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A NEW STRATEGY FOR EAST - WEST TRADE

INTRODUCTION

Ronald Reagan heads for London at the start of June to meet with the leaders of the Western world at their annual Economic Summit. While the principal issues on the agenda will be how to sustain the U.S.-led world economic recovery, cope with Third World debt, and stave off protectionism, Western leaders will also face a range of unresolved problems concerning East-West trade. One of the most pressing is the matter of official Western credits to the Soviet Union and its East European satellites. Ronald Reagan should arrive in London prepared to insist that his colleagues address this.

Official credits to the Soviet bloc are a questionable policy on economic, political and moral grounds. Economically, such practices distort the normal working of the market; politically, they allow Soviet bloc governments to escape hard choices in allocating resources between defense and non-defense sectors; and morally, they subsidize governments guilty of some of the globe's worst political and human rights records. Treatment of the credit issue in the past has been marked either by confrontation or by polite evasion by the Europeans in the guise of vague multilateral declarations. Although there has been some progress on the export credit question, wide policy differences remain between the U.S. and its allies.

The problem is sizeable. In the 1970s, East-West trade increased by over 300 percent. The engine of booming trade was an expanding Warsaw Pact debt; it grew from $8 billion in 1971 to $82 billion in 1980. The major financers were Western commercial banks, but substantial assistance was provided in the form of loans from the Western governments and guarantees of private loans. Between 1971 and 1980, government-backed lending to the Warsaw Pact exceeded American funds channeled to Europe under the

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Marshall Plan (even when measured in dollars adjusted for inflation). The total government-backed debt owed to the West by the Soviet Union is $17 billion, some 61 percent of their total debt to the West.

Even more disturbing is the fact that much of this government lending has been at subsidized below-market interest rates. Typical was the Yamal gas pipeline. France and other governments provided Moscow funds for the project at 7.8 percent interest while prevailing rates in the West were 16 percent. According to some estimates, interest rate subsidies reduced the overall cost of the pipeline project to the USSR by half.[1] In fact, it is very unlikely that the Yamal pipeline would have been financially feasible without the subsidization of Western governments.

In building this project, the West supplied equipment and technology to the USSR at costs far below those available to enterprises in the West. In return, Western Europe may become dependent on the USSR for 30 percent of its natural gas supply, and the USSR has received a helping hand in its industrial development. (Eighty percent of the gas carried by the line will be consumed by the Russians themselves.)[2]

Recent negotiations between the U.S. and its allies have succeeded in curbing some of the excesses of debt subsidization. But officially backed Western credits continue to be provided to the Warsaw Pact (albeit at stiffer terms). Ultimate resolution of this problem can be achieved only by revising the way U.S. allies view East-West trade and East-West political relations in general.

LENDING TO THE WARSAW PACT

During the 1970s, the increase in the debt to the West owed by the Soviet bloc states--formally known as the Council of Mutual Economic Assistance, and generally called COMECON--enabled their economies to import nearly 30 percent more goods than would have been possible without expanded Western lending. By 1982, total COMECON debt stood at $82 billion; of this $30 billion was backed by Western governments. For the past two years there have been some indications of a reversal in the trend of COMECON borrowing. Debt rescheduling for Romania and Hungary and the *de facto* default by Poland have made it evident that lending to the East has exceeded prudent levels; non-supported commercial lending has been cut back sharply. Government-backed lending, however, continues. By 1982, nearly 50 percent of all new loans

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1 Gordon Crovitz, *Europe's Siberian Gas Pipeline*, Occasional Paper #6 (London: Institute for European Defense and Strategic Studies, 1983), p. 20.

2 *Ibid.*, pp. 15, 28.

going to COMECON were government-backed. Last year, by one estimate, nearly 100 percent of new lending was government-backed.[3]

Nevertheless, an overall reduction in lending from the levels of the late 1970s has prohibited COMECON from rolling over its debts. As a result, the Soviet bloc has had to cut imports from the West. In 1982 and 1983, COMECON recorded aggregate balance of trade surpluses; net debt was reduced, and for the first time in ten years, capital flowed from the East back to the West. The question for the future is whether this trend will be reversed and the Organization for Economic Cooperation and Development (OECD) will again begin injecting finances into COMECON economies.

