to governments. The resulting buildup in arrears has boosted the 1983 financing requirement 25X1 and further worsened Warsaw's chances for financial recovery. 25X1

Warsaw negotiated debt relief from Western banks in 1982 on more generous terms than in 1981. Although Western banks held off rescheduling for the first several months of the year, by midyear they decided to begin negotiations. The Poles first requested total relief from principal and interest, but in August they 25X1 accepted rescheduling of 95 percent of principal. Unlike the year before, the banks agreed to defer interest payments due in 1982 for payment in installments in November and December 1982 and March 1983. Another major concession was that the banks agreed to relend 50 percent of interest payments in the form of short-term trade credits to finance imports from the West earmarked for Polish export industries. This arrangement in effect broke the banks' taboo against rescheduling interest payments (see table 7). 25X1

25X1

Table 7
Rescheduling Agreements

Agreement	Date of Agreement	Date of Signature	Obligations Covered	Amount of Debt Relief	Repayment Terms		Comments
					Interest Rate	Repayment Period	
Poland							
1981 Paris Club Agreement	March 1981	27 April 1981	90 percent of principal and interest on medium- and long-term loans in arrears of 1 May–December 1981	$2.2 billion	Varies with creditor; generally 1 percent above domestic government borrowing rate	January 1986–July 1989	Bilateral accord with the United States not signed because of $28 million arrears on unrescheduled payments due in 1981.
1981 Bank Agreement	August 1981	6 April 1982	95 percent of payments on medium- and long-term debt due 26 March 1981–31 December 1981	$2.3 billion	LIBOR plus 1.75 percent	December 1985–December 1988	1981 interest payments completed in March 1982.
1982 Bank Agreement	August 1982	7 November 1982	95 percent of principal on medium- and long-term debt due in 1982	$2.2 billion	LIBOR plus 1.75 percent	September 1986–September 1989	Interest paid in three installments, November 1982, December 1982, and March 1983. Separate agreement provided that 50 percent of interest payments be relent in the form of 6-month trade credits, rolled over for 3 years at an interest rate of 1.5 percentage points over LIBOR.
1983 Bank Agreement	August 1983	November 1983 (planned)	95 percent of principal on medium- and long-term debt due in 1983	$1.2 billion	LIBOR plus 1.875 percent	January 1988–July 1992	Principal repayment schedule is graduated: 10 percent due in 1988, increasing 5 percent annually to reach 30 percent in 1992. Separate agreement provides for 65 percent of interest payments to be relent in the form of 6-month trade credits, rolled over for 5 years at an interest rate of 1.75 percentage points over LIBOR.

Table 7
Rescheduling Agreements (continued)

Agreement	Date of Agreement	Date of Signature	Obligations Covered	Amount of Debt Relief	Repayment Terms		Comments
					Interest Rate	Repayment Period	
Romania							
1982 Bank Agreement	February 1982	7 December 1982	80 percent of payments on all debt, including short-term	$1.3 billion	LIBOR plus 1.75 percent	1985-88	Unrescheduled principal paid in January and March 1983. Agreement covered much less than orginally planned because suppliers and many banks refused to participate.
1982 Paris Club Agreement	June 1982	28 July 1982	80 percent of payments on medium- and long-term debt	$400 million	Varies with creditor, generally 1 percent above domestic government borrowing rate	1985-88	
1983 Bank Agreement	February 1983	21 June 1983	70 percent of payments due in 1983	$601 million	LIBOR plus 1.75 percent	10 percent of rescheduled amount due in 1984; remainder to be paid March 1987 to September 1989	Amount not being rescheduled due August–December 1983.
1983 Paris Club Agreement	18 May 1983	18 May 1983	60 percent of principal payments on medium- and long-term debt	$148 million	Varies with creditor, generally 1 percent above domestic government borrowing rate	31 December 1986 to 31 December 1989	Of the 40 percent not rescheduled, 30 percent due within one month of original due date, 10 percent due on 30 November 1984.

25X1

Despite more generous terms from commercial banks, Warsaw only managed to cover less than half of its $11 billion financing requirement last year.[6] Debt relief from banks covered $2.6 billion and use of previously committed government-guaranteed credits provided $1.5 billion in loan receipts. Under pressure to meet bank rescheduling terms, Warsaw also ran a surplus of $761 million on its current account (excluding interest). Warsaw slashed imports by 15 percent to earn the surplus; the lack of imported supplies for industry hampered Polish economic recovery. Lack of rescheduling agreements with Western governments meant that the bulk of receipts was used to cover payments due to banks. Western bankers report that payments of interest, fees, and principal under the 1981 rescheduling agreement were made on schedule as well as payments required under the 1982 agreement. Poland finished 1982 with arrears estimated at $6.6 billion. [redacted]

Romania. The credit crunch hit *Romania* in the spring of 1981 when Western banks ceased lending in part because of concerns about Poland but mostly due to doubts about Bucharest's creditworthiness. Despite the approval of an IMF standby program in June, arrears began to mount in the summer and reached $1.1 billion by the end of the year. At first, the Romanian authorities refused to respond to banks' demands for payment and appeared incapable of dealing with the emerging crisis. We believe that President Ceausescu must take some of the blame for Bucharest's refusal to come to grips with its hard currency problems sooner. The delay in seeking formal debt relief probably reflected his reluctance to take any action that would put Romania in the same boat with Poland. [redacted]

With a nudge from the IMF, Bucharest finally approached Western banks in January 1982 with a request for rescheduling. While an agreement was soon reached on terms, the negotiations dragged on for 11 months because of disputes among the banks and between banks and other creditors. On 7 December, Romania and Western banks signed an agreement to reschedule 80 percent of arrears from 1981 and principal payments due in 1982. [redacted] the debt relief from banks was worth only $1.3 billion—about $1 billion less than requested. Firms had balked at the Romanian request to convert their short-term loans into six-and-a-half year credits, and several banks managed to obtain payments and avoid rescheduling (see table 7). [redacted] 25X1

By mid-1982 there was a noticeable turnaround in Romania's approach to its financial problems. Bankers noted that Romanian officials had become more businesslike and realistic in their approach to rescheduling. A US Embassy official reported that the Romanian Bank for Foreign Trade, which previously had played a passive role in managing the country's finances, began holding daily meetings to decide how to allocate hard currency payments to creditors and foreign suppliers. Although his direct involvement has not been visible, President Ceausescu's oft-reported 25X1 tight overall control over government policy suggests that he probably played the major role in deciding to pursue more rational financial policies. [redacted] 25X1

Negotiations for debt relief from Western governments began in June 1982 after the IMF restored Bucharest's access to drawings. The Paris Club quickly agreed to reschedule 80 percent of principal and interest payments due in 1982 and arrears from 1981, providing debt relief of $400 million. The agreement rescheduled only medium- and long-term debt and required that $260 million in short-term credits be paid. Failure to pay these short-term obligations 25X1 delayed for months conclusion of bilateral agreements with the 15 signators to the Paris Club accord. [redacted]

Romania was overly optimistic about the amount of debt relief and new credits that it could come up with in 1982 to cover the year's $4.3 billion financing 25X1 requirement.[7] In addition to the shortfall in the debt relief it secured, IMF data show that new loans were $470 million less than the $1.7 billion target set early in the year. Bucharest reacted to the shortfall by cutting imports by one-third to earn a current account surplus of $655 million—an improvement of $1.5 billion compared with 1981. Despite this drastic adjustment, Romania was left with a gap of nearly $400 25X1

[6] See table on Poland in appendix. [redacted]

[7] See table on Romania in appendix. [redacted] 25X1

25X1

25X1

The Rescheduling Experience

Both Poland and Romania have dealt with a wide range of problems associated with rescheduling. Creditors have insisted on tough terms, negotiations have been lengthy and complicated, the debt relief provided has been inadequate, and both countries have been threatened with default.

Dodging Default. *Creditors have used the threat of default as one of their bargaining ploys during rescheduling negotiations. creditors have threatened Poland with default several times, and Warsaw has taken steps to protect its assets from seizure. Romania's failure to honor a $3 million payment under a foreign exchange contract led a US bank to begin default proceedings in late 1981, but the bank did not carry through.*

The risk of default has receded significantly in the past year. Romania's successful rescheduling and the possibility of a financial turnaround make it increasingly unlikely that creditors would take legal action, even as Warsaw's poor long-run prospects make default still an eventual possibility. In fact, one of the most important lessons of the Polish experience is how much creditors will tolerate without declaring default. By requiring large and rapid debt writeoffs and halting the trickle of payments, default could damage the creditors more than the debtors. Moreover, the emergence of LDC debt problems has made a declaration of default even more dangerous, since it would risk a chain reaction that could lead to other defaults.

Problems With Creditors. *One of the biggest sources of problems and delays during rescheduling has been disputes among creditors and creditor groups. In some cases, negotiations between debtors and bank groups have gone more smoothly than negotiations within bank groups. Romania, for example, agreed on financial terms for the 1982 bank rescheduling in February after a few meetings with nine major bank creditors, but objections by other creditors held up conclusion of the pact until December. The Polish negotiations have proceeded in the opposite way: the banks have negotiated among themselves for several months before presenting an agreed position to Warsaw.*

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25X1

25X1

The principle of equitable treatment of creditors has been difficult to apply. Poland has been the most serious problem. The martial law sanctions prevented the governmental creditors—the Paris Club—from rescheduling even as banks were rescheduling and added a political dimension to the debt relief question. With Romania, the bank creditors, the Paris Club, and the IMF each made their agreements in 1982 contingent on conclusion of pacts with the other groups; the banks complained that the Paris Club rescheduled only loans with a maturity of one year or longer while they rescheduled short-term credits. A key difference between banks and governments is that the latter in the Paris Club allow rescheduling of interest while banks insist that interest be paid.

25X1

25X1

Western creditors also have had difficulty in verifying the terms for debt relief from creditors outside Western bank groups and the Paris Club. Both Poland and Romania owe substantial sums to Middle Eastern and CEMA lenders. The Poles have given few details on the status of their payments to and debt relief from these creditors, while the Romanians have asserted that debt relief from non-Western creditors was obtained last year without specifying the terms.

25X1

25X1

The equity issue also complicates new loans granted during rescheduling. New loans are usually intended to increase the debtor's imports, but the debtors can use the loans to finance imports of goods that otherwise would have been bought with cash. This frees export receipts for payments to creditors, including those not providing the loans. Polish data recently provided to government creditors show that, when Western governments extended or guaranteed some $5 billion in loans in 1981, Warsaw halved imports from $2.14 billion in the first quarter to $1.07 billion in the fourth quarter, mainly by cutting cash imports. In the third quarter, for example, credits covered about 92 percent of imports.

In order to secure debt relief, Poland and Romania have been forced to provide creditors with unprecedented amounts of financial and economic data. Previously secret details on balance-of-payments performance and projections, payments due to creditors by types of creditor and country of origin, holdings of gold and other reserves, and financial relations with the USSR have been submitted to large numbers of bank and government creditors, and much of the information has appeared in the Western press.

Rescheduling has led creditors to try to become more involved in the debtor countries' economies. Romania's membership in the IMF has allowed the Fund to fulfill this role for the creditors, but, in the case of Poland, the creditors have been frustrated in their attempts to encourage economic reform and policies that would lead to economic recovery. The bank group established an International Economic Committee for this purpose, but the group has been able to do little more than collect data because Warsaw refuses to allow creditors a significant role in the economy.

million at the end of the year, reflecting arrears to suppliers and Paris Club members. Moreover, the import cuts intensified shortages of food, gasoline, and other consumer goods. Data presented to the IMF show that consumption fell for the first time since World War II and that the rate of growth of industrial production fell to a postwar low of 1 percent.

25X1

Hungary, East Germany, and Yugoslavia: Struggling To Remain Solvent

Since Poland and Romania already had gone broke in 1981, last year's banking "run" on Eastern Europe hit hardest at Hungary, East Germany, and Yugoslavia—the countries most dependent on new credits to meet debt obligations. With loans drying up, Budapest, East Berlin, and Belgrade faced three policy options: 25X1

- Impose tough adjustment measures in an attempt to pay off debt by running current account surpluses.
- Appeal for emergency help from Western governments and international financial institutions.
- Request debt rescheduling from private and official creditors.

The problems that Poland and Romania had faced in negotiating reschedulings reinforced the reluctance of other countries to risk the domestic political costs of rescheduling. The three hard-pressed regimes, however, proved to have different capabilities for imposing effective adjustment policies and for wheedling help out of the West: 25X1

- Although reluctant to impose austerity on consumers, *Hungary* implemented some adjustments and won enough financial help from Western governments, central banks, and the IMF to avoid rescheduling.

25X1

- *East Germany* could not hope to obtain much help from the West and opted to meet its obligations by wringing a large current account surplus out of its economy.

- *Yugoslavia*'s financial problems were too large, and its adjustment efforts too weak, to forestall bankruptcy

Hungary. Budapest was vulnerable to a loss in banker confidence because of reliance on short-term borrowing to cover its financing needs. The pullout of $1.3 billion in short-term credits by Western, OPEC, and CEMA banks and inability to roll over $200 million in maturing medium-term credits brought Hungary to the brink of a liquidity crisis in early 1982. liquid reserves fell from $1.8 billion to less than $400 million, or little more than one month's imports, between January and March. As a result, a growing number of Western suppliers reported delayed payments from Hungarian importers.

The Hungarians parlayed their good relations with the West and reputation as sound managers into enough emergency support from Western governments, the BIS, and the IMF to avoid a debt rescheduling. The Hungarians argued that a financial crisis would undermine their economic reforms and gratify those who want to tie Hungary more closely to the East. Budapest also tried to convince creditors that its difficulties resulted primarily from a temporary liquidity squeeze, not from serious or fundamental problems that might threaten its solvency. Hungary's arguments persuaded West European central banks and governments in April to provide $210 million in short-term bridge loans through the BIS to shore up Budapest's reserves. The BIS indicated that additional credits would be available later in the year if Hungary made progress in negotiating a standby credit agreement with the IMF. Several West European governments also extended guaranteed trade credits. This show of official Western support and some arm twisting by Western governments convinced 15 commercial banks to arrange a $260 million loan for Hungary in August.

While the regime temporized for several months over tightening its adjustment measures, Budapest came under growing pressure from the BIS and IMF to take more austerity steps in return for emergency loans. During the second half of 1982, the Hungarians responded by raising prices and cutting subsidies on some consumer goods and services, tightening domestic credit, imposing controls on hard currency imports, and devaluing the forint. The BIS lent another $300 million in September, and the IMF approved $620 million in credits in December; about a third of the IMF loan was disbursed immediately to repay the April BIS loan, with the remainder to be drawn this year. These loans and a growing trade surplus enabled Hungary to meet its debt service obligations, clear up its arrearages, and redeem most of its collateralized gold. By the end of 1982, Hungary had rebuilt its foreign exchange reserves to nearly $1.2 billion.

