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THE CONVETIBLE CURRENCY BALANCE OF PAYMENTS OF THE USSR AND EASTERN EUROPE AND TRENDS IN EAST-WEST ECONOMIC RELATIONS

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Note by the Deputy Secretary General

This report deals with recent and likely future short-term trends in the convertible currency balance of payments of the USSR and Eastern Europe. It was prepared by the Economic Committee primarily in the light of the findings of a meeting with Experts from capitals held on 21st, 22nd and 23rd May 1979.

2. The Council is invited to take note of this document.

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THE CONVERTIBLE CURRENCY BALANCE OF PAYMENTS OF THE USSR AND EASTERN EUROPE AND THE TREND IN EAST-WEST ECONOMIC RELATIONS

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THE CONVERTIBLE CURRENCY BALANCE OF PAYMENTS OF THE USSR AND EASTERN EUROPE AND TRENDS IN EAST-WEST ECONOMIC RELATIONS

Draft report by the Economic Committee

SUMMARY

(i) In 1978, the Soviet convertible currency trade balance rose to $3.8 milliard from the 1977 figure of $3.3 milliard(1). There was a sharp upswing in imports ($17.0 milliard), which rose by 16% as against a drop of 4% in 1977, mainly because of the big increase in grain purchases. The rate of growth of the Soviet Union's exports (16% as against 17% in 1977), which amounted to $13.2 milliard, was reduced slightly because of the stagnation in the value of oil sales: these account for almost half of the country's export earnings from commodity sales. In all likelihood, the USSR's terms of trade with the Western industrialized countries worsened last year as a result of the continued rise in the unit value of equipment imported from the West and the standstill in world oil prices (paragraphs 3 to 6).

(ii) The trade balance of the East European countries, taken globally, vis-à-vis the industrialized non-Communist world deteriorated notably in 1978, with the deficit going from the 1977 figure of $5.9 milliard to some $6.7 milliard. All East European countries showed a trend towards large trade deficits except Poland, which, by carefully selecting imports succeeded in reducing its deficit for the second year running. In absolute terms, however, Poland's imbalance remains the most pronounced of all these countries (paragraphs 7 to 9).

(iii) The value of Soviet gold sales ($2.5 milliard) rose sharply last year as the combined result of increases in the price of gold and an appreciable augmentation in the volume of sales. Arms sales to the developing countries were again an important and growing source of hard currency for Moscow, which earned $1.7 milliard as against $1.5 milliard in 1977. At the same time, the Soviet Union's traditional surplus in net invisible transactions gave way in 1978 to a small deficit of $59 million, due mainly to increased interest payments on its debt. All in all, during the last two years, the USSR has impressively redressed its balance of payments on current account: after deficits of $2.7 milliard in 1976 and $0.2 milliard in 1977

(1) Data provided by the US experts from the official Soviet Foreign Trade Statistics, converted into US $ on the basis, for each year, of the average monthly official rouble: US $ exchange rate

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there was a surplus of $0.3 milliard in 1978. Most of the East European countries probably recorded deficits in their invisible transactions because of the increased cost of interests on the debt (paragraphs 10-14).

(iv) The decrease in the Soviet Union's credit requirements went hand in hand with a slackening of the rise in net convertible currency indebtedness in 1977. And estimates indicate that the debt remained unchanged at $11.2 billion in 1978. As things stand, this debt burden is well within the scope of the Soviet economy, which has a debt servicing/convertible currency goods and services exports earnings ratio of only 17%, with a sizeable part of the debt being made up of self-liquidating credits (paragraphs 15-21).

(v) Eastern Europe's net convertible currency debt rose by $7 milliard in 1978 to an end of year total of $38.8 milliard, of which $15.0 milliard were owed by Poland and $7.3 milliard by East Germany. At present, Czechoslovakia, Hungary, Romania and the GDR have no difficulty in meeting the repayments on the debts and all four have apparently acceptable debt servicing ratios. On the other hand, Bulgaria's debt servicing ratio is much more onerous although it continues to be able to obtain credits on comparably favourable terms and Poland, while remaining generally solvent, is in the tightest financial position of all; big repayments are falling due and the servicing burden will be such as to make it virtually certain that Poland will have to refinance a part of its debt. But in all probability Western banks will extend new credit facilities to Warsaw to make this refinancing possible and so avoid a financial crisis which would only increase its difficulties with debt repayments (paragraphs 22-28).

