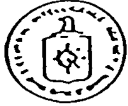

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HRP 94-3

The Soviet Bloc Financial Problem as a Source of Western Influence (U)

National Intelligence Council Memorandum

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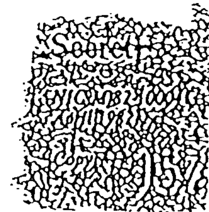

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The Soviet Bloc Financial Problem as a Source of Western Influence (U)

National Intelligence Council Memorandum

Information available as of 8 April 1982 has been used in the preparation of this report.

This memorandum was coordinated within the National Intelligence Council and the Directorate of Intelligence. Comments are welcome and may be addressed to the author, Maurice Ernst, National Intelligence Officer for Economics, on 351-4128. (U)

~~Secret~~

NIC M 82-10004
April 1982

The Soviet Bloc Financial Problem as a Source of Western Influence (U)

Key Judgments

The USSR and Eastern Europe are encountering serious hard currency problems caused by systemic deficiencies, accumulated hard currency debt, weak Western markets, and the Polish crisis. Private sources of long-term credit to the Bloc have largely dried up. Poland and Romania are unable to meet their hard currency obligations and most of the East European countries will be forced to curtail imports. The USSR still has substantial short-term flexibility but its long-term hard currency earnings' prospects are poor.

These problems give the West an unusual opportunity to influence Soviet Bloc developments, although there exists little direct leverage on these countries' policies. The main instruments of influence are the volume and terms of new government-guaranteed credits and the rescheduling of existing obligations. These actions can affect the Soviet Bloc's ability to finance hard currency imports both directly and through their impact on the willingness of private bankers to lend at their own risk.

Western financial restrictions would further curtail the USSR's ability to pay for hard currency imports in the 1980s and would thereby increase Moscow's difficulty in coping with worsening economic problems, including an already massive and rising defense burden. Hard currency shortages might force Moscow to weigh financial costs more carefully before embarking on foreign assistance programs or adventures. Such restrictions, however, would not force Soviet concessions in important areas of foreign or defense policies, such as Afghanistan. They could influence indirectly the evolution of Soviet policies, although the Soviet reaction might be either aggressive or accommodating.

With respect to Eastern Europe, Western financial instruments—notably the handling of Polish and Romanian rescheduling—can be used as sticks or carrots. A strongly restrictive policy could trigger widespread debt default, which would hurt the East European economies, force the Soviet Bloc economies closer together, increase the burden on Moscow of supporting its empire, and also create risks for the stability of the international banking system. On the other hand, a liberal Western financial policy would allow Hungary, and to a lesser extent Poland, some flexibility in the choice of economic and social policies, and Romania some limited independence in foreign policy. By the same token, Moscow's economic burden would be somewhat relieved.

The West's ability to use what potential influence its financial instruments provide is substantially restricted, however, by differences between the United States and our West European allies as to the role and importance of trade with the East. The Europeans view this trade as providing jobs at a time of severe unemployment and as creating mutual interdependencies that will tend to limit Soviet adventurism and provide bargaining chips with Eastern Europe. The European governments, like the private bankers, are concerned about excessive financial exposure to Soviet Bloc countries but are not willing to severely restrict trade with these countries.

Nevertheless, the common ground which exists may be sufficient to support an informal agreement now that has the effect of limiting the volume of new government-guaranteed credits and of tightening their terms. Such an agreement would not significantly reduce the USSR's import capacity. It could, however, prevent a possible increase in imports by: (1) giving a negative political signal to private lenders, thereby strengthening their reluctance to make long-term loans to the USSR; and (2) heading off possible attempts by West European governments to compensate for reduced private credits through larger or longer term government-guaranteed lending.

The Soviet Bloc Financial Problem as a Source of Western Influence (U)

Trends in East-West Economic Relations

Political detente in the 1970s helped to stimulate a massive increase in the volume of East-West trade—more than a threefold increase for the USSR and about a doubling for Eastern Europe. Trade with the West also grew as a share of most Eastern countries' total trade, with the most dramatic increase occurring for the USSR. The importance of trade with the West to the Eastern Bloc economies is greater than its share in their GNP would suggest (3 to 7 percent in Eastern Europe and less than 2 percent in the USSR). These countries all rely on the West for critical imports of food, steel, and high-quality equipment.

