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MEMORANDUM FOR:

Here are copies of the material we sent to Commerce for Secretary Baldridge in preparation for the Friday NSC Meeting on the Garn Amendment.

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(This NSC was post-poned. Finally took place on 3 Dec.)

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Date 10/31/85

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Eastern Europe: Boom Market for Syndicated Lending

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East European borrowing from Western banks has rebounded sharply this year. The region raised $2.8 billion in syndicated loans on increasingly favorable terms in the first 10 months of 1985—a sharp turnaround from the early 1980s when bankers slashed lending to the East. Japanese and Arab banks have played a leading role in new lending, while the importance of US and West European banks has fallen. Lenders have become more inclined toward Eastern Europe because of improved hard currency trade performance in the region over the past two years and a lack of comparably attractive investments elsewhere. Borrowers have taken advantage of favorable loan terms to restructure debt, build reserves, and cover shortfalls in hard currency earnings this year.

Widening Circle of Borrowers

The number of East European countries returning to the syndicated market has grown quickly this year, and many of the loans have been oversubscribed.[1]

- East Germany secured a $500 million loan in March; in June it obtained a consortium loan for $600 million.
- Hungary in June tapped Western banks for the bulk of an $800 million World Bank cofinanced loan and Japanese banks for an additional $400 million since January.
- Bulgaria borrowed $200 million in July and $120 million in October.
- Czechoslovakia borrowed $100 million from a Western bank consortium in July.
- Four commercial banks extended an $80 million bridge loan to Romania in May, and, most recently, a group of Romania's leading creditor banks agreed to try to syndicate a $167 million loan.

Only Yugoslavia and Poland, which still require debt reschedulings, remain shut out of the syndicated loan market.

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Japanese and, to a lesser extent, Arab banks have played a prominent role in the upswing in new lending. Japanese banks, looking to diversify their loan portfolios, have taken the lead or jointly managed 41 percent of the loans to Eastern Europe this year, as compared with 18 percent in 1979. According to West European bankers, increased competition from Japanese banks in the lending market has pushed down interest rates on loans to Eastern Europe. In contrast, US banks have managed 15 percent of this year's loans to the East, down from 20 percent in 1979. This parallels the decline in overall US exposure to Eastern Europe. Many US banks that have managed recent loans to the region have been mainly interested in earning the management fees and have tried to sell off their portions of the loans quickly to limit exposure.

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Western Bank Motives

The lack of comparably attractive lending opportunities elsewhere largely explains the willingness, and, in some cases, even eagerness of Western banks to resume lending to Eastern Europe. The financial positions of East Germany, Hungary,

[1] Oversubscription occurs when participating banks offer funds in excess of the original loan amount.

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Eastern Europe: Selected Major Loans in 1985

	Date	Million US $	Terms	Comment
East Germany	March 1985	500	7 years at LIBOR plus 0.875 point	Oversubscribed from $150 million.
	June 1985	600	8 years at LIBOR plus 0.75 on $520 million, US Prime plus 3/8 on $80 million	Oversubscribed from $20 million.
	NA	200	NA	Under discussion with European banks.
Hungary	January 1985	250	12 years at 11.2 percent fixed	From Japanese banks, which have extended an additional $150 million in smaller loans.
	June 1985	800	8 to 12 years at LIBOR plus 0.75	World Bank cofinanced loan.
	NA	420	NA	Under discussion with First Chicago, Bankers Trust, Dai-Ichi Kangyo.
Bulgaria	July 1985	200	4 years at LIBOR plus 0.375, 3 years at LIBOR plus 0.5	Oversubscribed from $100 million.
	October 1985	120	5 years at LIBOR plus 0.375	
	NA	125	4 years at LIBOR plus 0.25, 4 years at LIBOR plus 0.375	Under discussion with Deutsche Bank.
Czechoslovakia	July 1985	100	2 years at LIBOR plus 0.25, 6 years at LIBOR plus 0.375	
Romania	May 1985	80	5 months	To cover payments on rescheduled debt.
	NA	167	2 years at LIBOR plus 1.25, 3 years at LIBOR plus 1.375 with US Prime option.	Currently being subscribed; to cover payments on rescheduled debt.

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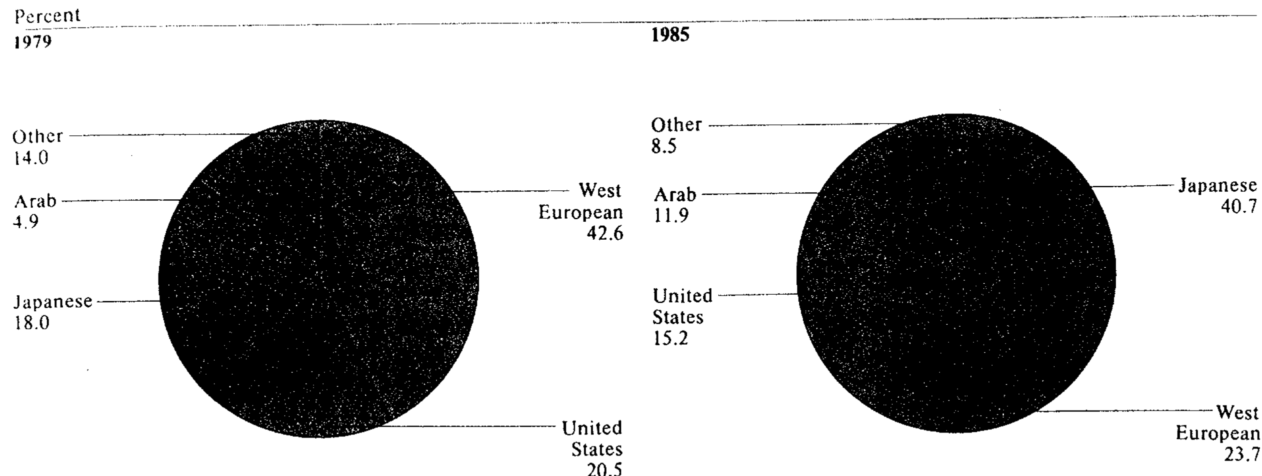
Management of Syndicated Loans to Eastern Europe, 1979 and 1985



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Bulgaria, and Czechoslovakia seem relatively more secure than those of many LDCs, especially in Latin America, where bankers feel overexposed. As a result, not only has the absolute amount of Eastern Europe's borrowing increased, but also its share of bank lending to countries outside the OECD—13 percent so far this year, as compared with 6 percent in 1976 and 10.5 percent in 1979.

Eastern Europe's hard currency trade surpluses in 1983-84 and some easing of East-West tensions have been the major factors encouraging bankers to look more favorably on the region. The East European borrowers have also substantially cut their debt since 1980, and, except for Romania, they have avoided rescheduling. Having made deep cuts in their East European exposure in 1981-83, banks now feel they have elbowroom to respond to loan requests from the more creditworthy countries. Some bankers—particularly in Western Europe and Japan—believe East European imports from the West will rise with the launching of new five-year economic plans for 1986-90, and they want to reestablish ties to the better credit risks

Western banks have been particularly receptive to loan requests from East Germany and Hungary for additional reasons. East Germany, besides running sizable trade surpluses, boasts the strongest record of economic growth in Eastern Europe since 1982. Banks also value the West German umbrella for East Berlin, which Bonn demonstrated by guaranteeing two large West German bank loans during East Germany's liquidity squeeze. Finally, banks have found East Berlin a lucrative loan market because of the regime's acceptance of relatively high interest rates—recent loans have carried higher spreads over LIBOR than those for most other Bloc countries. The East Germans apparently prefer to have their loans oversubscribed at higher interest rates than to obtain the most favorable terms

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In Hungary's case, bankers are counting strongly on Budapest's reform program to improve the efficiency and competitiveness of the economy. Hungary's good relationship with the IMF—which lent it nearly $1 billion in 1982-84—has added to

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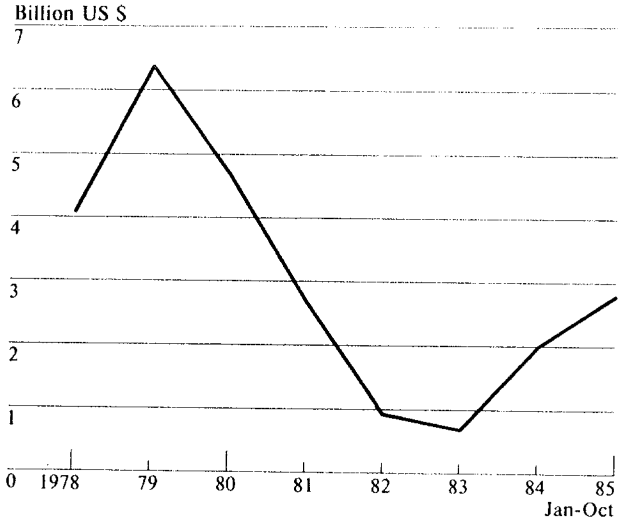
Syndicated Loans to Eastern Europe, 1978-85



banker confidence. Moreover, banks have been eager to participate in World Bank cofinancing loans because they believe that Bank involvement guarantees that the loans are exempt from rescheduling should Budapest run into repayment problems. Japanese banks have been particularly attracted by the apparent security of these deals.

In Romania's case, however, new lending has been less than voluntary. Recent loans have stemmed largely from the bankers' desire to avoid another round of reschedulings. Disappointing export performance earlier this year seriously reduced Romania's foreign exchange reserves. Leading creditor banks concluded that Bucharest needed a major loan to cover large payments due in October under its rescheduling agreements.

Reasons for Borrowings

The East Europeans initially used the borrowings to repair some of the damage to their financial positions caused by the credit crunch. They took advantage of the longer maturities and lower interest rates to replace more expensive short-term debt accumulated in 1982-83. Borrowers also used the funds to boost reserves and build financial cushions against another cutback in lending to the region. East Germany and Czechoslovakia returned to the loan market to reestablish their credit ratings. For example, East Germany continued to raise new credits even though it had not drawn down all its previous borrowings and sought oversubscribed loans as proof of its financial strength. In contrast, the more recent borrowing initiatives by Hungary, Bulgaria, and Romania have resulted from shortfalls in hard currency earnings caused by poor trade performance this year.

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Outlook

The borrowing trend is likely to continue, at least in the short run. Even countries with no immediate plans to draw down the funds will probably continue to exploit the continued shortage of lower risk LDC borrowers. In addition, some East European countries may plan more borrowings to finance an increase in Western imports as they enter the new cycle of five-year plans. Some countries may see the need to import more capital goods to redress import cutbacks in the early 1980s and meet modernization requirements resulting from Soviet pressure to improve the quality of exports to the USSR.

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Still, an extended downturn in the region's economic health or deterioration in East-West relations could reverse the trend. While this year's slump apparently has not alarmed banks, lenders—and even borrowers—may become reluctant if trade performance continues to slide. The current enthusiasm among bankers for Eastern Europe may cool when it becomes apparent that these countries have done little to produce the sustained growth in exports needed to pay for more imports. Failures by Poland, Romania, and Yugoslavia to meet obligations under rescheduling agreements might sour

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some bankers on the entire region, but such a spillover seems much less likely than in 1981. A more serious threat to Eastern Europe's ability to obtain new loans might result from a reemergence of severe payments problems in the LDCs.

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The attached financial information was requested by David Wigg at NSC. It was prepared for his consideration in light of proposed legislation on financial controls for U.S. banks.

The information was prepared by [redacted] [redacted] with a contribution from [redacted] [redacted] both of the Regional East-West Branch, East European Division.

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Comments and questions are welcome and should be addressed to Chief, Regional East-West Branch [redacted]

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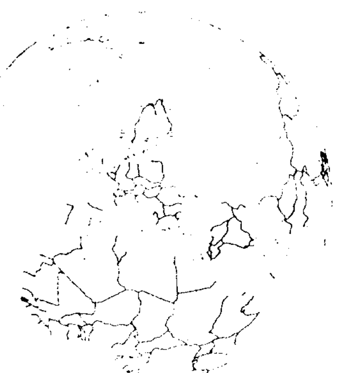

30 August 1985

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Office of European Analysis

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Syndicated Lending to Eastern Europe in 1985

Eastern Europe has undertaken in recent months a resurgence in borrowing from Western commercial banks. Syndicated credits to Bulgaria, Czechoslovakia, East Germany, and Hungary have totaled $2.6 billion so far in 1985--compared with just $3.2 billion in 1982-84--and have carried favorable terms. The principal borrowers have been East Germany, Hungary, Bulgaria, and Czechoslovakia, which have used the credits to improve debt maturity schedules and to rebuild hard currency reserves rather than to finance imports. The principal lenders have been Japanese and Arab banks, although West European and US banks have also participated. The surge in lending by bankers seems to be the result of high bank liquidity and a lack of better lending opportunities elsewhere instead of enthusiasm over East European economic performance and prospects.

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East Germany has borrowed $1.2 billion this year through two loans which were heavily oversubscribed at $600 million each. In March, three US banks and the Bank of Tokyo underwrote a loan for 7 years with 3 1/2 years grace, at 0.875 percent over LIBOR or 0.5 percent over US Prime. A second $600 million loan in June was led by the Arab Banking Corporation of Bahrain, the International Bank of Japan, and First Chicago. The loan was for 8 years, with rates of 0.75 percent over LIBOR on a $520 million tranche and 0.375 percent over US prime on an $80 million tranche. US bank participation was $50-60 million

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and included First Chicago, Bankers Trust, Security Pacific, and the American Security Bank.

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Hungary also has received over $1 billion in new loans this year. Japanese banks have been particularly active in lending to Hungary. In June, Budapest concluded an $800 million loan package from the World Bank and commercial banks. The commercial half was managed by National Westminster, Arab Banking Corporation, the Bank of Tokyo, and a US bank. The credit is a multicurrency facility including an ECU tranche, and was underwritten at favorable rates.

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Bulgaria borrowed $200 million in the form of an oversubscribed club loan signed in July. The loan is being led by the UK's National Westminister Bank and the Moscow Narodny Bank. It is for seven years with four years grace at interest rates of 0.375 percent over LIBOR for the first four years and 0.5 percent over LIBOR for the remaining three years of the loan.

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Czechoslovakia has also received Western credits. In July Prague borrowed $100 million from a bank consortium led by Credit Commerciale de France. The loan was placed at 0.25 percent over LIBOR for the first two years and 0.375 percent over LIBOR for the following six years. Banks from West Germany, Austria, Japan, the US, and Finland are participating. Only Bankers Trust participated from the US.

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Romania received an $80 million club loan in May to help it meet a

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repayment on previously rescheduled debt. The loan, which comes due in October, was arranged by Barclays Bank, Deutsche Bank, Union Bank of Switzerland, and a US bank. Bucharest hopes to raise a further $150 million this year in syndicated credits. 25X1

Yugoslavia received $25 million in credits since January as part of a World Bank co-financed loan. 25X1

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Share of U.S. Commercial Banks in Total
BIS-Area Lending to Eastern Europe
(millions of US $)

	BIS-Area Total[a]	U.S.[b]	U.S. Share in Percent[c]
Total Eastern Europe			
1982	48,505	6,048	12.5
1983	44,835	5,384	12.0
1984	41,491	4,668	11.3
1985[c]	40,602	4,418	10.9
Bulgaria			
1982	2,067	192	9.3
1983	1,757	128	7.3
1984	1,568	100	6.4
1985[c]	1,673	10.6	6.3
Czechoslovakia			
1982	2,848	171	6.0
1983	2,733	157	5.7
1984	2,410	157	6.5
1985[c]	2,393	107	4.5
East Germany			
1982	8,859	633	7.1
1983	8,373	485	5.8
1984	8,262	372	4.5
1985[c]	8,201	308	3.8
Hungary			
1982	6,757	937	13.9
1983	7,026	904	12.9
1984	6,765	765	11.3
1985[c]	6,900	663	9.6
Poland			
1982	13,910	1,513	10.9
1983	11,236	1,067	9.5
1984	9,003	693	7.7
1985[c]	8,826	687	7.8
Romania			
1982	4,243	282	6.6
1983	3,888	211	5.4
1984	3,836	202	5.3
1985[c]	3,099	190	6.1

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Yugoslavia			
1982	9,821	2,320	23.6
1983	9,822	2,432	24.8
1984	9,647	2,379	24.7
1985[c]	9,510	2,357	24.8

[a] Assets of reporting BIS-area banks vis-a-vis Eastern Europe based on semiannual statistics of the Bank for International Settlements (BIS).

[b] Assets of U.S. banks vis-a-vis Eastern Europe based on statistical releases of the Federal Financial Institutions Examination Council.

[c] March 1985.

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SUBJECT: Syndicated Lending to Eastern Europe in 1985

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Eastern Europe: Financial Situation and Outlook in 1983-84

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Key Judgments

Information available as of 16 July 1984 was used in this report.

Eastern Europe is recovering from its severe financial crisis. Last year the region posted its second consecutive hard currency trade surplus and its first current account surplus in more than a decade. Bulgaria, Czechoslovakia, East Germany, and Romania cut their net hard currency debt by an average of 13 percent, and the region as a whole built up foreign exchange reserves by 22 percent.

Much of the improvement stemmed from continued belt tightening. Imports declined for the third consecutive year, albeit not as dramatically as during the previous two years. Eastern Europe's financial position also was helped by loans from the IMF and the World Bank, rescheduling agreements with private and official creditors, and some revival of commercial lending for the more creditworthy countries.

The pace of improvement seems to be quickening in 1984. Excluding Poland, Eastern Europe's financing requirements will decline by about 15 percent this year. Prospects for new credits seem better than at any time in the last four years. While most of the upswing in lending consists of short-term, trade-related credits, Hungary and East Germany have already raised medium-term syndications. East Germany also has received a large government-backed loan from West Germany for the second consecutive year. Yugoslavia has arranged refinancing with private and official creditors, and Romania probably will avoid a rescheduling for the first time in three years.

Despite its recovery from the 1981-82 crisis, most of Eastern Europe still faces long-term trade and financial problems:
- Even with additional reschedulings, Poland almost certainly will be unable to close its financial gap, and the regime seems unwilling to impose the tough adjustment measures needed to restore creditworthiness.
- Yugoslavia's financing requirements are declining, but it will still need more debt relief in the next few years.
- The drastic import cuts imposed by Romania have drained the economy, and the possibility of a Romanian rescheduling in 1985 cannot be excluded.
- The financial recoveries of East Germany and Hungary seem more solid, but both countries must continue to cover large financing requirements.
- All of the countries of Eastern Europe will be additionally burdened by growing pressures from the Soviet Union to balance bilateral trade and provide Moscow with better quality goods.

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A number of economic and political factors still weigh against Eastern Europe in the risk assessments of Western lenders. To resume economic growth and maintain external balance, Eastern Europe must do more to improve its export performance. Many creditors regard the sharp import reductions of the past few years as a short-run expedient with little impact on long-term creditworthiness. Many bankers, still skeptical that the East Europeans will do much to correct fundamental problems, will be examining more closely than in the past the economic policy and performance of individual countries. Creditor confidence also could be undermined by further cooling in the East-West political climate or outbreaks of unrest.

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Eastern Europe: Financial Situation and Outlook in 1983-84

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Regional Overview

Performance in 1983

Eastern Europe's financial position began to improve in 1983 following the severe difficulties of the previous two years. The region posted a hard currency trade surplus of $4.4 billion, more than double the surplus of 1982 and a sharp reversal of the $3.7 billion deficit recorded in 1981 (see table 1). The region pared hard currency imports by about 4.7 percent last year, a much less severe cutback than the 15-percent reductions in both 1981 and 1982. The first increase in exports since 1980—due largely to resales of Middle Eastern oil—helped limit import reductions. The trade surplus, along with lower interest payments, helped produce a $2.2 billion current account surplus for the region, compared with the $1.9 billion deficit of a year earlier.

Current account surpluses helped most countries reduce their net hard currency debt for the second consecutive year (see table 2).[1] Foreign exchange reserves grew by 22 percent regionwide, offsetting the precipitous drop that occurred in 1982 at the height of the credit crunch. Thus, Bulgaria, Czechoslovakia, East Germany, and Romania cut their net debt by an average of 13 percent. Net debt increased for the other three countries because of Poland's climbing interest arrearages to Western official creditors and some new credits received by Hungary and Yugoslavia.

Eastern Europe's financial position was helped by support from international institutions and by generally improved relations with Western creditors. Loans from the IMF and the World Bank encouraged Western bankers to provide nearly $500 million in syndicated loans to Hungary. A $400 million government-guaranteed bank loan from West Germany helped revive lending to East Germany. East Germany and Hungary, which together had suffered a nearly $4 billion loss in bank credit lines between December 1981 and June 1983, according to BIS statistics, increased total borrowings by $500 million during the last half of 1983. In contrast with 1982, Romania quickly negotiated rescheduling agreements with Western banks and governments. Negotiations proved difficult for Poland and Yugoslavia, but both countries eventually obtained favorable rescheduling terms from Western banks. Yugoslavia also secured a package of new credits from the banks, Western governments, the IMF, and the World Bank.

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Improvements in Eastern Europe's hard currency balances were even more impressive given the economic pressures applied by the Soviet Union. The terms of trade continued to move in Moscow's favor last year, forcing the East Europeans to export a greater volume of goods to the Soviet Union just to maintain existing import volumes. In addition, Moscow apparently stepped up its pressure on some of its Warsaw Pact allies to improve their bilateral trade balances after a decade of allowing them to run large deficits. Last year Eastern Europe's trade deficit with Moscow declined by $500 million, with the largest cuts made by East Germany, Poland, and Bulgaria.

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Improvement Continues in 1984

The momentum generated by Eastern Europe in 1983 appears to be carrying over to 1984. Excluding Poland, Eastern Europe's financing requirements will drop an estimated 15 percent this year. The increase in reserves and the reduction in short-term debt have improved the liquidity position of most countries. Debt service ratios have improved for all countries except Poland and Yugoslavia due to a decline in scheduled debt repayments (see table 3).

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Prospects for new borrowing seem better than at any time in the last four years. Eastern Europe's standing with bankers appears to be rising because of trade and current account surpluses. Hungary and East Germany raised medium-term syndications in the first half of 1984 and may return to the market later this year.