(vi) The Soviet Union will likely suffer a substantial increase in its hard currency trade deficit in 1979, perhaps to $5 billion or more. The anticipated poor harvest this year will increase outlays for grain imports while problems in metals production will boost imports of steel products. The cutback in Soviet orders for Western capital equipment in 1977-78 should entail a fall-off in imports of these goods in 1979, although preliminary Western trade data indicate that the drop may not be substantial. On the export side, there will be probably an increase in earnings from oil sales, even if there is a drop in the volume of deliveries because the latter could be offset by price increases. The Soviet Union will probably register a new advance in sales of natural gas and certain semi-manufactured goods. Moscow can probably cover most of its 1979 trade deficit from arms shipments, gold sales, and invisibles. Meeting the balance of funding requirements will entail some increase in net hard currency debt as the Soviets draw down their hard currency assets and/or borrow from Western commercial banks (paragraphs 29-34).

(vii) The 1979 convertible currency trade deficit of the East European countries is likely to remain high and give rise to large credit requirements and extensive recourse to Western capital. These countries will probably obtain sufficient new credits which will, of course, increase an already heavy debt burden (paragraphs 35 and 36).

(viii) Industrial co-operation is of only marginal importance in East-West economic dealings and is likely to remain so for the foreseeable future. The most promising prospects in this field would seem to be for tripartite co-operative ventures with Western, Eastern and Third World partners (paragraphs 37 and 38).

(ix) Within the constraints of the primacy of political aims the Soviet Union's motives for trade with the industrialized West are essentially economic. Imports are intended to promote the modernization of the economy and offset the shortcomings of domestic production while exports are supposed to fund these imports. After having seemingly overestimated the advantages which capital equipment procurement in the West would bring, and bearing in mind the difficulties they encountered in earning convertible currency with exports, expecially manufactured goods, the Soviets have come to a better understanding of what trade with the West can do for their economy without however questioning the rôle of this trade. Among other things, they probably overestimated the advantages stemming from transfers of technology. Alongside this approach, born of a more realistic appreciation of the situation, the Soviet Union has pursued a more consistent and tighter financial policy aimed to a large extent at severely curbing the growth of the net convertible currency debt. It is to be expected that the same strategy will be applied for the foreseeable future (paragraphs 39-43).

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THE CONVERTIBLE CURRENCY BALANCE OF PAYMENTS OF THE USSR AND EASTERN EUROPE AND TRENDS IN EAST-WEST ECONOMIC RELATIONS

Note by the Economic Directorate

1. This report deals in turn with the convertible currency payments on current account and capital movements of the Soviet Bloc countries and with the likely trends in the main chapters of their convertible currency balance of payments. It ends with a few comments on the strategy and motives behind Soviet trade with the West.

2. It is based chiefly on the comments and conclusions of the Economic Committee's reinforced meeting on 21st, 22nd and 23rd May 1979 and on the information contained in the documents provided by certain delegations for the meeting(2)(3).

I. SOVIET BLOC CONVERTIBLE CURRENCY PAYMENTS ON CURRENT ACCOUNT IN 1977 AND 1978

A. Trade balance

(i) USSR

3. In 1978, the Soviet Union's hard currency trade deficit increased from the 1977 figure of $3.3 milliard to $3.8(4). This is a contrary trend to that registered in 1977 when the trade deficit was reduced significantly (see Table III, page 14).

4. After falling off by 4% in 1977, Soviet convertible currency imports rose significantly by 16% in 1978 to a total value of $17.0 milliard(1). These conflicting trends from one year to another are attributable chiefly to big fluctuations in the value of Soviet grain procurements which went from $2.6 milliard

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(1) These percentage changes include the effect of the appreciation of the rouble vis-à-vis the US $ (2.4% in 1977 and 8.2% in 1978)

(2) AC/127-D/588; AC/127-D/589 (NATO SECRET); AC/127-D/590; AC/127-D/592; X(79)1157 (NATO SECRET)

(3) The Economic Committee's previous report on the convertible currency balance of payments of the Soviet Union was issued on 6th September 1978 as C-M(78)52

(4) The totals for Soviet foreign trade include equipment and pipe imports for the Orenburg pipeline reported in footnotes in Soviet foreign trade statistics. In 1977 and 1978 imports of this nature amounted to $420 million and $245 million respectively

in 1976 to \$1.0 milliard in 1977 and to \$2.4 milliard in 1978(2). Purchases of machinery and capital equipment, which is leading category of imports (accounting for around 1/3 of the total), rose from \$5.1 billion in 1977 to \$6.0 in 1978, which means that the effect on Soviet imports of the fall-off in orders observed since end-1976 was not felt in 1978.

5. In 1978 Soviet convertible currency exports were worth \$13.2 milliard and registered a slightly lower growth tempo (+ 16%) than in 1977 (+ 17%) and 1976 (+ 24%)(1). Oil retained the lion's share of Soviet convertible currency exports and accounted for 43% as against 49% in 1977 of the overall total. Moscow's oil earnings rose only slightly in 1978 (from US \$5.6 billion in 1977 to \$5.7 billion) because of a standstill in the volume of sales (around 1.1 million barrels per day(3)) and unchanged world oil prices(4). But at the same time, Soviet exports of natural gas rose sharply, (+ 75%) amounting to \$1 billion) along with those of several non-energy raw materials and semi-manufactures (chemical products particularly).