The expansion of East-West trade was aided by formal and informal encouragement by Western governments, including a loosening of export controls, and a massive expansion of credit. In the early 1970s, most of the Western credit was in the form of government-guaranteed loans for machinery and equipment sales. As trade surged, however, and contacts multiplied, the USSR and the East European countries entered private Western financial markets on a much larger scale than before. For example, the USSR and several East European countries adjusted to the unexpected drop in foreign exchange earnings during the 1975 recession by borrowing on a large scale in the Eurodollar market. Encouraged by the detente atmosphere, the Communist countries' excellent payments record, the belief that Communist governments had the power to undertake any economic adjustment that financial circumstances might require, and the assumption that the USSR would play the role of lender of last resort for Eastern Europe, Western banks competed with each other for loans to the Eastern Bloc. By the end of 1980 Eastern Bloc hard currency debt exceeded $80 billion (compared with only $8 billion in 1971), or nearly $100 billion if the debt of the CEMA banks is included.

Poland has incurred the largest debt, about $25 billion. The other East European countries have been more cautious, but Romanian, East German, and Hungarian debt ranges between $8 billion and $15 billion. The Soviet hard currency debt surged from less than $2 billion in 1971 to over $10 billion in the mid-1970s, leveled off in the late 1970s at about $18 billion as Moscow restricted its hard currency imports, and then began to rise again to over $19 billion (see table 1).

Table 1

Soviet Bloc Hard Currency Debt and Debt Service Ratio

	Gross Hard Currency Debt (million US $)		Debt Service Ratio [a]	
	1970	1980	1970	1980
USSR	1,800	18,300	6	9
Poland	1,103	26,000	19	101
East Germany	1,416	14,500	14	55
Romania	1,639	10,700	36	25
Czechoslovakia	564	4,620	9	18
Hungary	601	8,700	16	30
Bulgaria	681	2,975	30	32

[a] Repayments of and interest on medium- and long-term debt as a share of hard currency exports.

This table is Secret.

The Soviet Bloc Hard Currency Problem. A fundamental reassessment of the risk of lending to Soviet Bloc countries has curtailed those countries' access to Western private credit and made some of the remaining credit flows vulnerable to new negative developments. The Soviet hard currency position has worsened greatly in recent months and long-term prospects are poor. Most East European countries either cannot meet their hard currency obligations or must make severe economic adjustments to do so.

The severe deterioration of the Soviet and European hard currency positions has been due to the following factors:

- Increasingly evident systemic deficiencies, resulting in declining growth of productivity and poor export performance.
- The logical implications of the rapid accumulation of hard currency debt in past years—a process which obviously could not continue unless hard currency earnings were also growing rapidly, which they are not.
- In the Soviet case, and to a lesser extent in the East European countries, events outside their control (Western recession, bad crops, lower oil and gold prices, high interest rates).
- The Polish political crisis and economic collapse and its fallout.
- The general worsening of East-West relations, especially in the past year.

These factors led to a fundamental reassessment of the risk of lending to Soviet Bloc countries, which in turn has curtailed those countries' access to Western private credit and made some of the remaining credit flows vulnerable to new negative developments. In the past few months, the possibility that Western governments might restrict or discourage credit to Eastern Europe has created added uncertainty in financial markets and has further discouraged bank lending.

The Soviet Problem. The Soviet hard currency position has worsened greatly in the last 12 months because of falling oil prices, bad crops, weak markets for other exports, and aid to Poland, and probably will remain difficult in the foreseeable future. Last year, Moscow drew its hard currency assets to dangerously low levels and has since had to sell large amounts of gold, expand its short-term borrowing, and cut nonfood imports. With large gold reserves (worth some $17 billion at a gold price of $300 an ounce) and small fixed debt obligations (equal to less than 10 percent of export earnings), Moscow has substantial flexibility to deal with its foreign exchange problems in the short run. Longer term prospects for increasing hard currency earnings, however, are poor.