VARIETIES OF OFFICIAL EXPORT CREDIT SUPPORT[4]

Export credit support generally is defined as government involvement in either funding, insuring, or subsidizing an export loan, the loan's interest rate, or other aspect of the transaction. Specifically, official support for export credits in East-West commerce consists of: 1) direct government loans; 2) refinancing agreements; or 3) insurance or guarantees.[5]

When an official institution finances a sale through direct loans, funds are lent to a foreign purchaser or his bank in the form of "buyer credit." This enables the buyer to pay cash to the foreign export supplier. Refinancing agreements are a common form of officially supported "supplier credit." An exporter who has previously agreed to lend funds to a foreign purchaser seeks to refinance or "cover" his outstanding credit through a government agency which then assumes both responsibility for funding the loan and financial risk in the event there is a failure to repay the loan.[6] A government may also provide insurance or guarantees for commercial bank credits. In this case, the government does not provide funding but does assume the risk of financial loss.[7]

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3 United Nations, Economic Bulletin for Europe, vol. 25, 1983, p. 2.33.

4 This paper is generally restricted to nation-to-nation lending. Hungary and Romania also receive funds from multinational sources: the IMF and World Bank.

5 A fourth type of credit support "mixed credits" which combine development grants with export finance is not used in East-West trade.

6 In some cases, "buyer credits" may be provided by a private bank and then "refinanced" by the exporting government.

7 Official credit supports are generally available only for loans with maturities over two years; these loans are used to purchase capital equipment and develop large-scale industrial projects--transactions that take several years to complete or that have very high initial costs which can be recouped only over the long run. As such, officially supported credit plays an especially important role in the efforts of the Warsaw Pact nations to boost their economic growth by means of importing Western industrial technology.

Official direct loans and refinanced loans traditionally are provided at below-market interest rates. Whenever the interest charged on a direct or refinanced loan is less than the market interest rate, the difference is termed a "subsidy."[8] By subsidizing export credits to Warsaw Pact nations, Western governments actually provide funds for capital investment in communist economies at a lower cost than funds are available in the West; as, for example, when projects similar to the Yamal pipeline went unbuilt because they were too expensive at the prevailing 16 percent commercial interest rate.

The simplest means of subsidizing low interest lending is to use tax revenues to cover the loss incurred when an official export bank borrows private funds at a market rate of interest and then lends out those funds at a lower rate. Below-market interest rates may also result from the fact that the government, as a "risk free" borrower, can attract capital for relending at lower rates than commercial banks; in this practice taxpayers provide an implicit subsidy by assuming the financial risk. Finally, an implicit interest rate subsidy will also exist when the government insures a commercial loan, eliminating the element of risk and thereby enabling the lending bank to charge a lower interest rate.

Historically, the effective interest rates on government direct loans and refinancing have been between 30 and 50 percent below market rates.[9] In 1980, OECD nations paid $5.5 billion in overt interest rate subsidies to finance their worldwide exports.[10] International efforts to control subsidization in export credits have been undertaken since the 1930s with little success. In 1978, the OECD "Arrangement" guidelines were established.

The "Arrangement" provided for a matrix of minimum interest rates for official direct loans and refinancing based on the length of the loan and the level of economic development of the importing country; less developed nations (measured by per capita GNP) were eligible for lower rates. The matrix rates were still well below market interest rates and were "fixed"; when inflation doubled commercial interest rates in the late 1970s and early 1980s, the "Arrangement" minimum rates remained nearly unchanged;

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8 Interest rate subsidies have been favored primarily as a means of "exporting unemployment," on the theory that acquiring a foreign purchase of goods by a relatively small subsidy is less burdensome to the government than the financial and social costs of unemployment. Of course, if other exporting nations offer competing subsidies the overall employment benefits will be lost and only the importer will gain.

9 Thomas Wolf, "East-West Trade Credit Policy: A Comparative Analysis," in Paul Marer, ed., U.S. Financing of East-West Trade (Bloomington, Minn.: International-Development Research Center, 1975), p. 165.

10 House Subcommittee on International Economic Policy and Trade, Export Credit Subsidies; Hearings, November 11, 1981, p. 29.

permissible subsidization expanded dramatically. In the last two years, the situation has improved; efforts by the Reagan Administration have prompted changes in the "Arrangement" system; interest rate subsidization has been cut back sharply and in some cases eliminated. (See the "Recent Negotiations" section below.)

Nevertheless, even if actual interest rate subsidization were completely eliminated, official export credit support would continue to affect East-West comercial relations in two important respects. First, direct loans, refinancing, and government guarantees increase the flow of revenue to East Bloc countries simply by supporting loans that would not have been made under purely commercial conditions due to the risk involved. Second, because commercial lending is sensitive to the political tenor of East-West relations, the level of direct government lending and government-insured lending will affect the level of non-supported commercial lending.