6. Among the various factors which determine the development of the Soviet trade balance, the rôle of price movements is difficult to assess with any accuracy because the statistics are unreliable(5). During the period 1972-1976, and except for 1975, it seems, however, that in its transactions with the industrialized Western countries the Soviet Union enjoyed a steady improvement in its terms of trade expressed in

(1) See footnote (1), page 7
(2) In 1978 the Soviet Union imported approximately 23 million tons of grain
(3) Some 55 million tonnes
(4) Recent statistics published by the International Energy Agency (1979/1 quarterly statistics) for all the OECD countries except Belgium and Turkey, show growth of approximately 5% in the volume of Soviet sales in 1978
(5) The series of unit value on which estimates of the terms of trade are generally based make too little distinction between real price movements and the effects of changes from one year to another in the commodity pattern of trade

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United States dollars; the improvement was particularly marked in 1974 and 1976(1). It is possible, though, that in 1977 the Soviet Union's terms of trade in its dealings with the industrialized West varied little because the rises in the unit values expressed in dollars of its exports and imports were roughly the same. Lastly, in 1978, Moscow probably recorded a slight worsening in its terms of trade with the Western developed countries expressed in dollars(2).

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(1) The unit value statistics in US dollars established by UNO for trade between the USSR and the Western industrialized countries show the following trend (annual percentage increase):

	1974	1975	1976	1977
Soviet exports	68	9	12	12
Soviet imports	20	23	-15	14

Source: UNO, advance copy of Economic Bulletin for Europe, number 30, table 3-1

(2) The preliminary GATT estimates indicate that in 1978 the increase in the unit value in dollars of the overall export of manufactures from the developed market economy countries was around 14%. On the other hand, the development in the unit value expressed in dollars of Soviet exports was probably influenced to a great extent by the standstill in oil prices

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TABLE I EASTERN EUROPE: RECENT TRENDS IN TRADE WITH THE WESTERN INDUSTRIALIZED COUNTRIES(FOB-FOB)(1)

in millions of US$

	1974	1975	1976	1977	1978(3)
Total					
Exports	11,326	11,282	12,819	13,275	15,140
Imports	16,470	17,687	19,168	19,181	21,820
Balance	- 5,144	- 6,405	- 6,349	- 5,906	- 6,680
Bulgaria					
Exports	466	474	628	608	700
Imports	990	1,289	1,050	997	1,270
Balance	- 524	- 815	- 422	- 389	- 570
Czechoslovakia					
Exports	1,702	1,673	1,671	1,903	2,130
Imports	2,102	2,244	2,429	2,639	3,000
Balance	- 400	- 571	- 758	- 776	- 870
East Germany					
Exports	2,658	2,631	3,170	2,930	3,370
Imports	3,549	3,704	4,626	4,070	4,880
Balance	- 891	- 1,073	- 1,456	- 1,140	- 1,510
Hungary					
Exports	1,363	1,327	1,553	1,712	1,980
Imports(2)	1,965	1,966	2,027	2,441	3,210
Balance	- 602	- 639	- 474	- 729	- 1,230
Poland					
Exports	3,042	3,278	3,563	3,852	4,260
Imports	5,335	6,199	6,798	6,374	6,160
Balance	- 2,293	- 2,921	- 3,235	- 2,522	- 1,900
Romania					
Exports	2,095	1,899	2,234	2,270	2,700
Imports	2,529	2,285	2,238	2,660	3,300
Balance	- 434	- 386	- 4	- 390	- 600

(1) All the OECD countries plus Israel. These figures do not provide a completely accurate picture of Eastern Europe hard currency trade since (i) they may include dealings with the Western countries covered by bilateral agreements and above all (ii) they do not take account of hard currency transactions between Eastern Europe and the Third World.

(2) c.i.f.

(3) Provisional estimates

Source: AC/127-D/588

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(ii) Eastern Europe

7. The estimates of 1978 trade between Eastern Europe and the developed market economy countries as a whole show, with the notable exception of Poland, an appreciable increase in the trade deficit of the East European countries (see Table I, page 10). For the whole of the area, the deficit for this trade rose from \$5.9 milliard in 1977 to some \$6.7 milliard.

8. Of significance is the big increase in the Hungarian trade gap, which rose from the 1977 figure of \$0.7 milliard to \$1.2 milliard (FOB c.i.f.) as the result of imports (up 31%) rising twice as fast as exports (up 16%); this rise in purchases by Hungary is largely explained by a surplus of investments and the building up of stocks by national enterprises. Romania, which in 1976 balanced its trade with the Western industrialized countries has since sustained a growing disequilibrium which reached \$0.4 milliard in 1977 and \$0.6 milliard in 1978; the widening of Romania's trade gap last year was chiefly due to the poor grain harvest and unexpected difficulties(1) in the oil industry which led to a drop in the country's sales of refined petroleum products.