The chances are that the volume of Soviet hard currency exports will stagnate or decline during the coming decade. Specifically:

- The volume of Soviet crude oil exports has been declining for three years and, with domestic oil production likely to be at best constant and at worst in steady decline, it will be extremely difficult to prevent a further drop, and eventually perhaps a complete cessation, of oil exports for hard currency.
- Gas exports will continue to increase, but not on a large scale until the Yamal pipeline can be completed—which will probably not be before the latter part of the decade. Even then the increase in gas exports will probably less than offset the decline in oil exports.
- Arms exports for hard currency appear to have leveled off for lack of large new clients. Even current large customers, such as Libya, may have to pare purchases if oil export revenues continue to decline.
- Other Soviet exports (wood, metals, manufactures) are likely to stagnate because of supply limitations and Soviet inability to adapt to Western market needs.

Without the Yamal pipeline a sizable decline in exports would be inevitable, even if Moscow redirected some of the gas to its own and Eastern Europe's use in order to free some oil for export to the West. With the pipeline and some good luck in oil development, the volume of hard currency exports may be held about constant.

Moscow's main hope for sizable increases in hard currency earnings would be another large jump in the prices of oil, gas, and gold—in the case of oil, an event that appears unlikely in the next two or three years, but increasingly likely during the second half of the 1980s.

If Soviet hard currency earnings are stable or declining in the long term, Moscow will need to greatly increase its new borrowing from the West to avoid a decline—even more to achieve an increase in its hard currency import capacity. But, unless the new credits were on very easy terms, with long maturities, the Soviet debt service ratio would reach dangerous proportions within only a few years. For example, with average maturity of new credits (other than for Yamal) of five years, and continuation of recent interest rates, hard currency borrowings sufficient to raise import capacity by 3 percent a year would push up debt service ratios to between 25 and 50 percent by 1985 and over 70 percent or more by 1990.

The East European Problem. East European countries' hard currency problem is far more severe than the USSR's. Their gold and foreign exchange assets are minimal and their debt service obligations are enormous. Leaving aside Poland, which is in a class by itself, East Germany has a debt service ratio above 60 percent, and the rest, except Czechoslovakia, are all above 30 percent. These ratios put the East European countries in the same class as Brazil, Mexico, and Chile, countries with far more flexible economies and generally rapidly increasing export earnings.

Although Poland's 1981 private debt rescheduling agreement finally has been signed, Warsaw has next to no chance of generating a large trade surplus or obtaining enough debt relief and credits to cover a 1982 debt service burden of $10 billion. None of the possible outcomes to Poland's financial mess is likely to improve the prospects for borrowing by other East European countries.

Romania also is in de facto default—a problem which, like Poland's, has hurt other East European countries' ability to borrow. Bucharest's effort to reschedule its debt with banks is off to a smoother start, but several obstacles must be overcome to conclude an agreement. Even with debt relief, Bucharest would face a large financial gap. After sharp import cuts in 1981, there is less scope for adjustment without damage to the already strained domestic economy. Reserves are low and Romania is reluctant to draw from its gold stock perhaps because some of it has been used as collateral for loans. Large, additional cuts in imports would set in motion an economic decline, such as has occurred in Poland.

East Germany and Hungary have multibillion-dollar borrowing needs this year, and they are virtually shut out of Western capital markets. Banks have been reducing their medium- and long-term exposure for the past year, and, in recent weeks, some West European banks have reduced their short-term lines of credit. Even if the cutbacks are modest, East Germany, Hungary, and Yugoslavia will face serious problems in 1982, but they might be able to get through by recourse to government-guaranteed loans, supplier financing, reserve drawdowns, and sharp import cuts.

Even if existing debt were rolled over, the East European economies would at best limp along with little or no economic growth for the next several years. It is important to keep in mind that Western credits played an important role in financing a large increase in investment in nearly all East European countries during the 1970s, and that this investment was an important factor in sustaining tolerable, if generally slow, growth rates. This important prop for inefficient economies has disappeared.

The Potential For Leverage and Influence on the Soviet Bloc

The Soviet Bloc's hard currency problems coupled with deteriorating economic performance throughout the Bloc present the West with an opportunity to exert a degree of influence over the USSR and its Warsaw Pact allies. Soviet Bloc dependence on Western credits for food, equipment, and technology gives the West the opportunity to use credits as an instrument of influence.