INDIVIDUAL NATIONAL FINANCING: INSTITUTIONS AND POLICIES

There are a great number and variety of Western government institutions that facilitate the transfer of resources to the East bloc.[11] Only the U.S. restricts, for political purposes, the operation of its export credit agencies in East-West trade, denying official credit supports to all but a few Soviet bloc economies. In other OECD nations, official credits and guarantees are supplied to the East without political limitations.

United Kingdom

All government involvement in financing British exports is controlled by the Export Credit Guarantee Department (ECGD), which is directly responsible to the Secretary of State for Trade. The ECGD does not extend credit directly to suppliers and foreign buyers but supports exports by refinancing bank export loans, traditionally on preferential terms. The cost of any overall interest rate subsidy is borne directly by the government as an expenditure in the annual budget. In addition to financing specific export sales, British banks may also provide an open line of credit to a communist government. The purpose is to facilitate the general financing of orders for British capital goods by the communist government.

The ECGD often assumes a major role in establishing these standing lines of credit and may participtate in negotiating the financing terms of individual sales under the general line of

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[11] For a detailed treatment of OECD export credit facilities see The Export Credit Financing Systems in OECD Member Countries (Paris: OECD, 1982); and Suzanne F. Porter, East-West Trade Financing (Washington, D.C.: U.S. Government Printing Office, 1976).

credit. Under ECGD supervision British banks have provided open lines of credit to most Warsaw Pact nations.[12] The most important function of the ECGD is insuring commercial export credits. About one third of total exports are guaranteed or insured by the department.

The Federal Republic of Germany

Bonn utilizes most of the major forms of export credit support, but direct lending and interest rate subsidization are comparatively limited. The vast majority of German exports are privately financed by individual banks or through a large banking consortium, the Ausführkredit GmbH (AKA). AKA generally uses private funding to finance buyer and supplier credits at market rates; however, one AKA credit line (Plafond B) employs funds obtained from the state bank (Deutsche Bundesbank) at preferential rates. Plafond B funds are available for supplier credits for trade with developing countries and Eastern Europe.

A second government agency, the Kreditanstalt für Wiederaufbau (KFW) grants long term credits largely for German exports of capital goods to developing nations. In the mid-1970s, KFW provided low interest financing for trade with Bulgaria, Romania, Poland, and the USSR. At present, low interest lending by KFW to Eastern Europe seems to have been terminated. Less than ten percent of Germany's worldwide exports are funded through KFW or AKA "Plafond B." Official insurance coverage for commercial export loans is provided by Hermes, a private stock company, which serves as an agent of the government. Hermes insures against lender loss due to commercial or political factors; all risk and financial loss on Hermes insurance is funded directly by the German government.

France

Mechanisms for extending official export credit support are more fully developed by France than by any other OECD nation. Subsidizing exports is so deeply ingrained in the French system that an American official remarked: "the French have trouble grasping the concept of non-subsidized exports." Public and semi-public agencies promote export finance; these are overseen by the Direction des Relations Economiques Exterieures (DREE) which sets overall export credit policy.

Official support takes the form of refinancing loans of commercial banks at preferential rates rather than direct subsidized lending to exporters and buyers. Long-term export credits (with maturities over seven years) are refinanced by the Banque Française du Commerce Exterieur (BFCE) which draws funds from commercial sources and the Treasury; medium-term export loans (2 to 7 years) are refinanced directly by the central bank (Banque

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[12] Porter, op. cit., p. 23.

de France) after approval by the BFCE. Insurance for short, medium, and long term export loans is provided by Compagnie Française d'Assurances pour le Commerce Exterieur (COFACE), a semi-public joint stock company.

In the past, the French government has negotiated directly with communist governments to establish open lines of credit to finance the purchase of French export goods. Such agreements stipulate the volume of credit to be provided, the rate of interest, and repayment periods, among other things. These lines of credit generally extend for five or more years and are subject to renewal. For example, in 1974 the French government signed an agreement to furnish a credit line of 12 billion francs to the USSR for purchases of capital equipment in France over the next five years.[13]

In 1980, the French signed a secret protocol with Moscow for a line of credit of an unspecified amount at 7½ percent interest to run through 1985.[14] French exporters seeking financing under such open lines of credit operate through the credit institutions described above. Approximately 34 percent of French worldwide exports receive some type of official credit support.