9. On the other hand, Poland last year reduced its hard currency trade deficit from the 1977 figure of \$2.3 milliard to \$1.9 milliard (Table II, page 12). This redressing of the Polish trade balance continues a trend already observed, and to an even higher degree, in 1977(2); this is the result of official efforts to stem the deterioration of the foreign payments position by being much more selective over imports from the West than was the case in the past. Much greater strictness has been shown in granting convertible currency allowances and import licences, and in some cases closer correlation between the granting of import licences and export performance has been established. In spite of the positive trend registered over the last 2 years, Poland's hard currency trade deficit remains very high and obliges Warsaw to make extensive use of Western capital.

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(1) For instance, an explosion in a refinery and the interruption of Iranian oil deliveries
(2) In 1977, the reduction in Poland's hard currency trade deficit was \$0.9 milliard

TABLE II RECENT TRENDS IN POLISH CONVERTIBLE CURRENCY TRADE

in millions of US$

	1977			1978		
	Exports	Imports	Balance	Exports	Imports	Balance
Multilateral trade with Western Europe	3,047	4,982	-1,935	3,299	4,714	-1,415
Multilateral trade with the industrialized Western countries as a whole	3,531	6,114	-2,583	3,877	5,997	-2,120
Multilateral trade with the developing countries	511	185	+ 326	487	270	+ 217
Total multilateral trade in hard currency	4,042	6,299	-2,257	4,364	6,267	-1,903

Source: Official Polish statistics provided by the Canadian Delegation.

B. Gold sales

10. The Soviet Union has traditionally used gold sales to offset its hard currency trade deficit. The value of such sales grew last year (from the 1977 figure of $1.6 milliard to $2.5 milliard) under the combined effects of the rise in the price of gold and a 21% increase in the volume of sales, which amounted to 401 tons. The high level of Soviet gold exports in 1978 (Moscow had not been so active on the market since 1965) reflects a wish to curb the use of Western credits and to cash in on high world prices. Moreover, in 1978 there were larger requirements for liquid assets to fund grain imports, which are paid for in cash or through short-term credits.

C. Arms sales

11. Exports of arms to Third World countries continued to be a big source of hard currency earnings for the Soviet Union in 1978. Available estimates show that the value of such sales stood at $1.7 milliard as against $1.5 milliard last year(1). Sales of

(1) The total value (i.e. including transactions not paid for in convertible currency) of Soviet sales to the Third World is estimated to have risen from $3.5 milliard in 1977 to $3.8 milliard last year.

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weapons by East European countries to developing countries totalled some $300 million in 1978 and came chiefly from East Germany and Czechoslovakia. Assuming that the proportion of the arms paid for in hard currency is the same as for Soviet sales, i.e. about 45%, the total value of sales works out at between $130 million and $140 million.

D. Invisible transactions

(i) USSR

12. After having remained stable at around $190 million for the three years 1975, 1976 and 1977, the Soviet Union's traditional surplus from invisible transactions (services plus transfers) gave way in 1978 to a small deficit of $59 million (see Table III). This is attributable mainly to the increase in payments of interest on the debt which, in net terms, amounted to $1.1 milliard. There was a stagnation in earnings from transport operations in 1978 ($970 million in net terms); in this connection, it is worth noting the scale of Soviet cross trading operations which brought in $410 million. Net tourist industry earnings continued to rise and stood at $200 million compared with $175 million in 1977. Lastly, for official transfers there was a deficit of $145 million, corresponding to the Soviet hard currency contribution to the United Nations Budget.

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TABLE III

SOVIET UNION: SUMMARY OF CONVERTIBLE CURRENCY PAYMENTS ON CURRENT ACCOUNT IN RECENT YEARS

in millions of US$

	1975	1976	1977	1978(1)
1 - Commodity exports FOB	7,835	9,721	11,345	13,157
2 - Commodity imports FOB	-14,257	-15,316	-14,645	-16,951
3 - Balance of commodity trade (3 = 1 + 2)	- 6,422	- 5,595	- 3,300	- 3,794
4 - Non-monetary gold sales	750	1,361	1,597	2,522
5 - Arms sales	600	1,500	1,500	1,700
6 - Hard currency sales N.E.S.(*)	- 450	- 200	- 200	- 32
7 - Net tourist industry earnings	136	150	175	200
8 - Net earnings from transport operations	720	860	980	970
9 - Earnings from direct investment abroad	2	8	2	0
10 - Interest on deposits in Western banks	234	288	292	685
11 - Interest paid on outstanding debt	- 804	- 1,012	- 1,140	- 1,769
12 - Balance of investment income (12 = 9 + 10 + 11)	- 568	- 716	- 846	- 1,084
13 - Balance from services (13 = 7 + 8 + 12)	288	294	309	86
14 - Balance of goods and services (14 = 3 + 4 + 5 + 6 + 13)	- 5,234	- 2,640	- 94	482
15 - Net official transfers	- 98	- 107	- 125	- 145
16 - Balance of payments on current account (16 = 14 + 15)	- 5,332	- 2,747	- 219	337