[1] Some of the debt reduction was only nominal, reflecting the depreciation of the nondollar component of the debt against the dollar, and did not represent an acutal liquidation of obligations

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Table 1
Eastern Europe: Hard Currency Trade

Million US $

	1979	1980	1981	1982	1983	1984 [a]
Exports						
Total	**33,896**	**38,830**	**37,387**	**36,438**	**37,404**	**39,975**
Bulgaria	2,335	3,021	3,198	3,298	2,879	2,900
Czechoslovakia	3,734	4,597	4,691	4,357	4,142	4,275
East Germany	5,098	6,565	6,714	7,172	7,625	8,000
Hungary	4,063	4,911	4,877	4,876	4,847	5,000
Poland	6,350	7,506	4,971	4,974	5,402	6,200
Romania	5,522	6,574	7,216	6,235	6,238	6,600
Yugoslavia	6,794	5,656	5,720	5,526	6,271	7,000
Imports						
Total	**45,556**	**47,302**	**41,065**	**34,695**	**33,047**	**35,550**
Bulgaria	1,621	2,035	2,546	2,684	2,415	2,500
Czechoslovakia	4,117	4,590	4,432	3,842	3,371	3,500
East Germany	6,908	8,145	6,654	5,663	6,300	7,050
Hungary	4,230	4,632	4,417	4,111	3,970	4,100
Poland	8,038	8,488	5,404	4,616	4,317	4,900
Romania	6,623	8,091	7,012	4,710	4,605	4,800
Yugoslavia	14,019	11,321	10,600	9,069	8,069	8,700
Balance						
Total	**−11,660**	**−8,472**	**−3,678**	**1,743**	**4,357**	**4,425**
Bulgaria	714	986	652	614	464	400
Czechoslovakia	−383	7	259	515	771	775
East Germany	−1,810	−1,580	60	1,509	1,325	950
Hungary	−167	279	460	765	877	900
Poland	−1,688	−982	−433	358	1,085	1,300
Romania	−1,101	−1,517	204	1,525	1,633	1,800
Yugoslavia	−7,225	−5,665	−4,880	−3,543	−1,798	−1,700

[a] Projections based upon announced trade plans.

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Because of continuing unease about the financial outlook for many LDCs, bankers seem to be looking for profitable opportunities to lend to those East European countries that have weathered the debt crisis.

Bankers, nonetheless, remain cautious and are limiting most lending to short-term, trade-related credits carrying higher interest spreads than in the past. Private lenders are reluctant to increase exposure significantly unless backed by Western government guarantees. The East Europeans seem equally cautious about new borrowing, with some regimes deliberately planning to run current account surpluses to reduce debts further. Most of the medium-term, untied money secured this year will be in the form of IMF loans for Hungary and Yugoslavia; the completed or planned commercial syndications generally are tied to trade and project financing. Because the inflow of credits probably will be small, we expect the region again to run a sizable trade surplus of roughly $4.4 billion and a current account surplus of $3.4 billion.

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Table 2
Eastern Europe: Gross and Net Hard Currency Debt at Yearend

Million US $

	1980	1981	1982	1983 [a]
Eastern Europe				
Gross debt	83,645	85,085	80,658	81,975
Commercial debt	61,658	59,050	53,031	48,041
Government-backed debt	18,688	21,152	21,133	26,380
IMF/IBRD/BIS	3,299	4,471	6,081	7,154
CEMA banks	NA	412	413	400
Reserves [b]	10,054	9,838	8,239	10,065
Net debt	73,591	75,247	72,419	71,910
Bulgaria				
Gross debt	3,536	3,065	2,757	2,463
Commercial debt	3,201	2,695	2,292	1,968
Government-backed debt	335	370	465	495
Reserves [b]	779	840	1,014	1,076
Net debt	2,757	2,225	1,743	1,387
Czechoslovakia				
Gross debt	4,926	4,508	4,053	3,707
Commercial debt	4,066	3,703	3,118	2,732
Government-backed debt	860	805	935	975
Reserves [b]	1,256	1,105	742	985
Net debt	3,670	3,403	3,311	2,722
East Germany				
Gross debt	14,098	14,863	13,039	12,630
Commercial debt	11,253	11,583	9,489	8,510
Government-backed debt	2,845	3,280	3,550	4,120
Reserves [b]	2,506	2,596	2,321	3,597
Net debt	11,592	12,267	10,718	9,033
Hungary				
Gross debt	9,090	8,699	7,715	8,250
Commercial debt	8,790	8,334	6,955	6,940
Government-backed debt	300	365	525	740
IMF/IBRD/BIS			235	570
Reserves [b]	2,090	1,652	1,151	1,518
Net debt	7,000	7,047	6,564	6,732
Poland				
Gross debt	25,000	25,453	24,840	26,400
Commercial debt	14,900	14,188	13,660	10,900
Government-backed debt	10,100	11,265	11,180	15,500
Reserves [b]	650	775	1,045	1,150
Net debt	24,350	24,678	23,795	25,250

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Table 2
Eastern Europe: Gross and Net Hard Currency Debt at Yearend (continued)

Million US $

	1980	1981	1982	1983 [a]
Romania				
Gross debt	9,387	10,160	9,766	9,000
Commercial debt	6,537	6,167	5,409	4,900
Government-backed debt	1,670	1,845	1,428	900
IMF/IBRD/BIS	1,180	1,736	2,516	2,800
CEMA banks	NA	412	413	400
Reserves [b]	300	345	370	250
Net debt	9,087	9,815	9,396	8,750
Yugoslavia				
Gross debt	17,608	18,337	18,488	19,525
Commercial debt	12,911	12,380	12,108	12,091
Government-backed debt	2,578	3,222	3,050	3,650
IMF/IBRD	2,119	2,735	3,330	3,784
Reserves [b]	2,473	2,252	1,596	1,489
Net debt	15,135	15,812	16,892	18,036

[a] Preliminary estimate.
[b] Excludes gold holdings. Changes in reserves shown may not equal those in the country balance-of-payments tables because of fluctuations in gold stocks and differing definitions of reserves.

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Trade turnover with the West—exports plus imports—will pick up for the first time since 1980. Economic recovery in the West will increase East European exports, which—coupled with moderately more financing—will allow most regimes to ease import curbs. Even so, hard currency trade is unlikely to increase at the double-digit pace common in the 1970s. Hard currency sales probably will increase by around 7 percent while import growth should approach 8 percent.

Long-Term Problems

Despite its relatively quick recovery from the 1981-82 credit crunch, Eastern Europe still faces long-term trade and financial problems. The East Europeans cannot continue to rely on import restraints to achieve trade and current account surpluses; strong export gains are imperative if the region is to attain economic growth and external balance. The regimes, however, have done little to correct longstanding problems with competitiveness, and the sizable cuts in imports of Western capital goods are widening the technology gap between Eastern Europe and the developed West.

Growing Soviet demands for more and better goods from Eastern Europe also may limit the region's ability to sell in hard currency markets. Financial problems in developing countries not only have hurt East European sales to those countries, but also have made the Third World a more aggressive competitor in developed country markets.

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Even with the recent debt reductions, debt service obligations will remain large for most countries, and increases in international interest rates will further burden current account performance. The reluctance of lenders to increase their medium- and long-term exposure will leave Eastern Europe vulnerable to rapid reductions in short-term credit lines as occurred in early 1982. The breathing space given by debt reschedulings for Poland, Romania, and Yugoslavia will expire in the next few years, forcing these countries to repay their obligations, refinance them with new loans, or negotiate new rescheduling terms.

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Table 3
Eastern Europe: Selected Financial Indicators

Percent

	Proportion of Bank Loans With Less Bank Loans With Less Than One Year Maturity					Reserves as a Share of Debt Maturing in One Year				
	1979 [a]	1980 [a]	1981 [a]	1982 [a]	1983 [b]	1979 [a]	1980 [a]	1981 [a]	1982 [a]	1983 [c]
Eastern Europe	**39.9**	**36.3**	**37.0**	**34.0**	**33.6**	**28.8**	**29.0**	**28.1**	**23.1**	**27.0**
Bulgaria	41.1	36.3	48.1	51.7	52.8	31.0	53.5	59.4	90.1	123.2
Czechoslovakia	47.1	43.1	37.6	31.2	32.8	46.8	65.3	67.8	55.8	95.6
East Germany	42.7	38.6	42.6	39.0	38.8	46.7	45.2	42.3	48.2	68.6
Hungary	47.4	42.9	40.4	33.2	36.0	27.2	34.0	25.0	29.0	31.7
Poland	39.1	33.1	36.1	32.8	29.3	14.7	7.5	9.7	9.0	7.2
Romania	50.5	42.7	35.3	38.9	32.8	9.6	9.4	8.9	9.5	16.7
Yugoslavia [e]	22.6	28.1	28.4	26.7	30.0	46.3	36.9	38.3	18.0	23.8
	Undisbursed Bank Commitments as a Share of Outstanding Debt					**Debt Service Ratios [d]**				
Eastern Europe	**16.5**	**17.4**	**11.7**	**8.4**	**7.5**	**36.7**	**39.9**	**48.7**	**56.7**	**61.0**
Bulgaria	8.4	16.7	24.5	15.5	18.3	33.7	32.5	33.9	26.9	22.1
Czechoslovakia	9.7	8.3	6.7	10.4	9.7	20.6	21.8	20.1	19.4	17.8
East Germany	16.5	15.2	16.2	13.3	11.1	44.6	43.9	51.6	53.2	45.9
Hungary	5.2	8.4	4.6	7.2	5.5	33.1	30.9	32.7	33.0	30.7
Poland	24.6	23.9	11.8	4.8	4.3	86.0	97.1	174.6 [f]	214.6 [f]	245.7 [f]
Romania	18.3	18.2	9.4	9.8	9.0	21.1	25.6	27.4	45.3	31.5
Yugoslavia	23.8	19.0	11.9	7.5	6.7	20.2	22.8	26.4	28.4	33.8

[a] At yearend.
[b] At midyear.
[c] Preliminary estimate at yearend.
[d] Repayments of medium- and long-term debt and interest payments on gross debt as a share of current account earnings.
[e] Reserves held by the National Bank of Yugoslavia.
[f] Ratio computed on the basis of obligations owed which were much larger than amounts actually paid.

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The warming of relations between Western lenders and several East European countries will likely be limited. The debt crisis of 1981-82 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 protection for lending to the region. Instead of making blanket judgments about the area's creditworthiness, bankers are likely to draw sharper distinctions among the countries on the basis of economic policy, performance, and prospects.

As a prerequisite for increased lending, bankers will likely look for evidence that the East Europeans are making structural changes to improve trade performance. Many creditors regard sharp import reductions as a short-run expedient with little positive impact on long-term creditworthiness. Some bankers consider the Western recession as only one factor in the disappointing export performance in recent years, and they remain skeptical that the East Europeans will or can do much to correct their fundamental problems.

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Political developments, as in the past, could again influence borrowing prospects. Any further cooling in the East-West political climate or outbreaks of unrest or violence could undermine creditor confidence. Threats to political stability could result from popular reaction to the pinch of austerity measures or from struggles over succession. Political problems in any one country could spill over and poison lenders' attitudes about the whole region, even though some countries—such as Czechoslovakia and Bulgaria—may be judged creditworthy solely on economic terms.

Table 4
Poland: Financing Requirements and Sources, 1982-84

Million US $

	1982	1983 [a]	1984 [b]
Financing requirements	**10,788**	**14,592**	**15,805**
Current account balance	−3,039	−1,807	−760
Trade account balance	358	1,085	1,300
Exports	4,974	5,402	6,200
Imports	4,616	4,317	4,900
Interest [c]	−3,799	−3,299	−2,560
Other net invisibles, (excluding interest)	402	407	500
Repayments of medium- and long-term debt due	7,061	5,447	4,045
Paris Club creditors	2,573	1,825	1,808
Banks	2,442 [d]	1,436 [d]	619
Other creditors	2,046	2,286	1,618
Repayments of short-term debt due	110	263	0
Arrearages from previous year	573	6,906	10,800 [e]
Net credit extended	−5	−69	−200
Financing sources	**3,882**	**2,103**	**7,900**
Credits	1,670	903	600
Debt relief	2,050 [f]	1,200	7,300
Other	162	0	0
Arrears/gap	**6,906**	**12,489**	**7,905**

[a] Preliminary.
[b] Projection.
[c] Amounts are for interest due rather than interest paid. Because Poland has not paid all interest due, the figures for interest and the current account deficits overstate the hard currency outflows.
[d] Includes principal payments deferred until the following year under the bank rescheduling agreements for 1981 and 1982.
[e] Arrearages at the end of 1983 according to Polish data. The total is not consistent with the $12.5 billion total we compute from data and estimates of current account performance, obligations due, payments made, new credits and reschedulings.
[f] Includes interest deferred until 1983 under the 1982 bank agreement.

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Individual Country Performance

The following sections summarize the recent financial performance of the individual countries and discuss their longer term prospects.

Poland

Warsaw continued last year to pursue a policy of limited adjustment by running a trade surplus large enough to meet the minimum demands of its creditors but not so great as to strain the beleaguered economy and risk unrest. Warsaw ran a record trade surplus of $1.1 billion as exports jumped 9 percent and imports fell 6 percent. Nonetheless, this surplus, coupled with other service earnings of $400 million (net), fell far short of the $3.3 billion owed in interest (see table 4). As a result, Warsaw slipped even further behind in meeting its debt repayments.

New credits and debt relief from banks covered little more than $2 billion of Warsaw's $15 billion financing requirement, which included almost $7 billion in arrears from 1982. Credit availability continued to decline as lines extended before 1982 were nearly exhausted. Warsaw was able to draw only $565 million in new money—about half in trade credits from Libya and China—plus $338 million in trade credits available from the 1982 and 1983 bank rescheduling agreements. Western banks agreed to reschedule $1.2 billion in principal—95 percent of the payments due in 1983—until 1988-92. The banks agreed to relend 65 percent of the interest due on original loan contracts as short-term credits to finance imports for Warsaw's export industries

Poland's large financial gap resulted primarily from failure to conclude a debt rescheduling with the Paris Club. Western government creditors, who had suspended debt rescheduling talks in January 1982 following Warsaw's imposition of martial law, agreed in

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principle in mid-1983 to negotiate debt relief and sent a technical team to Poland. The opportunity for progress was lost in November, however, when Polish officials made their first appearance at the Paris Club in two years and asked for a comprehensive package including generous debt relief, new credits, and IMF membership. The creditors responded that IMF membership and new credits were outside the scope of the Paris Club, and that further debt relief could not be provided until Poland met unpaid obligations under the 1981 rescheduling agreement.

The trends of the past two years—some improvement in the current account, dwindling credit availability, and difficult rescheduling negotiations—are being repeated in 1984. Poland owes about $16 billion this year, two-thirds of which represents payments overdue from as long ago as 1981. The current account deficit could fall below $800 million as interest payments drop to around $2.6 billion and if Warsaw achieves another record trade surplus as anticipated. Exports and imports are projected to increase by 20 percent and 14 percent, respectively. First-quarter statistics suggest that the projected $1.3 billion trade surplus is reachable.

The likelihood of new credits remains slim. Polish officials hope for over $2 billion in new credits this year, but they have acknowledged that they received only $90 million in the first quarter. Warsaw is more likely to receive around $600-800 million this year, including new money coming out of rescheduling agreements.

After three years of rescheduling, roughly three-fourths of Warsaw's debt to Western banks has now been rescheduled. About $600 million in principal is due this year, well below the levels of the past two years. This relatively small sum encouraged the banks to negotiate a multiyear rescheduling on the following terms:

- Rescheduling over 10 years of 95 percent of principal payments due from 1984 through 1987, including a grace period of five years.
- An interest rate of 1.75 percentage points over LIBOR on rescheduled obligations.
- Payment in 1984 of the remaining 5 percent of principal, a 1-percent fee, and interest due this year on all of the debt to be rescheduled.

The banks also agreed to extend about $700 million in short-term credit facilities over the next two years. Embassy reporting indicates that $330 million will be new credits. Each bank will contribute an amount based on its exposure, with approximately $230 million to be made available this year. The remaining $370 million is an extension on repayment of trade credits from the 1982 agreement, which come due in 1985. The rescheduling was contingent on Poland paying off some $100 million in interest arrearages.

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The accord was signed on 13 July. The scheduled signing was threatened at the last moment when the Poles insisted that all banks accept the new money portion of the agreement. They eventually agreed to less than 100-percent approval.

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Progress with the Paris Club has been slowed by Warsaw's delays in meeting the creditors' conditions for resuming debt relief negotiations. Warsaw initially agreed to pay all creditors 20 percent of the arrearages under the 1981 Paris Club rescheduling agreement as well as all of the unrescheduled debt due the United States in 1981. The money was due at the end of May, but many creditors have reported receiving only partial payments. In addition, Warsaw now maintains that it will pay only 20 percent of $34 million in unrescheduled principal and interest due under the 1981 bilateral agreement with the United States. In early July, the Polish delegation informed creditors that payments could not be met because of lack of funds. The regime in Warsaw apparently has set aside a fixed amount for debt repayments, and this limit cannot be exceeded. The delegation repeated its request that new financing was needed to meet debt obligations. A working group of the Paris Club has scheduled its next meeting for September and only then if the payments problem has been resolved.

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Even if it eventually completes reschedulings with commercial banks and the Paris Club and obtains some new credits, Poland will still face a financial gap of nearly $8 billion this year. This includes $2.7

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Table 5
Romania: Financing Requirements and Sources, 1982-84

Million US $

	1982	1983 [a]	1984 [b]
Financing requirements	**3,820**	**1,998**	**710**
Current account balance	655	902	1,000
Trade account balance	1,525	1,633	1,800
Exports	6,235	6,238	6,600
Imports	−4,710	−4,605	−4,800
Net interest	−917	−725	−730
Other services	47	−6	−70
Debt repayments	2,830	2,219	1,528
Medium-and long-term	2,081	1,263	1,190
Short-term	749	956	338
Net credits extended	−502	−293	−182
Arrears from previous year	1,143	388	0
Financing sources	**3,316**	**1,876**	**755**
Credits	1,591	1,056	560
Medium- and long-term	334	586	220
Short-term	956	338	300
IMF, net	301	132	40
Debt relief	1,700	749	0
Change in reserves	−25	−71	−195
Errors and omissions	**116**	**122**	**−45**
Financing gap/arrears	388	0	0

[a] Preliminary.
[b] Projected.

billion due Paris Club creditors in 1984 under original loan contracts and obligations owed to individual companies, LDCs, and CEMA banks. Moreover, Warsaw would be burdened with resuming payments to governments after two and a half years of self-imposed debt relief.

Despite four years of debt reschedulings, Warsaw still faces unmanageable financing requirements in 1985 and beyond. Not only will further reschedulings be necessary, creditors almost certainly will have to renegotiate agreements already concluded.

Romania

In narrow financial terms, Romania's turnaround has been the greatest in Eastern Europe and one of the most dramatic among all problem debtors. Bucharest has run sizable surpluses in its hard currency accounts the past two years in contrast to the large deficits recorded between 1977 and 1981. The current account surplus climbed to over $900 million in 1983—up from $655 million a year earlier (see table 5). These gains stem almost entirely from tight import curbs that enabled Bucharest to run trade surpluses in both years exceeding $1.5 billion. The current account surplus in 1983 allowed Romania to reduce its net hard currency debt by nearly $650 million from the 1982 level of $9.4 billion.

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Despite the improved current account, debt relief from Western banks and governments was needed again in 1983. Bucharest's rescheduling efforts proceeded more smoothly than the 1982 negotiations. As early as February 1983, Romania and major Western banks had agreed on terms, albeit tougher than those of 1982: only 70 percent of some $900 million in principal payments to banks were rescheduled instead of the 80 percent in 1982, and short-term debt was not covered. The Paris Club agreed to reschedule 60 percent of principal due in 1983 on medium- and long-term guaranteed credits.

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Romania so far has made good on its goal of avoiding a rescheduling this year. This is largely due to a projected hard currency trade surplus of $1.8 billion—assuming growth of about 4 percent in both exports and imports—and lower debt service obligations. But to keep current on meeting bank repayments, Romania is squeezing foreign suppliers.

Romania has delayed payments on imports and pressed suppliers to accept either countertrade deals or discounted repayments in cash.

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In addition, Romania must cope with the cancellation of the final drawings of its 1981 IMF standby arrangement (worth nearly $300 million). Romania and the Fund agreed to end the standby credit because Bucharest refused to raise energy prices further and complete some studies requested by the Fund. According to press reports, the Romanians will not request a new standby arrangement.

Romania's financial progress has been costly and may be short lived. The huge trade surpluses—primarily the result of a 42-percent drop in imports in 1981-82—have drained the economy and damaged the outlook for genuine recovery. Investment fell over 10 percent in 1981-82, and the officially acknowledged drop in consumption in 1982 was the first decline since World War II. In addition, industrial production growth has averaged a little over 1 percent the last three years, which is the slowest growth in the postwar era.

The breathing space associated with rescheduling ends in 1985 when Bucharest must begin to repay obligations rescheduled in 1981. Total repayments of medium- and long-term debt, including IMF repurchases, are scheduled to climb to almost $1.7 billion. The Ceausescu regime most likely will respond to the pressure of covering its external obligations by continuing to earn large trade surpluses rather than deal with underlying economic problems that hurt competitiveness and prevent sustainable and balanced growth.

Hungary

Hungary's financial position improved in 1983 even though Budapest failed to meet all its goals. The borrowing campaign fared reasonably well, bringing in roughly $1.3 billion in medium-term loans (see table 6). In addition to $352 million in IMF credits, Budapest obtained a $200 million three-year club loan from Western banks, $239 million in project credits from the World Bank, a $275 million commercial loan to cofinance World Bank projects, and increased trade credits. A surge in short-term borrowings late in the year helped boost gold and foreign exchange reserves by $600 million. The major disappointment was that the trade surplus reached only $877 million and the current account surplus only $297 million.