East Germany.[8] Although saddled with the largest cutback in credits and the second-highest debt service ratio in Eastern Europe, East Germany was the only financially troubled country in the region that did not require debt relief or emergency loans from Western creditors in 1982. Western bankers have often suspected that the USSR or West Germany gave special financial help. We, however, believe it probable that the East Germans managed last year's credit crunch on their own through tough adjustment measures and skillful cash management.

We estimate that the East Germans moved their current account from a $500 million deficit in 1981 to a $1.2 billion surplus last year.[9] Imports fell an estimated 15 percent due to cutbacks in purchases of grain, capital goods, industrial materials, and consumer goods while exports grew by more than 6 percent despite depressed Western markets. The trade adjustments offset more than 80 percent of the cutback in bank credits. The rapid adjustment of trade

[8] Analysis of East Germany's financial performance in 1982 is complicated by the lack of official balance-of-payments statistics.

[9] See table on East Germany in appendix.

exacted a stiff price, however, from the domestic economy. According to Embassy [redacted] reporting, shortages of needed goods caused disruptions in production and consumer supply, and investment was cut back even in priority sectors. We estimate that GNP growth fell from 2.4 percent in 1981 to 0.5 percent last year. [redacted]

The East Germans improved their cash flow by accelerating collection of export receipts, delaying payments for purchases, and shifting Western imports into intra-German trade. [redacted] East Germany also increased imports from West Germany from $2.5 billion in 1981 to $2.9 billion last year while cutting imports from other OECD countries. This shift occurred in large part because of easier access to trade credits in West Germany, including the swing credit.[10] Moreover, the East Germans gained by building up their trade surplus with OECD countries other than West Germany because—unlike surpluses earned with other Western partners—a surplus earned in inter-German trade does not yield cash that can be used to service hard currency debts.[11] [redacted]

The payments surplus and tighter cash management reversed the $900 million reduction in reserves that occurred in the first nine months of 1982. Reserves recovered by $700 million in the final quarter and stood at $1.9 million by the end of the year. The unexpectedly large late-year gain probably resulted from the regime's desperate efforts to adjust its trade and improve its cash flow. The East Germans may also have tried to improve their reserve position as reported by the BIS by borrowing short-term credits from banks not included in the BIS survey (for example, Middle Eastern banks) and redepositing the funds in Western banks. [redacted] 25X1 25X1

The credit squeeze would have hit East Germany even harder if the country had not had credit commitments with Western banks and governments. BIS statistics show that East Berlin may have mobilized as much as $560 million—nearly 20 percent of its gross borrowings from commercial banks last year—through drawdowns of previously committed credits. Berne Union statistics indicate only small growth in commitments of Western government–backed credits. We estimate that the East Germans had to draw down their stock of undisbursed officially backed loans by nearly $320 million [redacted] 25X1 25X1 25X1 25X1

East Germany's unblemished record in meeting payments led some Western bankers to conclude that the regime received special financial help from West Germany in 1982. [redacted] Of course, the roughly $1 billion obtained from West Germany through official service payments and tourism receipts were vital to East Germany's efforts to meet its obligations. Bonn, however, did not meet East Germany's request last year for special credits. According to press reports East Germany asked in late 1981 for official West German help in raising nearly $2 billion, but the West Germans held back, apparently because East Berlin refused to make concessions on political issues. This request, nonetheless, resulted in mid-1983 in a West German Government guarantee for a $400 million West German commercial bank loan but without explicit political concessions by the East Germans. [redacted] 25X1 25X1 25X1 25X1 25X1

Yugoslavia. Yugoslavia's financial crisis stemmed as much from failure to reduce the current account deficit and poor cash management in the country's banking system as from reduced Western bank lending. Western bank exposure with Yugoslavia fell by only some 6 percent, or $650 million, in 1982—the smallest percentage reduction for any East European 25X1

[10] The swing credit is an interest-free overdraft account for trade with East Germany maintained by the West German central bank. The credit ceiling totaled $360 million in 1982 but will be gradually reduced to $250 million by 1985. [redacted]

[11] Intra-German goods trade and most services are paid through bilateral clearing arrangements. Surpluses earned by one country can be used only to clear past debts with the other partner or to obtain increased future deliveries. The trade surpluses are not available to make payments to third parties. Some West German service payments and all currency exchanges by tourists are convertible currency that East Berlin can use for payments to other parties. [redacted]

25X1

country (excluding Poland). Nonetheless, by the end of the year Yugoslavia had mounting arrearages to foreign creditors and no prospect of meeting its 1983 obligations without Western financial help.

Belgrade in 1982 failed to cut its current account deficit to its target of $500 million and instead ran a deficit of $1.4 billion because of poor export performance, falling worker remittances, weak tourism receipts, and high interest costs.[12] Yugoslavia also suffered a $400 million outflow on the capital account, resulting mainly from reductions in short-term debt as Western bankers grew increasingly worried about the solvency of some Yugoslav regional banks. Growing concern about Yugoslavia's prospects also prevented Belgrade from meeting its target for medium- and long-term borrowing. Disbursement of some $600 million in IMF credits was inadequate to offset the shortfall in current earnings and capital flows, and Yugoslavia was forced to draw down its reserves by $1 billion.

Almost all of the decline in reserves came from the official foreign exchange assets of the Yugoslav National Bank. Belgrade decreed emergency foreign exchange controls in May 1982, requiring regional banks and enterprises to contribute to a liquidity fund with which the National Bank was to pay off arrearages of overextended commercial banks and build up its reserves. The banks and enterprises failed to comply, however, and as a result the National Bank lost reserves in a futile attempt to clear up overdue payments of the commercial banks. Belgrade imposed additional foreign exchange controls in October in an effort to save its dwindling reserves. By yearend, however, the National Bank's assets were inadequate to cover the overdue payments of commercial banks and meet other contingent liabilities. With arrears of $500-600 million, the country was technically bankrupt.

Czechoslovakia and Bulgaria: Conservatism Rewarded

Creditors did not favor Czechoslovakia and Bulgaria much over the rest of Eastern Europe in 1982, but Prague's and Sofia's past conservative trade and borrowing policies paid off. Both countries had small financing requirements, which insulated them from the full effects of the credit crunch. 25X1

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Czechoslovakia. The cutback in bank lending apparently accelerated Czechoslovakia's plans for curbing imports from the West and paying off hard currency debt. Bank exposure in Czechoslovakia fell by $400 million, most of which was covered by an estimated $210 million current account surplus and a $110 million drawdown on reserves.[13] The Czechoslovaks slashed hard currency imports by 19 percent. Prague's resolve to restrict purchases from the West led to the establishment of a so-called anti-import commission charged with monitoring all applications for spending hard currency to determine that no substitutes were available from domestic or CEMA sources. The imposition of this and other administrative measures to constrict imports flowed from President Husak's 1981 pronouncement that Czechoslovakia would not "live on credit," as well as from the $662 million decline in export receipts last year. With shrinking export earnings because of Western recession, Prague's planners had to make deep cuts in purchases to meet the leadership's goal of reducing external indebtedness. By the end of 1982, Czechoslovakia's net debt had declined to $3.2 billion from $3.5 billion the year before. 25X1 25X1

Despite the country's relatively small financing needs, Czechoslovak bankers apparently were concerned about their liquidity position and doled out little cash to importers. According to the Western business press, Czechoslovak foreign trade enterprises pressed harder for countertrade deals and for one- and two-year supplier credits for raw materials normally purchased for cash. Despite Husak's dictum against more borrowing, Czechoslovakia's Foreign Trade Bank also discussed in late 1982 the possibility of a $100-200 million syndicated loan with Western banks presumably to reduce its short-term debt or to rebuild its reserves. Although press reports claimed that the Czechoslovaks found a positive response, 25X1 25X1

[12] See table on Yugoslavia in appendix.

[13] See table on Czechoslovakia in appendix. 25X1

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[redacted] Western bankers balked at the long maturity and low interest rate Prague's bankers were seeking. [redacted]

Bulgaria. Sofia's relatively low debt and lack of dependence on the West paid off during last year's bank freeze of Eastern Europe. Creditors seemed less anxious to reduce their exposure to Bulgaria than to the rest of Eastern Europe. Although bank exposure fell by some $320 million during the year, the drop probably reflected Sofia's policies as much as banks' efforts to reduce exposure. After a dip in its deposits in Western banks in the first half of the year, Sofia managed an increase for the year. As a result, we estimate that Bulgaria's debt fell below $2 billion, continuing the steady decline begun in 1980. [redacted] 25X1

Not only was the bank pullout less severe for Bulgaria, but Sofia's minimal financing requirement left it better able to adjust. Its low debt and comfortable maturity structure meant that repayments were not large, and the regime's conservative trade policy yielded a surplus on the hard currency current account.[14] [redacted] 25X1

Bulgaria, however, was not totally immune from financial problems last year. The US Embassy in Sofia reported last July that Western firms experienced payment delays of several months because of: 25X1

- A drop in revenues from transportation and tourism.
- Delays in payments to Bulgaria by troubled Western firms (for example, AEG-Telefunken) and countries strapped for hard currency (for example, Iraq and Libya). 25X1
- Sofia's perception that it could obtain free credit unilaterally by extending payments periods.

Banks reported no payments problems, however, and, after a few months, the reports of arrearages to firms stopped. [redacted] 25X1

Financial Outlook

BIS statistics show another $2.1 billion fall in bank claims on Eastern Europe during the first quarter of 1983, but more recent developments suggest some improvement in the region's borrowing prospects: 25X1

- Hungary obtained a $200 million three-year syndicated credit in April, and a group of Arab and Japanese banks are now arranging a $250 million cofinancing loan to accompany project loans approved by the World Bank in June. Both Hungarian and Western bankers report that the outflow of short-term credits, which continued into early 1983, has now been reversed. 25X1
- [redacted] business opportunities were improving throughout Eastern Europe except for Poland and Yugoslavia. West European bank marketing officers, in particular, have begun to press their senior managers to look for more business in Eastern Europe. 25X1
- [redacted] the $400 million West German Government–guaranteed loan to East Germany has reinforced their already improving assessments of East Berlin's creditworthiness and has accelerated their plans to provide new trade credits. 25X1
- According to press [redacted] reports, Czechoslovakia obtained a $50 million club loan with a four-year maturity from a group of six Western banks in mid-July.

[redacted]

The panic that gripped Eastern Europe's creditors in 1982 is receding. The success of most countries in improving their balance of payments appears to have persuaded many bankers that Poland's problems do not necessarily typify those of other East European countries. Improving lender attitudes, revival of the

[14] See table on Bulgaria in appendix. [redacted] 25X1

Friends in Need . . .

The USSR has not provided significant hard currency loans or financial aid to its allies in Eastern Europe since early 1981, when Moscow agreed to lend Warsaw up to $1 billion.

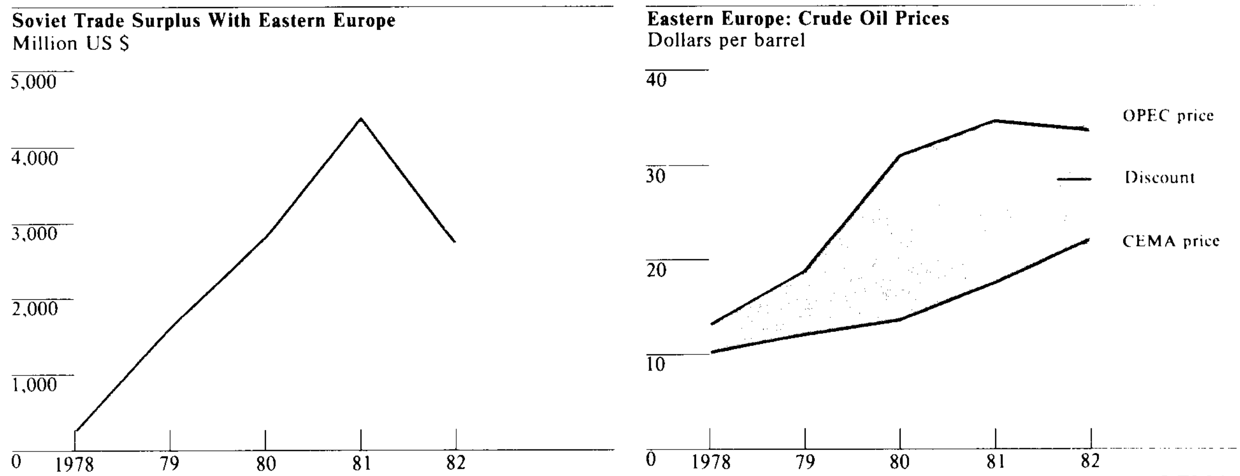
The gains from trade with Moscow also have fallen steeply from their peak in 1980-81 (see figure 7). In 1982 the reduction in oil deliveries to some East European countries, combined with the increase in East European exports to the USSR, suggests a reduction of real resource flows from the USSR. In 1982 Eastern Europe's deficit with the USSR was reduced to $2.7 billion from $4.4 billion in 1981. This reduction occurred despite a sharp deterioration in Eastern Europe's terms of trade with the USSR as the effect of Western inflation worked its way into CEMA prices. Although trade grew at some 12 percent annually during 1979-82, the increase resulted largely from price increases.

Soviet subsidies in the form of price advantages to Eastern Europe also have fallen substantially. In 1982 Soviet oil prices to Eastern Europe rose about $5 per barrel, while OPEC prices fell slightly. The gap between Soviet and OPEC prices narrowed from the maximum of $17 to $18 per barrel in 1980-81 to $12 in 1982. The Soviet price of crude oil to Eastern Europe is about $26, the same price of some spot trades in early 1983.

The USSR has shown more generosity toward Yugoslavia in 1983 than toward its financially strapped Warsaw Pact allies. Moscow's actions presumably have resulted, in part, from concern that the "Friends of Yugoslavia" financial rescue package would increase Western influence in Belgrade. In the 1983 Yugoslav-Soviet trade protocol, the USSR agreed to permit a small deficit in Belgrade's favor in contrast 25X1 *to the large surpluses run by Yugoslavia in recent years. This concession apparently has been helpful since the IMF reports that diversion of goods from CEMA markets contributed to Yugoslavia's strong hard currency export performance in the first months of 1983. Moscow has also been receptive to Yugoslav requests for additional oil deliveries. In March, the USSR agreed to ship an additional 200,000 to 300,000 tons of oil above the 4.5 million tons of crude agreed to in the 1983 trade protocol. The Soviets, however, apparently demanded more Yugoslav hard goods in return. More recently, a Yugoslav official told the US Embassy that the Soviets have agreed in principle to provide an additional 1 million tons of oil* 25X1 *apparently without requesting more Yugoslav exports this year.*

The Soviet assistance apparently has enhanced the USSR's standing in Belgrade. According to the US 25X1 *Embassy, Moscow's forthcoming attitude on additional oil deliveries and Belgrade's political interest in counterbalancing its financial dealings with the West have quieted much of the squabbling between* 25X1 *the USSR and Yugoslavia that was evident last year and in early 1983. Recent criticism by the Soviet media of Yugoslavia's economic and financial relations with the West probably served as a reminder to Belgrade to keep its relations with the East in good repair.* 25X1

Figure 7
Eastern Europe: Diminishing Economic Benefits From Trade With the USSR



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Western economies, and lower Eurodollar interest rates should ease somewhat the financial burden of most East European countries. The outbreak of new financial crises seems unlikely provided the regimes can maintain their austerity policies.