(*) Convertible currency purchases of Cuban sugar and 1978 hard currency trade balance with Hungary.
(1) Provisional estimates

(ii) Eastern Europe

13. The Economic Directorate does not have sufficiently recent and detailed information on the hard currency invisible transactions of the East European countries to be able to draw valid conclusions. All that can be said is that most of the countries concerned appear to have deficits due essentially to the increase in interest payments on the debt.

E. Balance of payments on current account

14. The foregoing description of various chapters of the balance of payments shows that the Soviet current payments position was sharply redressed during the last two years; after having recorded large deficits in 1975 and 1976 ($5.3 milliard and $2.7 milliard respectively), that of 1977 was considerably smaller ($0.2 milliard) and last year there was a $0.3 milliard surplus. In the case of Eastern Europe, statistics are available for Hungary and Romania and show that, for both countries, in 1978 the hard currency balance of payments on current account deteriorated badly, with Hungary's deficit going from the 1977 figure of $0.6 milliard to $1.6 milliard and Romania's from $0.3 milliard to $0.7 milliard. It is possible, however, that Bulgaria's deficit sunk slightly.

II. SOVIET BLOC CAPITAL MOVEMENTS AND CONVERTIBLE CURRENCY DEBT, 1977 AND 1978

(i) USSR

15. With the improvement in 1976 and, above all, the redressing after 1977 of its current payments situation, Moscow's recourse to Western financial sources has gradually declined. The global value of the net influx of capital first went down sharply from an all-time high of $5.8 milliard in 1975 to $2.7 milliard in 1976 and $1.1 milliard in 1977 to, according to preliminary estimates, a slight net outflow of $13 million in 1978 (see Table IV, page 18) Consequently, the net Soviet hard currency debt which went up sharply in 1975 and 1976, rose much more slowly in 1977 and was apparently slightly reduced in 1978 to an end-of-year figure of $11.2 milliard(1)(2).

(1) Compared with the previous estimates shown in C-M(78)52, paragraph 20, this figure implies a big downward revision of assessments of net Soviet indebtedness. This revision is based on a re-estimate of the debt of the COMECON banks (the figures for which are included in the BIS statistics under the Soviet Union) and also on new and lower estimates of drawings net of reimbursements of officially-backed Western credits. On the last point, the revision was made partly on the basis of the export credit statistics established by the Economic Committee

(2) Estimates of the Soviet debt in 1978 take no account of advance repayments made by the USSR at the end of the year

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16. After having been obliged in 1975 (because of the scale of the external payments deficit) to make wide use of the financial facilities offered by Western banks, the Russians in 1976 and 1977 reverted to a policy of making greater use of officially-backed credits. It is notable that in 1977 they made no use of publicised syndicated Eurocredits and even turned down an offer of $500 million at a rate of one point over the LIBOR.

17. Thanks to renewed confidence on the part of Western bankers and liquidity in the market, in March 1978 the Soviet Union obtained a loan of $400 million ($100 million more than originally planned) on especially favourable terms (0.75 of a point over the LIBOR). But for the year as a whole, the Soviet Union's commercial debt, expressed in net terms and taking into account the substantial rise in Soviet holdings in Western banks, dropped by $1.1 billion. Again in 1978, the Russians relied largely on officially backed credits for new borrowings and according to provisional estimates, the corresponding debt rose by $1.0 billion. As a result, the share of net debt covered by Western official guarantees rose from 52% in 1977 to 62% in 1978.

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TABLE IV - USSR: SUMMARY OF CONVERTIBLE CURRENCY CAPITAL MOVEMENTS

in millions of US$

	1975	1976	1977	1978(1)
(i) Capital flow				
1. Drawings on officially-backed Western export credits (principal only)	1,972	2,611	1,991	2,500
2. Repayment of principal - officially-backed Western export credits	730	1,057	1,305	1,459
3. Net drawings on officially-backed Western export credits (3 = 1 - 2)	1,242	1,554	686	1,041
4. Receipts, net of repayments, of all credits not backed by offical Western agencies	4,160	2,720	191	458
5. Net variation in Soviet holdings in Western banks	- 395	+1,611	- 240	+1,512
6. TOTAL NET CAPITAL RECEIPTS (6 = 3 + 4 - 5)	5,797	2,663	117	-13
(ii) Soviet debt (end of year position)				
1. Commercial debt	6,947	9,567	9,858	10,316
2. Outstanding debt for officially-backed Western credits	3,631	5,185	5,870	6,911
3. Soviet holdings in Western banks	3,127	4,738	4,498	6,010
4. TOTAL NET SOVIET DEBT (4 = 1 + 2 - 3)	7,451	10,114	11,230	11,217