Table 6
Hungary: Financing Requirements and Sources, 1982-84

Million US $

	1982	1983 [a]	1984 [b]
Financing requirements	**4,208**	**3,048**	**3,351**
Current account balance	−63	297	400
Trade balance	766	877	900
Exports	4,876	4,847	5,000
Imports	4,110	3,970	4,100
Net interest	−976	−662	−580
Other net invisibles	147	82	80
Repayment of medium- and long-term debt	894	1,216	1,534
Repayment of short-term debt	2,849	1,764	2,123
Net credits extended	−192	−65	−94
Repayment of BIS credit	210	300	0
Financing sources	**4,244**	**3,151**	**3,251**
Credits	3,663	3,751	3,240
Medium- and long-term	1,154	1,276	1,100
Short-term	1,764	2,123	1,700
IMF, net	235	352	440
BIS	510	0	0
Change in reserves	−581	600	11
Errors and omissions	**−36**	**−103**	**100**

[a] Preliminary.
[b] Projected.

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Overly buoyant domestic demand bears some of the blame, but depressed export prices and a substandard grain harvest also kept export gains well below the original goal.

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Unlike other East European countries, Hungary is again counting heavily on medium-term bank loans to cover much of its 1984 financing requirement. Budapest faces $1.5 billion in medium- and long-term debt repayments—up from $1.2 billion in 1983—and its IMF stabilization program calls for a reduction in short-term debt to limit vulnerability to the type of liquidity crisis that occurred in 1982. While total debt

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repayments thus are $800 million more than last year, Budapest plans to increase its current account surplus to only $400 million. Hungary is obtaining some $440 million in standby credits from the IMF, but it will need more than $1 billion in medium- and long-term commercial financing to prevent erosion of its reserves.

This year's borrowing campaign is off to a good start and should meet the $1.1 billion target. A $150 million bankers' acceptance was oversubscribed—eventually reaching $210 million—and an Arab consortium drummed up $50 million. The World Bank has approved another $200 million in project loans; commercial cofinancing loans for these projects will likely reach $450 million. Budapest may seek another syndication toward the end of the year to help offset any shortfall in the current account and to buttress foreign exchange reserves. Foreign exchange holdings dropped around $400 million in the first quarter of 1984 as Budapest reduced its short-term debt in compliance with the IMF program.

Early indicators for trade and current account performance seem favorable. Despite the lifting of some import restrictions, the hard currency trade surplus increased to $213 million in the first quarter of 1984 from $150 million in the same period of last year. The current account was in balance in contrast to last year's first-quarter deficit, indicating that the goal of a $400 million surplus for the year remains attainable. The Hungarians, nonetheless, must record substantial increases in exports since they have removed more import restraints in accordance with their IMF stabilization program. Sustained export gains are uncertain because they depend significantly on the outcome of this year's harvest.

The success of Hungary's foreign borrowing effort has led many observers to conclude that the country is close to financial recovery. Hungary's bankers exude increased confidence and insist that a debt rescheduling would only increase borrowing costs and yield little relief in managing medium- and long-term debt.

This optimism, however, tends to obscure important challenges facing Hungary's economic and financial managers. Budapest must cover large debt repayments in the next two years, $1.5 billion in 1985 and $1.2 billion in 1986. Improvements in the economy's efficiency and competitiveness are needed to increase the trade surplus. Budapest—with prodding from the IMF—is working out a new package of structural reforms to be introduced in 1986 for the purpose of improving trade performance. Hungary's experience shows, however, that the payoff from reform is not quick. Trade prospects also depend on the willingness of Hungary's CEMA trade partners, in particular the USSR, to allow Budapest to continue running large surpluses in intra-CEMA hard currency trade. In recent years, Hungary has relied on these surpluses to offset deficits in trade with the developed West, and Budapest is concerned that the Soviets will not want to continue this practice. None of these problems foreshadow an imminent financial crisis, but Hungary's position will remain vulnerable for the next several years.

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Yugoslavia

Belgrade's creditors recognized by early 1983 that the country could not meet its debt obligations. The IMF, which was shepherding Yugoslavia through the last year of a three-year stabilization program, pressed Western governments and banks to adopt a rescue plan for 1983 that would refinance maturing medium- and long-term credits, halt the erosion of short-term debt, and ensure enough new credits to rebuild Yugoslavia's depleted reserves. The IMF hoped—at least initially—that the refinancing package, coupled with improvement in Yugoslavia's current account, would produce a strong enough revival in commercial lending so that Yugoslavia would not require more help in 1984. The plan eventually grew into a complicated package involving new credits and refinancing:

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- Western governments pledged nearly $1.2 billion in export credits, financial loans, and rollovers of maturing officially backed loans.
- Western banks refinanced $1.0 billion in medium-term loans for six years with a three-year grace period, kept in place $900 million in short-term credits, and extended $600 million of new untied loans.
- Net funding from the IMF—involving the last drawings from the 1981 standby credits—and the World Bank amounted to nearly $700 million.
- The Bank for International Settlements contributed $500 million in short-term bridge loans.

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Yugoslavia achieved a major improvement in its trade and current accounts in 1983 (see table 7). Belgrade cut its trade deficit from $3.5 billion in 1982 to $1.8 billion in 1983 as a result of an upturn in exports and sharp cuts in imports. The delayed disbursement of credits in the refinancing package contributed to the reduction in imports, but the improvement in trade performance also resulted from the large devaluation of the dinar demanded by the IMF and Yugoslavia's success in redirecting exports from CEMA to convertible currency markets. Because of the reduced trade deficit and a revival of tourism earnings, Yugoslavia moved its current account balance from a $1.6 billion deficit in 1982 to a $300 million surplus in 1983.

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Despite the 1983 refinancing package and improved current account, Yugoslavia is seeking more debt relief in 1984. Belgrade faces an estimated $3.6 billion financing requirement, including $2.7 billion in repayments on medium- and long-term debt. The IMF projects a current account surplus of only $500 million for this year, leaving a large amount of maturing loans to roll over. Belgrade is not yet able to resume normal borrowing on its own, and its official foreign exchange reserves, which dropped $55 million last year to under $1 billion, give little scope for helping to cover the financial gap. Indeed, in the IMF's view, the reserves need to be increased by $500 million while the Yugoslavs would like to increase them by over $800 million.

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Belgrade is making progress toward covering this year's financing requirement. First-quarter current account results indicate that the IMF's projection of a $500 million surplus for the year is attainable. Resolution of a dispute with the IMF over pricing policies has permitted renewed disbursement of this year's $400 million standby credit. More important, settlement of this problem paves the way for completion of refinancing packages linked to the new IMF program:

- Private bankers have agreed to refinance $1.3 billion in debts falling due this year.
- Western governments are deferring about $800 million in maturing credits and carrying over nearly $400 million in unused credits from last year's package.

Table 7
Yugoslavia: Financing Requirements and Sources, 1982-84

Million US $

	1982	1983 [a]	1984 [b]
Financing requirements	**5,855**	**4,031**	**3,585**
Current account balance	−1,602	299	500
Trade account balance	−3,543	−1,798	−1,700
Exports	5,526	6,271	7,000
Imports	9,069	8,069	8,700
Net interest	−1,692	−1,489	−1,550
Other services, net	1,970	1,976	1,650
Remittances, net	1,663	1,610	2,300
Repayments of medium- and long-term debt	1,764	2,363	2,745
Repayments of short-term debt [c]	2,312	1,810	1,140
Net credits extended	−177	− 157	−200
Financing sources	**5,325**	**4,125**	**3,585**
Credits	4,314	4,070	4,095
Medium- and long-term	1,815		250
Short-term	1,810		900
IMF, net	563	410	10
IBRD	125	280	505
Rescue packages		2,340	2,430
Governments		790	1,190
Berne		790	390
Geneva		0	800
Banks		1,550	1,240
Other lenders		60	
Suppliers		980	
Change in reserves	−1,012	−55	510
Errors and omissions	**530**	**−94**	**0**

[a] Preliminary.
[b] Projected.
[c] Includes net change in outstanding supplier credits.

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In addition, Belgrade is counting on over $500 million in World Bank loans and about $250 million in medium- and long-term loans from other sources. Finally, last year's refinancing agreement commits banks to maintain some $900 million in short-term credit lines.

Yugoslavia almost certainly will require additional—albeit smaller—refinancing packages after 1984. Even with increasing current account surpluses, Yugoslavia will have larger borrowing needs than it can cover in the market and will require additional debt relief. Repayments of medium- and long-term debt are around $2.5 billion annually in 1985-86.

Yugoslavia and representatives of US commercial banks are already informally discussing Yugoslavia's future financial needs. Yugoslav officials told US bankers that they are interested in a multiyear rescheduling program to include 1985 and 1986 commercial bank debt.

Belgrade also has indicated to US bankers that it would like to avoid further Paris Club refinancings. But such a move could upset bankers who are concerned that all creditors should be treated equally. Some bankers still harbor ill feelings about the 1983 rescue package. They feel private banks were treated unfairly since they were required to put up new money, some of which was then used to pay off government creditors.

The Yugoslavs apparently are approaching further debt relief with one eye on Latin American debtors, according to the Embassy. Belgrade is monitoring closely Latin America's efforts to obtain debt relief, and Yugoslav officials have stressed increasingly the common difficulties shared by Third World debtors. We do not believe Belgrade is interested in joining a debtors' cartel as it wishes to keep current on its financial obligations and eventually resume normal borrowing. But Belgrade would argue that its financial record should entitle it to more favorable terms should this occur in Latin American reschedulings.

Financial recovery ultimately depends on Belgrade's ability to regain the confidence of Western bankers by attacking systemic problems that contribute to the imbalance between supply and demand and encourage reliance on Western imports. To date, Belgrade's administrative controls and the IMF's prescribed tight monetary policy have not slowed inflation. Belgrade will have to work harder to restrain increases in wages, prices, and domestic credit and to improve efficiency and competitiveness through systemic reform. This would involve abandoning policies that have given primacy to regional interests over integrative market forces. In addition, policies that misallocate investment resources have been used to protect jobs by shoring up money-losing enterprises and to subordinate efficiency to political objectives. An efficient national foreign exchange market also is needed to ensure that all producers pay the true cost of foreign exchange and that those best able to use foreign resources receive hard currency.

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Despite professions of good intentions from officials and some steps in the right direction, Belgrade's capacity to overhaul its economy remains 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. Differences among regions and nationalities further complicate the collective leadership's task of reaching a consensus on burden sharing policy. At the same time, a greater reliance on market forces challenges official ideology and threatens the prerogatives of powerful vested interests in the republics. Moreover, repeated disputes over the IMF stabilization program do little to inspire creditor confidence.

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East Germany

East Germany's financial position strengthened considerably in 1983 due to another current account surplus, increased short-term trade financing, and special financial credits from West Germany, as well as new government-backed trade loans from other Western countries. Although faced with total debt repayments of more than $4 billion, the East Germans

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Table 8
East Germany: Financing Requirements and Sources, 1982-84
Million US $

	1982	1983 [a]	1984 [b]
Financing requirements	**4,081**	**2,935**	**2,610**
Current account balance	1,239	1,310	1,080
Trade account balance	1,509	1,325	950
Exports	7,172	7,625	8,000
Imports	5,663	6,300	7,050
Net interest	−1,220	−865	−820
Other net invisibles	950	850	950
Repayments of medium- and long-term debt	3,000	2,790	2,300
Repayments of short-term debt	2,320	1,430	1,390
Financing sources			
Credits	3,865	2,344	NA
Medium- and long-term	2,130	2,230	NA
Short-term	1,460	1,390	NA
Change in reserves	**−275**	**1,276**	**NA**
Net errors and omissions	**216**	**566**	**NA**

[a] Preliminary.
[b] Projected.
[c] Includes net change in supplier credits.

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met their obligations, reduced their gross debt to Western banks by $400 million, and built up reserves by an estimated $1.3 billion to a record $3.6 billion (see table 8). In contrast to 1982, the regime was able both to run a current account surplus and increase imports from the West.

East Germany's trade surplus fell slightly, to $1.3 billion, in 1983 as a result of an 11-percent increase in imports and only a 6-percent gain in exports.[2] The current account surplus remained around the $1.3 billion level. The East Germans continued to maximize cash receipts by reselling for hard currency oil, silver, and other commodities obtained through barter arrangements with LDCs and on clearing account from West Germany.

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As in 1982, East Germany pursued a differentiated trade policy between West Germany and the other OECD countries in order to make maximum use of available import financing and to build up a convertible currency surplus. Capitalizing on West German trade credit facilities, East Germany boosted imports from West Germany by more than 30 percent during the first half of 1983 over the same period of 1982 and increased its net short-term debt to West Germany by roughly $300 million. During the same period, the East Germans ran a $300 million surplus with the rest of the OECD. The pattern shifted in the second half of the year when more credits became available from other Western sources. East Berlin ran a $250 million surplus in intra-German trade through a slowdown in imports and a boost in exports and paid back most of the increase in indebtedness to West Germany. While moving into surplus with West Germany, the East Germans ran a surplus of only $60 million with the rest of the OECD.

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In addition to trade financing, West Germany helped ease East Germany's liquidity problems by granting a $400 million government-guaranteed financial credit with a five-year maturity. Unlike other intra-German credits, this loan was in convertible currency and not tied to trade; thus, East Berlin could use the proceeds to cover debt service payments to non-German creditors. By demonstrating West Germany's financial umbrella, the loan apparently encouraged Western bankers to revive lending to East Berlin and helped improve the terms East Germany could obtain on new credits.

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Even though the likelihood of an East German rescheduling has diminished, the country will face financial pressures over the next few years. Repayments of medium- and long-term debt in 1984-85 will fall from the 1982-83 level, but at more than $2 billion annually they will remain substantial. The

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[2] A persistent problem in analyzing East German trade performance is the discrepancy between totals announced by East Berlin and by Western partners. East Germany, for example, reports that its exports to nonsocialist countries rose 24 percent in 1982 and imports rose 13 percent. OECD and intra-German trade data, however, show East German exports rising 4 percent and imports falling by 10 percent. This discrepancy may be explained by different statistical procedures, the lack of LDC partner data, and failure to count East German commodity resales in Western statistics. We use East German data to compute the overall trade balance, but rely on Western sources to estimate trends in exports and imports.

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East Germans must also roll over a large short-term debt. We expect smaller hard currency trade surpluses than in the past two years because East Berlin seems intent on expanding imports. Increased hard currency service receipts from West Germany will help offset some of the impact of smaller trade surpluses on the current account.

The East Germans have been actively seeking more trade financing and have been particularly anxious to raise additional medium-term credits—including syndicated loans—in order to refurbish their credit rating and to stretch out the maturity structure of their debt. East Germany's foreign trade bank succeeded in raising a $75 million credit in the Euromarkets in May. While not large, the credit represents East Germany's first medium-term untied loan since late 1981 and may open the door to more such lending. In late July, West German banks extended a new $330 million untied loan guaranteed by the West German Government.

Given recent improvements in East Germany's financial position, there is no pressing need for the new West German money. But the loan demonstrates the continuation of the West German financial umbrella and reduces doubts held by many creditors. They remain wary about East Germany, especially because of the lack of basic economic and financial data. For example, much uncertainty surrounds East Germany's recent reserve buildup. Some Western observers argue that the buildup has been funded by increased borrowing from outside the BIS area, and hence East German debt has not fallen as much as BIS statistics indicate. Lacking credible statistics on East Germany's trade and current account performance and on future debt service, many bankers count on continued West German financial support to offset the information gap.

East Berlin's decision to revive imports and to press Western bankers and governments for new loans shows that East German planners still see trade with the West as an important element of their economic strategy. The regime probably will hold to a more cautious borrowing strategy than in the late 1970s, but East Germany probably will be more aggressive than Bulgaria and Czechoslovakia in seeking new loans to increase imports. Nonetheless, East Germany can no longer rely on its strategy of the 1970s that attained rapid economic growth and improvements in living standards through large resource transfers from the West.

Table 9
Czechoslovakia: Financing Requirements and Sources, 1982-84

Million US $

	1982	1983 [a]	1984 [b]
Financing requirements	**1,365**	**664**	**590**
Current account balance	195	581	605
Trade account balance	515	771	775
Exports	4,357	4,142	4,275
Imports	3,842	3,371	3,500
Net interest	−380	−260	−250
Other net invisibles	60	70	80
Repayments of medium- and long-term debt [c]	320	435	405
Repayments of short-term debt	1,240	810	790
Financing sources	**1,468**	**607**	NA
Credits	1,105	850	NA
Medium- and long-term	355	100	NA
Short-term	750	750	NA
Change in reserves	−363	243	NA
Net errors and omissions	**−103**	**−57**	NA

[a] Preliminary.
[b] Projected.
[c] Includes estimated net change in supplier credits.

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Czechoslovakia

In 1983 Czechoslovakia maintained its cautious policy toward hard currency imports and reduced its net debt for the second consecutive year. The foreign trade plan envisioned a modest increase in both hard currency exports and imports. But a 5-percent decline in sales prompted Prague to cut imports by nearly 9 percent in order to meet its financial targets. These reductions resulted in trade and current account surpluses of $771 million and $581 million, respectively, both up from their 1982 levels (see table 9).

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Czechoslovakia seems to face few borrowing problems, and its liquidity has improved. The Czechoslovaks used part of their current account surplus last year to add more than $240 million to reserves in Western banks. To demonstrate its increased creditworthiness, Prague raised a $50 million medium-term club loan from Western banks in mid-1983. Prague's senior banker described the small credit as a "symbolic question of getting back on the Euromarkets" after the 1981-82 credit squeeze. The Czechoslovaks apparently balked at emulating Hungary's example of disclosing more information on their debt and balance of payments in return for a larger loan.

There appears to be some uncertainty about the future direction of Czechoslovakia's financial policy. In early 1984, Prague announced that it plans to pay off its debt to Western banks. A senior banking official put Czechoslovakia's net debt to banks at $1.8 billion and said Prague intends to pay off $600 million annually, about equal to the decline shown in BIS statistics for 1983. This seemed to reflect the leadership's frequently voiced concern that external debt provides the West with a tool for political and economic leverage. A Czechoslovak banker, however, recently indicated that Prague now has scaled back its plan for debt reduction and will permit some increase in imports of Western capital goods.

The regime may have softened its stance against foreign borrowing in response to criticism from both Western bankers and Czechoslovak planners about its reluctance to modernize industry through greater Western imports. Prague's long-held financial conservatism has contributed to the technological decline of Czechoslovakia's industry and the stagnation of the economy. Even with economic recovery in the West, inherent weaknesses undermine export performance, permitting little if any growth in real imports. Some Czechoslovak economists have been arguing that a judiciously planned pickup in investment—using borrowed Western resources—could help modernize key industrial sectors and jolt the economy out of its doldrums. Although the leadership may now be giving more credence to these arguments, fear of the political consequences of reliance on Western credits will probably continue to dissuade the Husak regime from adopting an aggressive strategy on Western imports and borrowing.

Bulgaria

Sofia's relatively low debt and lack of dependence on the West paid off during Eastern Europe's credit crunch. Creditors seemed less anxious to reduce their exposure to Bulgaria than to the rest of Eastern Europe. Although bank claims dropped somewhat, the decline probably reflected Sofia's policies as much as banks' efforts to reduce exposure. Not only was the bank pullout less severe for Bulgaria, but also the country faced minimal financing requirements as its low debt and comfortable maturity structure resulted in small repayments.

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Bulgaria—along with Czechoslovakia—remains in the strongest financial position of any East European country. Several consecutive years of current account surpluses have enabled Sofia to cut its gross debt to about $2.5 billion at the end of 1983 and to build up reserves of $1.1 billion, enough to cover over five months' worth of imports. Creditors continue to give high marks to Sofia's financial conservatism.

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Bulgaria's financial strength allows it a range of options in managing its hard currency accounts. 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. Some reports have suggested that Bulgaria was considering the latter option as Sofia was interested in negotiating contracts for Western equipment and technology needed to modernize its industry.

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Trade performance in 1983, however, shows that Sofia still chose to limit hard currency imports in order to maintain healthy trade and current account surpluses (see table 10). Imports from nonsocialist countries were down 10 percent from the 1982 level. The decision to reduce imports probably was driven by the 13-percent drop in exports to the West. Sales were off significantly to Iran, Iraq, and Libya, which rank among Sofia's largest hard currency trading partners. Bulgaria ended the year with a trade surplus of $464 million, down $150 million from a year earlier. The current account surplus was $624 million, compared to $669 million in 1982.

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Table 10
Bulgaria: Financing Requirements and Sources, 1982-84

Million US $

	1982	1983 [a]	1984 [b]
Financing requirements	**811**	**816**	**650**
Current account balance	669	624	600
Trade account balance	614	464	400
Exports	3,298	2,879	2,900
Imports	2,684	2,415	2,500
Net interest	−215	−130	−120
Other net invisibles	270	290	320
Repayments of medium- and long-term debt	640	510	490
Repayments of short-term debt [c]	840	930	760
Financing sources	**996**	**1,083**	NA
Credits	1,170	1,145	NA
Medium- and long-term	270	385	NA
Short-term	900	760	NA
Change in reserves	174	62	NA
Net errors and omissions	**−185**	**−267**	NA

[a] Preliminary.
[b] Projected.
[c] Includes net change in outstanding supplier credits.

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Exports must recover if Bulgaria is to meet its plans for modest expansion of trade with the West. Sofia, however, cannot count on large export gains because Bulgaria is not very competitive in developed country markets and must rely on Third World customers who are struggling with debt problems. If it chose to do so, Sofia probably could finance a larger volume of imports because of its good standing with bankers.

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The regime, however, probably will keep a close eye on its balance-of-payments performance and will not allow a repetition of the comparatively large deficits that occurred in the mid-1970s.

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East Germany's Economic Links to West Germany

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Key Judgments

Information available as of 27 July 1984 was used in this report.

A unique bilateral economic relationship has allowed East Germany to derive significant benefit from West Germany over the last 35 years despite their often bitterly adversarial political relations. Just as significantly, East Germany has been able to do so without becoming excessively dependent on its Western neighbor:

- During 1976-82 alone, the special relationship yielded an estimated net flow of resources to East Germany totaling over 12 billion West German marks (DM), (This was worth nearly $6 billion at then prevailing exchange rates.)
- In June 1983 Bonn decided to guarantee an untied DM 1-billion loan from West German banks. Another loan of similar proportions was approved in July 1984.