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The region's hopes for financial recovery, however, are fragile. Lenders who have been burned by debt problems in Eastern Europe and elsewhere remain cautious about the region's creditworthiness. An early return to the easy credit conditions of the 1970s is not foreseeable, and bankers will examine much more closely the quality of economic management and performance before increasing their exposure. Poland and Yugoslavia will continue to cause major headaches for creditors and will not be cured in the near future. The possibility of more reschedulings and requests for Western aid cannot be ruled out.

Limited access to loans will force the region to continue running trade and current account surpluses and to make difficult decisions about allocating scarce hard currency either to repay debt or to import. With fewer loans, import capacity will depend heavily upon success in boosting exports.

Creditor Attitudes

The emergence of LDC debt problems in mid-1982 may have complicated Eastern Europe's borrowing woes, but it also put the region's difficulties in a more balanced perspective. Although wary about new lending, bankers seem a little more relaxed about the region's financial situation because their worst fears proved exaggerated. Poland did not default or repudiate its debt and has kept current on its rescheduling agreements with the banks; Romania has made considerable progress in normalizing relations with its creditors. Other heavily indebted countries—notably Hungary and East Germany—survived the 1982 credit crunch without rescheduling, an achievement that may revive creditor confidence in these countries.

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. . . Friends in Deed

Eastern Europe's financial crisis has increased the importance of international financial institutions to the region. The IMF, BIS, and World Bank were the only creditors to increase their exposure to Eastern Europe last year. Moreover, to varying degrees, the IMF and BIS have helped manage the relations of Hungary, Yugoslavia, and Romania with both private and official creditors over the past two years. Since the international financial crisis first arose in Eastern Europe, the IMF and BIS set precedents in dealing with the problems of East European members that were to be repeated on a large scale with troubled Third World borrowers. [redacted]

The BIS-IMF Rescue of Hungary. *The $210 million in emergency help given to Hungary by the BIS and West European central banks in early 1982 represented the first major support operation by central bankers. (In mid-1981, France led an unsuccessful effort to organize a $500 million bridge loan for Poland through the BIS.) Once it had established a precedent with Hungary and the danger of a spreading world financial crisis had became obvious, the BIS arranged emergency bridge loans similar to the Hungarian credit for Mexico, Brazil, Argentina, Chile, and Yugoslavia.* [redacted]

The BIS decision to aid Hungary—when it had refused to help Poland—stemmed from the very different nature of the problem. In the eyes of most central bankers, Hungary was fundamentally sound and well managed but was close to illiquidity because commercial bankers had reduced their exposure to the country rapidly. The central banks hoped that a quick infusion of cash would stem the bankers' run on Hungary; moreover, the BIS commitment would only have to be short term. Budapest was negotiating its entry into the IMF and presumably could draw on Fund credit facilities by late 1982 to repay the BIS loans. Poland, by contrast, suffered a problem of basic insolvency that only its creditors could resolve by granting substantial debt relief for an extended period of time. [redacted]

The BIS and West European central banks also aided Hungary out of concern over the economic and political implications of Budapest's impending financial crisis. According to press reporting, BIS President Leutwiler believed that a Hungarian financial collapse would bring down the rest of Eastern Europe and in turn could severely undermine the international financial system. West European central banks and governments, which put up most of the funds for the BIS loan, feared that a Hungarian debt rescheduling would discredit Budapest's program of economic and political liberalization. [redacted] 25X1

The help for Hungary accomplished the central banks' objective of preventing bankruptcy until Budapest could arrange credits from the IMF and return to the syndicated market. The operation, however, has not been without pitfalls for the BIS. The Bank's commitment to Budapest has proved to be longer term than anticipated and it has come close to violating the dictum that central banks should not give explicit guarantees to commercial banks. The group of 15 commercial banks, which arranged a $260 million club loan for Hungary in August 1982, tried to make this backing explicit by tying their loan to a pledge from the BIS to disburse its then pending $300 million credit for Hungary. [redacted]

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BIS decision to extend another $100 million to Budapest in April of this year—after commercial banks put up an additional $200 million—suggests willingness to backstop banker's risk in Hungary. [redacted]

Problems With Yugoslavia. *The BIS-IMF rescue of Hungary set the stage for the far larger and more complex effort to save Yugoslavia. The first IMF program began in 1980 and was replaced in 1981 by the current three-year agreement worth $2.1 billion. By its own admission, the IMF failed to appreciate the seriousness of Yugoslavia's economic situation—particularly as Western commercial credits dried up in 1981-82—and overestimated the responsiveness of the economy to corrective measures. The IMF staff's repeated overoptimism about Yugoslavia damaged the Fund's credibility in the eyes of commercial bankers and led the Fund to assume a leading role in trying to work out the country's problems in 1983.* [redacted]

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The multilateral rescue effort began to take shape in September 1982 when the Yugoslavs appealed to the BIS for a three-year, $500 million credit to bolster the National Bank's reserves and pay off arrearages.

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The central banks refused on grounds that they could only extend short-term financing that would cover obligations until a longer term refinancing program was in place. Shortly thereafter, senior IMF officials began warning Western governments that a financial crisis was imminent and that the Fund would have to halt disbursement of the standby loan. Although Yugoslavia's situation called for rescheduling, the IMF argued on political grounds that a rescheduling could prove divisive in Yugoslavia. In return for a tougher 1983 stabilization program, the IMF pressed Western banks, governments, the World Bank, and BIS to provide $6 billion in refinancing and new credits.

The Yugoslav rescue effort has been a trying experience for both the IMF and BIS, and more difficult decisions are in store for both institutions. The BIS has had problems arranging the $200 million gold-secured tranche of its $500 million credit because some creditors have refused to waive Yugoslav pledges entitling them to equal security. Since Yugoslavia's liquidity problems show no sign of easing, the BIS probably will have to renew its credit. Yugoslav authorities have indicated they will need another IMF standby credit next year. Since the Yugoslavs have made little progress in controlling inflation, the IMF will have to press for even tighter adjustment measures if the stabilization program is to remain credible in the eyes of Western creditors. The Fund has already been caught between Western governments and banks in disputes over burden sharing in this year's effort. The problem almost certainly will worsen if, as seems likely, the Fund presses for another refinancing effort in 1984 in lieu of rescheduling.

The Fund's Mixed Results With Romania. *In June 1981 the IMF and Romania agreed on a three-year, $1.2 billion standby arrangement. The pact proved to be too little, too late:*

- *The Fund's seal of approval did nothing to bolster banker confidence and the program quickly fell apart.*
- *Bucharest had little time—and probably not much enthusiasm—to implement the program's measures on energy prices, exchange rates, interest rates, and the organization of foreign trade.*
- *The first disbursement of 140 million SDR was swamped by the tide of the bank pullout.*
- *The large accumulation of arrearages violated conditions of the standby arrangement, and in November the IMF suspended further drawings.*

The standby arrangement—launched at the time that Bucharest's financial situation was just beginning to sour—cast the Fund in a major role in the resolution of Romania's difficulties.

Bucharest to take the distasteful step of requesting debt relief in January 1982, the first move Bucharest made to address its difficulties. Until then, the Romanians had seemed stunned and defiant, refusing to respond to creditors' demands for payments. The IMF's hold over access to disbursements under the standby arrangement provided incentives for successful conclusion of negotiations with banks and the Paris Club. Last December the IMF released $300 million to Romania, which Bucharest set aside to make the downpayments due the banks under the rescheduling agreement. Romanian payments data also show a $100 million BIS loan in 1982, repayable in $25 million installments due this February, March, July, and December.

The IMF has had difficulty in applying conditions and monitoring performance for Romania, the first CEMA country to join the Fund. Although Romania is a centrally planned economy without a convertible currency, the Fund's policy prescriptions have focused on reducing the number of exchange rates, raising domestic prices, tightening domestic credit policy, and eliminating subsidies—measures that experience shows have had little impact on improving Romania's external payments position.

Warsaw's IMF Application on Hold. *After years of indecision and apparent resistance from Moscow, Poland decided in late 1981 to apply for IMF membership. Shortly afterward, martial law was declared and the application shelved. Polish officials and press continue to urge the completion of the application and accuse the West of blocking it for political reasons. Warsaw is likely to press the West to allow membership when negotiations with the Paris Club resume this fall, although some Poles probably remain wary about the conditions Warsaw would have to accept in order to gain access to IMF credits.*

Eastern Europe's problems no longer appear unique nor even extraordinarily severe, Poland excepted. Concern over the threat to the world's financial system from overextended borrowers has demonstrated that both debtors and creditors bear responsibility for resolving financial problems. In particular, the involvement of the BIS and IMF in Hungary's and Yugoslavia's crises has encouraged—and to some extent compelled—continued banker involvement with these countries.

Warsaw's plight, however, has changed bankers' long-term thinking about Eastern Europe. The banks can no longer point to Eastern Europe's financial conservatism and unblemished payments record, and they have learned that they cannot trust in Soviet financial support as adequate justifications for lending to the region. Instead of making blanket judgments about the area's creditworthiness, bankers are beginning to draw sharper distinctions among the countries on the basis of economic policy and performance, thus reducing somewhat the danger of spillover.

Continuing unease among bankers about foreign lending and closer government supervision of commercial bank exposure will impede the ability of Eastern Europe and the LDCs to return to Western financial markets, although both could benefit if Western countries seek to support their own exports by boosting credits through guarantee and insurance programs. Even when they return, comparisons will be made between the two groups of countries on the extent and success of adjustment programs. While Eastern Europe may look better in the short run because of the dramatic trade adjustments made during the last two years, its longer run economic prospects probably are bleaker.

Political developments, in our opinion, also could influence borrowing prospects. Any further cooling in the East-West political climate or outbreaks of unrest or violence could further undermine creditor confidence. Threats to political stability could result from popular reaction to the pinch of austerity measures or from struggles over succession, and problems in one country could spill over and poison lenders' attitudes about the whole region.

As a prerequisite for increased lending, bankers are looking for evidence that the East Europeans are addressing their payments imbalance through structural changes to improve export performance. Creditors regard the draconian import reductions of the past two years as a short-run expedient with little positive impact on long-term creditworthiness. Some bankers remain skeptical that the East Europeans will or can do as much as financially troubled LDCs to correct their fundamental problems. As a result, they are putting more weight on IMF membership, while urging the East Europeans to provide more complete economic and financial information. 25X1

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Even when providing new loans, many Western bankers indicate they will keep Eastern Europe on a short leash. The days of granting large untied credits at long maturities and low interest spreads are gone. Major Eurodollar syndications will be much rarer than in the late 1970s; a far greater share of lending will be short-term and trade-related. Commercial banks will probably insist on more Western government backing for their loans or demand security from the borrowers, including gold collateral and offsetting deposits. The cost of credit will be higher than in the late 1970s, and the debt maturity structure will remain unfavorable for most countries. 25X1

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Prospects for Credit Flows

Eastern Europe's hopes for easing restrictions on imports depend upon whether the region can reduce—and eventually reverse—the net outflow of funds suffered in 1981-82. In 1983 we estimate that the region (excluding Poland) will experience another large outflow on the capital account of more than $2.4 billion (table 8).[15] This actually reflects some improvement in borrowing capacity over 1982 when the net credit outflow exceeded $3.5 billion; Yugoslavia, however, will probably be the only net gainer this year, thanks to the Western financial rescue package. 25X1

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Projecting financing flows in 1984-85 is more uncertain because of factors affecting both the supply of

[15] See appendixes for projections of 1983 financing requirements for individual countries. The totals discussed in this section exclude Poland because of the many uncertainties underlying debt relief for Warsaw. 25X1

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Table 8
Net Financing Flows: [a] **1976-82 Actual, 1983-85 Projected**

Million US $

	1976-80 *(annual average)*	1981-82 *(annual average)*	1983 Projected	1984-85 [b] *(annual average)*		
				Scenario I	Scenario II	Scenario III
Total	**7,455**	**−2,055**	**−2,450**	**−2,200**	**115**	**2,380**
Bulgaria	185	−360	−440	0	100	200
Czechoslovakia	725	−390	−300	0	165	330
East Germany	1,800	−505	−1,075	−700	−175	500
Hungary	1,230	−750	−500	−400	−100	375
Romania	1,305	−390	−800	−600	0	475
Yugoslavia	2,210	340	665	−500	125	500

[a] New credits less repayments.
[b] See insert on page 26 for explanation of Scenarios I, II, and III.

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and demand for credit. We cannot easily quantify the impact of IMF stabilization programs, Western rescue packages, and developments in international financial markets on the willingness of creditors to lend. It is difficult, in addition, to generalize about the prospects for new borrowings by the region as a whole because lenders are likely to differentiate among these countries more than in the past in making decisions about new credits, and some regimes—notably Czechoslovakia and Bulgaria—may be unwilling to make full use of available borrowing capacity.

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In the attempt to establish a range for likely net credit inflows and outflows for Eastern Europe (excluding Poland), we have made broad assumptions about each country's ability to raise credits over the next two years under three scenarios:

- Scenario I—our most pessimistic variant—envisions a continued outflow from Eastern Europe of $2.2 billion annually in 1984-85. This presumes that bankers continue to reduce their exposure because of financial problems in the region or reluctance to undertake foreign lending in general. Under this scenario, Yugoslavia almost certainly would need another debt refinancing or rescheduling because it has little margin for paying down its debt from reserves or current earnings. Hungary, East Germany, and Romania would remain under intense pressure to run large trade and current account surpluses to avoid reschedulings.

- Scenario II presumes enough revival of lending to leave the region's net financing flows roughly in balance over the next two years, with a moderate inflow of credit in 1985 offseting some outflow in 1984. This variant assumes that Eastern Europe's adjustment efforts instill enough confidence in bankers first to halt reductions in exposure and then to begin extending small amounts of new credits. The modest net credit inflow for Yugoslavia is based on IMF projections, which we believe presume at least some additional refinancing in 1984 at least. The positions of Hungary, East Germany, and Romania are more manageable, but these countries will not receive the large inflows that buoyed economic performance in the 1970s.

- Scenario III, which provides for an average net credit inflow of $2.4 billion in 1984-85, is optimistic about Eastern Europe's ability to return to international capital markets. In this case, most East European countries are able to reestablish their credit rating with Western banks, and the interest of Western exporters in reviving markets provides more trade financing. Even under these circumstances, the region's net resource inflow is less than a third of that enjoyed in 1976-80.