(1) Provisional estimates

18. Among the components of the Soviet convertible currency commerical debt, it is difficult to estimate the amount of supplier credits which are not officially-backed and not included in the assets of the banks reporting to the BIS. Most of the bills of exchange are probably rediscounted without recourse by the Western exporters on the à forfait market; the yearly volume of these transactions seems to have gone down slightly in 1978 from an average of $500 million from 1974 to 1977 to $400 million. Soviet indebtedness in this respect was estimated to be around $1.4 milliard at the end of last year. In 1977 the Russians took steps to limit the transferability of their promissory notes (and the adverse publicity on their debt standing to which the widespread circulation of these bills on secondary markets might have given rise). The Bank of Foreign Trade can refuse to back a bill of exchange if the exporter negotiates it on the à forfait market and it also retains a preferential option in the event of discounting.

19. As matters stand at present, the hard currency debt burden puts no strain on the Soviet economy. If the commitments arising from this debt are considered, it is seen that the debt servicing(1)/hard currency goods and services exports earning ratio was 17% last year. This was a fairly modest percentage and means that the Soviet Union has no problems in meeting its due payments.

20. An illustration of the healthy financial position of the Soviet Union is that since September 1978 it has repaid in advance a large proportion (at least 50%) of the Euro-credits ($1 milliard) borrowed in 1975 and 1976. So far it seems that the Russians have only refinanced $250 million by means of a fresh loan on the Euro-market contracted early in 1979 on especially favourable conditions (8 years at 0.625 of a point over the LIBOR). Moreover, a large part of the Soviet debt is made up of self-liquidating credits.

21. The various Soviet banks in the West provide Moscow with effective back-up in some of its financial dealings. They provide valuable commercial information, effect transactions on behalf of the Soviet Union and even participate in syndications. Their assets include a significant proportion of Soviet-backed promissory notes which they can help to restrict the circulation of. But their scope for extending credit to the USSR is governed by national legislation where maximum commitments to foreign borrowers is concerned.

(1) Debt servicing comprises repayment of: (i) the principal and interest on officially-backed export credits, (ii) interest on the whole of the commercial debt and (iii) the principal on the medium-term commercial debt.

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(ii) Eastern Europe

22. Contrary to what was the case for the Soviet Union, the convertible currency debt of the East European countries continued to rise appreciably last year to reach a total of \$38.8 milliard (see Table V). This means that the efforts by these countries to reduce the deficit of their balance of payments on current account have been unsuccessful or insufficient. Poland is faced with the heaviest debt (\$15.0 milliard at end-1978), followed by the GDR (\$7.3 milliard) and Hungary (\$5.8 milliard), with the latter's indebtedness rising by a sharp 57% last year.

23. Of the different types of loans contracted by the East European countries, the available data on publicised medium-term syndicated Euro-credits reveal a big rise in 1978 in loans of this type (from \$1.6 milliard in 1977 to \$2.3 milliard, a rise of 44%). The GDR and Hungary were the most active borrowers with \$732 million and \$515 million respectively (see Table VI on page 20).

TABLE V - EASTERN EUROPE: NET CONVERTIBLE CURRENCY DEBT VIS-A-VIS THE WEST(1)

(in milliard US\$, end of year position)

	1975	1976	1977	1978
Total	19.1	25.9	31.6	38.8
Bulgaria	1.8	2.3	2.6	3.0
Czechoslovakia	1.5	2.1	2.7	3.2
East Germany	3.8	5.2	6.0	7.3
Hungary	2.1	2.8	3.7	5.8
Poland	6.9	10.2	12.8	15.0
Romania	3.0	3.3	3.8	4.5

(1) These are American estimates based on a method worked out several years ago. Eastern Europe's indebtedness is now being recalculated by means of a revised methodology which among other things will seek to break down the debts owed by the COMECON banks to the West (approximately \$4.6 milliard in net terms) among the different East European countries. Apart from the addition of the banks debt, there should be no significant changes to the current estimates of the hard currency debt.

Source: AC/127-D/588

TABLE VI - PUBLICISED SYNDICATED MEDIUM-TERM(1) EURO-CREDITS EXTENDED TO THE SOVIET BLOC

in millions of US$

Country	Jan-June 1977	July-Dec 1977	Jan-June 1978	July-Dec 1978	TOTAL 1977	TOTAL 1978
USSR	-	-	400.0	-	-	400.0
Poland	19.0	-	304.0	70.0	19.0	374.0
GDR	150.0	542.0	562.0	220.0	692.0	782.0
Bulgaria	20.0	225.0	149.0	90.0	245.0	239.0
Czechoslovakia	-	150.0	150.0	-	150.0	150.0
Hungary	150.0	200.0	400.0	115.0	350.0	515.0
Romania	125.0	-	225.3	-	125.0	225.3
Total Eastern Europe	464.0	1,117.0	1,790.3	495.0	1,581.0	2,285.3
International Investment Bank	500.0	600.0	-	500.0	1,100.0	500.0

(1) Credit commitments for a period of more than one year.