A reduction in the availability of Western credits to the Soviet Bloc would at least temporarily affect the Bloc's capacity to import Western goods. For Moscow, declining hard currency imports would pose serious problems. In the 1980s slower economic

growth will present the Soviet leadership with increasingly tough and politically painful choices in resource allocation and economic management. Annual increments to national output will be too small to simultaneously meet mounting investment requirements, maintain growth in defense spending at the rates of the past, and raise the standard of living. Simply stated, something will have to give. The Soviet need for Western goods and technology will therefore increase greatly. Imports can relieve some economic problems by raising the technological level of key Soviet industries and by reducing shortages of grain and such important industrial materials as steel. Western equipment and know-how will be particularly important to raising productivity in the critical machine-building and energy industries. The Soviets must continue importing large amounts of agricultural products and will probably expand their purchases of steel and some other industrial materials.

The main Western government policy instruments affecting the flow of capital to Soviet Bloc countries are: the volume and terms of government-guaranteed credits; interest rate subsidies; rescheduling of past government-guaranteed credits; and pressure on private banks. Moreover, any official financial actions would surely have an indirect effect on the willingness of the private sector to lend at their own risk to the Soviet Bloc. Credits financed or guaranteed by Western governments make up about one-third of the Soviet Bloc's total hard currency debt—with Poland, the USSR, and East Germany having relied the most on such credits (see table 2).

The Direct Levers. Western governments have at their option a number of direct measures to influence the flow of capital to the USSR and/or its Warsaw Pact allies.

To illustrate the ***direct*** impact of some such measures:

- A 3-percent increase in interest rates charged on the new government-guaranteed credits—roughly the recent increase in OECD Consensus rates for the

Table 2

Soviet Bloc Dependency on Western Government-Backed Credits in 1981

Million US $

	Soviet Bloc	USSR	Poland	Romania	East Germany	Hungary	Czechoslovakia	Bulgaria
Stocks								
Total hard currency debt	87,775	24,500	26,000	10,700	14,730	8,250	4,620	2,975
Of which:								
Government-backed debt	29,225	8,500	13,500	1,700	3,800	350	900	475
As a percent of total debt	33	41	52	16	26	4	19	16
Flows								
Gross hard currency borrowing	40,324	5,600	10,000	4,274	6,600	4,310	1,930	910
Gross borrowing from government-backed credits	9,715	2,300	5,750	360	700	100	265	140
As a percent of gross borrowing	24	41	58	8	11	2	14	15
As a percent of imports		8	88	5	10	2	6	6
Net change in stock of government-backed debt		+300	+3,100		+300	+50	+50	+35

[illegible] Secret

USSR—provided at the 1981 annual level would gradually increase interest payments for the USSR by about $60 million a year, assuming a five-year repayment schedule and no grace period in repayments. The cumulative effect of such a policy over a 10-year period, for example, would result in a total increase of interest payments of some $1.5 billion for the USSR and $2-2.5 billion for the Soviet Bloc, excluding Poland. It should be noted, however, the aggregate numbers still pale in face of an East Bloc financing requirement of hundreds of billions of dollars for all of the 1980s.

- At the extreme, a moratorium on new government-guaranteed credits to Soviet Bloc countries (excluding credits for the Yamal pipeline) would reduce the net flow of Western capital by amounts equal to 5 to 6 percent of the 1981 level of hard currency imports. The effects would take some three to five years to be fully felt as the government-guaranteed credits under existing commitments were drawn down.

- Western creditors could also declare Poland in default of its obligations as a result of the initiatives of either private banks or Western governments, but formal default would not of itself have much impact on Poland's capacity to import from the West. It would cause substantial but short-lived disruptions of Polish exports, thereby reducing earnings. Polish default could have severe repercussions for other East European countries, and for Western banks. Private bankers' willingness to lend to other East European countries would be even further weakened. Not only Romania, but also Hungary and East Germany could be forced into debt rescheduling or, failing this, into de facto default.

The Indirect Impact. The greatest potential effects of Western government credit restrictions are of an ***indirect*** nature. They would come from the political signal restrictions on government-guaranteed credits would convey to private lenders. It is highly unlikely that Western banks would be willing to resume unguaranteed long- and medium-term lending if Western governments were imposing politically motivated limits on government-guaranteed credits. Short-term lending might also contract, depending partly on the creditworthiness of the individual countries. To some extent, this effect has already been felt by the Bloc.