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Projection of Credit Flows and Exports in 1984-85

Credit Flows. *We have established three scenarios regarding the size of net financial flows (new credits less repayments) in 1984-85 for each East European country except Poland. Scenario I is the most pessimistic about Eastern Europe's borrowing prospects and assumes either no change in net financial flows or a small reduction in net debt; Scenario II presumes a small revival of lending; and Scenario III assumes all countries can resume net borrowings. We have differentiated among the countries on the basis of banker perceptions of creditworthiness and have computed credit flows on the basis of changes in net debt.*

We assume that Czechoslovakia and Bulgaria have the best borrowing prospects:

- *Scenario I presumes no net credit inflow or outflow in 1984-85.*
- *Scenario II presumes a 5-percent increase in net debt each year.*
- *Scenario III presumes a 10-percent increase in net debt each year.*

We assume that both Hungary and East Germany will experience a net loss of credits under Scenarios I and II and will be net borrowers under Scenario III:

- *Scenario I presumes a 7-percent fall in net debt each year, the average rate of decline for both countries in 1981-83.*
- *Scenario II presumes a 3.5-percent fall in net debt in 1984 and no change in 1985.*
- *Scenario III presumes a 5-percent increase in net debt both years.*

We have estimated the flows for Yugoslavia and Romania from IMF projections for 1984-85:

- *Scenario I for Romania is the IMF's projection of a net capital outflow averaging $600 million in 1984 and 1985. We assume that, in each year, Yugoslavia falls $500 million short of the IMF's projected financing sources which total $5 billion in 1984 and $4.75 billion in 1985. The shortfalls presume Yugoslavia fails to obtain projected medium-term bank credits.* 25X1
- *Scenario II assumes Romania raises enough credits to run a balanced current account in 1984-85 while Yugoslavia obtains the IMF's projected credit flows.*
- *Scenario III assumes Romania increases its net debt by 5 percent in 1984-85 while Yugoslavia obtains $500 million more in untied bank loans than the IMF projects.* 25X1

Exports. *We assume that the relationship between the growth of Eastern Europe's exports to developed countries in 1984-85 and projected growth in the OECD will be the same as that between increases in exports and OECD growth in 1976-81. We have excluded Eastern Europe's exports of petroleum products from the 1976-81 base because of their extraordinarily rapid increase in this period, which is unlikely to be repeated. We assume exports to developing countries in 1984 will be 5 percent below last year's level and will return to the 1982 level in 1985. These projections are probably optimistic because competition from LDCs in developed country markets and Western protectionism could hold relative export gains below the levels achieved in the 1970s. Restraints on Eastern Europe's imports could also undercut export performance.* 25X1

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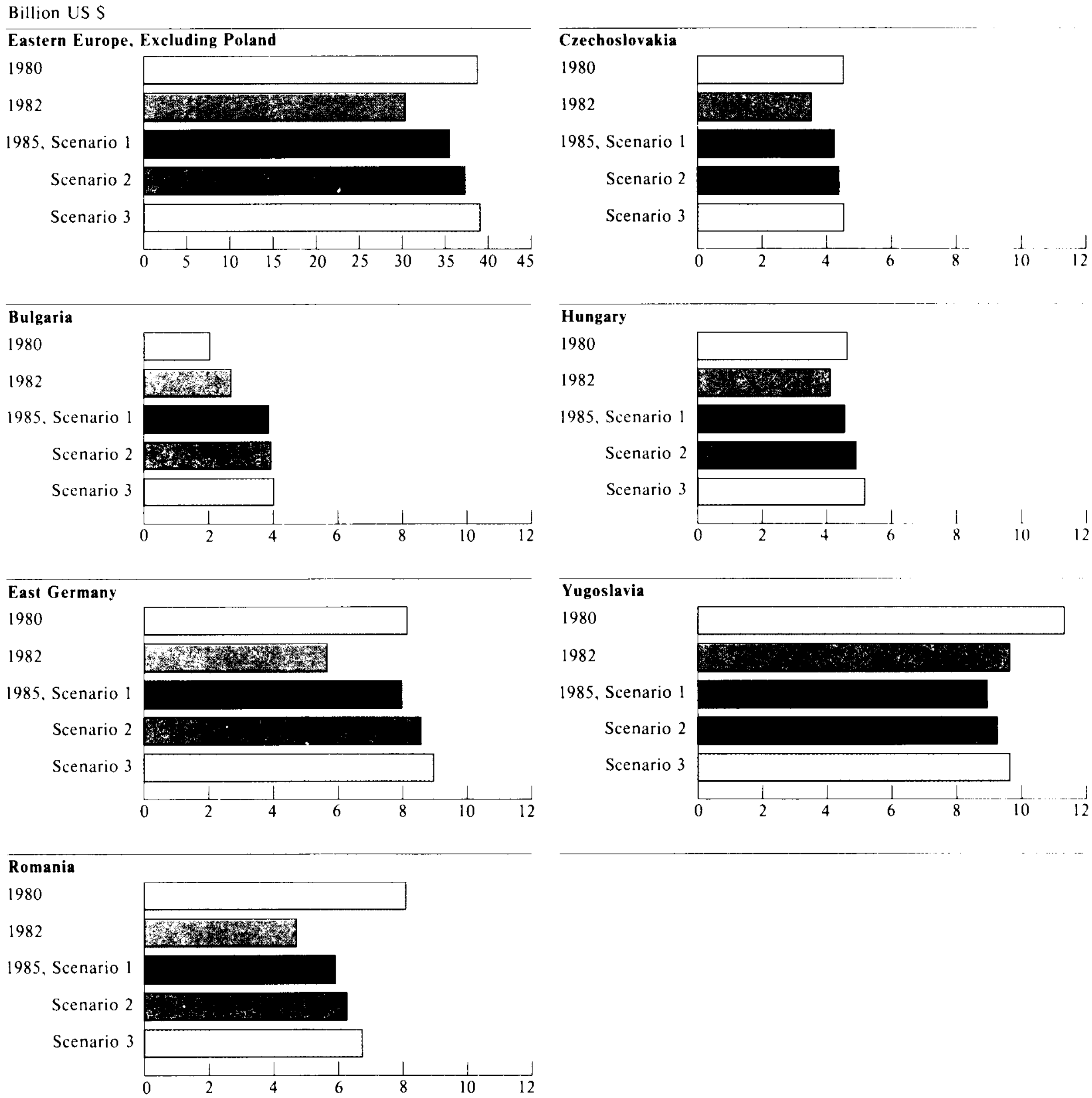
Implications for Import Capacity

Some improvement in borrowing conditions and a pickup in Western demand for East European exports should enable the East Europeans (excluding Poland) to ease the import cuts of the past two years. Since the revival of both lending and Western economic growth will probably be slow, we anticipate another 1- to 2-percent decrease in Eastern Europe's hard currency imports this year. Gains in import capacity probably will be achieved in 1984-85, assuming continued growth in the West and improvement in creditor attitudes, but only under the most favorable lending assumption (Scenario III) does the absolute level of imports in 1985 ($39.0 billion) exceed the level reached in 1980 ($38.7 billion) (see figure 8). With

Figure 8
Eastern Europe: Hard Currency Imports 1980, 1982, and Projected 1985, Under Financing Scenarios



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only a modest revival of lending (Scenario II), imports in 1985 are about 4 percent below the 1980 peak and 8 percent below the least favorable lending assumption (Scenario I). [redacted]

Under our assumptions, Bulgaria exhibits the greatest capacity for gains in imports while Yugoslavia has the least.

- Under almost any circumstances, *Sofia* should be able to increase imports at a faster rate than achieved in 1976-80.

- Although we assume the same borrowing prospects for Czechoslovakia as for Bulgaria, *Prague* probably can do little better than resume growth of imports at the late 1970s' pace because of sluggish export growth. Projected import capacity in 1985 would reach the 1980 level only under the most favorable lending scenario.

- The import capacity of both *East Germany* and *Hungary* in 1985 would be more than 5 percent above the 1980 level under Scenario II and more than 10 percent higher under Scenario III. Our projections permit much faster import growth for East Germany in 1984-85 than for Hungary. East Berlin, however, would need much of this to offset the far sharper cutbacks in imports which it made in 1981-82.

- *Romania's* import capacity, on the other hand, would reach only 80 percent of the 1980 level under the most optimistic scenario and would be as low as 70 percent under the most pessimistic assumptions.

- The poor growth in *Yugoslavia's* import capacity results from the nearly 10-percent reduction in imports this year, which overwhelms modest increases in 1984-85. [redacted]

Even if lending revives, some countries may be unwilling to expand imports at the rates our projections suggest. Some regimes (Czechoslovakia, Bulgaria, and Romania) may opt instead to continue reducing hard currency debt or building up reserves. But, while regimes currently place high priority on continuing to run trade and current account surpluses, their resolve may weaken if more credits become available. Pressures to make full use of available import capacity will be intense because most economies need more Western inputs. [redacted] 25X1

In the short run, Eastern Europe's import priorities will most likely remain those of the past two years. 25X1
Most regimes will give preference to goods needed for consumption and current production. Purchases of grain and food products will fluctuate in accordance with agricultural performance. Some economists and planners (notably in Hungary and Czechoslovakia), however, are arguing more strongly that their economies need a revival of investment using Western resources to lay the foundation for long-term growth, and this may have some greater impact down the road. Bulgaria, in fact, has recently shown more interest in purchases of Western equipment and technology. [redacted] 25X1

To raise imports significantly, the East Europeans need robust gains in hard currency sales. Their ability to power an export drive is open to question:

- Exports suffer from longstanding problems of quality and marketing, and tinkering with trade bureaucracies is unlikely to infuse more export orientation.

- Cutbacks in imports of capital goods have probably widened the technology gap between the West and Eastern Europe.

- Many of Eastern Europe's traditional exports face increasingly stiff competition from LDCs and growing protectionist sentiment in Western Europe.

- The East Europeans are unlikely to repeat sizable gains in exports of raw materials and petroleum products because of softer prices and cutbacks in deliveries of Soviet oil.

- Cash shortages are forcing OPEC and other developing countries to slash imports, possibly leading to a greater share of East European sales to these countries through bilateral clearing arrangements and not for cash. 25X1

- Efforts to expand exports through countertrade deals with Western trading partners have limited prospects for success due to their resistance to East European barter goods. [redacted] 25X1

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Debtor Prospects [16]

The prospect of slow export growth and more credit outflows, or at best small inflows, means that financial problems will continue to beset nearly all the East European countries. In the near term, Poland—and very likely Yugoslavia—simply cannot generate enough debt servicing capacity on their own to meet obligations. The outlook for other countries may be less bleak, but further reductions in credit availability could expand the number of countries needing rescheduling or Western aid. Even if the likelihood of more reschedulings recedes in 1984-85, limited import capacity will continue to hobble economic performance. Most regimes will have to restrain consumption and investment in order to lower demand for imports and free goods for export. Within these constraints, pressure will build to produce more output with fewer inputs. This will point up the necessity of attacking the systemic flaws that contributed to low productivity.

The nature of the financial problems and the capacity of individual countries to respond seem likely to diverge even more over the next several years:

- Poland and Yugoslavia are caught in a medium- to long-term financial crisis, and their regimes seem the most ineffective in imposing adjustment measures and attacking structural problems. Warsaw's financing gap far exceeds Belgrade's, but Western creditors will have to give Yugoslavia debt relief beyond this year's rescue package.

- Romania, East Germany, and Hungary show signs of financial recovery, but their positions remain fragile. East Berlin and Bucharest have squeezed their economies much harder than Budapest, while the latter seems farther along in addressing structural problems. East Germany probably retains the strongest financial safety net (particularly by obtaining help from West Germany), but Hungary, and to a lesser extent Romania, are better positioned to win general Western support, including help from the IMF.

[16] See appendix for detailed discussion of the prospects of individual countries.

- Thanks to their small debts and generally good standing with Western banks, Czechoslovakia and Bulgaria have the option of choosing to continue paying down their debt or to lift self-imposed restraints on imports from the West.

Poland. Insolvency and lack of progress in dealing with its debt problems have locked Poland into a crisis that is likely to prevent economic recovery for several years. Poland has almost no hope of earning a surplus and obtaining debt relief, credits, and a trade surplus sufficient to cover its $13 billion financing requirement this year. While its rescheduling agreements with banks and governments are not yet concluded, its debt continues to grow by the amount of unpaid interest as creditors involuntarily increase their exposure. Merely to stem the increase in its debt, Poland must generate net exports equal to annual interest payments. Financial recovery—at a minimum, halting the growth of the debt—will require both large current account surpluses and commitments by the regime to revive economic growth and by the populace to make large sacrifices. 25X1 25X1

Yugoslavia. Completion of the financial rescue package should provide Yugoslavia with nearly enough debt relief and new credits to cover this year's $5.8 billion financing requirement, but there will be little or no rebuilding of reserves. We believe that Belgrade will need more help in 1984 and 1985 and that it may be difficult to avoid rescheduling, particularly because creditors may not want even to maintain their exposure, much less increase it. The key to Yugoslavia's financial recovery is Belgrade's ability to attack the economy's deeply entrenched inflationary tendencies and to correct systemic problems and weak financial management. But needed adjustment policies and structural reforms may impose a higher price than the population and regional political leaders are willing to pay. 25X1

Romania. The 1983 financial picture looks much better than last year's, primarily because Bucharest has crossed the hump in its debt maturity structure. It has already concluded negotiations to reschedule its

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Yugoslavia: A Little Help From Its Friends

The IMF and the US Government appealed to Western governments to pledge enough credits to Yugoslavia that commercial banks would be encouraged to refinance their own maturing loans and provide new medium-term credits to replace last year's withdrawal of short-term loans and rebuild reserves. A group of 15 governments responded in January with a $1.4 billion credit package. The commercial banks' International Coordinating Committee (ICC) subsequently proposed a $3.8 billion restructuring of commercial obligations consisting of $1.4 billion in refinancing of maturing medium-term loans, a two-year renewal of $1.8 billion in short-term debt, and $600 million in new credits. These refinancing packages are more generous than the reschedulings done for Poland and Romania by Western banks and governments. If Yugoslavia had rescheduled its debts under the terms obtained by Poland in 1982, it would have received only $3 billion instead of the $5.1 billion in rollovers and new credits pledged by banks and governments.

In addition to the refinancing packages provided by its creditors, Yugoslavia is receiving substantial financial support from international financial institutions. The IMF is providing the last $600 million tranche of Yugoslavia's three-year standby credit. The BIS has approved a $500 million short-term loan to bridge Belgrade's cash needs until the entire credit package is disbursed, although problems over the use of gold as collateral have limited drawings to $300 million. Finally, the World Bank has contributed a $275 million structural adjustment loan in addition to some $175 million in new project credits.