Official Export Credit Support Programs

Country	Direct Loans (Buyer credits)	Refinancing (Supplier credits)	Insurance
France	BFCE, Banque de France	BFCE, Banque de France	COFACE
United Kingdom	ECGD	ECGD	ECGD
West Germany	KFW	KFW, AKA Plafond B	Hermes
Japan	EX/IM	EX/IM	EID/MITI
Italy	--	Mediocredito	SACE
U.S.	EXIM, CCC	EXIM, CCC	EXIM, CCC, FCIA

Italy

Buyer and supplier credits are available from a number of banking facilities such as MEDIO BANCA and EFI BANCA; each is a joint stock company with mixed public and private stockholders.

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13 Ibid., p. 66.
14 Crovitz, op. cit., p. 20.

Export loans made by these facilities are eligible for direct interest rate subsidies or refinancing by Instituto Centrale per il Credito a Medio Termine (Mediocredito). An autonomous government institution, Mediocredito draws funds from a permanent endowment and by borrowing in the commercial market. Net losses resulting from the difference between the interest rate at which Mediocredito borrows and the lower subsidized rates at which it lends are covered by an annual appropriation from the Italian Treasury. Insurance against both commercial and political risks for short, medium, and long term credits is provided by the Special Section for Export Credit Insurance (SACE). Approximately 7 percent of Italy's worldwide exports receive some form of official credit support.

Japan

Two institutions provide official Japanese export credit support. The Export Import Bank of Japan (EXIM) is an independent government agency which grants supplier loans and lends directly to foreign purchasers of Japanese exports. The Export Insurance Division of MITI (EID/MITI) offers insurance for commercial export loans; some 50 to 70 percent of Japanese exports are provided with some type of official export credit support, the overwhelming part of this support being in the form of EID insurance.

United States

The U.S. official export credit system centers on two institutions: the Export-Import Bank (ExIm) and the Commodity Credit Corporation (CCC).[15] ExIm coordinates its activities with two private organizations, the Foreign Credit Insurance Association (FCIA) and the Private Export Funding Corporation (PEFCO). Direct loans and some export refinancing are provided by the ExIm bank. The ExIm bank provides insurance against commercial and political risk for its own loans as well as export loans by commercial banks. Insurance is also available from FCIA, an association of 50 private insurance companies. FCIA companies provide insurance against commercial risk and are, in turn, reinsured by the ExIm bank. In addition, the ExIm bank insures all export loans made by PEFCO, a consortium of 55 private banks established in 1971; all PEFCO loans are subject to ExIm approval.

The Commodity Credit Corporation of the Department of Agriculture provides insurance and loans to finance the export of American agricultural products. Interest rates on CCC credits are at market levels.

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15 A third agency, the Overseas Private Investment Corporation (OPIC), is not technically an export credit facility. OPIC insures U.S. investments in developing countries; it is governed by the same restrictions as EXIM and CCC. Among communist countries, OPIC operates only in Romania and Yugoslavia.

Official credit relations between the U.S. and Eastern bloc nations are restricted by explicit political criteria. During the 1950s and 1960s official credits to the East were virtually non-existent. However, this policy of denial was reversed by the Nixon Administration. Official credit assistance to the Soviet Union and Eastern Bloc became the centerpiece to detente and the politics of linkage. In 1970, President Richard Nixon gave blanket approval for the ExIm bank to supply and guarantee credit to Romania, Poland, and the USSR. Two years later, the U.S.-USSR trade agreement promised the Soviets full access to ExIm funding. There was a surge in ExIm lending to Eastern Europe amounting to $634 million in the following two years.

This trend ended when the Jackson-Vanik amendment in 1974 tied ExIm credits to freedom of emigration, making Kissinger's implicit diplomatic linkage explicit and widely publicized. Shortly thereafter, the Stevenson Amendment placed a ceiling of $300 million on new ExIm lending to the USSR, effectively eliminating official credit as a linkage instrument. The Soviets responded by repudiating the 1972 Trade Agreement.