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The key for East Germany has been its ability to exploit special intra-German trade and financial mechanisms to obtain vital imports on credit and to obtain hard currency for purchases in other countries:

- Bilateral trade has been conducted since the early 1950s through a clearing account mechanism that allows East Germany to purchase West German goods without spending hard currency.
- Because of readily available West German credits, East Berlin has been able to run chronic bilateral trade deficits that, particularly during the 1970s, allowed it to support rapid economic growth and rising consumption.
- Since the normalization of relations in 1972, millions of West German visitors have provided significant hard currency revenues. Bonn has also paid East Berlin considerable sums of hard currency for services and for major construction projects improving the economic health of West Berlin.

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Although East Germany did not escape the economic malaise that gripped Eastern Europe by the early 1980s, the intra-German relationship helped East Berlin to weather its acute financial problems in 1982-83. East Germany used the clearing account to finance increased imports of West German goods as well as commodities obtained from third countries. At the same time, East Berlin not only boosted sales to other Western countries, but used the large special earnings on services to West Germany to cover hard currency obligations outside West Germany. Perhaps most important, Western lenders have seen Bonn's loans as creating a West German financial "umbrella" underwriting East Germany's creditworthiness.

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Bonn has supported these special economic mechanisms more for political than commercial reasons, and has done so for most of this period without wresting major political concessions from East Berlin. All West German governments have felt responsibility for the well-being of the East German people, and most have justified a special relationship as keeping alive ties that could lead to eventual reunification.

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We believe that East Germany will continue to be able to derive considerable economic benefit from its special relationship at relatively little cost. We expect Bonn will adhere fundamentally to its accommodating line despite conflicting domestic pressures in West Germany that will impel it to seek more tangible political concessions for future assistance:

- Tourism, fees, and long-term agreements on services should provide East Berlin at least DM 2 billion annually over the next few years.
- The extensions of the loan guarantees serve as a precedent for Bonn providing special assistance on short notice.

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Although not economically dependent on the West German connection in any absolute sense, we believe East Germany will continue to regard the special relationship as vital to addressing its significant economic problems:

- East Germany's financial position, although improved significantly, remains vulnerable: its factories need modernization, and it must become more efficient in its use of oil and raw materials that Moscow is reluctant to continue providing on concessionary terms.

East Germany's dealings with West Germany will be constrained, however, by the Soviet leash and its own fears of becoming too dependent on its neighbor.

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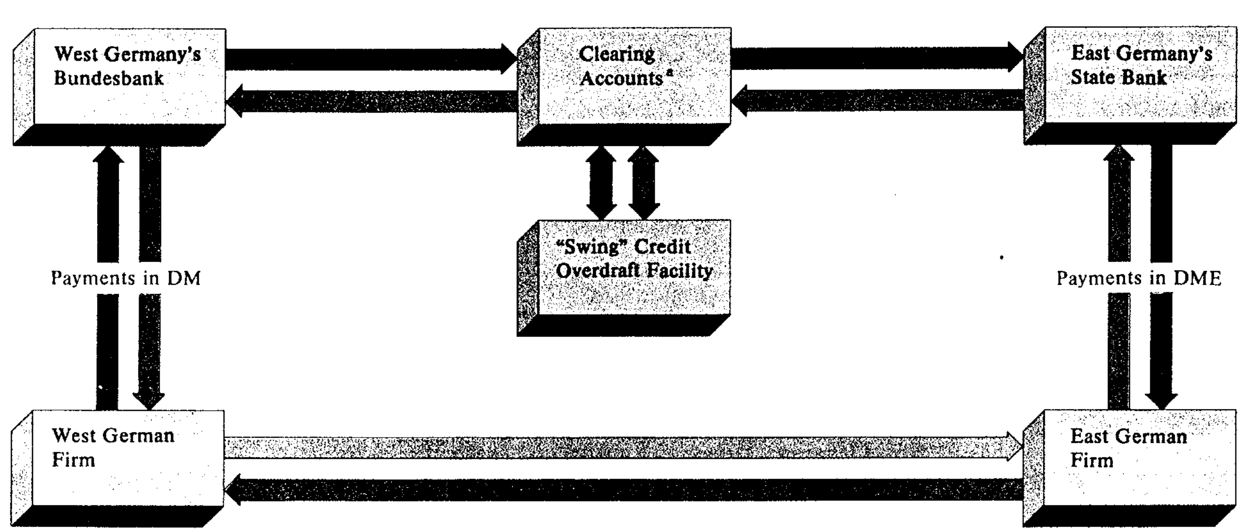
Figure 1
Intra-German Trade: Goods and Payments Flow



This diagram represents a conceptualization of intra-German trade. In a typical transaction, an East German exporter delivers goods to a West German firm and is paid in East German marks (DME) by the East German State Bank. The FRG firm pays for the goods by delivery of West German marks (DM) to the Bundesbank. The two central banks settle the transactions in accounting units (VE) through the clearing account. In the case of an East German purchase, the payments flows are reversed.

[a] All clearing account flows are in Verrechnungseinheit (VE).

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East Germany's Economic Links to West Germany

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Ties between the two Germanys have long included a special economic relationship that has provided East Germany substantial support, especially since the early 1970s. This paper attempts to analyze the various aspects of that special relationship—trade, credits, service transactions, payments for emigration, and transfers—and to assess the economic advantages East Germany has derived and the prospects for future benefits. The paper also provides a description of the legal and institutional framework governing trade and financial links between the two countries. The conclusions must remain tentative in some areas, however, because we have only limited information on the inner workings of the economic relationship. Both Bonn and East Berlin cloak many of their dealings in considerable secrecy.

The First Quarter-Century

Despite the severe disruption of economic ties during the late 1940s as a result of the occupation policies of the victorious allies, particularly the Soviets who forced partition, West Germany remained a relatively important trading partner for East Germany. In the early 1950s, West Germany was East Germany's largest nonsocialist partner but lagged Poland, Czechoslovakia, and Hungary as well as the USSR. This pattern reflected, of course, eastern Germany's traditional trade ties with the western part of Germany as well as East Berlin's limited commercial relations with other Western countries and its heavy dependence on trade with the USSR and its new East European allies.[1]

Despite political tensions during the 1950s, both sides sought improved commercial relations. Although the Adenauer government refused to recognize East Germany as a separate country (and threatened to break relations with any country that did), it favored an expansion of commercial links. Moreover, West German business and labor wanted to boost exports as a way of fostering growth. For its part, East Germany needed capital equipment and spare parts unavailable in the East. Such motivations contributed to the conclusion in 1951 of the Inter-Zonal Trade Agreement (IZT), which established rules for bilateral commerce and facilitated trade during a period when the two countries' currencies were inconvertible and both countries were short of hard currency (see inset, "The Intra-German Trade and Finance Mechanism" and figure 1). The IZT established a clearing account mechanism and included a "swing" credit overdraft facility to cover short-term trade imbalances. These arrangements reduced the need for East German firms to obtain bank financing for their trade with West Germany. The 1957 Treaty of Rome, which established the European Economic Community, explicitly protected the intra-German trade relationship by accepting Bonn's claim that this trade is "domestic" and by exempting East German exports to West Germany, but not to other members, from tariffs.

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By 1960 the value of West Germany's share in East Germany's overall trade had increased from less than 5 percent to about 11 percent, or to over 45 percent of East Germany's trade with the nonsocialist world.[2] The volume of trade continued to rise in the 1960s despite the Berlin Wall crisis and continuing East-West tensions (see figure 2). In the 1960s West German businessmen, becoming convinced that bilateral tensions were costing them contracts, increasingly pushed for an easing of trade restrictions. The West German Government itself came to show greater interest in improving relations with East Germany, particularly after the Social Democrats became part of the ruling "Grand Coalition" in December 1966. Government steps to help stimulate trade included a

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[1] By contrast, the FRG's greater size, more rapid growth, and marked reorientation toward the West consistently have made bilateral trade with East Germany comparatively less important to it. In terms of trade volume, the GDR is about as important to the FRG as Denmark.

[2] See appendix A for a description of the data sources and problems associated with the analysis of intra-German economic relations.

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The Intra-German Trade and Finance Mechanism

Reflecting the unusual intra-German political relationship, the two Germanys have established special mechanisms to handle bilateral trade. The legal basis of intra-German trade continues to be the September 1951 Interzonal Trade Agreement, or Berlin Agreement, that was established to facilitate trade between the two Germanys. Modified several times, the Agreement requires that:

- *Trade must eventually be balanced, although no payment schedule is stipulated.*
- *Trade is conducted in a special accounting unit, the* Verrechnungseinheit *(VE), which for practical purposes is equal to the West German mark (DM) but which cannot be converted into DM.*
- *Payments are made through clearing accounts of the note-issuing banks of each country. The banks currently operate three accounts—two for commodities and one for services.*
- *To maintain the flow of goods, each side is allowed to overdraw its clearing accounts up to a specified limit—the "swing" credit. Originally, any overdraft had to be settled once each year. The FRG waived its right to this requirement in 1968, and the swing subsequently has been, in effect, a permanent West German interest-free credit to East Germany.*
- *A special "Account S" established in 1958 allows payment for goods and services in hard currency. East Germany has used the account rarely in recent years to make payments. East Berlin, however, has sought to have some of its receipts funneled through Account S, while generally using the clearing account to run up its debt to the FRG.* 25X1

Medium- and long-term financing of West German capital goods exported to the GDR is handled by a special organization, the Gesellschaft zur Finanzierung von Industrieanlagen MbH (GeFi). Although under the administrative control of the corporation that finances East-West trade (Ausfuhrkredit-Gesellschaft MbH, AKA), the GeFi is a legally independent institution. Similarly, West German export insurance is provided by the Deutsche Revisions und Treuhand, A.G. (Treuarbeit) instead of Hermes-Kreditversicherungs A.G. (Hermes), a private company which acts as agent for the FRG Government in providing credit insurance for exports to other countries. In contrast, East Berlin handles intra-German trade through its regular foreign trade institutions because it considers such transactions to be foreign commerce 25X1

gradual simplification of commercial regulations, relaxation of some quotas, and cuts in tax rates. After months of negotiation, interrupted only briefly by the Warsaw Pact invasion of Czechoslovakia, the two sides signed a new trade agreement in December 1968. The agreement raised trade quotas and increased the level of the "swing" credit, and the West German Government waived its right to demand annual balancing of merchandise trade payments. 25X1

New Ties

The economic relationship expanded further with the normalizing of political relations in the early 1970s. The new government of Chancellor Brandt sought improved relations with the GDR in order to increase contacts between residents of the two countries, to improve links between the FRG and West Berlin, and to keep alive hopes for eventual German reunification. West Germany also offered to conduct relations on a more equal basis (implying the abandonment of its longstanding claim to being the only legitimate German state) and held out the prospect of increased economic benefits. 25X1 25X1

East Berlin eventually responded to Bonn's overtures, but only after some prodding from Moscow and the replacement of hardline party leader Walter Ulbricht by Erich Honecker.[3] The Honecker regime probably saw Bonn's offer of "equality" as a way to boost its

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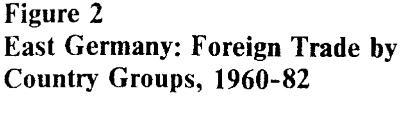
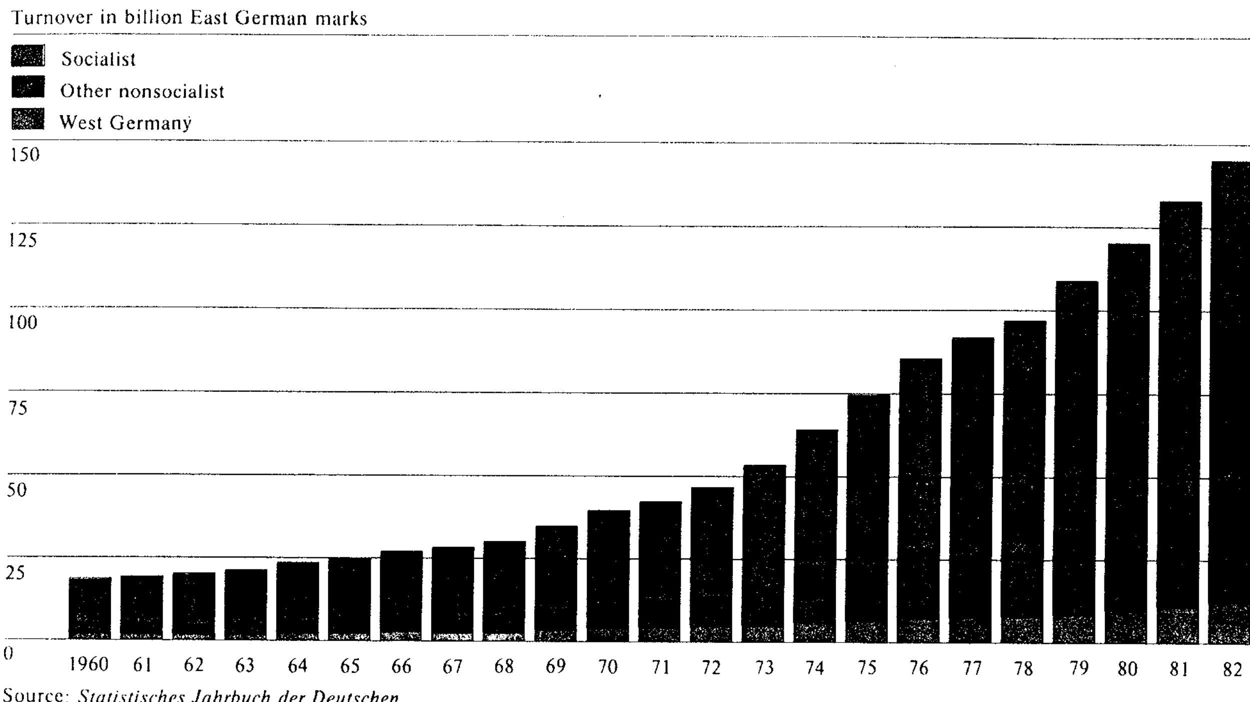


Figure 2
East Germany: Foreign Trade by Country Groups, 1960-82



Source: *Statistisches Jahrbuch der Deutschen Demokratischen Republik* (various years)

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legitimacy and international standing. While remaining wary of close economic ties because of fear that they would lead to an undesirable dependence on its rival and raise concern in Moscow, the Honecker regime also undoubtedly tried to exploit the advantages of economic cooperation—particularly in view of its ambitious plans for the 1970s.

The economic consequences of this new special relationship—especially after conclusion of the "Basic Treaty" in 1972—have been a steady increase in bilateral trade, chronic East German trade deficits (financed largely by readily available West German trade credits), and significant hard currency earnings for East Berlin from invisible transactions and direct payments by Bonn. West German Government estimates of the balance of payments between East and West Germany indicate that the relationship has yielded a net flow of resources to East Germany totaling some 12.4 billion West German marks (DM) over the period 1976 to 1982.[4] 25X1

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[3] East German Premier Stoph met Chancellor Brandt twice in 1970, but relations remained relatively cool until 1971, when Erich Honecker replaced Ulbricht and the four occupying powers signed the Quadripartite Agreement clearing up longstanding East-West differences over Berlin. Subsequently, the two sides signed major new agreements in 1971 and 1972 that opened the way for much expanded bilateral contacts. The "normalization" of bilateral political relations—through the conclusion in December 1972 of the "Basic Treaty on Relations Between the Federal Republic of Germany and the German Democratic Republic"—established the basis for all future intra-German dealings.

[4] In this paper we generally use West German Deutsche Marks (DM) because West German trade and financial data are our best source of information and valuation in DM provides a better indication of real resource transfers during a period of considerable fluctuation in the dollar-DM exchange rate. The estimated net gain to East Germany of DM 12.4 billion would equal nearly $6 billion converted at the average annual exchange rates prevailing in the period 1976-82. See appendix B for data on exchange rates. 25X1

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East Germany's Commercial Advantages in West Germany

Although subject to licensing and some restrictions, East German goods enjoy special access to West German markets. The intra-German trade clearing mechanism—unique in East Germany's trade with developed Western countries—reduces the need for arranging commercial bank credits, a major advantage in times of tight credit. The clearing mechanism also eliminates the risk of exchange rate fluctuation, a problem when East Germany trades with third countries in dollar-denominated deals.

East German manufactured goods are not subject to West German tariffs. The GDR thus escapes duties which the EC estimates will average 7 percent when the current (Tokyo) round of tariff cuts is completed. Moreover, Bonn does not impose a value-added tax (currently 14 percent) on East German manufactures even though they are classified as "domestic" goods, thus giving West German importers special incentive to buy East German products. Bonn also exempts East German services and agricultural goods from other domestic taxes. On the other hand, Bonn charges a tax on sales to the GDR even though it does not tax "exports." West German officials have argued publicly that the purpose of the tax was to help reduce East Germany's chronic trade deficits.

The actual benefit to the GDR of such policies is difficult to calculate because the savings are shared by both purchasing and selling firms. West German consumers also benefit from lower prices. One West German critic of the special relationship nevertheless estimates, probably excessively, that in 1980 the FRG government lost DM 1 billion from the duty exemption, DM 100 million from the farm product exemption, and DM 300 million from the lack of VAT.

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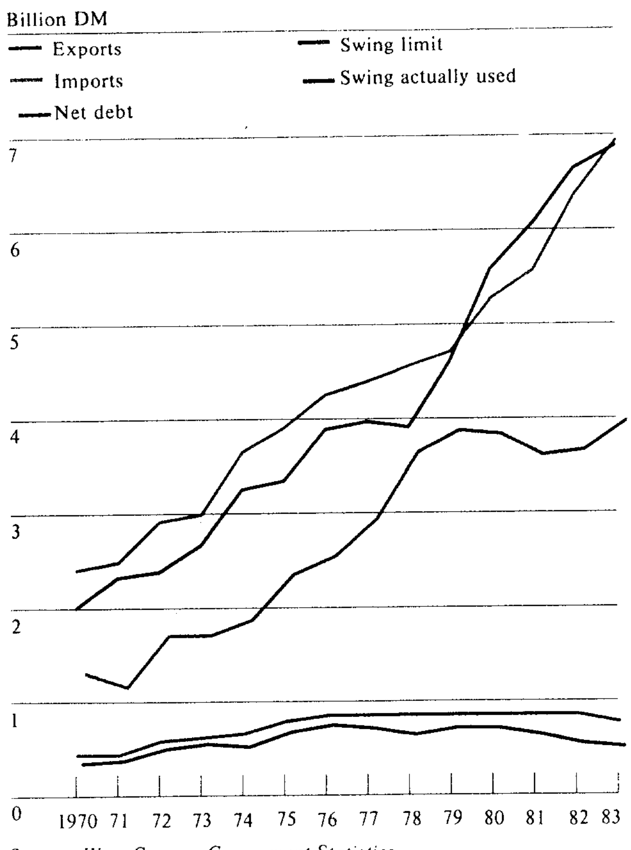
Figure 3
East Germany: Trade and Debt With West Germany, 1970-83



Source: *West German Government Statistics*

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Intra-German Trade. Developments in bilateral trade since the early 1970s have been shaped by the two countries' competing political objectives, their desire to exploit the commercial opportunities offered by mutually advantageous trade, and the unique institutional arrangements that govern their trade. East Germany used its commercial ties and special financial arrangements with West Germany to boost imports, particularly of capital goods, chemicals, and nonferrous metals; to support its ambitious targets for economic growth; and to sustain increases in personal consumption. Despite its preferential access to West German markets (see inset, "East Germany's Commercial Advantages in West Germany"), the growth of East German exports—while impressive in some years—did not keep pace with imports, in part because of the low quality of goods being offered. As a

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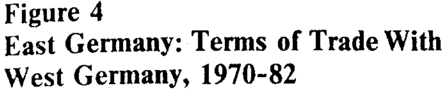
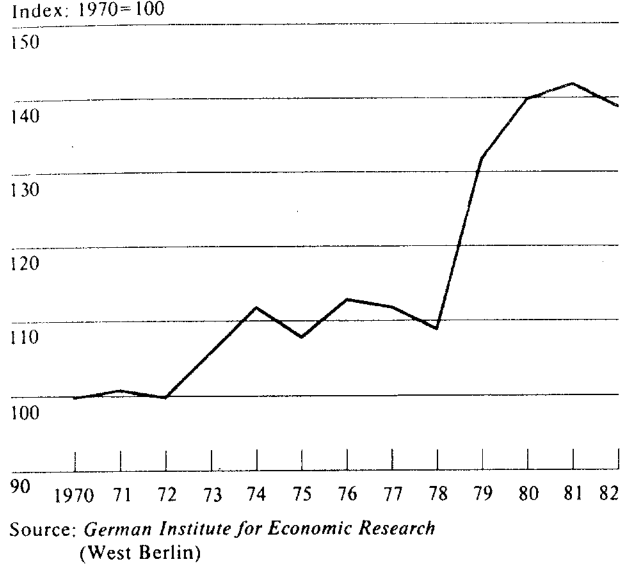


Figure 4
East Germany: Terms of Trade With West Germany, 1970-82



Source: *German Institute for Economic Research* (West Berlin)

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result, in the decade ending in 1979, East Germany annually ran deficits in its trade with West Germany—averaging about DM 400 million per annum (see figure 3 and appendix C).[5] East Germany returned to surplus in 1980-82, before the onset of its financial crisis, as the regime pushed exports harder and controlled imports better.

Despite the advantages of bilateral trade, we believe that the Honecker regime kept the size of these deficits under some control because neither it nor the Soviets wanted East Germany to become excessively dependent on West Germany. Another factor helping to moderate the size of bilateral trade deficits was the improvement in East Germany's terms of trade with West Germany (see figure 4). Scholars at the German Institute for Economic Research (DIW) estimate that East Germany's terms of trade improved by nearly 39 percentage points between 1970 and 1982, with particularly large gains in 1973-74 and 1979-80—years of large oil price hikes. Their price series indicate that East Germany's worsening terms of trade in capital goods and farm products was more than offset by improvements in manufactured goods and, particularly, raw materials related to oil.