Despite the generous amount of assistance, the effort to avoid a formal rescheduling has not provided Yugoslavia with the type of aid needed and has led to problems among creditors that delayed conclusion of the package. In contrast to a conventional Paris Club rescheduling agreement, each government decided the type and amount of financial assistance it wished to provide to the rescue plan. The contributions from most governments consisted largely or entirely of 2- to 3-year credits tied to future exports from their countries. While Yugoslavia clearly needed trade financing, Belgrade's more pressing problem was cash to cover maturing obligations and an extended period of relief from debt repayments. Moreover, the decision of governments to offer new trade loans instead of rolling over maturing claims meant that the governments were not bearing a commensurate share of the refinancing. 25X1

The package led to problems over burden sharing between governments and banks because the IMF pressed banks to provide in effect a rescheduling of all maturing loans plus new money. Although banks pressed governments to refinance maturing loans, the latter could not easily restructure their package. Some governments were already disbursing new credits, and some made disproportionately large pledges of new funds in lieu of extensions on obligations falling due. The banks concluded that the governments are not providing a long enough maturity on new loans and are not providing the type of credits Yugoslavia needs. Moreover, some Western governments are actually receiving more repayments from Yugoslavia in 1983 than they pledged in new credits while the banks are increasing their exposure. The ICC, nonetheless, decided it had to accept the government package to keep the rescue effort on track. 25X1

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1983 debt to banks and governments. The Romanians, however, have balked at the IMF's demands to establish timetables for adjusting exchange rates and domestic energy prices, and the Fund has suspended drawings under the standby arrangement. The stalemate with the Fund, combined with a continued shortfall in credits, could lead to a substantial financial gap this year. Bucharest has vowed that it will not need debt relief next year and counts on a current account surplus to cover more than half of its 1984 financing requirement. The test of Romania's external adjustment efforts will come in 1985 when Bucharest must begin to repay obligations rescheduled in 1982. Next year's expiration of the current IMF standby arrangement also will increase pressure for large current account surpluses. Romania's ability to cover its financial obligations will depend on whether it has used debt relief to deal with underlying economic problems, on whether creditors judge that Bucharest has overcome its debt woes, and on how debilitating the import cuts have been.

East Germany. East Germany probably can avoid a rescheduling, but the country continues to face a serious liquidity problem. Covering this year's financing requirement without a reduction in reserves will require another large current account surplus and more than $3.5 billion in credits. The East Germans continued to encounter difficulties in raising loans in the first half of 1983, but the recent $400 million government-guaranteed credit from West German banks should improve prospects for covering this year's borrowing requirement. Even before announcement of the loan, Western bankers seemed more willing to provide short-term trade loans and the new West German credit may encourage even more lending. Bankers, however, still do not anticipate an increase in medium-term financial credits needed to lengthen the maturity structure of East Germany's debt. East Berlin nonetheless can draw on new government-guaranteed trade credits from France, Canada, and Austria.

If East Germany gets through this year's financial squeeze, repayments on medium-term debt will be less in 1984-85. East Berlin still will need to roll over a large short-term debt, but further improvement in its financial position should strengthen lender confidence and ease the task of refinancing. Western bankers, however, will press harder for basic economic and balance-of-payments data before increasing their exposure. Over the medium term, the country will have to live more within its means and implement measures that improve export competitiveness and promote economic growth without heavy reliance on Western imports and credit.

Hungary. Hungary is still on a financial tightrope despite some successes in raising credits in the first half of 1983. The IMF now estimates that exports will again stagnate this year, as opposed to the nearly 8-percent growth originally projected in the standby program. The Fund has lowered the projected current account surplus from $600 million to $500 million, but meeting this goal still requires new restraints on domestic demand. Depressed exports and continued withdrawal of short-term credits reduced reserves to less than two months worth of imports in early 1983, and the IMF now projects a $155 million decline in reserves for the year instead of the increase originally planned. This leaves Hungary in a very weak position because Budapest faces a rising level of debt repayments through 1985. The Hungarians have requested a second IMF standby credit, and they will have to tighten adjustment policies, as well as continue to forge ahead with measures to improve efficiency and competitiveness if they are to avoid rescheduling. Fortunately for Budapest, many Western bankers believe they should support Hungary's reform program as an example for other East European countries.

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Bulgaria and Czechoslovakia. Both countries have weathered the credit crunch as a result of their financial conservatism. Since neither encountered problems in covering obligations during the height of the crisis in 1982, we expect they will be able to roll over their 1983 obligations. Their financial strength has left them with a range of options not available to the other East Europeans. They could maintain their policy of limited economic relations with the West, hold down imports, and reduce their debt even further. Or Sofia and Prague could use their financial cushion to expand hard currency imports. While there are signs that Sofia may move to expand its trade with the West, Prague apparently is committed to running current account surpluses and paying down its debt through 1985. This will contribute to a further technological decline of the industrial sector and stagnation of the Czechoslovak economy.

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Legacy of the Crisis: Lessons and Perspectives

Our forecast of continuing serious financial problems for some countries (Poland and Yugoslavia) and, at best, slow improvement for the rest implies that the leadership will face difficult decisions in the next few years. The problems are not new ones, but are now

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more severe than in the past. Muddling through—tinkering, temporizing, and relying on help from the USSR and the West—has become less of an option. More than ever, the East European countries will be forced to rely on their own resources and on the ability of their economic managers and systems to adjust. Continuing financial and related problems will influence East European policy on a wide range of issues:

- Relations with the USSR, the West, and each other.
- Allocation of resources to investment, consumption, and defense.
- Economic reform—along with its political and ideological implications.

While East European officials instinctively blame the West for their problems, they must also recognize that their own shortcomings at least made them more vulnerable to the credit cutoff. They must be disappointed, for example, with the results of their decision to expand trade with the West, launched in the early 1970s. The import boom did not lead to a sustained improvement in the growth rates of their economies, implying either that the imports did not help or that their benefits were swamped by other problems. Moreover, the imported technology and equipment failed to generate enough exports to repay the loans.

The regimes are likely to conclude from their experiences that caution should guide their economic relations with the West for some time. Thus, while creditors' attitudes indicate that the supply of financing will be tight, demand by the East European debtors also may be constrained by a new conservatism. Several East European countries apparently intend to pay off their debts to the West. At a minimum, others probably will try to be more certain that they can repay loans and will build more caution into their forecasts for the Western economies, carefully considering the potential impact on their external accounts.

At the same time, the East Europeans may conclude that they now need the West more than ever. Indeed, most still seem anxious at least to maintain their economic ties with the West. The fundamental economic problems that led them to seek Western trade and credits a decade ago are now even more pressing. Dwindling economic resources—recently aggravated by Moscow's cuts—place a greater premium on efficiency. With the East's relatively weak technology and research base, the West remains the preferred source of equipment and technology to boost productivity. In addition, some of the countries still need debt relief, aid, and credits to relieve their financing problems. 25X1

Economic relations with the USSR will figure heavily in their decisionmaking, and Bulgaria's relative economic success in recent years is an example of the advantages of less dependence on the West and strong Soviet ties. Moscow is pressing for more balanced and possibly less subsidized trade, as well as increased 25X1 CEMA integration. East European resistance has delayed the long-talked-about CEMA summit which, if and when it is held, will give a good indication of the direction of Soviet–East European relations. We do not believe that the key issues will be resolved soon. The East Europeans will continue to need Soviet energy and other raw materials and will try to minimize the political as well as economic costs of obtaining them. 25X1

Most of the regimes do not regard their economic relations with East and West as an either/or proposition; as in the past, they will try to get as much as possible from both. The leaderships realize that one of 25X1 their chief assets is their borderline position between the USSR and the West. The Soviets want to retain the strategic and military advantages that flow from domination of much of the region and the membership of most states in the Warsaw Pact; the West wants these countries at least to maintain traditional ties to the West and to express some independence from Moscow. Most East Europeans will be deft at playing off East against West. 25X1

Within the region, the increased need for efficiency and more rational use of scarce resources are likely to give fresh impetus to reform advocacy. The capital inflows of the 1970s—together with Soviet largesse— 25X1 allowed the East Europeans to get along without making fundamental changes in their economies. Without new loans, and with prospects for continuing slow or negative growth, systemic reform has become more urgent. The priority of boosting sales in hard currency markets means that East European production must be of higher quality and more flexible in reacting to changing tastes and conditions. This calls for decentralization at least in the direction and operation of the external sectors. The problem is that, as the Hungarian experience shows, reforms take a long time to implement and even longer to pay off. Moreover, the present tight payments situation requires quick results, which would be difficult to achieve during a period of structural transition. Reform, furthermore, can be politically unsettling in that it threatens the privileges of entrenched bureaucracies and challenges the ideological underpinnings of these regimes.

Finally, the prospect of stringency in economic relations with the West and the continued need for sharp domestic adjustments to the credit squeeze are likely to heighten tensions within the leaderships and between the leaderships and the led. The prospect of lower capital inflows or of outflows will require reduced imports and increased exports, both of which will take resources out of the domestic economies and depress living standards. While the populations have accepted recent austerity reasonably placidly, their patience may not last as long as the tough period of austerity that lies ahead. The regimes will have to decide whether to use more repression (as in Romania) or to explain the problem and enlist public support (as in Hungary). In any case, economic deprivation will serve as a continuing, and perhaps growing, source of potential political instability in the months and years ahead.

Implications for Economic Partners

Eastern Europe's bleak economic prospects present problems and opportunities for both the USSR and the West. Moscow perceives economic weakness in
25X1 Eastern Europe as a threat to its security interests at a time when its own problems reduce its options. The Kremlin appears ambivalent about Eastern Europe's financial problems, as reflected in apparent indecision about policy toward Eastern Europe. Moscow can gloat over Eastern Europe's misadventures—particularly Poland's—in buying and borrowing from the West and can cite these problems in arguing for more closely meshed economic relations within CEMA. The predicament of its client states, on the other hand, means that considerable economic support is needed from one source or another to maintain stability in the region. The Soviets are likely to have to field more requests for aid to supplant credits and other economic constraints of their own, the Soviets will want to supply the minimum necessary to assure this stability, but will find this level difficult to estimate. 25X1

Moscow's proposals to its troubled allies have focused on CEMA integration rather than on narrower trade issues. The Soviets' agenda for the CEMA summit concentrates on sweeping changes that would increase Soviet economic influence over the East European economies and draw them more tightly into the
CEMA orbit. The Kremlin may have chosen this time 25X1
to exert pressure because it perceived that the East Europeans' problems left them little opportunity to resist. But such a calculation would ignore the Soviets' experience in Eastern Europe since World War II and could prove dramatically counterproductive. At the same time, growing economic difficulties in Eastern Europe may persuade Western governments that they have new opportunities to weaken Moscow's influence in the region. To do so, however, would require a revival of willingness to take financial risks and to use new policy tools, such as including more East European states in the IMF, and pursuing agreements between them and the EC or assuming politically motivated aid burdens of indefinte duration and return. 25X1

The West cannot expect substantial economic gains in its relations with Eastern Europe. Financial con-
straints are likely to make East European markets 25X1
tough for Western exporters to penetrate. The adjustments of the past two years have disappointed firms—especially in Western Europe—who acquired a major stake in exporting to the region in the 1970s. Capital goods have borne the brunt of Eastern European import cutbacks, and most of the countries apparently have no plans to revive large-scale equipment purchases. Imports of grain also have been slashed sharply, and Western farmers cannot expect that this market will soon be as large as a few years ago.

Eastern Europe also will still be a source of concern and uncertainty to creditors. Western exporters are likely to press their banks and government export credit insurers to provide financing for their sales. The banks, however, will have enough trouble getting payments on past loans and, in the cases of Poland and Yugoslavia, will be involved in protracted negotiations on debt relief and aid. 25X1

Appendix

East European Debt [a]

	1971	1972	1973	1974	1975	1976
Eastern Europe						
Total	**9,510**	**11,572**	**14,727**	**21,468**	**30,659**	**38,264**
Commercial	5,396	7,243	9,828	15,634	23,721	29,667
Official [b]	3,765	3,921	4,406	5,123	6,002	7,168
IMF/World Bank	349	408	493	711	936	1,429
Bulgaria						
Total	**743**	**1,009**	**1,020**	**1,703**	**2,640**	**3,198**
Commercial	442	765	818	1,520	2,453	2,878
Official [b]	301	244	202	183	187	320
Czechoslovakia						
Total	**485**	**630**	**757**	**1,048**	**1,132**	**1,862**
Commercial	284	435	558	821	926	1,575
Official [b]	201	195	199	227	206	287
East Germany						
Total	**1,408**	**1,554**	**2,136**	**3,136**	**5,388**	**6,292**
Commercial	693	771	1,348	2,243	4,423	5,217
Official [b]	715	783	788	893	965	1,075
Hungary						
Total	**1,071**	**1,372**	**1,442**	**2,129**	**3,135**	**4,049**
Commercial	968	1,274	1,353	2,053	3,081	3,998
Official [b]	103	98	89	76	54	51
BIS/IMF						
Poland						
Total	**1,399**	**1,825**	**3,057**	**5,313**	**8,879**	**12,307**
Commercial	420	856	1,951	3,586	6,547	9,159
Official [b]	979	969	1,106	1,727	2,332	3,148
Romania						
Total	**1,227**	**1,249**	**1,611**	**2,693**	**2,924**	**2,903**
Commercial	585	597	682	1,780	2,024	1,841
Official [b]	642	652	814	797	706	659
IMF/World Bank/ CEMA banks	0	0	115	116	194	402
Yugoslavia						
Total	**3,177**	**3,933**	**4,704**	**5,446**	**6,561**	**7,653**
Commercial	2,004	2,525	3,118	3,631	4,267	4,999
Official [b]	824	1,000	1,208	1,220	1,552	1,628
IMF/World Bank	349	408	378	595	742	1,026

[a] Because of rounding, components may not add to totals shown.
[b] Includes Western government-guaranteed credits and direct official loans.

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Poland

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Warsaw's financial problems continue to mount with no solution on the horizon. While Poland's $25 billion debt is not large compared with the major Latin American debtors, Western financial experts often cite Poland's situation as the most hopeless. Martial law halted the slide of the economy but cost Warsaw the financial support of Western governments and admission to the IMF. Poland is close to a moratorium, with no payments being made to government creditors and banks only receiving payments due under rescheduling agreements. Credit lines have been almost used up, and creditors are unwilling to lend new money to a regime that is considered harsh as well as financially bankrupt.

Warsaw's Projection. The Law on the Balance of Payments for 1983, approved by Poland's Parliament at the end of 1982, projects a hard currency trade surplus of $700 million, a surplus on services (except for interest) of $340 million, and $800 million in credit inflows. In our view, Warsaw's projections are unrealistic. The projected 13-percent increase in exports will be hard to achieve because coal prices are down in Western Europe this year. Moreover, the projected 4-million-ton increase in coal exports to the West does not track with the expected drop in domestic production of 3.3 million tons. Polish plans for substantial boosts in exports of silver, copper products, and synthetic rubber also appear inconsistent with production plans.