The Jackson-Vanik Amendment as incorporated into the Trade Act of 1974 (Section 402; 19 USC 2432) forms the foundation for current U.S. policy on official credit to the Eastern Bloc. The Amendment prohibits the U.S. government from providing export credits, or credit insurance to any nonmarket economy nation which denies its people freedom of emigration by legal/administrative barriers or through the charging of fees. This ban applies to ExIm, CCC, PEFCO, and FCIA. The President may waive these prohibitions under certain conditions. Currently, among Warsaw Pact states, Poland, Romania and Hungary have received waivers or exemptions.[16]

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[16] The prohibitions of the 1974 Act may be waived by the President on the condition that: 1) he has determined that such a waiver will substantially promote the goals of the freedom-of-emigration provision; and 2) the President has received assurances from the government in question of its intention to improve its emigration policies and practices. Any waiver must be approved by a joint resolution by both Houses and is subject to an annual review. Poland and Yugoslavia were exempt from the provisions of the 1974 Act. Waivers were granted to Romania in 1975, Hungary in 1978, and Mainland China in 1980. Sporadic interest in granting a waiver to the USSR continued through the late 1970s but disappeared with the invasion of Afghanistan in 1979.

Poland remains formally exempt from the provisions of the 1974 Act, but all NATO nations suspended issuance and rescheduling of government-backed credits to Poland followin the declaration of martial law in December 1981. Tentative negotiations concerning the rescheduling of this debt were resumed in October 1983.

RECENT NEGOTIATIONS

Since the volume of American official lending to the Eastern Bloc is relatively small, U.S. efforts to stem the flow of official credit must focus on allied policies. The U.S. has taken two negotiating approaches:

1) It has sought a specific East-West credit policy, emphasizing the security threat from subsidizing the COMECON economies.

2) It has sought to control official credit supports in international commerce in general through the forum of the OECD "Arrangement" emphasizing the issue of economic efficiency.

Efforts to formulate a specific East-West credit policy have been unsuccessful. During 1981, allied governments developed a collective set of sanctions to be imposed in the event of Soviet use of force to suppress the liberalization movement in Poland; these sanctions entailed a suspension of the pipeline project and almost certainly included other measures affecting official credits.[17] The declaration of martial law in Poland in December 1981, however, technically fell short of the actual Soviet invasion needed to trigger the collective sanctions. Western governments suspended rescheduling of the Polish debt, but ironically, left trade relations wth Poland's big brother, the USSR, basically unchanged.[18] A few weeks after the martial law crackdown, France finalized its agreement with the Russians to purchase 280 billion cubic feet of natural gas per annum via the Yamal pipeline.

Unwilling to accept another "status quo" response from the Europeans, President Reagan sent Under Secretary of State James Buckley to Europe in the spring of 1982. The Buckley mission proposed an allied policy on official credit to the USSR: subsidies should be eliminated and a limit on total lending would be imposed.[19] The Buckley Mission and subsequent negotiations at the Versailles summit in the summer of 1982 came up empty. At Versailles, a communiqué was issued affirming the need to

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17 Allied governments also developed a policy of credit inducement in 1981, offering the Polish government a "mega-carrot" of about $900 million in IMF loans as a quid pro quo for continuing liberalization. Permanent liberalization in Poland would have been a decisive event in the Cold War; in that context the "mega-carrot" seems inadequate. If there was any hope that permanent liberalization was possible far greater financial incentives should have been offered.

18 In addition, to suspending issuance and rescheduling of government credits, the U.S. imposed the following sanctions on Poland: suspension of MFN status; blocking Poland's entry into the IMF; restricting sales of high tech equipment; suspension of fishing and airline landing rights. With the exception of airline and fishing rights, these sanctions remain in effect.

19 The Economist, May 22, 1982, pp. 70-72.

exercise "prudence in limiting export credits" to Eastern Europe, but President Mitterrand almost immediately proclaimed that France had made no concessions and would not alter its policies.[20] Since this rebuff at the Versailles summit, efforts to formulate a specific East-West credit policy for the allies have remained decidedly "low-key."

The situation was not as bad as Mitterrand's retorts suggested. In July 1982, only a few weeks after the Versailles summit, breakthroughs were achieved in the OECD "Arrangement." Agreed minimum interest rates for official credit for "relatively rich" importing states were raised to 12.4 percent, competitive with commercial rates in most currencies at that time. More important in terms of the East-West issue, the definition of a "relatively rich" state (measured in per capita GNP) was lowered to include the USSR, Czechoslovakia, and East Germany.