As things now stand, no Soviet Bloc country has received any mid- or long-term unguaranteed bank credit for almost a year. Shorter term credit is available (except to Poland and Romania) but on less favorable terms than in the past. To date, credit restrictions have come entirely from the private sector, and not from any specific Western government action. The current discussion over credit restrictions has contributed to an atmosphere of uncertainty for the private banking community, however.

Pressure on the USSR could also be exerted via Eastern Europe. Soviet trade with Eastern Europe helps to knit the Soviet empire together. All the East European countries, except Romania, depend on the USSR for one-third or more of their trade (see table 3), including the bulk of supplies of oil, gas, and other critical commodities. But Moscow pays a high price for this close relationship. By denying East European countries the possibility of developing economies and economic systems that could be reoriented mainly toward the West, Moscow has little choice but to provide some direct and indirect forms of aid. The direct aid is in the form of credits on bilateral account. The indirect aid takes the form of delivery of undervalued Soviet raw materials and foods in return for overvalued East European manufactured goods. Many of the commodities the USSR exports to Eastern Europe are also sold on the world market, generally at higher prices. The most important Soviet export—oil—is sold to Eastern Europe far below world market prices. Most of the East European exports can be sold on world markets only at severe discounts, if at all, but the Soviets pay world market prices for them.

Before the Polish crisis and its negative impact on Soviet Bloc creditworthiness, Moscow had planned to reduce its price subsidies on oil exports to Eastern Europe, thereby forcing painful economic adjustments in those countries. The Bloc hard currency crisis reopens the issue of Soviet support.

Table 3

Soviet Bloc Trade Patterns in 1980

Percent

	Exports To			
	USSR	Eastern Europe	Developed Countries	Other
USSR		42.3	31.9	25.8
Poland	33.1	22.4	34.2	10.3
East Germany	35.5	24.5	24.3	15.7
Romania	20.7	19.1	34.5	25.7
Czechoslovakia	34.4	26.9	22.2	16.5
Hungary	36.6	26.6	23.7	13.1
Bulgaria	50.0	16.5	16.9	16.6
	Imports From			
	USSR	Eastern Europe	Developed Countries	Other
USSR		42.9	35.4	21.7
Poland	34.6	20.4	33.8	11.2
East Germany	35.1	23.6	30.8	10.5
Romania	16.5	15.7	30.8	37.0
Czechoslovakia	36.3	28.9	24.0	10.8
Hungary	35.5	23.9	30.3	10.3
Bulgaria	58.4	17.3	17.7	6.6

This table in Unclassified.

A worsening of the East European hard currency and economic situation is bound to impose additional burdens on the USSR. Moscow simply cannot afford to let the East European countries go begging to the West by themselves, or alternatively to let their economies deteriorate to the point that serious political consequences could follow. Additional Soviet assistance to Eastern Europe may or may not take the form of hard currency, but, even if it did not, there would be indirectly an unfavorable impact on the Soviet hard currency position. By the same token, an improvement in the East European economic situation would make it easier for Moscow to reduce some of its economic burden of empire.

The Limitations of Leverage and Influence on the USSR. This is not to say the West could force the Soviet Union to reverse basic policies through the use of credit levers. Although Moscow could make good use of increased imports from the West to help relieve its serious and growing economic problems and Western aid to Eastern Europe would serve to reduce the Soviets' burden, Western credit policy used either in a negative or positive fashion would provide little direct leverage on the USSR. It would be difficult to find any specific linkages between Western credit policies and Soviet military and foreign policies. The East-West interface is simply not broad enough to permit policy *quid pro quos* which might be feasible given the nature and limited scope of the economic restrictions and at the same time do not engage central issues of national power and prestige. On these central issues there is little chance that Western economic pressure on the USSR would induce Moscow to become more accommodating. For example, the threat of Western credit restrictions, or a promise to lift them once they have been imposed, could not

induce Moscow to withdraw from Afghanistan, or allow Poland to slip out of the Soviet power orbit, or concede significant military advantages to the West. Moreover, the Soviet economic problems are predominantly homegrown, and cannot be greatly worsened by Western actions.

On the other side, Western economic pressure could provide hardline Soviet leaders with an excuse for economic problems, a justification for continuing dynamic military growth at the expense of the Soviet consumer, and a political rationale for assuming a more aggressive stance in foreign areas to show defiance of Western actions. There also exists a slight possibility that a sharp curtailment of Western credits could provoke Moscow to declare a moratorium on the repayment of the Bloc's $80 billion worth of debt to the West.