The import level this year will be largely a function of the amount of credit available and the regime's decisions on how to allocate its hard currency resources between payments to creditors and expenditures on imports. The Poles project a 6.2-percent boost in imports. They intend to restrain imports of agricultural products and capital equipment while increasing purchases of raw materials for industry.

The flow of new credits to Poland from Western governments apparently has slowed to a trickle. Data recently provided to the banks show that Warsaw obtained $145 million in new medium- and long-term credits in the first quarter of this year. Poland also has received $130 million in short-term credits under the 1982 bank rescheduling agreement. Warsaw's prospects for lining up the remainder of the $800 million projected loans are dubious; Polish officials now expect to draw only $400-500 million this year.

Debt Service Due. We estimate that Warsaw's obligations to creditors total $14.6 billion this year, more than half of which are principal and interest unpaid from last year and payment due this year to Paris Club creditors. Under original loan contracts, Poland owes Western banks $1.3 billion in medium- and long-term principal, and an estimated $800 million in interest; an estimated $514 million is owed under the 1981 and 1982 bank rescheduling agreements. Finally, an estimated $2.4 billion in principal and interest is due to creditors outside the Paris Club and the Western bank group. Obligations to this group could be much larger because presumably very little of the $2.8 billion due them in 1982 was paid or rescheduled.

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If Warsaw continues to meet obligations under the 1981 and 1982 bank rescheduling agreements, this will absorb all of its projected payments capacity of $1.04 billion. More payments can be made only if Poland earns a larger surplus or obtains credits and does not use them to increase imports.

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Rescheduling Negotiations. Rescheduling got off to a slow start this year. Western governments continued to refuse to reschedule Polish debt through the first half of the year, but in July they agreed in principle to begin negotiations in the Paris Club. Poland's initial proposal to the banks was so extreme that the banks did not even consider it a realistic starting point for negotiations. In February the Poles tabled a proposal to reschedule all principal and interest due under original loan contracts between 1983 and 1990 for repayment during the 1990-2002 period. The banks insisted on terms similar to the 1982 agreement. By mid-year, the Poles had moved significantly toward the banks' position, and during negotiations in Vienna in mid-August, both sides agreed to reschedule 95 percent of principal for 10 years with a five-year grace

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Poland
Financing Requirement and Sources

Million US $

	1981	1982 [a]	1983 [b]
Financing requirement	**10,697**	**10,984**	**13,559**
Current account	−2,247	−3,258	−1,947
Trade account	−433	358 [a]	700 [c]
Exports	4,971	4,974 [a]	5,600 [c]
Imports	5,404	4,616 [a]	4,900 [c]
Interest due	−2,293	−4,019	−2,987
Under original loan contracts	2,293	3,387	2,273
Paris Club		1,582	1,145
Banks		1,005 [d]	575
Other creditors		800	553
Under rescheduling agreements		632	714
1981 Paris Club		288	200
1981 Bank		307	228
1982 Bank		37	286
Other invisibles, net (excluding interest)	479	403	340 [c]
Short-term debt repayments, net	−839	−92	0

	1981	1982 [a]	1983 [b]
Medium- and long-term debt repayments due	−7,282	−7,061	−5,013
Paris Club		2,573	1,770
Banks		2,442 [e]	1,417 [e]
Other creditors		2,046	1,826
Arrears from previous year	0	−573	−6,599
Net credit extended	−329	0	0
Sources of financing	**10,124**	**4,385**	**2,050**
Credits	4,930	1,677	800 [c]
Medium- and long-term (guaranteed)		1,481	
Short-term (recycling facility-from 1982)		196	
Debt relief	4,769	1,613 [f]	1,200
Payments received from debtors, net		95	50
Aid from socialist countries	325	0	
Drawdown of reserves	100	0	
Arrears/gap	**573**	**6,599**	**11,509**

[a] Source: *Report on the Economic Situation in Poland*, Statistical Supplement, Warsaw, February 1982.
[b] Projection.
[c] Polish projection: "Law on the Balance of Payments in 1983," Warsaw, 29 December 1982.
[d] Includes $273 million due in 1982 but deferred until March 1983 under the bank rescheduling agreement. Does not include $400 million in interest arrears from 1981 paid by April 1982, which is counted as arrears.
[e] Includes principal payments—5 percent of total—deferred until the following year under the bank rescheduling agreements for 1981 and 1982.
[f] Includes $117 million in principal and $273 million in interest deferred until 1983 under the 1982 bank agreement.

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period. The banks insisted that the interest on unrescheduled debt and the remainder of the principal be paid this year, but they agreed to relend Poland 65 percent of the interest payments as trade credits.

Government creditors expect to begin formal negotiations with Poland in October. The Paris Club has decided that arrears from 1981 must be covered before an agreement for 1982 can be signed. Despite the impatience of neutrals and some Allied countries to reschedule, these creditors have not developed terms that the Poles could meet or that would lead to a significant flow of payments. At the same time Warsaw has been tardy in providing data to the Paris Club and more aloof in seeking negotiations, possibly because of pessimism over what would result. Negotiations are likely to be difficult when creditors' desires for Poland to resume payments clash with Warsaw's likely request for total and long-term debt relief. With payments capacity now absorbed by payments to the banks, payments to government creditors could be made only at the expense of payments to the banks.

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Longer Term Outlook. Beyond this year, the outlook is no less bleak. Because Poland is unlikely to be able to pay the interest on its debt for many years, the debt will grow by the amount of unpaid interest and creditors will involuntarily have to increase their exposure. The arithmetic of the process shows that, the longer financial recovery takes, the more difficult it will be to achieve. As long as interest is unpaid, both the debt and the interest payments required to service the debt will grow. For example, if Warsaw can pay only $1 billion in interest annually, the debt will increase to $40 billion by 1990, and the interest payments will reach $4 billion. 25X1

To stem the increase in its debt, Poland must balance its current account, that is, generate net earnings equivalent to annual interest payments. Financial recovery thus requires a revival in economic growth and a regime decision to allocate more resources to support production and to repay foreign creditors rather than to continue to boost domestic consumption. Poland currently is allocating a very small share of its depressed output to service its debt. In Polish currency, the trade surplus in 1982—the first in 11 years—represented 2.8 percent of national income while imports represented 8.5 percent. If the 1983 foreign trade targets are achieved, the share of net exports to the West in national income will decline to 2.6 percent and cover only one-fourth of interest due this year. 25X1

Financial recovery will require a massive commitment by the regime and the people to economic growth and large sacrifices in living standards over many years. At this point there is no such commitment and the regime instead has concentrated on trying to stabilize the economy and on providing minimal levels of consumer satisfaction. Jaruzelski and his closest economic advisers appear to regard the debt problem as an obstacle to the solution of the economy's ills. The regime would like more Western credits in order to finance imports which, in turn, would be expected to increase production and exports. This policy is similar to the path followed in the late 1970s, which ended in the present crisis. This time Poland's economic prospects leave creditors unwilling to risk further exposure. 25X1

Moreover, the regime intends to distribute the fruits of any economic recovery to the populace. The 1983-85 plan calls for a 21 percent rebound in consumption by 1985. Because this goal is greater than projected growth in national income of 10 to 12 percent, it probably implies that a reduced share of output will be exported and that a surplus will not be available to repay creditors. 25X1

Yugoslavia

By late 1982, Yugoslavia's creditors recognized that the country had no prospect of meeting this year's debt obligations, but Belgrade was adamant that it would avoid a rescheduling at all costs. The IMF urged Western governments and banks to arrange a financial rescue that would spare Yugoslavia the opprobrium of having to request a debt rescheduling. The IMF contended that a rescheduling would seriously undermine the federal executive's authority, compromising its ability to implement needed adjustment policies and structural reforms. The Fund feared that, because of the highly decentralized nature of Yugoslavia's financial system, rescheduling would be a lengthy and potentially divisive operation that could well end in failure.

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The IMF proposed a rescue plan that would roll over maturing medium- and long-term credits, halt the erosion of short-term debt, and ensure enough new credits to rebuild Yugoslavia's reserves by at least $600 million. The Fund hoped that the refinancing package, coupled with improvement in Yugoslavia's current account, would produce a strong enough revival in commercial lending that Yugoslavia would not require more help next year. The plan has grown into a complicated $6 billion package involving credits from Western governments, banks, the BIS, IMF, and World Bank.

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Completion of the rescue package proved to be a more lengthy process than any of the participants had anticipated. Progress initially was delayed by disputes between Western governments and banks over burdensharing, with governments refusing demands to refinance all maturing loans while providing new credits. The more serious obstacle was Belgrade's resistance to banker demands for the National Bank and government to assume responsibility for the debt and in effect recentralize the financial system. After stormy debate in the Federal Assembly and the Federal Executive Council, the Yugoslavs approved a compromise wording of the bank refinancing agreement in early July. The Federal Republic accepted the role of guarantor for credits borrowed by Yugoslav banks under the refinancing plan and acknowledged that Western creditors can sue the Republic to enforce the agreement. At the same time the Federal Assembly passed legislation strengthening the National Bank's role in debt management. Despite these actions, Western banks and the Yugoslavs still had not signed the refinancing accord by late August mainly because some banks were reluctant to contribute their share of the new money.

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Yugoslavia
Financing Requirements, 1981-83

Million US $

	1981	1982	1983
Financing requirement	**6,687**	**5,585**	**5,762**
Current account balance	−1,821	−1,420	−750
Trade balance	−4,880	−3,779	−2,750
Exports	5,720	5,858	6,200
Imports	10,600	9,637	8,950
Net invisibles	3,059	2,359	2,000
Net invisibles, excluding interest	4,649	4,319	4,000
Net interest	−1,590	−1,960	−2,000
Repayment of short-term credit	−2,936	−2,300	−1,810
Repayment of medium- and long-term debt	−1,695	−1,690	−3,052 [a]
Credits extended (net)	− 235	−175	−150
Financing sources	**6,218**	**4,573**	**5,677**
1983 Western rescue package			
IMF			620
IBRD			450
Government loans			700
Financial credits			200
Export credits			500
Banks			3,460
New loans			600
Short-term rollover			1,460
Medium- and long-term rollover			1,400
Other			447
Net errors and omissions	**589**	**0**	**0**
Change in reserves	**120**	**−1,012**	**−85**

[a] Includes $500-600 million in arrears as of 1 January 1983 plus $344 million in debt service.

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Current Account. Yugoslavia has improved substantially its trade and payments performance during the first months of 1983. Data provided by the Yugoslav National Bank to the US Embassy in Belgrade show a $180 million current account deficit in the first half of 1983 compared with a deficit of more than $1.5 billion in the same period of last year. Yugoslavia cut its hard currency trade deficit to $990 million from $2.1 billion in January–June 1982 on the strength of a 6-percent gain in exports and a 22-percent reduction in imports. According to Embassy reporting, the marked gains so far this year have encouraged some Yugoslav officials to believe that they will eliminate their hard currency current account deficit this year. The Yugoslav National Bank (YNB), nonetheless, told Western bankers recently that it is projecting this year's current account deficit at $550 million. [redacted]

The IMF is even more cautious about the current account outlook. In its midyear review of the stabilization program, the Fund raised its forecast for the 1983 deficit to $750 million from its initial projection of a $500 million shortfall. The IMF actually anticipates a somewhat smaller trade deficit than the YNB due to slightly lower imports; the main difference is that the Fund projects net invisibles will fall to $2 billion from last year's nearly $2.4 billion while the YNB estimates net earnings at $2.3 billion. [redacted]

The IMF's caution about the current account seems warranted. A sharp falloff in advance tourist bookings for the key summer months indicates that tourism receipts will not recover substantially from last year's low level. Net worker remittances will decline, perhaps by even more than the IMF assumes, as Yugoslavs react to the limits placed on hard currency deposit withdrawals last year and anticipate new restrictions on the use of foreign exchange. Export growth may also fall short of the 6-percent increase projected for the year by both the IMF and the YNB. Growth in hard currency sales, in fact, declined sharply from 20 percent in the first quarter to only 3 percent in the second quarter partly because import cuts are hampering production for export. [redacted]

The delayed disbursement of credits from the financial rescue package may well hold imports below the levels projected by both the IMF and the YNB. This has led some Western bank economists to forecast that the current account deficit will be on the order of $300 million, less than both the IMF and YNB projections. These more optimistic forecasts make the strong assumption that continued tight restraints on imports do not result in a commensurate loss of exports. [redacted] 25X1

Financing Sources. Even with completion of the financial rescue package, Yugoslavia will probably fall at least $300 million short of the $6 billion in credits that the IMF originally projected for 1983. The $1.3 billion credit package pledged by governments is likely to yield no more than $1 billion in total credits since approximately $300 million are tied to capital goods which Yugoslavia does not plan to import; moreover, the Yugoslavs probably will draw only about $700 million of the commitments this year because of delays in negotiating bilateral agreements with donor countries. Although commercial banks pledged in the refinancing agreement to maintain most of Yugoslavia's $1.8 billion in short-term debt, the IMF anticipates some short-term capital outflow since trade credits must be repaid before new ones are drawn. [redacted] some banks may be slow in anteing up their share of the $600 million in new loans. On the other hand, some of the shortfall in the rescue package has been offset by a greater amount of supplier credits provided outside of the refinancing effort. [redacted]

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Reserves. The Yugoslav National Bank's reserves are the critical indicator of the country's liquidity situation. The lack of a foreign exchange market and the tendency of the better managed banks to hoard their reserves have forced illiquid banks to depend on the National Bank for hard currency. The recently adopted banking legislation has strengthened the National Bank's central role by giving it the explicit responsibility of meeting the country's external obligations if enterprises, regional banks, and republics fail to cover debt service payments. [redacted]

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The IMF's upward revision of the current account deficit and the likely shortfall in credits result in a nearly $100 million decline in reserves compared with the original goal of a $600 million increase. Even if Belgrade can hold the current account deficit below the IMF forecast and obtain more credits than we assume, we would anticipate only a small increase in

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the National Bank's cash holdings at best. Since a significant portion of reserves are not liquid, cash available to meet current obligations probably will total no more than $400-500 million by yearend. The size of liquid reserves will also depend upon compliance by enterprises and regional banks with regulations requiring contributions to the National Bank's liquidity fund and upon the level of demands to meet overdue obligations of illiquid banks in the next few months. [redacted]

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First-Half 1984 Balance-of-Payments Outlook. Yugoslavia's position entering 1984 will be very similar to that at the beginning of this year—stocks of imported goods and reserves will be at minimal levels and few credits will be in the pipeline to bridge the seasonal financing gap in the first half of the year. Assuming Western bankers maintain their short-term exposure, we believe that Yugoslavia probably will have a financing requirement of $2-2.3 billion in January–June 1984. The IMF projects $1.2 billion in long- and medium-term capital repayments and the extension of $100 million in net long-term loans by Yugoslavia during this period. The IMF estimates the current account deficit to be $700 million, while we believe it could run as high as $1 billion. [redacted]