The momentum toward reform continued in the next year; the October 1983 OECD agreement linked the matrix rates automatically to changes in average international commercial interest rates. Moreover, through a complicated formula, interest rates for the category of "intermediate economies" (which includes the remaining COMECON states) are to be raised to commercial levels by the mid-1980s.[21]

Arrangement Interest Rates for Official Export Credit
October 1983
(in percent)

For importing countries which are:	Maturity of Loan		
	2 - 5 Years	5 -8.5 Years	8.5 - 10 Years
Relatively Rich	12.15	12.40	--
Intermediate	10.30	10.70	10.70
Relatively Poor	9.50	9.50	9.50

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20 Following the Versailles Conference, President Reagan extended the ban on the sale of American equipment for the Yamal pipeline to foreign subsidiaries of U.S. firms and foreign firms using U.S. licenses. This action was in part a response to Mitterrand's rebuff as well as an effort to acquire greater leverage on East-West trade issues. Restrictions on the sale of equipment were rescinded for both U.S. and foreign firms on November 13, 1982.

21 The "Arrangement" rates apply only to government direct loans and refinancing and not to loans by private institutions. For example, an exporter might loan funds to an East European purchaser at below market rates and recoup the interest rate loss through a higher initial selling price. A Western government could provide insurance for such a private transaction even though the interest charged was below the "Arrangement" minimum rates.

Problems remain in the OECD "Arrangement" even after the 1983 reforms. Although the degree of subsidization of interest rates has been reduced everywhere, some subsidization will continue in high inflation economies (e.g., France and Italy where domestic interest rates still exceed 14 percent). Moreover, the 1982-1983 agreements were not retroactive; interest rates on lines of credit opened before 1982-1983 (like the French protocol with the USSR) are unaffected. These lines of credit will expire in the mid-1980s; the amount of funds available in them is unknown. However, thanks to the 1982-1983 agreement, large scale subsidization of the Eastern Bloc of the type experienced in the 1970s and early 1980s has ended--at least temporarily.

CURRENT ISSUES

At present, U.S. allies tend to acknowledge that past subsidizing practices were harmful and that "subsidized" financing to the East should be eliminated.[22] Yet the Europeans argue that loan guarantees and official credit financing at market rates do not constitute subsidies.[23] According to them, a subsidy occurs only when the state incurs a current cost. This ignores the fact that government credit activities almost certainly impose costs by shifting resources away from other potential borrowers or may result in future costs to the state in case of default.

Europeans regard continuing official finance and guarantees as an indispensable ingredient of East-West trade. That this encourages non-government lending, raises trade levels and permits more importing by the East is seen as a welcome result, since East-West trade is presumed to be of "mutual benefit." The "mutual benefit" argument raises a formidable barrier to the development of a responsible policy on East-West trade and finance by the Western allies. Since both sides allegedly gain from trade and no one loses, Europeans resist pressures to "rock the East-West trade boat" by tying trade to political issues, especially since the diplomatic benefits of "linkage" and "economic sanctions" are admittedly hard to find.

Unfortunately, while both sides may benefit from trade, the benefits are not equal. This inequality is inherent in the very structure of East-West trade. Eighty percent of OECD exports to the COMECON are machinery and capital equipment while imports from the COMECON are 80 percent raw materials and food stuffs. The shipment of plant and equipment to the East constitutes a direct infusion of new "embodied" technology into COMECON economies. Technological change in the mode of new equipment has

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22 Hans-Dietrich Genscher, "Toward an Overall Western Strategy," Foreign Affairs, Fall 1982, p. 56.

23 Stephen Woolcock, "East-West Trade After Williamsburg," World Today, July-August 1983, p. 293.

long been known as the single most important factor in promoting long run productivity growth in economies. Raw material imports in the West, on the other hand, may (possibly) reduce consumer costs, but they certainly do not boost productivity growth. Official trade financing by promoting higher levels of East-West trade, in the long run, helps to shift the balance of economic and military power against the West.

A second problem generated by official credit supports is that by encouraging higher levels of COMECON debt (both government-backed and private), the West may be creating a diplomatic weapon to be turned against it. The implicit threat of default may in the future be used to induce political concessions in the West. The beginnings of a Western "debt lobby" can be seen in the remarks by a Citicorp banker that the U.S. should not respond negatively to the reimposition of totalitarian political control in Poland: "Who knows which political system works...the only test we care about is can they pay their bills."[24] Similarly, Western bankers have supported politically the Yamal pipeline in hopes that increased Soviet hard currency earnings may indirectly help them recoup their loans to Poland. But the West European governments seem little concerned by the long run political implications of the COMECON debt.