Table 4 Percent

Soviet Bloc Imports From the Developed West

	As a Share of Total Imports		As a Share of GNP	
	1970	1980	1970	1980
USSR	24.0	35.3	0.7	1.7
Poland	26.0	33.7	2.4	3.9
East Germany	28.0	30.8	4.2	4.2
Romania	40.0	33.3	3.6	3.4
Czechoslovakia	24.8	24.0	3.1	3.3
Hungary	27.1	30.3	5.0	7.4
Bulgaria	19.3	17.7	3.7	4.2

This table is Unclassified.

Within these limits, there remains the possibility that sustained Western economic pressure could influence Soviet policy choices. Restrictions on government-guaranteed credits, coupled with the likely negative reaction of private lenders, would increase the cost to the USSR of both civilian and military programs and thereby exacerbate the worsening economic trends. It is reasonable to expect that the negative impact would fall particularly hard on Soviet programs requiring large foreign exchange expenditures, such as foreign aid to or other involvements in Third World countries. Moscow might then give greater weight to cost considerations in their policy decisions concerning such programs. Eventually, growing economic stringencies could lead to major changes in Soviet policies and priorities, although we see no sign that such changes are in the offing.

Leverage and Influence on Eastern Europe. Western economic leverage directed toward East European countries is potentially larger than that on the USSR because of their far greater dependence on economic relations with the West (table 4), and their lesser concern with national power and prestige. But Western leverage on Eastern Europe is also severely limited by the present threat of Soviet military control and the self-interest of Communist leadership and elites in protecting the existing political system. Leverage, moreover, is a two-way street. For example, West Germany for decades has traded economic concessions to East Germany in return for limited rights of travel and access, and to Poland in return for the repatriation of ethnic Germans.

Potential Western leverage or influence in Eastern Europe varies from country to country. It is small in Czechoslovakia and Bulgaria, both countries with a relatively small hard currency debt, close economic ties with the USSR and hardline political leaderships. Although West German economic leverage has been employed on East Germany, that country's central role in sustaining the USSR's East European empire and military position in central Europe leaves room for little political flexibility in relations with the West. The possibilities for Western leverage and influence are greatest in Poland, Romania, and Hungary. It should be noted, however, that realizing this influence requires use of both carrot and stick, for under present circumstances positive Western government actions will be necessary to avoid a further curtailment of Western trade with these countries.

The potential for Western political influence in Poland has been greatly reduced by the imposition of martial law and the political dynamics that this

critical step set in motion. The present Polish leadership is unwilling to share power in any meaningful way with the workers' movement, and the Soviets probably would not allow them to do so. This means that Western actions can affect only those aspects of the Polish scene that are considered politically safe by both Warsaw and Moscow. There remains considerable uncertainty, however, as to how Poland can rebuild a workable, if not efficient economy, and a tolerable form of political control. Although the exigencies of martial law give the hardline elements in the Polish party a clear advantage for the present, competing political factions will push for diverse solutions, and there will be considerable uncertainty as to what will work, what is politically safe internally, and what will be acceptable to Moscow.

These uncertainties provide the West not so much with direct leverage on the Polish Government, as with a potential for indirectly influencing in a small way Polish internal policies. So long as formal default, and the consequent legal scramble for Polish assets, can be avoided, reformist elements in Poland can hold out the hope of some new Western assistance in the future. Even more, a rescheduling by Western governments of Poland's 1982 official debt obligations, and/or acceptance of Poland as an IMF member, would provide clear signals of support for Polish policies if these were seen by the West as moving in the right direction. By the same token, formal default would probably foreclose these options and would leave Poland no alternative but to seek even greater Soviet support and economic integration into the Soviet Bloc. Although Moscow might welcome these added restraints on the restive Poles which would come with a formal Polish default, it would be very unhappy at the prospect of adding to what it regards as an already excessive level of economic assistance.

The degree of Western influence on Poland should not be exaggerated. Western actions cannot affect Poland's foreign policies in any significant way, its military position in the Warsaw Pact, or its fundamental political system. Even the politically acceptable scope of economic reform would be far less in Poland at this stage than in Hungary. Hungary was able to undertake a substantial economic decentralization, but only years after Kadar had established a stable political base. By contrast, Poland could expect any substantial decentralization of economic authority to quickly become highly politicized, and to present a major threat to the party's monopoly of political power.