Even if the Yugoslav National Bank exhausts its holdings of liquid foreign exchange to meet the financing requirement during the first half of the year, external financing of some $1.5-1.9 billion would be required to prevent major arrearages. The Yugoslavs should be able to draw some commercial and government-backed trade credits—including some loans remaining from this year's package—as well as World Bank and possibly IMF credits. [redacted]

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[redacted] We expect bankers to remain cautious about new lending because of:

- Yugoslavia's possible failure to reduce its current account deficit as much as originally planned.
- Belgrade's inability to curb inflation and deal with other domestic economic problems.
- Uncertainties about a new IMF stabilization program and lending facilities.
- Widespread belief that the country needs more debt relief. [redacted]

We believe some Western creditors may be inclined to force Belgrade into a formal rescheduling in 1984. Because of the problems in this year's rescue effort, commercial bankers seem increasingly convinced that rescheduling is the only way to ensure equitable burdensharing among all creditors. [redacted] Western governments that reluctantly accepted the "Friends of Yugoslavia" package may insist that Yugoslavia's problems be addressed in the Paris Club. If this year's problems convince the Yugoslavs to swallow their objections to a debt rescheduling, creditors can probably arrange debt relief without extended delays. But rescheduling could prove difficult if the Yugoslavs do not show more maturity and cohesiveness in dealing with their creditors than they displayed this year. [redacted]

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Is Financial Recovery Possible for Yugoslavia? Unlike Poland, Yugoslavia has some chance at financial recovery provided it regains the confidence of Western bankers and continues to reduce its current account deficit. But the recovery process will almost certainly require more time than for Romania, since Yugoslavia's debt repayment schedule does not improve soon. IMF data show over $2.5 billion in maturing medium- and long-term loans in both 1984 and 1985, and the comparatively short maturity of the government-backed trade credits offered in the rescue package will add to the debt service burden over the next few years. Furthermore, the Western bank pledge to maintain short-term credit lines will expire in 1985, and the Yugoslavs need to rebuild their reserves. Acquiring some $5 billion in credits annually—whether part of a restructuring package or not—will be a formidable task in itself, leaving no room for financing current account deficits. [redacted]

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Yugoslavia cannot hope for financial recovery until the leadership attacks the economy's deeply entrenched inflationary bias. Demand restraint measures had little effect in reducing inflation, and most of the improvement in the balance of payments has resulted from a forced reduction in imports caused by the drying up of credits. Belgrade must work harder to restrain increases in wages, prices, and domestic

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credit and continue devaluing the dinar if it is to meet the IMF goals of an improving current account. But this will require gains in efficiency and competitiveness that can be achieved only through systemic reform. Yugoslavia must abandon policies that have given primacy to regional interests over integrative market forces. The country can no longer protect jobs by shoring up money-losing enterprises and must not subordinate efficiency to political objectives in allocating investment resources. An efficient national foreign exchange market is needed to ensure that all producers pay the true cost of foreign exchange and those best able to use foreign resources receive hard currency. 25X1

Despite professions of good intentions from some officials, Belgrade's capacity to overhaul its economy is suspect. Needed adjustment policies and structural reforms may impose a higher price than society is willing to pay. The population is already grumbling about falling living standards, and resistance could intensify as consumption levels decline further. Sacrifices are not distributed equally among regions and nationalities, making it difficult for the collective leadership to reach a consensus on policy. Moreover, greater reliance on market forces challenges official ideology and threatens the prerogatives of powerful vested interests in the republics. 25X1

Romania

The 1983 financial picture looks somewhat better than last year, although recent problems with the IMF and continuing difficulties in lining up credits could deal at best a temporary setback to Bucharest's progress. Based on incomplete and inconsistent data supplied to the IMF and Western banks, we estimate that Bucharest's sources of financing fall some $400 million short of its requirements. Failure to cover the gap would jeopardize Romania's prospects for avoiding rescheduling next year. The improvement stems this year mostly from Bucharest's crossing the hump in its debt maturity structure and would be greater were it not for the need to cover overdue obligations from 1982. Nearly two-thirds of the debt contracted through 1980 came due in 1981-82, but beginning this year the payments schedule stretches out considerably. The picture also looks brighter because debt relief negotiations were concluded by midyear, and Bucharest's credit needs are modest. The major uncertainties are whether Bucharest can meet its ambitious trade surplus target, satisfy demands made by the IMF, and roll over its short-term debt. If creditors are spooked by political problems in Romania or by developments elsewhere in Eastern Europe and choose to reduce further their short-term exposure, Bucharest will have difficulty in meeting its obligations.

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Romania
Hard Currency Financing Requirements and Sources

Million US $

	1981	1982	1983 (projected)
Financing requirement	**4,215**	**4,268**	**2,566**
Current account	−818	655	800
Debt repayments	3,231	3,153	2,663
Medium- and long-term debt	1,106	2,394	
Short-term debt	2,125	759	
Reserve buildup	−77	−125	−106
Credit extensions, net	−89	−502	−209
Arrears from previous year	0	1,143	−388
Sources	**3,072**	**3,596**	**2,158**
Credits, of which:	3,072	1,157	879
Commercial credits [a]	2,453	525	295
World Bank	297	331	250
IMF (net)	322	301	334
Rescheduling	0	2,439	963
Western banks		1,616	572
Western governments		400	136
CEMA banks		153	28
Arab banks		270	
Suppliers			227
Drawdown of BIS deposit			316
Financial gap/arrears	−1,143	−388	−408
Net errors and omissions		**−284**	

[a] Including rollover of short-term credits.

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Continued Trade Adjustment. Romania is holding to its strategy of painful adjustment by forcing a net flow of resources out of the economy. In a letter to the IMF accompanying the review of the standby arrangement in March, Finance Minister Gigea pledged to meet tough external account targets even at the expense of goals for growth. Bucharest projects a hard currency current account surplus of $800 million on the strength of another large trade surplus of $1.6 billion. Not only will these targets be difficult to achieve but they may be risky as well, given the impact on the economy of the adjustments already made. Imports are set to rise slightly to $5 billion—still far below the 1980 peak of $8.1 billion—with further reductions in imports of crude oil and grain and substantial increases in imports of machinery, equipment, and metals. Bucharest told the IMF that the 6-percent growth rate projected for exports will come largely from a 17-percent increase in sales of refined petroleum products, an overly optimistic target given the soft energy market and Romania's own energy problems.

Trade data through May show that exports were well below the target rate, and Bucharest had to reduce imports accordingly. The IMF in July reduced its projections of both imports and exports for the full year by $532 million while maintaining the projected surplus of $1.6 billion. 25X1

Status of Rescheduling. Bucharest's effort to reschedule its 1983 debt to the banks appears to be moving smoothly, especially compared with the 1982 negotiations. Creditors were uncertain about whether debt relief would be needed this year, but at the end of

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1982 Bucharest informed its creditors that payments due in 1983 would be suspended pending conclusion of a rescheduling agreement. In only their second negotiating session held in February, Romania and the nine major Western banks that led the 1982 rescheduling effort agreed on tougher terms than in 1982: only 70 percent of some $900 million in principal payments to banks is to be rescheduled instead of the 80 percent in 1982, and short-term debt is not covered. Moreover, all the unrescheduled principal is due in the second half of this year, and some of the rescheduled amount is due next year. The agreement was signed on 21 June. Several factors account for the rapid progress this year:

- Romanian officials have been more businesslike and cooperative, both in negotiating with the banks and in meeting commitments of the 1982 agreement.
- The amount to be rescheduled is less than half the amount of debt relief from private creditors in 1982.
- Treatment of short-term bank debt is not an issue because most of it was either paid or rescheduled last year.
- Some of the banks most opposed to the 1982 agreement have little or no debt due this year.

The Paris Club got off to a slower start because of Romania's continuing problems in wrapping up bilateral accords with Western governments to conclude the 1982 Paris Club agreement. On 18 May, the Paris Club met and quickly agreed to reschedule 60 percent of principal due this year on medium- and long-term guaranteed credits. Although Bucharest's original request last December called for debt relief to cover 75 percent of 1983 principal and interest, Romanian Finance Minister Gigea readily accepted the terms.

Credits. The IMF also reduced the amount of credits projected for the year as a result of a shortfall in supplier credits in the first five months of the year. More serious is the regime's current disagreement with the IMF. The IMF approved Romania's performance in the December 1982 and March 1983 reviews of the three-year standby arrangement, but Bucharest failed to agree to the timetables for raising domestic energy prices and interest rates required for the July review. As a result, the IMF has withheld further disbursements. A continuation of the stalemate could deny Romania $200 million in IMF

Romania Current Account *Million US $*

	1981	1982	1983 (projected)
Current account balance	**−818**	**655**	**800**
Trade balance	204	1,525	1,600
Exports	7,216	6,235	6,068
Imports	7,012	4,710	4,468
Services	−1,022	−870	−800
Tourism	190	116	155
Interest	−1,047	−917	−805
Transportation and communications	−346	−139	−220
Other	181	70	70

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credits, add substantially to the financing gap for this year, and complicate relations with creditors. At a minimum, Bucharest will not be able to meet its target of a $250 million increase in reserves. The problem with the IMF could deal a severe blow to Bucharest's fragile financial recovery. 25X1

Outlook for 1984 and Beyond. If Bucharest manages to cover most of its 1983 financing requirement, continued gradual improvement in the financial situation is possible. Although it is too early to make firm predictions, we judge that Romania's financing requirement next year is small enough—about $2.2 billion—that the goal of avoiding rescheduling can be achieved. According to IMF projections, more than $2 billion in principal payments is due next year. The remainder of the financing requirement is $200 million in credit extensions to support Romanian exports. 25X1

Bucharest plans to cover $850 million of the requirement by earning a current account surplus, largely on the strength of a $1.7 billion trade surplus. If drawings this year proceed on schedule, about $300 million will be available from the IMF under the third and final year of the standby arrangement. The Fund projects that another $400 million in loans will be provided by the IBRD and suppliers. This projection for loans seems realistic, and Bucharest should have little trouble borrowing this amount, especially if it demonstrates continued success in dealing with its financial problems. 25X1

The breathing space associated with the rescheduling ends in 1985 when Bucharest must begin to repay obligations rescheduled in 1981. The IMF standby arrangement will have expired by 1984. Both of these factors will put pressure on the regime to continue earning large trade surpluses in order to cover external obligations and to deal with underlying economic problems that hurt competitiveness and continue to prevent sustainable and balanced growth. If creditors take into account Bucharest's success in overcoming its debt woes, access to commercial credits should improve somewhat. 25X1

East Germany

Last year's current account surplus of over $1 billion, a healthy buildup of reserves late in 1982, and recent financial support from West Germany have diminished the likelihood of an East German rescheduling in 1983. According to press reports, East Germany planned to run another large trade surplus—perhaps as much as last year's $1.5 billion surplus—and continue paying off its debts. The East Germans must have solid gains in exports to achieve their goals because the economy almost certainly needs some increase in imports after the 30-percent nominal reduction over the past two years. If East Germany were to repeat last year's 7-percent growth of exports, it could increase imports by 9 percent and maintain a $1.5 billion trade surplus. This increase in imports would seem the minimum necessary to rebuild inventories, preclude serious declines in industrial production and living standards, and ensure export growth.

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OECD trade data for the first months of 1983 suggest that import growth may exceed 9 percent and that the trade surplus could be smaller than last year's. The balance with OECD countries slipped from a $175 million surplus in January–March 1982 to a $20 million deficit in the same period of this year due to a 21-percent increase in imports and 2-percent growth in exports. The surplus with countries other than West Germany actually increased by $50 million because of sizable gains in exports. The balance with West Germany, on the other hand, plummeted from a $130 million surplus in the first quarter of 1982 to a $126 million deficit this year. By midyear, East Germany's deficit with West Germany widened to $275 million—compared with a $106 million surplus at mid-1982—as a result of a 33-percent jump in imports and a 2-percent gain in exports. Because of easier access to trade credit in West Germany and the advantages of the intra-German payments mechanism, the East Germans are continuing the strategy of shifting Western imports into intra-German trade.

Even with healthy trade and current account surpluses, East Germany will still require over $3.5 billion in credits to cover its financing requirement without dipping into reserves. Raising this amount of funds will not be easy, but the East Germans have some financing sources. Entering 1983, East Berlin still had some undrawn Western government–backed commitments, and France, Canada, and Austria have extended new officially guaranteed trade loans. West German banks are continuing to finance intra-German trade deals, and the East Germans have access to the swing credit. East Germany's success in managing the credit squeeze has begun to encourage Western banks to offer more short-term trade credits. The main problem remains medium- and long-term financial loans needed to cover debt service payments and to refinance short-term debt on more favorable terms. East Germany has used many of its previously undisbursed commitments with Western banks, and bankers have remained cool toward a medium-term syndication. The late-June decision of the West German government to guarantee a $400 million five-year loan from West German commercial banks has provided needed funds to cover debt service obligations. It may also revive other untied lending to East Germany.

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East Germany
Financing Requirements, 1981-83

Million US $

	1981	1982	1983
Financing requirement	**5,250**	**4,254**	**3,575**
Current account balance	−500	1,246	1,075
Trade balance	60	1,509	1,175
Exports	6,714	7,172	7,675
Imports	6,654	5,663	6,500
Net invisibles excluding interest	985	950	850
Net interest	−1,545	−1,213	−950
Repayments of short-term debt	−2,500	−2,350	−1,475
Repayments of medium- and long-term debt	−2,250	−3,150	−3,200
Borrowing sources	**5,550**	**4,000**	NA
Medium- and long-term credits	3,200	2,525	NA
Short-term credits	2,350	1,475	NA
Net errors and omissions	**−265**	**33**	NA
Change in reserves	**35**	**−21**	NA

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Nonetheless, East Berlin probably cannot return to the general syndicated market before next year.

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Even though an East German rescheduling seems less likely than a year ago, the country still faces a tight financial squeeze through at least the first six to nine months of this year because of a continuing high level of debt service payments. By the end of this year, East Germany will probably have surmounted the worst of its financing problem. Repayments of medium- and long-term debt will decline in 1984-85 mainly because East Berlin will have paid down a major portion of these obligations. East Germany will face the problem of rolling over a large short-term debt because lenders will remain cautious about extending new medium-term credits. Difficulties in raising loans could still force East Berlin into a debt rescheduling or default; however, solid evidence of further improvement in East Germany's balance-of-payments position would strengthen lender confidence and ease the task of refinancing maturing loans.

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The trade adjustment measures imposed over the past two years have addressed East Germany's immediate credit crisis, but they do not lay the basis for economic growth and balance-of-payments equilibrium. The regime may be able to ease some import restraints as economic recovery in the West leads to modest growth in exports and Western lenders become less concerned about the country's creditworthiness. A sizable portion of new loans, however, will have to go to covering debt service rather than to acquiring more imports, and the regime may opt to continue reducing its debt rather than to expand imports significantly. Moreover, Western bankers are likely to press East Berlin much harder for basic economic and balance-of-payments data before increasing their exposure.