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The composition of intra-German trade has been similar to West Germany's trade with other East European countries. West Germany has continued to export technically advanced goods, according to West German statistics, while in recent years about three-fourths of its imports from East Germany consisted of raw materials, semifinished goods, and consumer products. The share of investment items in East German sales fell in the early 1970s and in recent years has languished at about 10 percent (see figure 5 and appendix D).

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The East Germans have had little success in selling high-technology goods to the West and, in the manufactures field, have concentrated on relatively simple machinery and consumer goods. Moreover, in the view of knowledgeable Western observers, the East Germans have consistently exported rather poor-quality goods and have suffered from marketing and service problems. In addition to oil products, East Germany exports large quantities of intermediate goods—such as steel and chemicals—which it can price competitively and which face less stringent quality standards. Knowledgeable West German commentators and government officials regularly have expressed dissatisfaction with the composition of bilateral trade and have pointed to the low technological level of East German goods as a major impediment to the further growth of intra-German commerce.

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[5] East Germany ran the deficits despite significant surpluses in its trade with West Berlin. The GDR sells large quantities of goods to the city; much of the oil products it sells to the FRG go to West Berlin, and East Germany also provides the enclave significant quantities of raw materials. West German statistics show that, in 1982, nearly 31 percent of East German exports to the FRG went to West Berlin, whose population was only about 3 percent of West Germany's.

East Germany's cumulative trade surplus with West Berlin totaled nearly DM 6 billion during the 1970s even as its overall deficit with the FRG during the period was DM 4.1 billion. The surpluses swelled further in 1980-82, reaching 1.72 billion DM in 1982. Without its commerce with West Berlin, East Germany's trade balance with West Germany in 1982 would have shifted from a DM 257-million surplus to a DM 1.46-billion deficit.

Technically, West Berlin and East Berlin do not "belong" to the FRG or GDR. Unless otherwise noted in this paper, however, each country's statistics include "its" part of Berlin.

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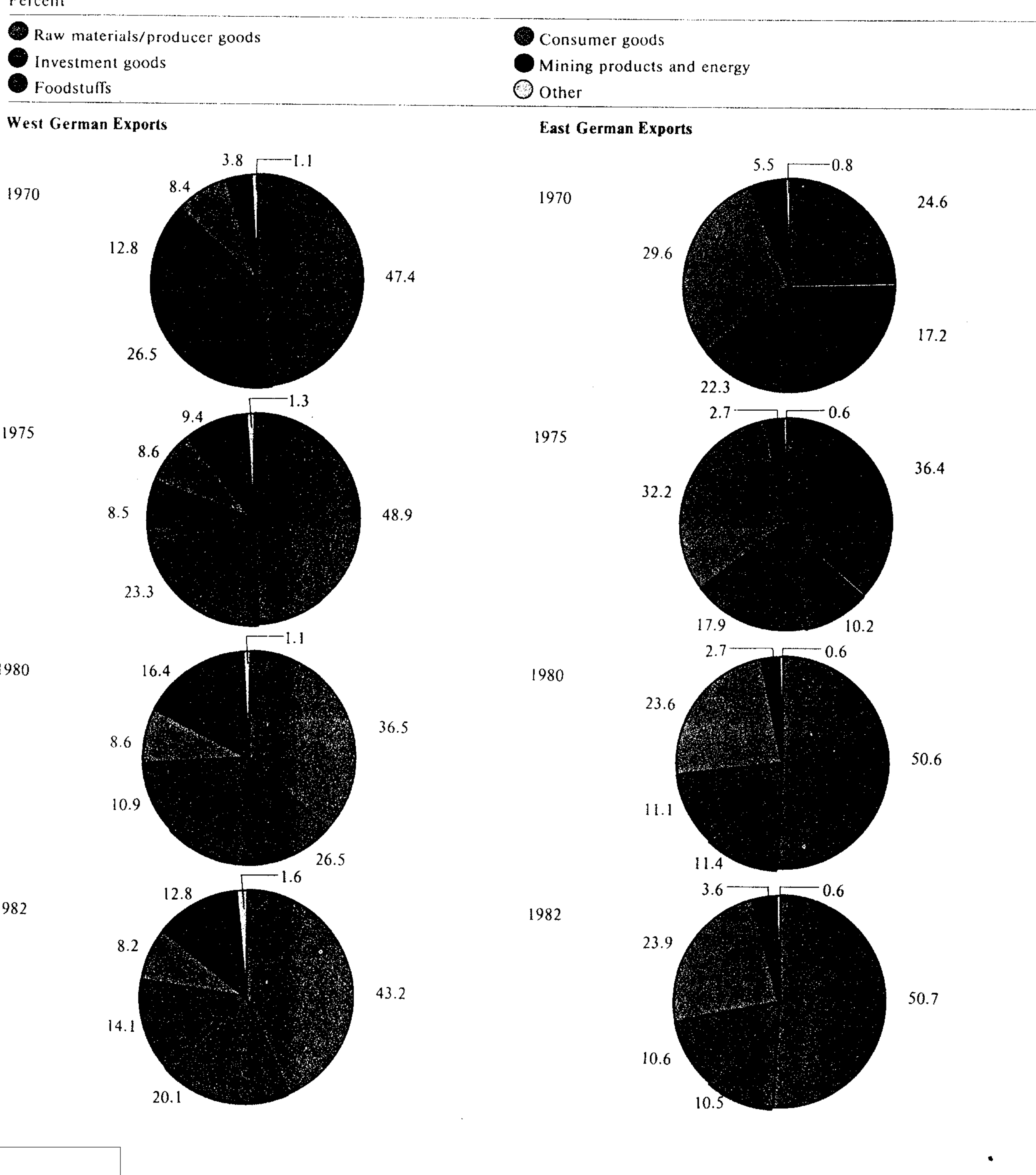
Figure 5
East Germany/West Germany: Composition of Trade, 1970-82



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Window to the West?

The lack of West German tariffs on East German goods provides East Berlin an opportunity to use West Germany as a channel for sending goods to other EC countries. [ ] *the East Germans on occasion have:*

- *Falsely labeled East German products as West German or "German" for duty-free reexport to other EEC countries.*
- *Reassembled or repackaged Eastern Bloc and Asian goods for reexport to the FRG as East German products.*
- *Delivered components for assembly in West Germany as West German goods.*

West Germany periodically has charged businessmen with violations of trade regulations and has obtained-convictions. [ ]

The West German Government estimates, however, that such illegal transactions account for less than 1 percent of bilateral trade. Evidence available to us suggests that East Germany does not pursue an official policy of directing exports to other EC countries through West Germany. [ ]

[ ] *high-level East German directives about developing commerce, especially exports, with selected nonsocialist countries—including EC member France—fail to mention any efforts to route sales through the FRG. In fact, East Berlin repeatedly has sought to negotiate individually with other nonsocialist countries bilateral trade pacts, barter deals, official credits, and loan guarantees on terms that require payment of appropriate duties.* [ ]

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If comparatively easy access to the West German market has skewed the distribution of East Germany's trade with nonsocialist countries, it does not appear to have markedly increased East German trade with Western countries as a group. Neighboring and structurally similar Czechoslovakia, which conducted only 6.2 percent of its trade with West Germany versus East Germany's 8.6 percent in 1982, showed an overall trade with the West that was nearly identical to East Germany's, according to official statistics. Moreover, Hungary and Romania—and Poland before its recent economic troubles—have had higher percentages of overall trade with the West. [ ]

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Accompanying the rise in intra-German trade in the 1970s was an even faster growth of East German trade with other nonsocialist countries and LDCs. A slowdown in the growth of deliveries of Soviet raw materials threatened ambitious East German plans for upgrading domestic consumption and led East Germany to turn increasingly to nontraditional partners such as the United States and the LDCs to cover its import needs. The boom in East-West trade and the increased availability of Western credits in the early 1970s created opportunities for East Germany to increase trade with other Western countries. And, as hard currency deficits soared, East Germany tried to boost exports to these markets, sometimes using its special West German "window" (see inset, "Window to the West?"). As a result, although West Germany has remained East Germany's second-largest trading partner, East German statistics show the FRG's share of GDR trade with nonsocialist countries fell from about 36 percent in 1970 to less than 25 percent in 1981 before rising slightly in 1982 (see figure 2).[6] [ ]

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[6] Western partner country trade data, however, show a greater West German role in East Germany's trade with nonsocialist countries when calculated in hard currency terms. IMF, OECD, and West German data indicate that West Germany accounted for about 40 percent of such trade in the 1970s, ranging from as much as 46.0 percent in 1971 to as low as 37.7 percent in 1974. We believe that the discrepancy between the two series reflects valuation differences due to use of exchange rates that often do not correspond to current market rates, possibly differing concepts of attributing origins of foreign trade, and lack of accurate reporting by some LDCs. Western countries' data attribute commerce to the country of purchase or sale, while the East Germans reportedly source trade with Western firms to the country of each firm's parent organization—sometimes multinational corporations based in third countries. Such practices probably also help account for significantly different Western and GDR figures on East Germany's trade with Austria. East Berlin's presumably consistent method of calculating GDR trade worldwide makes its figures useful for comparing East Germany's trade by region of origin even though they may understate West Germany's role in economic relations with the West somewhat. [ ]

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Importance of The "Swing"

East Germany has long used the interest free "swing" credit extended by Bonn to finance its purchases from West Germany even when it ran trade surpluses. Created as part of the Frankfurt Agreement of 1949, the swing facility was raised in stages from DM 16 million in 1949 to DM 30 million in 1951 and to DM 200 million in 1960. In the period 1969-75, the swing was set at 25 percent of the previous year's bilateral trade before being raised to a flat DM 850 million in 1976. An impasse in late 1981 over terms for renewing the swing agreement—including West German efforts to link renewal of the swing to an East German reduction in the Zwangsumtausch *(the minimum daily currency exchange requirement imposed on Western visitors to East Germany)—prompted the two sides to extend the swing on existing terms for 6 months. They eventually agreed in June 1982 to cut back the swing gradually from DM 850 million to DM 600 million by 1985. At current interest rates and utilization levels, the swing represents a savings to East Berlin of about DM 30-50 million annually—the amount East Berlin would have to pay to secure the same credit from commercial sources.* [ ]

As intra-German trade has grown, the swing has become a relatively less important means of financing trade. [ ] [ ] *the value of the swing fell from 30 percent of overall trade in 1976 to 16 percent in 1982. Because trade is likely to grow and the credit limit is to fall through 1985, the swing will become an even less important instrument of bilateral trade.* [ ]

Financial Links. East Germany financed most of its trade deficits with West Germany during the 1970s by borrowing from FRG institutions and using the "swing credit," even though it was running large bilateral current account surpluses (see inset, "Importance of the 'Swing'"). In the years 1976-80, for example, movements in intra-German debt closely mirrored trends in the trade balance, with cumulative East German trade deficits totaling DM 1.3 billion compared with net capital inflows of DM 1.6 billion (see table 1). The positive services balance deriving from the "special relationship" had limited impact on the level of debt to West Germany because most of the earnings represented convertible currency receipts that East Berlin opted to spend outside the bilateral relationship. East Berlin's policy clearly has been to exploit the intra-German bilateral trade and financial mechanisms in order to maximize the financial resources available to cover hard currency purchases from other countries. [ ] 25X1

Debt held by West German commercial and government sources roughly tripled during the decade before tapering off slightly in 1980-82 (see figure 3). We calculate that during the 1970s financing from West German domestic sources covered 62 percent of East Germany's accumulated deficit on bilateral trade, while credits from subsidiaries of West German banks in other countries may have provided an additional 10 percent.[7] Nonconvertible services ties and some convertible earnings payments through the so-called S hard currency account covered much of the rest. Much of this lending was extended by the West German Government. Official West German figures show that in 1982 government credits and guaranteed commercial loans comprised about 60 percent of the DM 4.6 billion in debt held by domestic West German sources—similar to the government's share in financing exports to other East European countries.[8] 25X1

[ ] 25X1

We estimate that in 1982 West German institutions held only about 15 percent of East Berlin's hard currency debt, although West Germany accounted for about 25 percent of East Germany's trade with all nonsocialist countries.[9] The relatively low West German share of East German debt in part reflects the 25X1 25X1 25X1

[7] One West German banker claims FRG banks use offshore subsidiaries to raise most of the credits not covered by Bonn's loan guarantees and estimates that this is about 10 percent of all West German loans. (C NF)

[8] The DM 4.6-billion debt total reported for yearend 1982 is gross debt and does not take into account East Germany's claims on West Germany. Net debt, which subtracts from gross debt the amount of East German deposits in West German banks and East German trade credits extended to West German firms, stood at DM 3.7 billion at yearend 1982. [ ] 25X1

[9] West Germany's actual share of East German debt almost certainly is somewhat higher. Although we believe we have captured most West German credits, we have probably not included all. [ ] for example, that some short-term supplier credits are not even reported to the West German Government. [ ] 25X1 25X1

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Table 1
East Germany: Balance of Payments With West Germany

Million current West German marks

	1976	1977	1978	1979	1980	1981	1982
Current account balance	728 [d]	852 [d]	665 [d]	1,858 [c]	2,082 [c]	2,527 [c]	2,291 [c]
Trade Balance	−392 [a]	−448 [a]	−675 [a]	−144 [c]	321 [c]	577 [c]	356 [c]
Exports (gross)	3,877 [a]	3,961 [a]	3,900 [a]	4,589 [a]	5,580 [a]	6,051 [a]	6,639 [a]
Deductions [b]				233 [c]	207 [c]	233 [c]	227 [c]
Net				4,356 [c]	5,373 [c]	5,818 [c]	6,412 [c]
Imports (gross)	4,269 [a]	4,409 [a]	4,575 [a]	4,720 [a]	5,293 [a]	5,575 [a]	6,382 [a]
Deductions [b]				220 [c]	241 [c]	334 [c]	326 [c]
Net				4,500 [c]	5,052 [c]	5,241 [c]	6,056 [c]
Services (net)	500 [d]	580 [d]	600 [d]	1,245 [c]	902 [c]	1,091 [c]	1,104 [c]
Transfers (net)	620 [d]	720 [d]	740 [d]	741 [b]	859 [c]	859 [c]	831 [c]
Balance on capital account	190 [d]	390 [d]	710 [d]	186 [c]	88 [c]	−297 [c]	117 [c]
Swing credit	−75 [a]	71 [a]	−71 [a]	3 [c]	16 [c]	−231 [c]	−92 [c]
"S" account [e]				−5 [c]	−25 [c]	−21 [c]	21 [c]
Tied financial credits				139 [c]	−53 [c]	−81 [c]	65 [c]
Trade credits				83 [c]	15 [c]	66 [c]	211 [c]
Free DM accounts [e]				−34 [c]	135 [c]	−30 [c]	−88 [c]
Balance on capital and current accounts	918 [d]	1,242 [d]	1,375 [d]	2,036 [c]	2,170 [c]	2,230 [c]	2,408 [c]

[a] Public information.
[b] The West German Government internally deducts transactions with third countries and certain payments from its publicly announced import and export figures.
[c] 1983 Bundesbank study.
[d] CIA estimate.
[e] Signifies known payment in DM (hard currency).

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smaller trade deficit accumulated with West Germany in the 1970s compared with deficits with the rest of the West, as well as West German regulations that prohibit domestic banks from extending untied loans to East Germany or financing GDR trade with other countries.[10]

[10] Overseas subsidiaries of West German banks apparently have heeded this restriction; West German banks did not participate in large syndicated Eurocurrency loans to East Germany in the 1970s. In 1983, Bonn made an exception to the rules, allowing the overseas banks to underwrite a large untied loan guaranteed by the West German Government.

Despite the comparatively small amount of West German lending, creditors' faith in a West German umbrella helped East Germany to obtain large credits from non-German bankers. Many Western bankers regarded Bonn as the unwritten guarantor of East German debt and pointed to the special intra-German economic ties to justify extending credits to East Germany even after financial prudence might have dictated greater caution. This banker largesse allowed

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Table 2
East Germany: Net Service Transactions and Transfers From West Germany

Million current West German marks

	1976	1977	1978	1979	1980	1981	1982
Total	**1,120** [a]	**1,300** [a]	**1,340** [a]	**1,986** [b]	**1,761** [b]	**1,950** [b]	**1,935** [b]
Services	500 [c]	580 [c]	600 [c]	1,245 [b]	902 [b]	1,091 [b]	1,104 [b]
Lump-sum transit payments [d]	400 [a]	400 [a]	400 [a]	400 [a]	525 [e]	525 [e]	525 [e]
Transportation improvements [f]	46 [a]	99 [a]	79 [a]	566 [a]	450 [c]	350 [c]	200 [c]
Entry fees for Berliners	24 [a]	18 [a]	24 [a]	18 [a]	50 [b]	50 [b]	50 [b]
Post and telegraph [g]	10 [a h]	10 [a]	11 [a h]	11 [a h]	85 [e i]	85 [e i]	85 [e i]
Sewage removal	11 [a]	11 [a]	10 [a]	11 [a b]	22 [b]	25 [b]	25 [b]
Road use tolls	20 [a]	35 [a]	30 [a]				
East German tourism [d]	−23 [a]	−23 [a]	−25 [a]	−25 [a]	−75 [b]	−130 [b]	−140 [b]
Interest [j]				−79 [b]	−96 [b]	−121 [b]	−361 [b]
Transportation [j]				104 [b]	80 [b]	97 [b]	125 [b]
Other (net)	12 [c]	30 [c]	71 [c]	239 [c]	−139 [c]	210 [c]	595 [c]
Transfers	620 [c]	720 [c]	740 [c]	741 [b]	859 [b]	859 [b]	831 [b]
Minimum currency conversion [d]	230 [a]	230 [a]	250 [a]	250 [a]	250 [b]	300 [c]	350 [b]
Intershop purchases [d]	650 [a]	750 [a]	750 [a]	750 [a]	750 [c]	750 [c]	750 [c]
Genex (gift shops)	131 [a]	139 [a]	145 [a]	181 [a b]	187 [b]	180 [b]	192 [b]
Visa payments (private) [d]				62 [b]	62 [b]	52 [b]	47 [b]
Payments to West German Communist Party	−50 [a]	−50 [a]	−50 [a]	−50 [a]	−50 [c]	50 [c]	−50 [c]
Other (net)[k]	−341 [c]	−349 [c]	−355 [c]	−452 [c]	−340 [c]	−473 [c]	−458 [c]

[a] 1979 Bundesbank study.
[b] 1983 Bundesbank study.
[c] CIA estimate.
[d] Signifies known payment in DM (hard currency).
[e] Public information.
[f] Signifies at least some payment in hard currency.
[g] Signifies known payment in VE (clearing account).
[h] Net.
[i] Gross.
[j] Data covering those conventional invisibles accounts (as opposed to "special services" are not available for period before 1979).
[k] This entry reportedly does not include West German humanitarian payments to East Germany, such as prisoner "ransoms" and payments for legal emigrants. We are uncertain about where the FRG Government accounts for such monies.

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East Germany to diversify its sources of imports by running chronic trade and current account deficits with other Western countries. The result was a buildup in the estimated net hard currency debt to a peak of $12.3 billion by yearend 1981. And, East Germany's debt service ratio rose from 13 percent in 1970 to 59 percent in 1982—the second highest in Eastern Europe (see appendix F). Despite this heavy debt burden and the slowdown in Western bank lending to Eastern Europe in 1981-82, unconfirmed rumors that Bonn was providing direct financial aid helped maintain some banker confidence in East Germany's creditworthiness.

Special Earnings and Other Invisibles. Since the early 1970s, there has been a fairly steady increase in East Germany's hard currency earnings from the provision of special services to West Berlin and West Germany.[11] East German revenues from these nontrade sources increased after 1978 in particular, when the two sides signed a major package of agreements (worth over DM 7 billion through 1989) that provided for major construction projects and an increase in fees

[11] For a detailed explanation of the different types of special earnings, see appendix E.