Source: World Bank, "Borrowing in International Capital Markets".

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24. The strain of servicing the hard currency debt varies from one East European country to another. Czechoslovakia apparently remains in the strongest financial position, for in absolute terms its debt is small and the ratio of debt servicing to export earnings in the industrial West is in the region of 30%, a proportion which raises no problems. Romania would also seem to be fairly well placed with a relatively low debt servicing ratio of some 20% and financial facilities extended by the IMF and the World Bank. Hungary and the GDR can still easily meet their repayment schedules which amount to approximately 40% of their earnings from exports to the developed market economy countries. The GDR also has the advantage of extensive invisible earnings from its dealings with the Federal Republic of Germany.

25. Although in absolute terms it has the lowest debt in the area, Bulgaria has a very high debt servicing ratio (probably between 50 and 70%) which, if it were to persist, might entail economic difficulties. Be this as it may, Sofia does seem to have succeeded last year in reducing the deficit of its convertible currency balance of payments on current account. Moreover, should a pressing need arise, Moscow might well grant Bulgaria financial aid in view of the close political links between the two countries and the smallness of the Bulgarian debt. In any event, Bulgaria continues to enjoy the confidence of international banking circles which in 1978 granted it credits on comparatively favourable terms.

26. Poland's financial position is the most vulnerable of all. In absolute terms, its debt is the heaviest and, what is worse, the proportion of current hard currency earnings allocated to debt servicing is probably very high (perhaps as much as 70% in 1979). Poland has certainly made significant progress during the last two years towards narrowing its convertible currency trade gap, mainly by cutting back on imports from the West. But in view of the fairly close relationship which seems to exist between capital equipment purchases in the West and investments, if severe restrictions on imports from the West were kept up for any length of time there could be repercussions on the production of consumer goods (a potential source of public discontent) and on the output of exportable goods.

27. In spite of its heavy debt, Poland remains financially solvent although the big repayments falling due in 1979 and 1980 will probably make some rescheduling necessary. In all likelihood, Western banks will grant Poland further credit facilities to refinance part of its debts, firstly because they retain confidence in the country's long-term economic soundness and also to avoid driving Poland to a financial crisis which would only increase the country's difficulties with debt repayments.

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28. The Soviet Union has not so far directly contracted hard currency loans on behalf of any East European country and does not seem likely at present to depart from this attitude for the sake of Poland if only in order not to establish a precedent which might lead other East European countries to ask for similar assistance. In any event, although the possibility of Soviet intervention on private money markets on behalf of a COMECON partner has been discussed in Western financial circles, it may well be that there is no clearly defined Soviet policy in this respect and that the approach will be empirical.

III. LIKELY FUTURE TRENDS

(i) USSR

29. The Soviet Union will likely suffer a substantial increase in its hard currency trade deficit in 1979, perhaps to \$5 billion or more. Declining domestic economic performance is largely responsible for the growing deficit.

30. The dollar value of Soviet hard currency imports could rise by 15% or more over last year's level of \$17 billion. Because of an anticipated poor harvest this year, hard currency outlays for grain and soya beans will probably rise to \$3.8 billion from last year's \$2.6 billion. Mounting problems in metals production could push imports of steel products from \$2.5 billion in 1978 to over \$3.5 billion this year. The drop in orders of machinery and equipment in 1977-78(1) presages a sharp decline in deliveries from last year's \$6 billion; however, available 1979 Western partner country data indicate that deliveries could run to \$4.5 billion or more.

31. Trends in exports during the first months of 1979 suggest that Moscow will not improve its export performance sufficiently to offset its increased import bill. However, the value of Soviet oil exports for hard currency is likely to increase from last year's level, even if there is a drop in the volume of sales because of higher prices. Earnings from exports of natural gas, chemical products, and manufactured goods should rise, but the gains are likely to be less than in 1978.

(1) The value of Soviet capital equipment orders fell from \$6.0 milliard in 1976 to \$3.8 milliard in 1977 and to \$2.8 milliard in 1978. The fall-off in orders reflects Soviet determination and ability to redress the payments situation and also the difficulties encountered in making use of equipment already purchased

32. Moscow should be able to cover a trade deficit of \$5 billion or more without difficulty. Because of a drop in new military sales, net earnings from arms shipments and invisibles may decline somewhat; nevertheless, income from these items will remain substantial, covering roughly \$1.5 billion of this year's deficit. If the price of gold remains relatively high and market demand strong, the Soviets could earn up to \$3 billion from gold sales. Soviet sales through July 1979 totalled an estimated \$1.5 billion.