In Romania, as in Poland, the main Western policy issue is whether or not to reschedule debt service obligations, and on what terms. A successful rescheduling will not eliminate Romania's hard currency problems, which are deep-seated, nor prevent a drastic slowdown in economic growth. But it could give Romania some options other than a substantial redirection of its trade from the West toward the Soviet Bloc. In recent years, some 60 percent of Romania's foreign trade has been with non-Communist countries and less than 20 percent with the USSR. Should Romania be forced to make such a shift, the limited freedom of action Bucharest has been able to exercise in its foreign policy will almost certainly be greatly curtailed. These expressions of Romanian independence from Moscow, although on largely peripheral issues, have been useful to the West. On the other hand, accommodating Romania's economic needs would involve substantial economic costs to the USSR.

Hungary has developed broad economic linkages with the West as well as the CEMA countries and created a unique amalgam of central planning with elements of market economy without in any way threatening the Communist Party's monopoly of political power or the country's attachment to Moscow in foreign policy. There are few indications that Moscow has opposed Budapest's relatively liberal economic policies or would welcome an opportunity to reverse them. Nevertheless, lack of access to Western credits could force a sharp curtailment of Hungarian trade with the West and consequently greater economic dependence on Moscow. Hungary depends little on government-guaranteed credits, but a great deal on medium-term private credits, and these are highly vulnerable to changes in market psychology. Membership in the

IMF would provide both an important new source of hard currency and a boost to market confidence in Hungary.

West European Perspectives and Interests

The differences of perspective and interests between the United States and its European allies concerning economic relations with the East make it difficult to find common ground on which to base joint financial restrictions aimed at the East and thus limits our ability to exercise that leverage which exists.

The broadest agreement among the allies is in the private sector. Bankers throughout the West are concerned about their financial exposure to Soviet Bloc countries and would like to reduce it. They consider themselves particularly overexposed in Eastern Europe but also have become increasingly aware of the extent of the USSR's long-term hard currency problem. Moreover, they see the severe worsening of East-West relations in the past two years or so as substantially increasing the political risk involved in any long-term lending to the Bloc.

To some degree the reduction in the East Bloc's creditworthiness in the private sector is reflected in the attitudes of Western governments. As mentioned before, Western governments do not want to be saddled with the heavy budgetary costs that would be entailed in a large-scale bailout of private bank exposure under government guarantees. Moreover, most Western governments probably agree that they have excessively encouraged credit to the Bloc in the past and would prefer to reduce or eliminate the subsidy element in this lending in the future.

This common ground becomes severely limited, however, by the following considerations:

- Trade with the East is still viewed by the Europeans as promoting their economic, political, and strategic interests. West Europeans view this trade as providing jobs at a time of severe unemployment and as creating mutual interdependencies which will tend to limit Soviet adventurism and provide bargaining chips with Eastern Europe.

- They give little weight to the argument that East-West trade buttresses Soviet military power because of its small size in the overall Soviet economy and the long-established priority given to the Soviet military.

- They are even more reluctant to reduce trade with Eastern Europe than with the USSR because of their greater bargaining power with the East European countries, the close bilateral economic, historical and cultural ties with a number of them, and the belief (or rationalization) that Western influence can spread through Eastern Europe and eventually to the USSR.

More precisely, East-West trade plays a small role in the West European economies but is important to certain industries. Even for West Germany, which accounts for about one-fourth of OECD exports to the Soviet Bloc, sales to the East amount to only about 6 percent of total exports and directly provide jobs for about 1 percent of the labor force. The relative importance of trade with the Soviet Bloc increased sharply in the mid-1970s, but has since been declining, and is now nearly back to what it was in 1970 (see table 5).

Nevertheless, the West European countries consider their trade with the East to be important for both economic and political reasons:

- Although a small part of total trade, trade with the Soviet Bloc is one of the most important sources of export earnings from outside the European Community. In the case of West Germany and France, exports to the Bloc about equal those to the United States and are far larger than exports to Japan.