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The 1980 Exchange Requirement Increase

In October 1980 the Honecker regime suddenly increased to DM 25 the amount of money each West German and other Western visitor must exchange daily for East German currency—the Zwangsumtausch*—and eliminated exemptions for children and pensioners. Previously, West Berliners were required to convert DM 6.50 while residents of the FRG had to exchange DM 13. The move created a crisis in intra-German relations. The regime argued publicly that the increase was needed to compensate for rising costs of subsidized goods and services provided visitors. But the timing of the hike—immediately after the rise of Solidarity in Poland—suggested that the main reason was to reduce the number of visitors from West Germany.* [ ]

The increase provided East Berlin a financial windfall. We believe that revenues remained constant in 1980, despite a drop in visitors, and then soared as the number of visitors returned to more normal levels. The US Embassy in East Berlin calculated that in 1980-81 a decline in revenues from visits of West Berliners—many of whom make casual day trips—was more than offset by increased revenue from visitors from the Federal Republic, many of whom take longer trips. A report by the West Berlin Senat *said that visits by West Berliners to the GDR and East Berlin increased by 300,000 in 1982 over 1981. The total number of visits of 1.82 million remained significantly below the pre-1980 level of about 3 million, but the higher exchange requirement generated increased revenues. Despite some uncertainty about the length of visits, we estimate that East Berlin now earns about DM 350 million annually.* [ ] 25X1

The Zwangsumtausch *is a continuing source of intra-German friction, but East Berlin has shown little inclination to reduce the requirement greatly. The Kohl government made clear that it expected some action in the "humanitarian" area in response to its guarantee of the 5-year DM 1-billion loan from West German banks in July 1983. Last September East Berlin eliminated the exchange requirement for children under 14. Rather than rescind a lucrative source of hard currency earnings, the regime, in our view, is more likely to allow more East Germans to visit West Germany—possibly by reducing the age at which East Germans may travel relatively easily to the FRG—or roll back the exchange requirement for certain groups such as pensioners.* [ ]

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for the use of East German transportation facilities connecting West Berlin with West Germany (see appendix E). The flow of West German visitors to East Germany has been the most important source of earnings, totaling more than DM 1 billion annually throughout the period. Although *Intershop* purchases have remained fairly constant, East German hard currency earnings from currency conversion requirements imposed on Western visitors have increased appreciably in recent years (see table 2 and inset, "The 1980 Exchange Requirement Increase"). [ ] [ ]

With these special agreements, East Germany thus has exploited the accident of history that created the "island" of West Berlin, has taken advantage of Bonn's efforts to keep the door open for reunification by expanding ties between the two Germanys, and has exploited such "humanitarian" concerns as the desire of West Germans to remain in contact with family and friends in the East.[12] East Berlin has allowed increased contacts despite its concern that these would undermine its control of the populace and thwart its efforts to create a separate East German national identity. These special earnings have accounted for all of the rise in East Germany's invisibles surplus with West Germany, from DM 1.1 billion in 1976 to DM 1.9 billion in 1982 (see table 1), and have been the key factor in the tripling of the bilateral current account surplus during this period. On conventional services transactions, such as transportation and interest payments, East Germany has been running an overall deficit in recent years. [ ]

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[12] For West Germany, "humanitarian" issues refer to a variety of East German policies that separate the German people and limit the freedom of East Germans. These include restrictions on FRG residents' travel to the GDR and East German controls on emigration and on travel by East German residents to the FRG. The humanitarian issues are especially important to Bonn because it maintains that East Germans, as German nationals, hold West German citizenship. [ ]

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Table 3
East Germany: Total Hard Currency Balance of Payments and Debt

Million US $

Year	Net Invisibles Excluding Interest	Net Interest	Trade Balance	Current Account Balance	Net Debt [a]
1970	56	−50	−299	−293	1,007
1971	132	−61	−268	−197	1,205
1972	175	−75	−483	−383	1,229
1973	220	−135	−774	−689	1,876
1974	260	−211	−1,068	−1,019	2,592
1975	250	−192	−1,125	−1,067	3,548
1976	450	−305	−1,591	−1,446	5,309
1977	550	−376	−1,510	−1,336	6,159
1978	650	−607	−1,137	−1,094	7,548
1979	800	−848	−1,810	−1,858	9,776
1980	900	−910	−1,590	−1,600	11,592
1981	985	−1,534	60	−489	12,267
1982	950	−1,220	1,509	1,239	10,718
1983 [b]	850	−865	1,324	1,309	9,033

[a] Changes in current account balance do not translate into identical changes in net debt because of occasionally sizable errors and omissions entries.
[b] Preliminary.

Source: CIA estimate based on BIS, OECD, NATO, UN, and West German data.

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Our estimates show that East Berlin's earnings from the relationship with West Germany have more than offset its large net outflow in hard currency interest payments to other Western countries through 1978 and kept its net invisibles payments in only modest deficit through 1980. We compute that earnings from West Germany accounted for essentially all of the East German surplus on hard currency invisibles excluding interest payments, which increased from an estimated $56 million in 1970 to $950 million in 1982 (see table 3 and, for additional detail, appendix F).[13] Therefore, while other East European countries were borrowing increasingly in the late 1970s to cover their debt service requirements, East Germany until 1981 used its borrowings almost exclusively to import real goods and services. Moreover, these earnings helped sustain bankers' confidence that Bonn provided a financial "umbrella" for East Berlin and reinforced their willingness to lend to East Germany, delaying the need for East Berlin to eliminate its chronic trade deficits with the West.

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The West German Cushion in 1982-83

East Germany's special economic ties with West Germany continued to help East Berlin even when debt servicing requirements and increased bankers' anxieties finally forced a major trade adjustment. Beginning in 1982, East Berlin increased its imports from West Germany to help compensate for a forced cutback in imports from other Western countries and in 1983 received a major, untied hard currency loan guaranteed by Bonn. It was able to increase purchases

[13] For example, at their current exchange rates, we estimate that in 1982 invisibles earnings from the FRG (DM 1.9 billion) accounted for about $800 million of East Germany's overall $950 million surplus.

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Figure 6
East Germany: Trade With West Germany, 1982-84

Source: *Warenverker mit der Deutschen Demokratischen Republik und Berlin (Ost),* (various issues)

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from West Germany abruptly by using the intra-German clearing account and taking advantage of readily available West German trade credits. For 1982 as a whole, imports from the FRG grew about 14 percent, according to West German data, while imports from other nonsocialist countries dropped by 30 percent.[14] Such purchases were particularly large during the last quarter of 1982 and the first half of 1983. During this nine-month period, East Germany registered a trade deficit with West Germany of DM 902 million, according to West German statistics (see figure 6).

Evidence of a West German financial umbrella and East Berlin's ability to shift to a hard currency surplus in trade with other Western countries made international bankers more willing to lend again to East Germany by mid-1983. As a result, East Germany then cut imports from West Germany, boosted exports, and for 1983 as a whole managed to register a modest DM 69-million trade deficit with the FRG.[15] East Berlin had increased trade-related borrowings from West Germany by about DM 700 million between mid-1982 and mid-1983. It reduced this debt by about DM 500 million in late 1983 when lending from other sources began to revive, cutting net debt to DM 4.0 billion at yearend, according to the West German Government. 25X1

East Germany was able to redirect trade toward West Germany because of its continued special access to West German markets and the clearing account. West German banks and trading companies financed not only increased sales of West German goods but also deliveries of commodities such as grain that were channeled into intra-German trade from other countries. As a result, the composition of East German purchases from West Germany shifted noticeably in 1982-83 toward increased raw materials and semimanufactured goods and relatively fewer investment goods (see appendix D). 25X1

The East Germans also used the intra-German clearing account to generate hard currency. East Berlin bought some commodities, such as silver, on credit from West Germany and then exported them elsewhere for cash to help improve its financial position. West German officials estimate that such transactions netted $100 million in hard currency for East Germany in 1983 at the cost mainly of a rise in official, clearing account debt to West Germany. 25X1 25X1

Bonn's decision in June 1983 to guarantee an untied DM 1-billion loan from West German bank subsidiaries in Luxembourg gave East Berlin a further financial boost and, helped 25X1

[14] We estimate that, despite the increase in imports from West Germany, shortages caused industrial disruptions and cut GNP growth from about 2 percent in 1981 to almost zero in 1982. For a

[15] OECD data mirror the West German statistics. In the third quarter of 1983, as East Germany's borrowing prospects in the West improved and its imports from the FRG began to fall, purchases from other Western countries rose by about 30 percent compared with year-earlier levels to help reduce its bilateral trade imbalance. As the GDR boosted exports to the FRG in the third quarter of 1983, deliveries to other Western countries fell 3.5 percent. 25X1 25X1 25X1

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restore Western banker confidence in East Germany's creditworthiness.[16] The loan helped ease the threat of a liquidity crisis by covering about 12 percent of East Germany's 1983 financing requirement. It also provided East Germany with less expensive intermediate-term money—1 percent over the London Interbank Offered Rate (LIBOR)—than we believe it had been able to find since 1980. The five-year credit improved the maturity structure of East Germany's debt; between late 1981 and mid-1983, East Germany apparently had been able to arrange only two-year and shorter trade credits from commercial sources.

The drop in Western lending and the expansion of intra-German economic relations left West Germany as the leading source of hard currency (or hard currency-equivalent) resources for East Germany—in contrast to the situation in the 1970s—(see figure 7). Current account earnings in intra-German transactions continued to grow while receipts from other Western partners fell. More important, the East Germans suffered a nearly DM 4-billion outflow on the capital account to other Western countries in 1982 and another DM 2.7 billion in 1983. The "jumbo" loan made by offshore bank subsidiaries and increased trade financing raised East Germany's debt to West German–controlled institutions by an estimated DM 1.2 billion in 1983. By buying on clearing account from West Germany, the East Germans were able to direct hard currency export receipts and West German invisibles payments toward paying off debt owed to other Western banks. The East Germans, in effect, paid off creditors outside West Germany through borrowings from West German–controlled institutions.

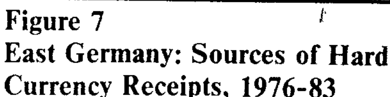
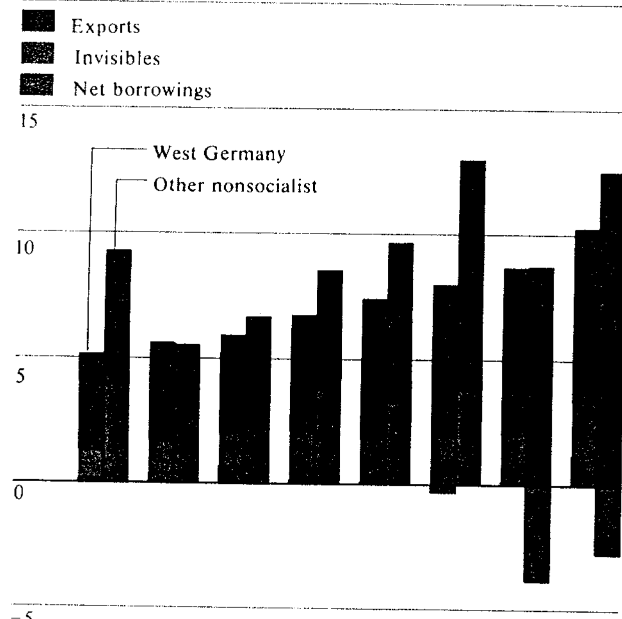


Figure 7
East Germany: Sources of Hard Currency Receipts, 1976-83



This figure represents sources of hard currency available for either financing imports or servicing debt.

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[16] The guarantee—secured by Bonn's ability to withhold regular lump-sum payments to East Berlin in the event of default—was extended without any explicit economic or political conditions. It was granted with the expectation, however, that East Germany eventually would reciprocate by making "humanitarian" concessions such as easing travel barriers. The government was widely criticized for having failed to secure a tangible quid pro quo (see cartoon).

The loan was a surprise and was an apparent reversal of previously stated Christian Democratic Union (CDU) policy that economic benefits should be extended to the GDR only in return for political concessions. Moreover, Chancellor Kohl's Christian Social Union ally Franz Josef Strauss, long a recognized hawk on intra-German relations, publicly claimed major responsibility for arranging the deal. Shortly after the loan was announced, Strauss visited three East European countries and conferred with Honecker in East Berlin; he since has portrayed himself as a leading proponent of better intra-German relations.

Kohl and Strauss appear to have been motivated partly by a desire to prevent economic dislocations in East Germany, which they feared could lead to social instability and cause East Berlin to impose more rigid domestic controls and restrict ties with the West. They also apparently hoped the credit would help insulate intra-German ties from any deterioration in East-West relations after the deployment of US intermediate-range nuclear weapons in the fall of 1983.

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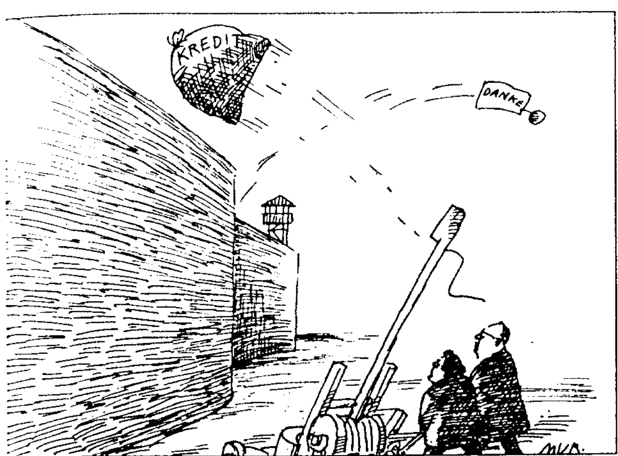

Suddeutsche Zeitung ©

Many West Germans believe that Bonn gets little in return for its payments to East Berlin.

Prospects

Recent history suggests that East Germany will continue to enjoy considerable economic benefits from its special relationship with West Germany, so long as the latter remains willing to assume the costs in order to promote its political goals. The large umbrella that went up in 1982-83 indicates that the West Germans are willing to arrange assistance quickly and waive regulations when the need arises. Moreover, the aid was extended without political strings or explicit concessions from East Berlin, save the hope of "humanitarian" concessions somewhere down the road. In July 1984 the West German Government approved the guarantee of a second jumbo loan of DM 950 million in return for some relatively minor easing of intra-German travel restrictions, including a reduction in the *Zwangsumtausch* for pensioners and increasing the length of visits allowed each year. The loan will help improve East Berlin's financial situation further by extending maturities and reducing interest expenses somewhat. We believe Bonn would step in again should it become concerned about the economic and political stability of East Germany.[17]

[17] Last September, East Berlin announced relaxation of controls on emigration for purpose of marriage and elimination of the *Zwangsumtausch* for children under 14 years old. It also dismantled some of the automatic-firing devices along the GDR-FRG border. The reduced exchange requirement affects only about 5 percent of travel, however, and some West German commentators called the moves an inadequate response to the 1983 loan guarantee.

We expect that the growth of intra-German commerce will moderate as other Western bankers become more willing to extend trade credits. Moreover, to prevent excessive dependence, East Berlin will seek to maintain a reasonable balance in the bilateral trade relationship. In fact, it ran a DM 424-million surplus in the first quarter of 1984, continuing the trend begun in September 1983, and we expect East Berlin will register a surplus for the year. Trade deficits may emerge again for short periods, but East Berlin will seek to control their size and duration. We thus believe that East Germany will reduce the share of its bilateral trade financed with West German Government credits.

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At the same time, we think that East Germany may strike new industrial cooperation agreements with West German firms that bring it new technology and, in the long run, enhance its hard currency export earnings. Although they are traditionally reluctant to enter joint ventures with any Western firms, the East Germans early this year tentatively agreed to produce car engines for Volkswagen beginning in 1988. At the Leipzig Fair in March, the GDR announced a DM 300-million long-term deal calling for West German companies to roll East German slab steel. We believe East Berlin is willing to make more such commitments if the economic price is right and the political cost is low. The regime probably will move deliberately, however, and the predictions of West German businessmen that industrial cooperation will increase substantially seem overoptimistic.

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East German earnings from services, fees, and tourism from West Germany will continue to provide an important economic cushion. According to our estimates, they will total at least DM 2 billion annually. We think East Berlin will have some success in increasing fees and service payments as agreements come up for renewal. Moreover, the apparent eagerness of Bonn and East Berlin to continue economic discussions despite the chill in East-West relations could lead to agreements on new joint projects in the

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areas of water pollution control, rail electrification, and further improvements in the autobahns and border-crossing points. The two sides also could resurrect negotiations on construction of a lignite-fired power plant to serve West Berlin or an electricity transmission line from the FRG to the city.

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Bonn remains committed to securing humanitarian gains and, we believe, could persuade East Berlin to lower the exchange requirement for all visitors by offering a lump-sum annual payment. But, in our view, the East Germans will demand a payment that is higher than their present income from the exchange requirement; they probably would want at least DM 400 million yearly. East Germany may also want to strike a multiyear agreement to facilitate long-term planning. In 1982 the East Germans sought an extension of the swing through 1985 explicitly to facilitate economic planning. Any improvement in bilateral political relations could stimulate more visits by West Germans and increase tourism revenue for East Germany. Moreover, East Berlin could realize additional earnings by again liberalizing its emigration policy and thus exploring Bonn's willingness to pay for the release of East German citizens.

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While considerable benefits accrue to East Germany from its "special relationship" with West Germany, they will not be enough to overcome the effects of other economic problems. East Berlin's debt remains high and some Western bankers remain skeptical of its creditworthiness. East Germany still needs to improve significantly its industrial efficiency and export capabilities. Moreover, continuing difficult relations with its CEMA partners, which account for almost two-thirds of East Germany's total trade, will present the regime with major challenges. These pressures will push East Berlin to continue to exploit its intra-German economic opportunities, but always within the constraints posed by the Soviet leash and by its own fear of becoming too dependent on West Germany.

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Appendix A

Intra-German Economic Data

The reluctance of both East and West Germany to publish complete data and the existence of peculiar institutional arrangements combine with the normal problems of making international financial comparisons to make analysis of intra-German economic transactions unusually difficult.

West Germany's refusal to treat intra-German commerce as foreign trade reflects its contention that the GDR is an integral part of the German nation. Bonn steadfastly refers to its exports (normally *Ausfuhr*) to East Germany as *Lieferungen*, or deliveries, and its imports (normally *Einfuhr*) as *Bezuege*, or purchases. It does not report intra-German trade figures to international organizations such as the United Nations and Organization for Economic Cooperation and Development (OECD) and does not report its banks' loans to East Germany to the Bank for International Settlements (BIS). Instead, its statistical office publishes separate figures on bilateral trade and financial transactions.

East Germany describes its transactions with West Germany as foreign commerce, a reflection of its insistence on being recognized as a sovereign state. It also refuses to include transactions with West Berlin as part of trade with the FRG, asserting that West Berlin is not part of West Germany.

Trade Data
West Germany publishes the better trade data. The Federal Statistical Office in Wiesbaden publishes monthly data broken down by commodity. East Germany, by contrast, reports only a few commodity categories, refuses to specify exports and imports, and publishes instead turnover figures, which are useless for most analytical purposes. East Berlin occasionally releases figures on hard currency trade with all nonsocialist countries, but only, we believe, when it thinks the numbers reflect well on the GDR. On the other hand, we are compelled to use the limited East German data when discussing the FRG's share of total GDR trade; no other source contains information on East German transactions with the entire world.

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Debt and Credit Statistics
East Germany stubbornly refuses to release any debt or reserve figures, maintaining that such data are state secrets. When told by a Western banker recently that bankers needed more information upon which to make lending decisions, Foreign Trade Bank President Polze reportedly replied, "There is only one piece of information that you need: that we will pay the money back."

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West Germany periodically reports net bilateral debt, but only occasionally gross debt. In keeping with its policy of considering intra-German debt "domestic," the Bundesbank—West Germany's central bank—holds its statistics very closely. Bonn itself probably does not know the extent of German-source credits; we believe West German suppliers provide trade credits that they, for their own reasons, do not report to Bonn.

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International Trade and Finance Statistics
The OECD provides the best Western data but they are incomplete. Fifteen to 20 percent of East Germany's trade with nonsocialist countries in recent years has been with LDCs that do not belong to the OECD. BIS statistics also suffer from a lack of completeness. For example, the GDR has borrowed from Arab sources that do not report to the BIS. In addition, West German–controlled institutions mask their lending by operating through third countries such as Luxembourg.

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Special Payments
The two Germanys maintain payment flows that both countries prefer to keep confidential. For example, the West Germans regularly "ransom" political prisoners for up to DM 100,000 or more each. East Berlin does not want publicly to be seen dealing in human trade, while Bonn fears that East German embarrassment over any publicity would halt the releases. We remain uncertain of the exact payments mechanism.

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The Currency Problem
To make matters worse, intra-German economic transactions occur in several currencies and accounting units, some of which are only tenuously related. West Germany reports bilateral trade in West German deutsche marks (DM), but most trade actually is conducted via a special accounting unit, the *Verrechnungseinheit* (VE), which is equal in value to but not convertible into DM. East Germany, in turn, pegs its foreign trademark or Valuta Mark (VM)—an inconvertible accounting unit similar to the USSR's transferable ruble—to the VE. East Berlin ostensibly also pegs its domestic mark (DME) to the VE.

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The DME in recent years has traded on unofficial West German currency markets at about one-fourth the value of the DM. In addition East German statistics on bilateral trade, probably for accounting reasons and a desire to minimize the appearance or dependence on Bonn, show levels of trade that are consistently lower than West German figures by about 10 percent.

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Exchange Rates
Since the deutsche mark/US dollar exchange rate has fluctuated widely in recent years, we use the DM as the currency unit of bilateral transactions in this paper. Use of the dollar or any other currency would distort trends in real resource flows. On the other hand, because OECD and BIS statistics are reported in dollars converted from national currencies at prevailing exchange rates—which similarly would be distorted if reconverted to DM—we use the dollar in our estimates of East Germany's trade and financial transactions with other nonsocialist countries and nonsocialist countries as a whole.

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Appendix B

West Germany: Deutsche Marks per US Dollar

Year	Yearend	Year's Average
1949	4.2	4.2
1950	4.2	4.195
1951	4.2	4.195
1952	4.2	4.195
1953	4.2	4.2
1954	4.2	4.2
1955	4.2	4.2
1956	4.2	4.2
1957	4.2	4.2
1958	4.2	4.2
1959	4.2	4.2
1960	4.2	4.2
1961	4.0	4.0333
1962	4.0	4.0
1963	4.0	4.0
1964	4.0	4.0
1965	4.0	4.0
1966	4.0	4.0
1967	4.0	4.0
1968	4.0	4.0
1969	3.66	3.9433
1970	3.66	3.6600
1971	3.2225	3.4908
1972	3.2225	3.1886
1973	2.6690	2.6726
1974	2.4095	2.5878
1975	2.6223	2.4603
1976	2.3625	2.5180
1977	2.1050	2.3222
1978	1.8280	2.0086
1979	1.7315	1.8329
1980	1.9590	1.8177
1981	2.2548	2.2600
1982	2.3765	2.4266
1983	2.7238	2.5533

Source: *International Financial Statistics*, International Monetary Fund, various years.