POLICY OPTIONS

U.S. policy on official credits exists on two levels: the multilateral level and the unilateral level. Because most official credits and guarantees provided to the COMECON are not American, the formulation of a multilateral or collective policy with NATO allies and Japan is clearly the most important aspect of the problem. However, unilateral U.S. policy remains important in that: it directly affects U.S. foreign policy relations with specific COMECON nations; it provides a symbolic statement of U.S. East-West relations; and it establishes the basis for negotiations concerning multilateral controls.

With respect to unilateral U.S. policy, there are two approaches available other than current policy, which differentiates among Soviet bloc nations solely on the basis of emigration policy. First, the current Jackson-Vanik criteria of emigration could be expanded to include other important human rights questions such as the unimpeded existence of human rights monitoring groups. The other alternative would be to establish a blanket denial of credit privileges to all Eastern European nations by rescinding the waivers granted to Romania, Hungary, and Poland or perhaps even repealing the authority for waivers.

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[24] Wall Street Journal, December 21, 1981, p. 10.

Any collective policy must address two issues. First, residual subsidization through below-market interest rates must be eliminated. Second, the remaining official loan guarantees, as well as official refinancing and direct loans at market rates, must be controlled in some way, either through a policy of "denial" or a policy of "linkage." Five policy options are available.

1. Improving the OECD Arrangement. This would entail tightening the existing "Arrangement" to eliminate the remaining elements of direct subsidization. The Reagan Administration is pursuing this objective and the prospects for success appear to be fairly good. Potential improvements would include: charging higher fees for insurance; modifying the technical definitions of "market rates"; and increasing differentation in the system so that continued subsidies in high interest/ high inflation currencies are prevented.[25]

2. Elimination of All Official Credit Supports in International Commerce. This policy would follow up the current efforts in the OECD arrangement to eliminate interest rate subsidies with a proposal to eliminate government direct loans, refinancing, and insurance in all international commerce. This would be compatible with the Reagan Administration's long-run aim of allowing the marketplace to govern export financing. (If government financing institutions do not distort market forces, they are merely redundant and should thus be eliminated.)

3. Elimination of Official Credit Supports in East-West Trade. This policy would eliminate official loans, refinancing, and guarantees to the COMECON by the U.S. and its allies. Restrictions on official credits presumably would be implemented progressively to avoid jeopardizing outstanding debts by forcing defaults in the COMECON.

The overall reduction in lending would considerably inconvenience the COMECON states: in the short run, by forcing them to reduce imports (by perhaps 10-15 percent per annum for 5 years) in order to pay off their existing debt; in the long run, by forcing them to stockpile hard currency to finance the purchase of large scale plant and equipment. Huge "cooperative" projects like the Kama truck plant and the Yamal pipeline would become impossible. However, a substantial importation of Western machinery and technology would continue as before. Real blockage

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[25] The current "Arrangement" system is partially differentiated. Countries like Japan and Germany with market interest rates well below those set forth in the "matrix" are permitted to provide official export credits at interest rates equal to commercial rates in their country. A fully differentiated system would eliminate the matrix entirely and tie export credit interest rates directly to the prevailing market levels in each currency.

of the flow of capital equipment to the Eastern Bloc would require restrictions not just on trade financing but on trade volumes as well.

4. Denial to the USSR; Linkage in Other European States. Under this policy, subsidized interest rates would be prohibited across the board. In addition, official credit insurance and official credits at market rates would be denied to the USSR. Official credit insurance and official credits at market rates would be potentially available to specific East European states but access would be "linked" to the policies of each state. The Western allies would agree to coordinate their official credit support policies for political purposes, although each Western state would retain the right to credit policies more restrictive than those of the group.

This policy is likely to be more acceptable to the allies than a policy of uniform denial. Although at present, the West Europeans are strongly resisting both "linkage" and "denial," "linkage" is ultimately quite compatible with the European outlook on East-West relations. Europeans still profess a belief in the "dynamic" elements of detente--"elements which encourage long-term development in communist countries of Europe toward greater freedom and self-determination."[26] A *de facto* refusal to link trade to other aspects of East-West relations must inevitably derail any presumed dynamic.

In concrete terms, the consequences of this refusal can be seen in the Conference on Security and Cooperation in Europe (CSCE) which reviews the Helsinki Accords. The Helsinki Accords are divided in separate sections commonly called "baskets." Basket II calls for improvements in East-West trade relations while Basket III deals with human rights. The U.S. has insisted that Baskets II and III be linked, i.e., that Western concessions on trade normalization be tied to human rights policies in Eastern Europe. The Europeans have refused such linkage; trade normalization was pursued without any communist *quid pro quo*, thereby turning the always dubious CSCE process into a charade.