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Although we see no evidence that East Berlin is rethinking its economic policy, the regime can no longer rely on a strategy that attained rapid economic growth and improvements in living standards in the 1970s through large resource transfers from the West. The regime presumably is satisfied that its restructuring of economic management that began in the late 1970s has enabled the economy to cope with the credit crisis. The question remains, however, whether East Germany's strongly centralized structure is flexible enough and oriented sufficiently to efficiency to perform well in an environment of reduced resources. Continuing financial pressures may yet force East Berlin to address the taboo question of introducing more market forces into the economy.

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Hungary

The IMF stabilization program for 1983 originally projected that Hungary would cover its $2.6 billion in debt repayments and increase its reserves by $500 million with the help of a $600 million current account surplus, $250-300 million in trade credits (primarily government-backed), $60-70 million in drawings on World Bank loans, $200-260 million in untied bank loans, $366 million in IMF credits and $1.6 billion in short-term borrowings. The Hungarians hoped to increase their trade surplus from nearly $770 million to over $1.1 billion by raising exports nearly 8 percent while holding imports at last year's level. The program also projected a $400 million decline in net interest costs. [redacted] 25X1

Hungary
Financing Requirements, 1981-83

Million US $

	1981	1982	Original IMF Projection 1983	Revised IMF Projection 1983
Financing requirement	**4,918**	**4,294**	**2,071**	**2,378**
Current account balance	−727	−149	600	500
Trade balance	445	766	1,142	1,062
Exports	4,877	4,876	5,252	4,920
Imports	4,432	4,110	4,110	3,858
Net interest	−1,100	−976	−669	−669
Other	−72	61	38	107
Repayments of medium- and long-term debt	−826	−894	−936	−1,005
Repayments of short-term debt	−3,261	−2,849	−1,371	−1,476
Repayments of BIS credits		−210	−300	−300
Export credits, net	−104	−192	−64	−97
Borrowing sources	**4,292**	**3,375**	**2,571**	**2,223**
Medium- and long-term credits	1,443	1,154	579	613
Short-term credits [a]	2,849	1,476	1,626	1,244
IMF credits		235	366	366
BIS credits		510		
Change in reserves	**−626**	**−919**	**500**	**−155**

[a] Includes net errors and omissions and change in net short-term trade credits.

[redacted] 25X1

Adjustment Policies. The need to produce a current account surplus forced Budapest to tighten its adjustment policies. Beginning in 1979, Budapest shifted economic priorities from promotion of growth to gradual reduction in the country's current account deficit. The growth of demand was dampened mainly by sharp reductions in investment. Although increases in consumption slowed, the regime tried to maintain living standards. IMF statistics show that between 1979 and 1982 investment fell by more than 3 percent annually while consumption rose by 1.6 percent annually. [redacted] 25X1

The need to accelerate adjustment in 1983 compelled Budapest to place a greater burden on the consumer. Hungary's targets envision a 3- to 4-percent decline in real domestic demand to be accomplished by a 1.5- to 2.0-percent reduction in consumption, a 6.5- to 7.5-percent fall in investment, and a 3.5- to 5.5-percent reduction in government outlays. The Hungarians hope to hold real GDP at the 1982 level by growth in net exports. [redacted]

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Performance. The IMF's midterm assessment has found that Hungary is falling short of the IMF goals. Domestic demand has not been dampened to the degree anticipated due to faster-than-planned increases in incomes and excess enterprise liquidity. The Fund now estimates that exports will grow less than 1 percent largely because of price cutting on agricultural exports to meet international competition, and a mediocre grain harvest will probably depress export earnings even more. The IMF has lowered Hungary's projected current account surplus from $600 million to $500 million, but meeting this goal depends on new measures to reduce consumption and investment and to encourage savings and exports. [redacted] 25X1 [redacted] the regime has approved, but not announced, new restraints on domestic demand designed to cut imports 6 percent below last year's level and that import restrictions will be maintained into at least 1984. [redacted] 25X1 [redacted] however, that Hungary cannot afford more

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import reductions and needs to run a smaller trade surplus next year. Because of the worsening outlook for exports and possible resistance to more import cuts, the trade and current account surpluses may fall $100-200 million below the revised IMF projections. [redacted]

Borrowing. Hungary succeeded in raising credits in the first half of 1983, but Budapest probably will fall short of covering its $2.5 billion borrowing goal.

- Hungary obtained a $200 million three-year loan from a group of Western banks, including two Soviet-owned banks in the West.
- A group of Arab banks also arranged a $100 million credit early this year.
- Despite some slippage in the program targets, the Hungarians are continuing to draw on IMF standby credits.
- [redacted] Budapest has stepped up use of guaranteed trade credits, particularly from West Germany, France, and Japan, and it has a reserve of undrawn commitments.
- The World Bank has approved $239 million in project credits.
- [redacted] the Hungarians have also been lining up short- to medium-term trade financing from commercial banks, particularly in the form of bankers' acceptances. [redacted]

Despite these loans, the IMF estimates that Hungary will suffer a $650 million outflow on the capital account. This reflects larger outflows on export credits to meet competition and cover delayed payments, continuing withdrawals of short-term credits, and larger repayments on medium-term loans. Hungary lost $500 million in short-term credits during the period January to April. Some of this represented repayments to the BIS, but withdrawals of commercial bank lines probably totaled $200-300 million. More recent information, however, suggests that the outflow of short-term credits has stopped. [redacted]

Reserves. The projected shortfall in Hungary's current account surplus and financing sources will preclude a $500 million buildup of reserves. Depressed exports, delayed payments from some cash-short developing countries, and withdrawal of short-term credits reduced reserves of gold and foreign exchange by nearly $350 million in early 1983. According to press reports, Hungary's low level of reserves induced Western central bankers to grant a two-month extension on repaying $100 million of the $300 million BIS credit due in April. The IMF anticipates little rebuilding of reserves in the last half of 1983 and estimates that reserves will be down $155 million for the year. The decline could run even higher if Hungary's trade and current account performance falls below the Fund's midyear projections. [redacted]

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New IMF Program. The gloomier outlook for Hungary's financial position has prompted the IMF and Budapest to begin discussions on another standby program for 1984. Hungarian economists have told the US Embassy in Budapest they expect the IMF to press harder for more structural reforms in a second program. Indeed, the Fund commented in its midterm review of the 1983 program that Budapest's short-term adjustment measures need to be followed up by structural changes and eventual relaxation of emergency import restraints to ensure sustained growth. The regime has already pushed ahead this year with additional reforms which link wage incentives more closely with enterprise profitability, encourage elimination of excess labor, and reduce subsidies to inefficient producers. Hungarian bankers claim the leadership will consider additional reforms later this year. Disputes among affected interest groups, however, may well slow Budapest's actions. [redacted]

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Outlook Through 1985. Hungary must address its fundamental balance-of-payments problems more effectively because the country needs a growing hard currency trade surplus to cover rising debt service payments. According to IMF estimates, repayments on medium- and long-term debt and gross interest payments will rise to $2.3 billion in both 1984 and 1985, compared with $1.8 billion this year (see debt service payments table). Hungary will also have to roll over more than $1 billion in short-term credits each year. Because banks will probably remain reluctant to extend new medium-term credits, the Hungarians will continue to face the problem of bunched up maturities for several years. [redacted]

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Hungary
Debt Service Payments, 1981-85 [a]

Million US $

	1981	1982	1983	1984	1985
Total	**1,840**	**1,898**	**1,770**	**2,360**	**2,297**
Amortization of medium- and long-term debt	826	894	1,005	1,610	1,606
Interest payments on gross debt	1,014	1,004	765	750	691

[a] Source: IMF and National Bank of Hungary.

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Structural reforms, while necessary, will not be sufficient to ensure improved balance-of-payments performance. Hungary also needs a continued fall in international interest rates and sustained growth in its major Western markets. But even projected current account surpluses wil leave Hungary far short of covering its financing requirements over the next several years. Thus the Hungarians will have to seek large borrowings from Western banks and the IMF to meet their obligations or face the unpleasant option of rescheduling. 25X1

Czechoslovakia

Czechoslovakia plans to continue running current account surpluses and paying down its debt through 1985. The 1983 foreign trade plan called for some reduction in the trade surplus by raising imports from the West more rapidly than projected increases in exports, but poor export performance apparently has led Prague to continue reducing imports. During the first half of 1983, exports to the West rose only 1.3 percent and imports were down 8.9 percent over the same period a year ago. We estimate exports and imports will rise by about 2 percent for the year. The current account surplus will rise to $300 million this year and be on the order of $350 million in 1984 and 1985 as reduced interest costs and small growth in service earnings raise net invisible receipts. This presumes Prague keeps the growth of imports in 1984-85 in line with the growth of exports.

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Czechoslovakia faces few borrowing problems, but it will have scarce hard currency resources as long as the leadership maintains its conservative posture vis-a-vis Western banks. The Czechoslovaks should have little problem finding adequate short-term trade credits to finance their restrained level of imports. The country's major financial need is medium-term financial credits to build up reserves and stretch out the compressed maturity structure of debt. In mid-July, Prague obtained a $50 million loan with a maturity of four years from a small group of Western banks.

Czechoslovakia
Financing Requirements, 1981-83

Million US $

	1981	1982	1983
Financing requirement	**2,009**	**1,355**	**1,090**
Current account balance	−79	210	300
Trade balance	330	492	500
Exports	4,691	4,029	4,100
Imports	4,361	3,537	3,600
Net invisibles excluding interest	50	60	70
Net interest	−459	−342	−310
Repayments of short-term debt	−1,530	−1,140	−930
Repayments of medium- and long-term debt	−400	−425	−460
Borrowing sources	**1,570**	**1,120**	NA
Medium- and long-term credits	430	190	NA
Short-term credits	1,140	930	NA
Net errors and omissions	**57**	**122**	NA
Change in reserves	**−382**	**−113**	NA

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The key question in Czechoslovakia's hard currency trade and payments outlook is whether the economy can afford a strategy that links hard currency imports to the growth of exports and will not modernize industry through hard currency borrowings. Prague's long-held financial conservatism has contributed to the technological decline of Czechoslovakia's industry and the stagnation of the overall economy. This trend can only worsen under the current policy of relying almost totally on domestic and CEMA technology in lieu of acquiring Western materials and equipment.

Even with economic recovery in the West, inherent weaknesses will undermine export performance, permitting little if any growth in real imports. Prague continues to focus its export strategy on heavy industrial goods, which are falling ever further behind world standards, while neglecting light industry where it could be more competitive. Czechoslovakia's trade bureaucracy is probably the most inflexible in Eastern Europe, and recent tinkerings with foreign trade organizations appear unlikely to make them more responsive to market opportunities. According to Embassy reporting, some Czechoslovak planners have been pressing for more borrowings to acquire Western goods needed to upgrade key sectors (such as electrical machinery, ferrous metallurgy, and coal mining). The planners argue that a judiciously planned pickup in investment—using Western resources—is needed to jolt the economy out of its doldrums. However, fear of the political consequences of reliance on Western credits and general satisfaction with its financial conservatism will most likely continue to dissuade the Husak regime from adopting a more aggressive import strategy.

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Bulgaria

Bulgaria entered 1983 in the strongest financial position of any East European country. Several consecutive years of current account surpluses enabled Sofia to reduce its gross debt to less than $3 billion at the end of 1982 and to build up reserves of $1 billion, enough to cover four months' worth of imports. Creditors continued to give high marks for Sofia's financial conservatism. [redacted]

Bulgaria owes roughly $1.0 billion in principal on medium- and long-term debt and net interest in 1983, about the same amount of debt service due last year. Because Sofia had little problem covering its obligations during the more difficult year of 1982, we expect that rolling over of maturities will be accomplished easily this year. [redacted]

Sofia's financial strength allows it a range of options in managing its hard currency accounts this year. It could maintain its policy of holding down imports and reducing its debt even further. Or Sofia could use the cushion provided by the conservatism of recent years to pursue an expansion of hard currency imports. We estimate, for example, that Bulgaria could boost imports by $1 billion this year—a 40-percent gain—without incurring a rise in debt. This assumes a small (6 percent) increase in exports which is probably the best Sofia could hope for, given weak Western markets for its oil products. If Sofia chooses to increase its debt or if exports rise faster, even higher imports would be feasible [redacted]

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Political rather than economic factors are more apt to hinder access to credits. [redacted] Early this year Italy froze guaranteed export credit lines in connection with its investigation of Bulgaria's alleged role in the attempted assassination of the Pope. While the spotlight has been less intense recently, Bulgaria's international image has been tarnished and Sofia will be vulnerable to any further allegations. While banks may not choose to reduce their exposure, they may be wary about undertaking a highly visible syndication effort on Sofia's behalf. [redacted]

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Bulgaria
Financing Requirements, 1981-83

Million US $

	1981	1982	1983
Financing requirement	**851**	**988**	**1,036**
Current account balance	608	537	439
Trade balance	652	500	300
Exports	3,198	3,200	3,300
Imports	2,546	2,700	3,000
Net invisibles excluding interest	285	270	295
Net interest	−329	−233	−156
Repayments of short-term debt	−684	−750	−725
Repayments of medium- and long-term debt	−775	−775	−750
Borrowing sources	**960**	**1,290**	NA
Medium- and long-term credits	210	565	NA
Short-term credits	750	725	NA
Net errors and omissions	**−48**	**−141**	NA
Change in reserves	**61**	**161**	NA

[redacted]

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According to preliminary indications, the Bulgarians may be easing away somewhat from their strict conservatism. In recent months Sofia has obtained guaranteed credit lines from several Western countries:

- In bilateral economic talks in Paris, France agreed to provide an unspecified amount of credit. 25X1
- Japanese Embassy officials in Sofia told US counterparts that they believed that a $200 million credit line for Bulgaria would replace a line that expired unused at the end of March. [redacted] 25X1

Several reports show that Bulgaria is actively negotiating for Western equipment and technology—apparently the only East European country currently showing any interest. [redacted] after a year of reviewing 25X1

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investment plans, Bulgaria has decided to move ahead on several projects requiring Western equipment and technology, including:

- A high-technology steel mill for the Burgas metallurgical complex.
- A new telephone exchange system.
- Renovation of the food-processing industry to improve the marketability of food products in the West.
- Development of auto production, including purchase of a machine tool plant and possibly an assembly plant. [redacted] 25X1

The Japanese, however, recently have been skeptical of Sofia's intentions and doubt that these projects will reach fruition.

We estimate that Sofia will run a hard currency trade surplus this year of $300 million, down from the $500-600 million of recent years. Lower interest payments should help raise the current account surplus somewhat to $440 million. [redacted] 25X1