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Appendix C

East Germany: Trade With West Germany

Million current West German marks

	Exports		Imports		Balance
	Total	Percent Change Over Previous Year	Total	Percent Change Over Previous Year	
1952	220.3		178.5		
1953	306.9	39.3	271.3	52.0	35.6
1954	449.7	46.5	454.5	67.5	−4.8
1955	587.9	30.7	562.6	23.8	25.3
1956	653.5	11.2	699.2	24.3	−45.7
1957	817.3	25.1	845.9	21.0	−28.6
1958	858.2	5.0	800.4	−5.4	57.8
1959	891.7	3.9	1,078.6	34.8	−186.9
1960	1,122.5	25.9	959.5	−11.0	163.0
1961	940.9	−16.2	872.9	−9.0	68.0
1962	914.4	−2.8	852.7	−2.4	61.7
1963	1,022.3	11.8	859.6	0.8	162.7
1964	1,027.4	0.5	1,151.0	33.9	−123.6
1965	1,260.4	22.7	1,206.1	4.8	54.3
1966	1,345.4	6.7	1,625.3	34.8	−279.9
1967	1,263.9	−6.1	1,483.0	−8.8	−219.1
1968	1,439.5	13.9	1,422.2	−4.1	17.3
1969	1,656.3	15.1	2,271.8	59.7	−615.5
1970	1,996.0	20.5	2,415.5	6.3	−419.5
1971	2,318.7	16.2	2,498.6	3.4	−179.9
1972	2,380.9	2.7	2,927.4	17.2	−546.5
1973	2,659.6	11.7	2,998.5	2.4	−338.9
1974	3,252.5	22.3	3,670.8	22.4	−418.3
1975	3,342.3	2.8	3,921.6	6.8	−579.3
1976	3,876.7	16.0	4,268.7	8.9	−392.0
1977	3,961.0	2.2	4,409.4	3.3	−448.4
1978	3,899.9	−1.5	4,574.9	3.8	−675.0
1979	4,588.9	17.7	4,719.6	3.2	−130.7
1980	5,579.6	21.6	5,293.2	12.2	286.4
1981	6,050.6	8.4	5,575.1	5.3	475.5
1982	6,639.3	9.7	6,382.3	14.5	257.0
1983	6,877.8	3.6	6,947.1	8.8	−69.3

Source: *Warenverkehr mit der Deutschen Demokratischen Republik und Berlin (Ost) 1983* (official West German statistics). (U)

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Appendix D

East Germany: Composition of Trade With West Germany

Thousands of West German marks

Commodities	Imports		Exports	
	1981	1982	1981	1982
Total	**5,575,074**	**6,382,316**	**6,050,648**	**6,639,298**
Products of farms, forests, fishing, and so forth	**27,038**	**181,256**	**465,233**	**475,841**
Farm and market garden produce	21,227	167,218	183,894	188,500
Live animals and animal produce	221	1,099	251,814	260,217
Forestry produce	5,010	8,048	22,450	18,988
Fish produce	580	4,891	7,075	8,136
Mining products	**1,039,845**	**819,889**	**203,082**	**241,135**
Raw materials and semifinished goods	**2,009,118**	**2,754,224**	**3,181,158**	**3,366,402**
Minerals	22,690	28,432	1,628,842	1,704,999
Chemical elements and isotopes	463	739	972	1,393
Stone and earth	38,529	40,452	113,985	125,846
Iron and steel	321,892	612,798	273,596	243,462
Nonferrous metals and semifinished metals	391,238	559,992	249,951	251,063
Foundry products	7,549	4,969	15,243	17,154
Drawn and cold rolled goods	59,706	70,952	28,108	29,840
Chemicals	981,800	1,290,295	704,813	778,793
Cut and worked timber	75,744	52,453	42,137	92,552
Wood pulp, paper, and boards	47,393	49,236	93,553	81,294
Rubber goods	62,114	43,906	29,958	40,006
Investment goods	**1,426,347**	**1,282,810**	**607,836**	**694,424**
Shaped steel	7,058	5,453	25,350	32,579
Constructional steel and rails	66,579	53,681	29,171	41,732
Mechanical engineering products and so forth	971,829	886,128	157,623	188,261
Road vehicles	37,595	37,898	24,023	24,245
Water craft	3,745	13,631	33,937	13,264
Aircraft and spacecraft	39		37	41
Electrical engineering products	214,384	176,637	192,601	228,187
Precision instruments, optical equipment, and clocks	47,647	33,103	43,238	49,173
Iron plate and metal goods	67,278	58,232	92,407	106,650
Office equipment, data processing, and so forth	10,110	17,988	7,636	9,712
Finished sections for construction engineering	83	59	1,813	580

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East Germany: Composition of Trade With West Germany (continued)

Thousands of West German marks

Commodities	Imports		Exports	
	1981	1982	1981	1982
Consumer goods	**471,307**	**523,024**	**1,343,205**	**1,589,782**
Musical instruments, sports equipment, and so forth	17,133	14,727	61,070	71,127
Pottery, china, and so forth	4,060	3,925	74,120	74,500
Glass and glass goods	12,165	15,000	87,351	104,328
Wooden goods	12,874	11,429	267,996	300,916
Paper and board products	16,311	14,028	36,179	33,235
Printed goods	39,537	40,261	31,601	34,973
Plastic goods	52,061	49,997	46,944	61,338
Leather	39,611	67,933	4,471	5,316
Leather goods and shoes	46,745	37,399	43,739	49,817
Textiles	186,633	235,675	385,804	450,968
Clothing	44,177	32,650	303,930	403,264
Foodstuffs and so forth	**533,228**	**745,978**	**213,902**	**229,840**
Foodstuffs	508,525	718,537	210,655	221,208
Tobacco	24,703	27,441	3,247	8,632
Miscellaneous goods	**68,191**	**75,135**	**36,232**	**41,874**

Source: *Warenverkehr mit der Deutschen Democratischen Republik und Berlin (Ost) 1982* (official West German statistics).

East Germany bought more raw materials and semimanufactured goods in 1982-83 mainly to meet the needs of current production. West German statistics show that East Germany boosted imports of iron and steel products 63 percent in 1983—to about DM 1 billion —after a 90-percent gain in 1982. Imports of foodstuffs rose 31 percent in 1983 after a 41-percent rise the year before. Growth in these imports slowed markedly in the second half of 1983 when overall imports declined as East Berlin returned to a more normal trading pattern. Imports of investment goods, on the other hand, fell slightly after a 10-percent drop in 1982. East Germany's best export gains, though modest, were in investment and consumer goods.

OECD commodity trade data for 1982 show that East German purchases of foodstuffs from non-German sources declined by $340 million—over 47 percent. Imports of manufactured goods declined by about one-third, paced by a 46-percent decline in chemicals and a 63-percent drop in transportation goods. The composition of East German exports to OECD, on the other hand, showed little change in 1982 from 1981, similar to the relatively small change in East German exports to West Germany.

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Appendix E

East Germany's Special Earnings

East Berlin derives considerable hard currency earnings from special arrangements with Bonn affecting the city of Berlin and relations between West German and East German citizens.

Construction
Most of the lucrative construction agreements signed with Bonn and the West Berlin government have involved improvements in West Berlin's infrastructure and upgrading of the city's transportation links to the Federal Republic (see table E-1 and map). Bonn has paid East Berlin to:

- Expand and upgrade the autobahns between the FRG and West Berlin.
- Improve border-crossing points.
- Electrify rail links to the city.
- Reopen the Teltow Canal in Berlin and repair canals linking West Berlin with the FRG.
- Improve the Berlin area transportation network.

The value of construction projects in the period 1979-83 exceeded DM 1.5 billion. We estimate that East German receipts from these projects (see item "Transportation Improvements" in table 2) totaled more than DM 500 million in 1979, but fell thereafter as major projects were completed

In 1983 the two sides reached several new agreements. In May East Berlin signed a contract with the West German firm Ruhrgas AG to build a spur line off the Siberia–Western Europe natural gas pipeline to deliver gas to West Berlin. In September, Bonn agreed to finance construction of a plant to purify water entering a river that flows from the southern GDR into Bavaria. Late in the year East Berlin also agreed in principle to install a fiber-optic telecommunications link to West Berlin. The governments have at various times discussed several other projects, including the construction of additional power-generating facilities for West Berlin and further improvements in transportation links between West Berlin and West Germany.

Services
For more than a decade East Berlin has received periodically increasing annual lump-sum payments—over DM 300 million in 1983—for services it provides West Germany, such as postal delivery, removal of sewage from West Berlin, disposal of solid wastes for the city of Hamburg, and hauling trains to and from West Berlin. Last November, Bonn agreed to raise its annual payment for post and telecommunications services from the DM 85 million it had paid since 1971 to DM 200 million in the period 1983-90. Beginning in 1984 the East German state railroad will receive small annual payments for the use of some of its West Berlin facilities that were transferred to the operational control of a West Berlin *Senat* authority. The payment will total DM 3.4 million this year but may vary slightly in the future. The agreement ceding control to the West Berlin government also relieved East Berlin of operating losses which, totaled over DM 1.5 billion since 1970.

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Fees
East Berlin collects substantial travel-related fees from both the West German Government and West German citizens. Since the 1971 Transit Agreement, Bonn has made lump-sum annual payments—currently DM 525 million—for the use of road, rail, and inland water routes to and from West Berlin.[18]

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[18] The original sum was DM 235 million. It rose to DM 400 million in the period 1976-78 and, as part of the 1978 package of agreements, to DM 525 million yearly for the period 1979-89.

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Table E-1
East Germany: Selected Joint Construction Projects With West Germany and West Berlin

Project	Cost (*Million DM*)	Status	Ongoing Fees	Comments
Hamburg-Berlin Autobahn	1,200	Completed		Project involved expansion of some existing road near Berlin and new construction on the autobahn link. Part of 1978 package.
Warta-Herleshausen Autobahn	Undetermined	Under negotiation		Highway improvements.
Berlin-Hof Autobahn	500-1,500	Under negotiation		Project to widen and resurface existing roadway.
Helmstedt Autobahn	Undetermined	On hold		Highway improvements.
Spandau Lock expansion (Berlin)	30	Completed	Transit fees	Agreement signed 30 November 1977. Expansion benefits FRG and GDR shippers.
Teltow Canal reopening (Berlin)	70	Completed	Transit fees	38 kilometers through West Berlin shortens barge transport time for shippers by one to two days. Canal had been closed since 1945. Reopening agreement signed November 1978.
Havel and Mittelland Canal improvements	NA	Completed	Transit fees	Canals link the FRG with West Berlin and, ultimately, Poland via the Oder-Spree Canal. Improvements widened and deepened the canals, increasing capacity and reducing costs. Part of 1978 agreement package.
Power plant	Undetermined	On hold		Lignite-fired plant to provide electricity for West Berlin.
Natural gas pipeline	230	Under construction	9 million VE annually.	Contract signed March 1983. Spur gasline to provide Soviet gas to West Berlin. Contract signed with Ruhrgas AG. Transit fees to begin upon completion in October 1985.
Electricity transmission line	150-200	On hold	Transmission and right-of-way fees.	Project designed to transmit electricity from the Federal Republic to West Berlin.
Fiber optic telephone lines to West Berlin	15-20	Under negotiation		Agreement in principle signed as part of November 1983 post and telegraph agreement.
Crossing point in Berlin		Under construction		East Berlin agreed to keep open Staaken crossing point until completion of the new border-crossing point.
Electrification of rail lines	Undetermined	On hold		Long under tentative negotiation.
Pollution control on Elbe, and Werra Rivers	At least several hundred million	Under negotiation		East German industry dumps heavy metals into the Elbe. Potash mining pollutes the Werra with salts. Bonn and West German states apparently near agreement on sharing the costs.
Roeden River water purification plant	60-80	Agreed upon		Signed agreement in October 1983. Eighteen million DM committed by FRG and Bavarian governments for 1984. Project scheduled for completion in 1987 at Sonneberg, East Germany.

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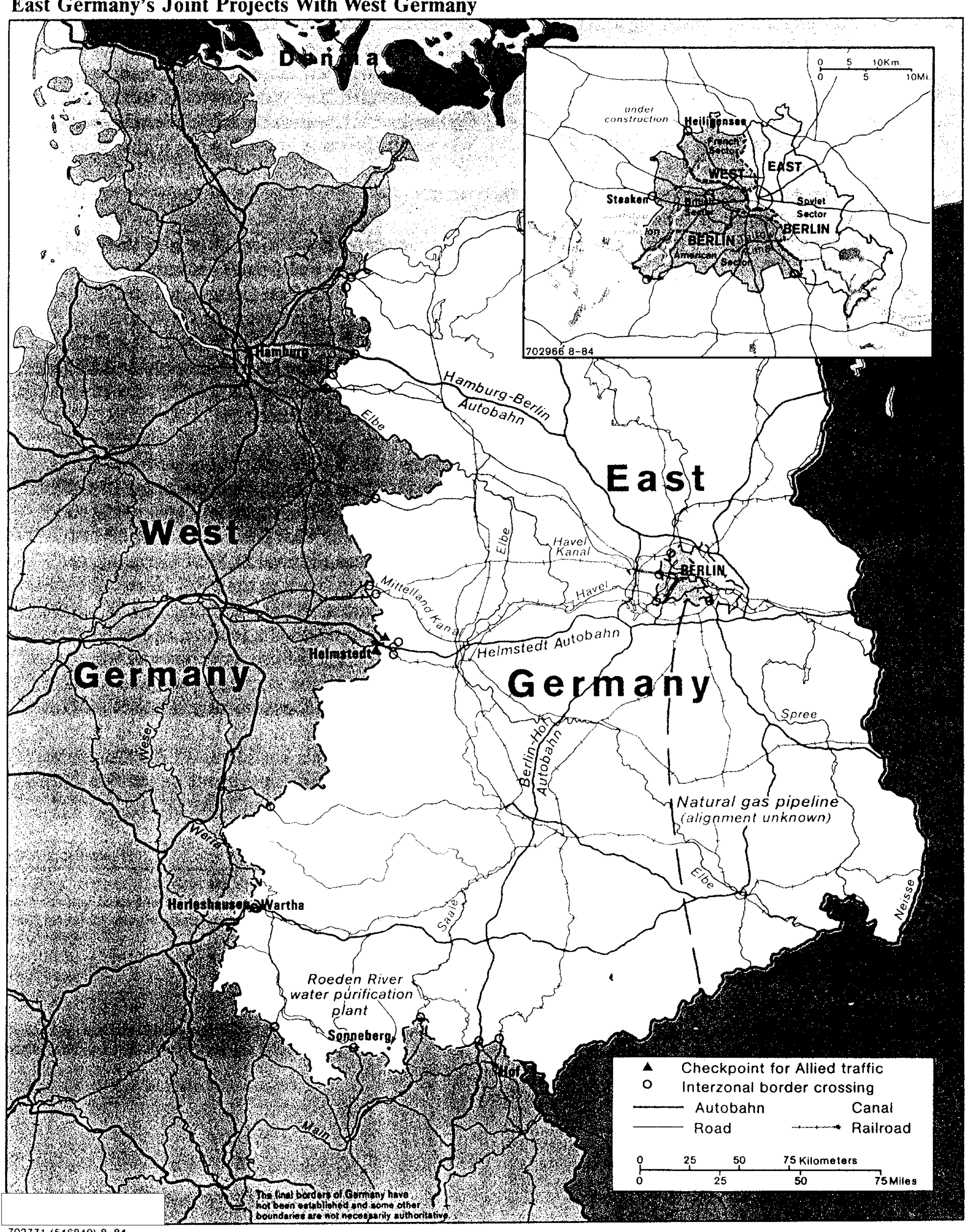
Figure 8
East Germany's Joint Projects With West Germany



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Emigration Payments

Bonn has paid large sums annually to secure the exit from East Germany of emigration applicants. In recent years, East Berlin has allowed between 1,000 and 1,500 East German political prisoners and some 8,000 to 10,000 other people to emigrate annually. The number of legal emigrants increased substantially in late 1983 to nearly 1,000 per month and then rose sharply again in early 1984 as East Berlin suddenly expedited exit visa applications; some 25,000 left in the first four months of 1984 before the regime slowed the exodus in May. We believe Bonn on average pays about DM 50,000 in "ransom" per prisoner and at least DM 5,000—sometimes much more—for each of those legally emigrating to the FRG.[19] The two governments arrange deals through "private" intermediaries who also receive compensation from West Germany. We estimate that this program normally has netted East Berlin DM 150-200 million annually

Transfers From Individuals

After East Berlin agreed to ease travel restrictions in the 1972 Traffic Treaty, the number of West German visitors swelled from 2.62 million in 1971 to 7.10 million in 1973. An important source of tourist revenues—worth about DM 350 million in 1982 according to our estimates—is the *Zwangsumtausch*, or requirement that Western visitors buy a minimum amount of East German marks (DME) for each day they are in the GDR; the money cannot be converted back into hard currency when the visitor leaves the country. We believe that revenue from the exchange requirement has continued to rise even though the number of visitors from West Germany dropped sharply in 1980 when the regime increased the daily requirement to DM 25 (see inset, "The 1980 Exchange Requirement Increase").[20]

The regime capitalized further on the increase in Western visitors by establishing in 1973 and then expanding a series of retail stores (called *Intershops*) that sell luxury and imported goods only for hard currency. The West German Government confidentially estimated that West Germans spent some DM 750 million in the shops in 1978. We believe the sum was about the same in 1982, when higher prices on goods offset a decline in visitors after 1980.

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West Germans, in addition, often give their East German relatives and friends consumer goods and currency, including East German marks they are forced to buy upon entering the GDR. Gifts of consumer goods unavailable in the East and hard currency spendable in *Intershops* provide East Germans with much appreciated income supplements that soften the impact of shortages in the GDR.

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East Germany's tight restrictions on travel by its citizens to West Germany has preserved its hard currency windfall from tourism. Apparently concerned that many East Germans would never return home if allowed to travel to West Germany, the regime restricts travel to the FRG largely to individuals faced with such "urgent family needs" as the grave illness or death of a relative, and to retirees who it calculates are less likely to defect and whose loss would not reduce the work force but would cut pension payments.

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[19] East Berlin charges different rates for prisoners based partly upon an individual's education. Physicians, for example, reportedly are "worth" up to DM 150,000. Twelve people who won release to West Germany as legal emigrants after entering the FRG Permanent Representation Mission in East Berlin this January cost Bonn DM 94,000 each, according to West German officials. The GDR apparently insisted on the higher payment because of the publicity and embarrassment the incident caused the regime.

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[20] West German statistics suggest that the number of visits is highly sensitive to the level of exchange requirement. The number of visits fell in 1974 after the requirement was raised, but rebounded strongly after it was reduced for most people and was eliminated entirely for pensioners.

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East Germany: Hard Currency Balance of Payments and Debt

Million US $ (except where not[...]

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981 a	1982 a	1983 b
Current account balance	−293	−197	−383	−689	−1,019	−1,067	−1,446	−1,336	−1,094	−1,458	[illegible]	−459	1,239	1,30
Trade balance	−299	−268	−483	−774	−1,068	−1,125	−1,591	−1,510	−1,137	−1,310	[illegible]	60	1,509	1,32
Exports	1,261	1,368	1,642	2,230	3,014	3,062	3,643	3,578	4,158	[illegible]	[illegible]	6,714	7,172	7,62
Imports	1,560	1,636	2,125	3,004	4,082	4,187	5,234	5,088	5,295	[illegible]	[illegible]	6,654	5,663	6,30
Net invisibles, excluding interest	56	132	175	220	260	250	450	550	650	800	[illegible]	965	950	85
Net interest	−50	−61	−75	−135	−211	−192	−305	−376	−607	[illegible]	[illegible]	−1,534	−1,220	−86
Capital account balance	298	211	146	528	1,000	2,052	1,668	1,289	1,749	2,779	[illegible]	675	−1,730	−60
Drawings	418	352	354	858	1,367	2,520	1,376	2,156	2,862	4,179	[illegible]	2,925	1,270	2,19
Repayments	120	141	208	276	367	468	708	867	1,113	1,400	[illegible]	2,250	3,000	2,79
Errors and omissions	−5	−1	359	42	303	111	−53	224	−295	−170	[illegible]	296	216	56
Changes in reserves	−6	13	122	−65	284	1,096	−831	177	360	551	[illegible]	90	−275	1,27
Gross debt	1,197	1,408	1,554	2,136	3,136	5,188	6,118	7,145	8,894	11,671	[illegible]	14,563	13,039	12,63
Commercial	700	855	945	1,510	2,495	4,485	5,043	6,140	7,729	9,672	[illegible]	11,583	9,489	8,51
Official	497	553	609	626	641	703	1,075	1,005	1,165	[illegible]	[illegible]	3,280	3,550	4,12
Reserves	190	203	325	260	544	1,640	809	986	1,346	1,897	[illegible]	2,569	2,321	3,59
Net debt	1,007	1,205	1,229	1,876	2,592	3,548	5,309	6,159	7,548	9,776	[illegible]	12,267	10,718	9,03
Of which:														
West Germany	460	500	550	675	790	920	1,100	1,420	1,700	[illegible]	[illegible]	1,650	1,555	1,4
Total debt service	170	202	283	411	578	660	1,013	1,243	1,720	2,245	[illegible]	3,734	4,220	3,6
Debt service ratio *(percent)* c	13	15	17	18	19	22	28	35	41	44	[illegible]	56	59	[illegible]
Gross annual financing requirements (repayments on medium- and long-term debt plus current account deficit) d	413	338	591	965	1,386	1,535	2,154	2,203	2,207	[illegible]	[illegible]	2,739	1,761	1,4
Net resource transfer	248	150	71	447	789	1,860	363	913	1,142	1,931	[illegible]	−459	−2,950	−1,4

a 1981 East German trade data are especially inconsistent with partner country data. For this reason the 1981-82 trade and current account estimates should be regarded as very tentative.
b Preliminary.
c Repayments of medium- and long-term debt plus net interest as a share of exports.
d Difference between drawings and debt service.

Source: CIA estimates based on official East German partner country trade and BIS data.

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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

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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,

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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. 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).

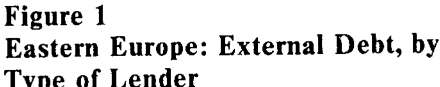
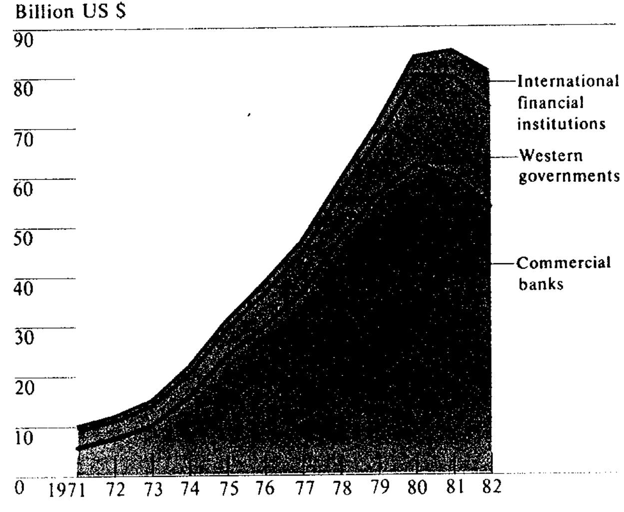


Figure 1
Eastern Europe: External Debt, by Type of Lender



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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 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.