Professed West European beliefs in continuing "detente" ultimately require some type of active linkage policy. A collective allied policy within the CSCE forum which linked official credit supports and MFN status, for example, to human rights practices on a state by state basis could have real influence (within definite limits) over Eastern Europe in the long run. Such a policy would be consistent with West Europe's alleged goal of using trade to draw the East Europeans away from the Russians.[27]

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26 Genscher, *op. cit.*, p. 57.

27 However, whether or not, after a linkage policy was accepted in principle, the Western governments could muster the political will to make it work effectively is another question; like all linkage policies this one would suffer from the enervating effects of Western pro-trade lobbies.

5. Overall Linkage. This would be the same policy as that described above except that the Soviet Union would be included in the linkage process. For example, official credits might be denied as long as Soviet troops remained in Afghanistan. The drawback of this type of linkage is that it encourages dangerous wishful thinking about the USSR.

CONCLUSION

To develop an allied consensus on the question of official credits and guarantees as well as on other East-West trade questions, the U.S. will not only have to modify basic European attitudes, it will have to convince the allies that the U.S. is willing to share the economic costs of restricting East-West trade and financial flows. Current U.S. policy objectives in East-West trade--limiting technology transfers, limiting energy dependence, and controlling official credits--all disrupt East-West trade patterns for the Japanese and Europeans but have little effect on U.S. trade. Over 80 percent of European export sales to the East are machinery/technology; use of official credits and guarantees is heavy. About 80 percent of U.S. exports to the East are agricultural; official credits and guarantees are generally not available. Thus, allied governments have taken a cynical attitude toward U.S. efforts to restrict the flow of allied high-tech equipment and credits while at the same time the U.S. has signed new grain agreements with the Soviets which expand sales by up to 100 percent.

American counterarguments--that grain sales are strategically different from capital equipment sales, and that the U.S. already has accepted disproportionate economic sacrifices through stiffer unilateral policies on technology transfers and official credits--while technically correct, are politically unpersuasive. Since the U.S. wishes to take the lead in establishing East-West trade policies for the allies, the U.S. must, in every way, appear willing to take the lead in bearing the economic sacrifice that comes from restricting trade. As long as the U.S. pursues ever larger grain deals with the Soviets, it will find its efforts to curtail "business as usual" between the allies and the Eastern Bloc all the more difficult.

In the 1970s, the West followed a policy of expanding official credits and trade with the East. This policy was often accompanied by an unfounded belief that trade and credit would have a moderating effect on Soviet behavior. Far from it, Soviet aggression and expansionism actually increased during the period of "detente," but Western credit policy has remained largely unchanged.

A new policy is needed. It should permit non-strategic trade on strictly commercial terms but would not allow any governmental involvement in the terms of such trade. Specific elements of such a policy could include an end to government underwriting

of loans or loan guarantees; no concessionary interest terms permitted to borrowers in the Soviet bloc; and no preferential tax treatment offered to any income derived from trade with the Soviet bloc nations.

Any policy of this nature, to be truly effective, would require implementation by Japan and Western Europe as well as the U.S. Given European attitudes on East-West trade, this will be a long-term process. Although the Europeans have agreed in principle to eliminate official interest rate subsidies in trade with the East, they strongly resist any additional restrictions on official export credits. Thus while the U.S. should press its allies to work toward the goal of eliminating all official credit supports in East-West trade, given European attitudes, it may be necessary to settle for an interim compromise policy which falls short of this long-run objective.

In this light, a policy of linkage may represent a possible halfway house between the U.S. views and those of its allies. Such a linkage policy would deny official credit supports to the USSR while allocating rights to official credit supports among the East European states on the basis of their human rights records. Such an interim policy would be consistent with a unilateral U.S. policy based on an expanded version of the Jackson-Vanik Amendment (covering human rights issues beyond emigration).

In any event, the U.S. should continue to act forcefully on this and other East-West trade issues. While criticized domestically and abroad, President Reagan's strong stand on East-West trade has, in fact, caused the Europeans to reassess their trade and credit policies toward the Soviet bloc and to begin a process of tightening such policies. The U.S. policy of leadership is working and should be continued.

Prepared for The Heritage Foundation
by Robert Rector,
a Washington, D.C.-based writer
on international economic issues