- About one-half of West European exports to the Soviet Bloc and the USSR consist of machinery and steel. The Soviet Bloc, especially the USSR, is an important market for West European steel and for some types of machinery. For example, it accounts for about 15 percent of West German and 12

Table 5 Percent of Total Exports

Soviet Bloc Share of Western Exports 1970-80

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
West Germany	5.6	5.6	6.5	7.1	7.7	8.8	7.6	7.1	6.9	6.5	6.3
France	3.6	3.6	3.7	3.7	3.6	5.0	4.9	4.4	3.8	4.1	4.2
United Kingdom	3.1	2.6	2.7	2.5	2.6	2.9	2.6	2.5	2.6	2.3	2.3
Italy	5.3	4.9	4.2	4.4	5.4	6.2	5.3	5.0	4.3	3.7	3.5
Japan	2.3	2.2	2.6	2.2	3.0	3.9	4.2	3.3	3.3	3.2	2.8

This table is Unclassified.

percent of Italian steel exports. Some West European plants are almost exclusively dependent on the Soviet Bloc market.

- During the current Western economic recession, there are few alternative markets for exports to the Soviet Bloc. The United States and Western Europe are giving priority to fighting inflation. Many less developed countries, faced with a massive debt burden and depressed prices for their primary product exports, are forced to curtail imports. Falling oil revenues are greatly slowing growth of the OPEC market. Consequently, any source of increased or sustained demand is important to the West Europeans. Moreover, the steel industry is in secular decline, so that orders from the Soviet Bloc are important in cushioning the needed adjustment in employment and plant capacity.

- Perhaps most important, the Europeans see their political and security interests best served by increasing economic contacts with Eastern Europe and the Soviet Union to promote political and economic stability there and to establish a web of interdependence between East and West. For West Germany, moreover, ties with the East are vitally important in keeping alive the ideal of German reunification and maintaining a high level of personal contacts between West and East Germans.

Although some groups within the West European countries—such as certain conservative political parties and the military establishments—are sympathetic to the view that Western exports to the East Bloc have at least indirectly supported Soviet military efforts, these particular groups generally have had little say in trade and credit matters. European business interests and trade officials have consistently promoted increased trade with the East as has most of the foreign policy establishment.

For all these reasons the West Europeans look favorably on trade with the East and are reluctant to restrict this trade except where its specific contribution to Soviet military strength can be demonstrated. Among our major allies, West Germany and France have the strongest economic and political stake in economic relations with the Soviet Bloc. Italy too has substantial ties with the Bloc. UK interest is substantially less, however, and Japan's is smaller than that of any West European country.

The major West European countries have used government-guaranteed credits as an important means of increasing exports to the Soviet Bloc. These credits are particularly important in financing exports to the USSR because a large proportion of those exports are for major projects, such as gas pipelines and chemical plants, which require long-term credit financing. About 30 percent of exports to the USSR, including the bulk of exports of machinery and steel from the major West European countries have been financed

by government-guaranteed credits. At least for the next few years, the Western governments will face a dilemma. They are loath to increase an already large budgetary exposure to bank credits which are seen as increasingly risky for both economic and political reasons. On the other hand, they are under pressure at least to maintain exports to the Bloc by providing increased credits under government guarantees to offset the decline in Soviet Bloc access to the private credit market.

For all these reasons it is highly unlikely that our European allies will accept any restrictions on government credits to the USSR or to Eastern Europe which would have the effect of forcing sizable reductions of East-West trade. They may be willing to accept some sort of de facto ceiling on credits or on debt exposure and some further reduction in interest subsidies, but any such agreement is likely to be informal and flexibly applied.

The European governments are extremely concerned with preventing a spread of the Polish financial crisis to the rest of Eastern Europe. They would very much like to see Poland's and Romania's 1982 debt service obligations rescheduled and generally would like both Hungary and Poland to join the IMF. In addition, the West Germans want to avoid any public discussion of East Germany's precarious financial position, for fear that they will have to confront much more openly and dramatically the inconsistencies between economic actions designed to maximize contacts with East Germany and West Germany's key role in the Western alliance and the European Community.

The strong West European views on protecting their economic ties with Eastern Europe give the United States some potential leverage with its allies, since these may be willing to trade off some moderate restrictions on credits to the USSR in return for some US cooperation on Polish and Romanian rescheduling and Polish and Hungarian IMF membership.