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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*

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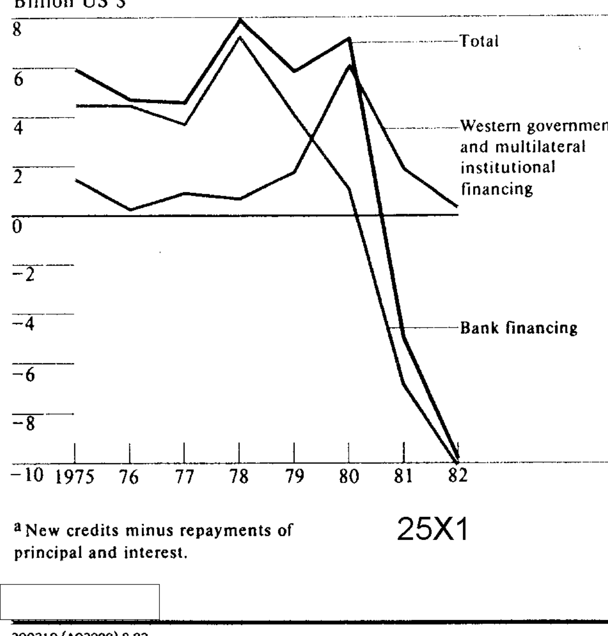
Figure 2
Net Resource Transfer to Eastern Europe From Western Financing[a]



[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

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 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 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

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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 although East Germany and Romania also drew down their commitments. Statistics published by the Bank for International Settlements (BIS) show a similar

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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.

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).

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

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- 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. BIS sources indicate that 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.

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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.

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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.

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.

Table 5
Eastern Europe: Debt Service Ratios [a]

Percent

	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.
[b] Reflects debt service paid. Ratio based on amounts owed equals 213 percent.
[c] Excludes $400-500 million in arrearages.

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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. bankers quickly implemented large cutbacks in their exposure to Eastern Europe with little or no consideration given to the relative creditworthiness of individual countries. 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]

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[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.

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.

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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.

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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.

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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.

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 indicates that some governments turned down East

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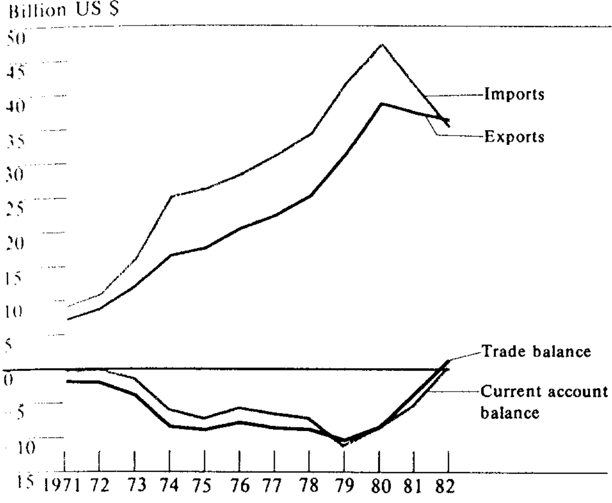
Figure 3
Eastern Europe: Trade and Current Account Balance



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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.

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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 a result of a jump in exports and a reduction in imports.

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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 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.

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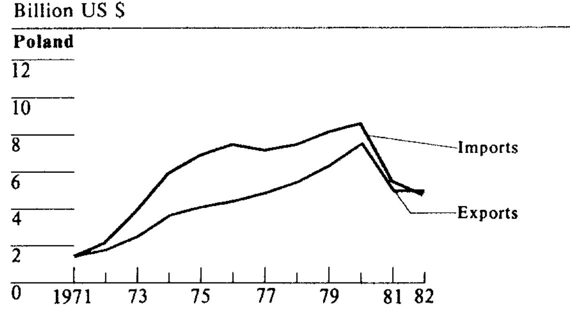
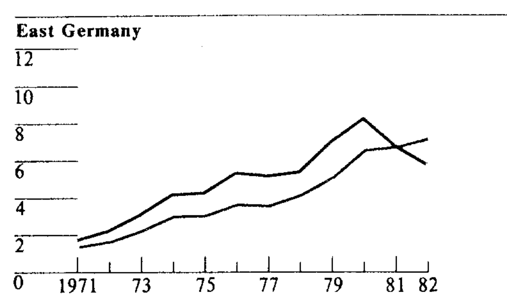
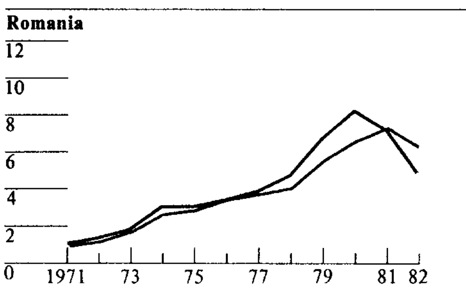
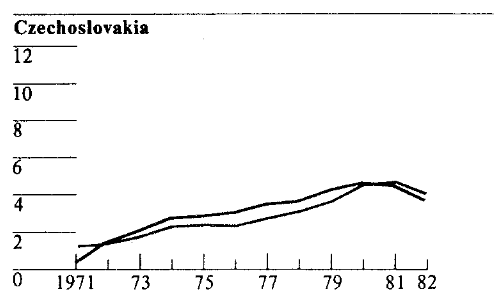
Figure 4
Eastern Europe: Hard Currency Trade

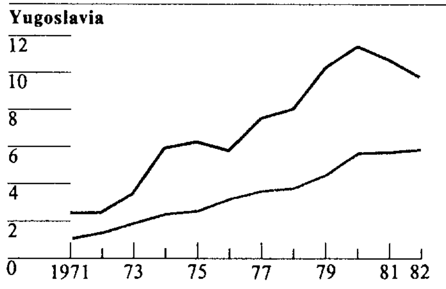
Billion US $

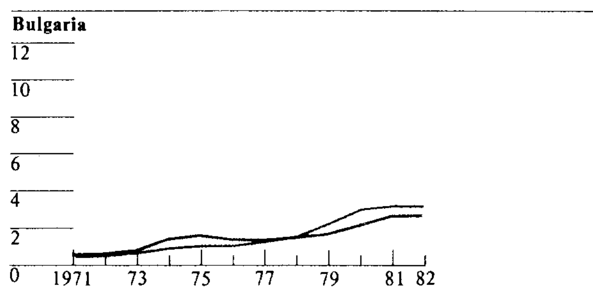












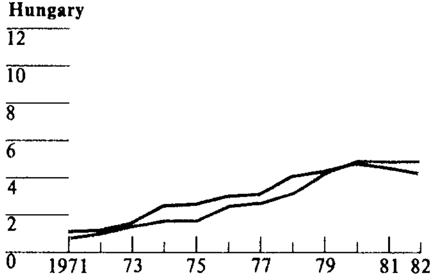


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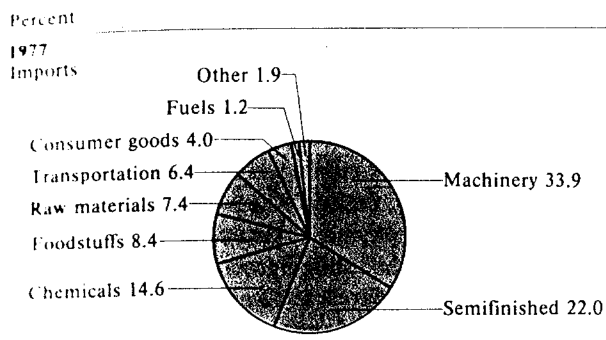
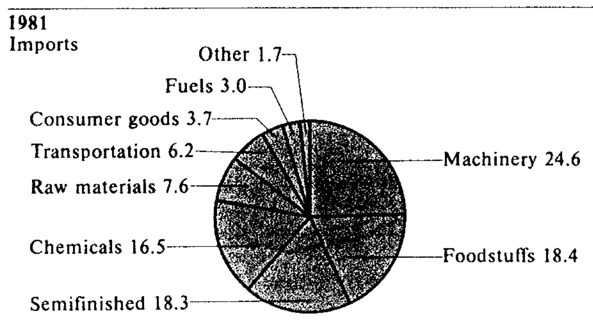
Figure 5
Eastern Europe: Trade With the Developed West, 1977 and 1981

Percent

1977
Imports



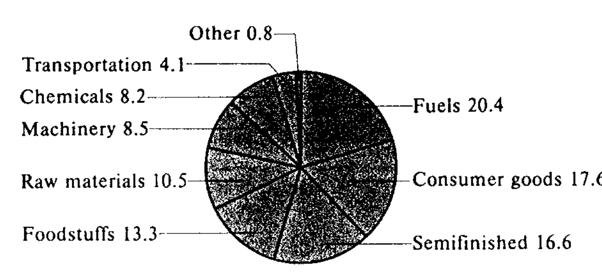
1981
Imports



Exports

Other 1.3
Transportation 5.4
Chemicals 5.9
Machinery 6.6
Raw materials 12.5
Fuels 14.4
Consumer goods 18.9
Semifinished 18.1
Foodstuffs 17.0

Exports



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

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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.

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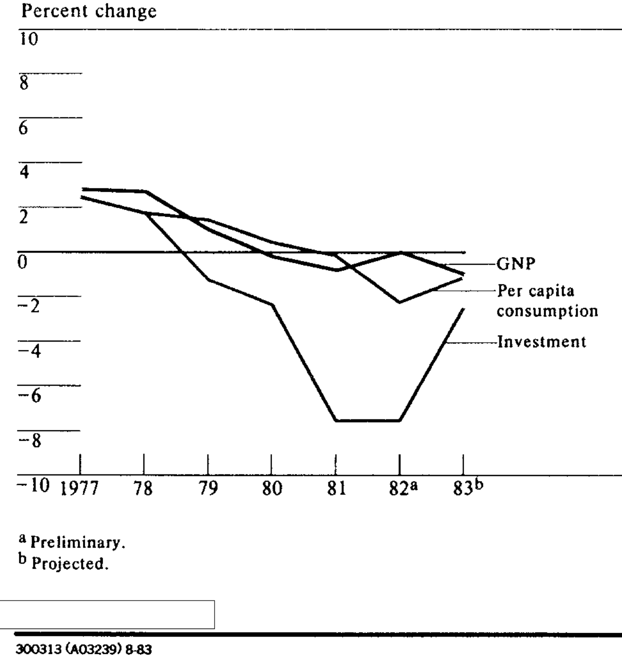
Figure 6
Eastern Europe: Domestic Economic Indicators



[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. 25X1

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 and further worsened Warsaw's chances for financial recovery 25X1 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 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

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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.

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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.

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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.

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.

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. According to data supplied by Romania to the banks, 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).

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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 tight overall control over government policy suggests that he probably played the major role in deciding to pursue more rational financial policies.

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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 delayed for months conclusion of bilateral agreements with the 15 signators to the Paris Club accord.

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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 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

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[6] See table on Poland in appendix.

[7] See table on Romania in appendix.

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The Rescheduling Experience

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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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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.

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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.

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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.

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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:

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- 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.

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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:

- 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.

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- *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. 25X1

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 25X1

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. the IMF expressed concern to top-level officials over Budapest's lack of political will to impose tougher stabilization measures. 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. 25X1

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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 25X1

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. 25X1

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exacted a stiff price, however, from the domestic economy. According to Embassy [ ] 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. [ ]

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. [ ] [ ] the East Germans were successful in exporting for cash while pressing suppliers for extended grace periods on their own payments. 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] [ ]

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. [ ] 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. [ ]

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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. [ ] [ ] 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. [ ]

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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

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[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. [ ]

[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. [ ]

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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

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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.

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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.

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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,

[12] See table on Yugoslavia in appendix

[13] See table on Czechoslovakia in appendix.

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

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.

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.[1]

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:
- 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).
- 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.

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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:

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- 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.

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- 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.

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- 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.

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- Czechoslovakia obtained a $50 million club loan with a four-year maturity from a group of six Western banks in mid-July.

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- the "a forfait" market is reviving for short-term Hungarian, East German, and Czechoslovakian trade notes.

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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

[1] See table on Bulgaria in appendix.

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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. 25X1

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. 25X1

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 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 apparently without requesting more Yugoslav exports this year. 25X1

The Soviet assistance apparently has enhanced the USSR's standing in Belgrade. According to the US 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 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

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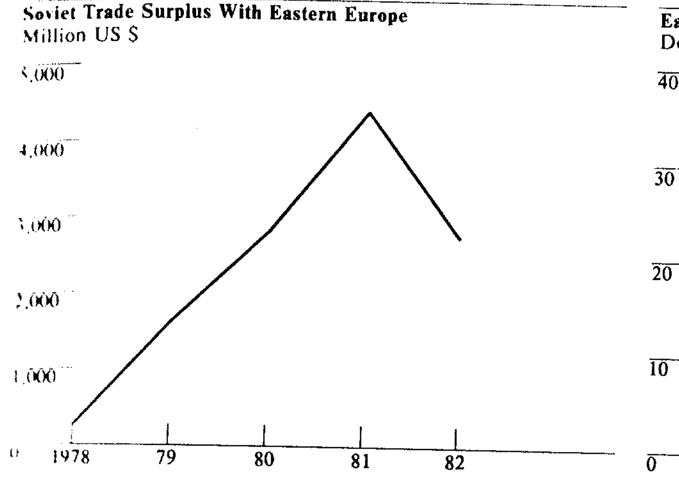
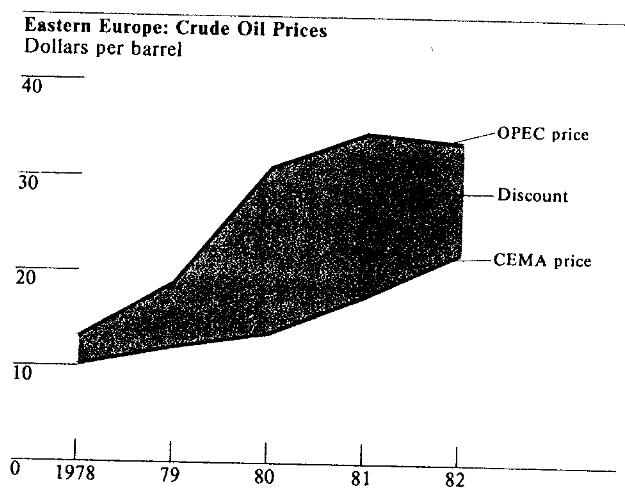
Figure 7
Eastern Europe: Diminishing Economic Benefits From Trade With the USSR





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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.

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.

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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. 25X1

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.* 25X1

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. 25X1

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 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.

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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. 25X1 25X1

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[4]—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* 25X1

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. 25X1

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. 25X1

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.* 25X1

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. 25X1 *that IMF officials were instrumental in convincing 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.* 25X1

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. 25X1

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.* 25X1

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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. 25X1

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. 25X1

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

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

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 25X1

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 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.

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.

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- 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.* 25X1

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.* 25X1

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

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

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

Billion US $

Eastern Europe, Excluding Poland
1980
1982
1985, Scenario 1
Scenario 2
Scenario 3
0 5 10 15 20 25 30 35 40 45

Czechoslovakia
1980
1982
1985, Scenario 1
Scenario 2
Scenario 3
0 2 4 6 8 10 12

Bulgaria
1980
1982
1985, Scenario 1
Scenario 2
Scenario 3
0 2 4 6 8 10 12

Hungary
1980
1982
1985, Scenario 1
Scenario 2
Scenario 3
0 2 4 6 8 10 12

East Germany
1980
1982
1985, Scenario 1
Scenario 2
Scenario 3
0 2 4 6 8 10 12

Yugoslavia
1980
1982
1985, Scenario 1
Scenario 2
Scenario 3
0 2 4 6 8 10 12

Romania
1980
1982
1985, Scenario 1
Scenario 2
Scenario 3
0 2 4 6 8 10 12

25X1

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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). 25X1

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.

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. 25X1

In the short run, Eastern Europe's import priorities will most likely remain those of the past two years. 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. 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.
- 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. 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.

- 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.

25X1

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.

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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

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

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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. 25X1

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. 25X1

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

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

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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. 25X1

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 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.

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 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.

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—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

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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 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.

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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 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.

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The West cannot expect substantial economic gains in its relations with Eastern Europe. Financial constraints are likely to make East European markets 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.

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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.

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	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Eastern Europe												
Total	**9,510**	**11,572**	**14,727**	**21,468**	**30,659**	**38,264**	**46,572**	**58,614**	**70,310**	**83,598**	**84,842**	**80,503**
Commercial	5,396	7,243	9,828	15,634	23,721	29,667	36,388	46,952	55,904	61,793	59,692	53,383
Official [b]	3,765	3,921	4,406	5,123	6,002	7,168	8,583	9,715	11,862	18,506	20,267	20,223
IMF/World Bank	349	408	493	711	936	1,429	1,601	1,948	2,544	3,299	4,883	6,897
Bulgaria												
Total	**743**	**1,009**	**1,020**	**1,703**	**2,640**	**3,198**	**3,707**	**4,263**	**4,032**	**3,562**	**3,065**	**2,782**
Commercial	442	765	818	1,520	2,453	2,878	3,394	3,935	3,619	3,128	2,575	2,187
Official [b]	301	244	202	183	187	320	313	328	413	434	490	595
Czechoslovakia												
Total	**485**	**630**	**757**	**1,048**	**1,132**	**1,862**	**2,616**	**3,206**	**4,096**	**4,756**	**4,400**	**3,998**
Commercial	284	435	558	821	926	1,575	2,290	2,798	3,502	4,013	3,610	3,158
Official [b]	201	195	199	227	206	287	326	408	594	743	790	840
East Germany												
Total	**1,408**	**1,554**	**2,136**	**3,136**	**5,388**	**6,292**	**7,828**	**9,666**	**12,312**	**14,089**	**14,680**	**13,077**
Commercial	693	771	1,348	2,243	4,423	5,217	6,528	8,166	10,225	11,411	11,535	9,642
Official [b]	715	783	788	893	965	1,075	1,300	1,500	2,087	2,678	3,145	3,435
Hungary												
Total	**1,071**	**1,372**	**1,442**	**2,129**	**3,135**	**4,049**	**5,024**	**7,290**	**8,140**	**9,276**	**8,700**	**7,800**
Commercial	968	1,274	1,353	2,053	3,081	3,998	4,965	7,197	8,008	9,053	8,380	6,748
Official [b]	103	98	89	76	54	51	59	93	132	223	320	415
BIS/IMF												637
Poland												
Total	**1,399**	**1,825**	**3,057**	**5,313**	**8,879**	**12,307**	**14,621**	**17,600**	**21,100**	**24,840**	**25,500**	**24,800**
Commercial	420	856	1,951	3,586	6,547	9,159	10,393	12,532	15,300	14,740	15,045	14,340
Official [b]	979	969	1,106	1,727	2,332	3,148	4,228	5,068	5,800	10,100	10,455	10,460
Romania												
Total	**1,227**	**1,249**	**1,611**	**2,693**	**2,924**	**2,903**	**3,605**	**5,221**	**6,950**	**9,467**	**10,160**	**9,766**
Commercial	585	597	682	1,780	2,024	1,841	2,306	3,609	5,100	6,537	6,167	5,408
Official [b]	642	652	814	797	706	659	715	800	905	1,750	1,845	1,428
IMF/World Bank/ CEMA banks	0	0	115	116	194	402	584	812	945	1,180	2,148	2,930
Yugoslavia												
Total	**3,177**	**3,933**	**4,704**	**5,446**	**6,561**	**7,653**	**9,171**	**11,369**	**13,680**	**17,608**	**18,337**	**18,280**
Commercial	2,004	2,525	3,118	3,631	4,267	4,999	6,512	8,715	10,150	12,911	12,380	11,900
Official [b]	824	1,000	1,208	1,220	1,552	1,628	1,642	1,518	1,931	2,578	3,222	3,050
IMF/World Bank	349	408	378	595	742	1,026	1,017	1,136	1,599	2,119	2,735	3,330

[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

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.

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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.

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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 inisted 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
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.

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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.

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.

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.

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.

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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.

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.

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.

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), [ ] is projecting this year's current account deficit at $550 million. [ ] 25X1

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. [ ]

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. [ ]

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. [ ] 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, 25X1 the IMF anticipates some short-term capital outflow since trade credits must be repaid before new ones are drawn. [ ] 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. [ ] 25X1

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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. [ ] 25X1

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 25X1

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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. 25X1

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.

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. skeptical that Yugoslavia can raise enough untied bank loans to cover a financing gap of $500 million to $1 billion in the first half of 1984. 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.

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. 25X1 the banks will resist pressures to provide more new money. 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. 25X1 25X1

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. 25X1 25X1 25X1

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 25X1

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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.

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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.

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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.

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.

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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.

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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.

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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

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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

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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.

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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.

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

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.

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.

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.

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.

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.

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. One Hungarian banker claims 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. Another senior Hungarian official has asserted, however, that Hungary cannot afford more

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.

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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.

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.
- 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.
- the Hungarians have also been lining up short- to medium-term trade financing from commercial banks, particularly in the form of bankers' acceptances.

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.

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.

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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.

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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.

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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.

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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.

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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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. the Czechoslovaks balked at emulating Hungary's example of first disclosing more information on its debt and balance of payments in return for a larger loan.

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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.

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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.

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.

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.

Sofia has untapped borrowing capacity.

Political rather than economic factors are more apt to hinder access to credits. Italian commercial banks withdrew deposits placed with Bulgaria late in 1982 for political reasons. 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.

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

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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:

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- In bilateral economic talks in Paris, France agreed to provide an unspecified amount of credit.
- 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.

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Several reports show that Bulgaria is actively negotiating for Western equipment and technology—apparently the only East European country currently showing any interest. The Japanese Ambassador to Sofia reported early this year that after a year of reviewing

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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.

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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.

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