33. The Soviet Union enjoys a number of options to cover the balance of its funding needs. Moscow could probably tap up to \$2 billion of its \$6 billion in Eurocurrency holdings without endangering its ability to meet trade related financial requirements. Much of the equipment ordered but not yet delivered is covered by officially-backed exports credits already granted by Western countries(1). Although the USSR apparently has not been very active in international capital markets thus far in 1979, it could easily borrow several hundred million from Western commercial banks at favourable rates. If it wishes to use bank credit, the Soviet Union will benefit from the present very favourable borrowing conditions on the Euromarket and from the confidence of Western bankers (who recently granted it conditions comparable to those reserved for prime rate borrowers).

34. To the extent Moscow draws down its assets and/or increases borrowings from Western banks, it will sustain the first significant increase in its net hard currency debt since 1976. Assuming the USSR maintains a heavy volume of gold sales for the balance of 1979, the growth of Soviet debt should fall far short of the increases in 1975-76.

(ii) Eastern Europe

35. In 1979 the East European countries intend to step up their efforts to restrict imports from the industrialized market economy countries. In most cases however, the success of these efforts is by no means certain because of the relationship between imports of Western goods and the fulfilment of growth targets; only Poland and Hungary have reduced their growth targets to any extent. Any growth of exports from the East European countries beyond the volume reached in 1978 would appear problematical because of the slow growth in Western demand, the increase in these countries' domestic requirements and difficulties in certain exporting sectors.

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(1) At end-1978 officially backed credits committed by Western countries to the Soviet Union and not yet drawn upon stood at some \$7 milliard (capital only)

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36. So, it is probable that the trade deficit of these countries taken as a whole vis-à-vis the Western industrialized countries will remain high in 1979 (although it could be somewhat smaller than last year) and that funding requirements will necessitate continued and extensive recourse to Western capital. In 1979, they should have no difficulty in again securing export credits backed by official Western agencies(1). And because of continued liquidity - at least in 1979 - in the private capital markets, the banks will probably remain receptive to a strong East European demand for medium-term Euro-credits(2). On the other hand, leasing, which has sometimes been mentioned as another possible funding source for East-West trade, and in which some countries (Poland and Hungary notably) have shown interest, is unlikely to be of significance now or in the near future.

(iii) East-West industrial co-operation and tripartite East-West-South co-operation

37. Industrial co-operation(3) at present plays a very small part in East-West trade and the situation is unlikely to change in the near future. Western firms hesitate to take in such ventures because they consider that more often than not in terms of profitability they have no advantage over direct commercial dealings. Despite the lack of success, however, at least some of the East European countries will continue to encourage such agreements in order to improve managerial and marketing efficiency within their industrial sectors.

38. A possibility for industrial co-operation could be in the development of tripartite East-West-South co-operative agreements. But in this respect it is necessary to distinguish between genuine agreements on industrial co-operation, which are few, and the much more common specific agreements on marketing in the developing countries concluded between enterprises in the West and East. In these cases, the Third World plays a passive consumer rôle.

(1) Poland in particular seems to have left a large fraction of the committed credits undrawn

(2) During the period January to July 1979 these countries apparently negotiated $2.35 milliard worth of medium-term publicised syndicated Euro-credits (Source: OECD). A large proportion of this amount was to finance imports. A significant amount however was used to refinance part of the existing debt in order to take advantage of the favourable terms currently available in the Euro-currency market

(3) This paragraph does not take account of the compensation agreements which, although the East European countries try to portray them as such, cannot really be considered as industrial co-operation agreements

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IV. COMMENTS ON SOVIET EAST-WEST TRADE STRATEGY AND MOTIVES

39. Soviet trade with the industrialized market economy countries appears to be motivated by purely economic considerations, within, however, the constraints of the general primacy of political aims in the Soviet Union. Trade is seen above all in terms of imports, which are meant to remedy inadequacies or shortfalls in Soviet domestic production. And exports are seen mainly as a means of paying for imports. In order to pay for vital imports, exports of certain products may be promoted even at the expense of domestic requirements. It is probable that Soviet trade with the Third World, particularly when it takes the form of clearing arrangements, is more politically motivated and reveals a desire to assert some presence in the areas concerned. However, even in its bilateral trade with the developing countries, Moscow obtains economically important commodities (bauxite from Guinea, for instance) and rarely grants its trading partners specially favourable terms, even when they are underdeveloped.

40. While not questioning the principle of its trade with the industrialized West, the Soviet Union now has a more realistic vision of the scope it offers for developing the national economy. In the early Seventies it apparently believed that trade with the West had great potential for solving many of its economic problems. This belief was based on the assumption that the country would be able to absorb easily the imported technology, that it would get active co-operation from the Western governments for the promotion of trade and that it could penetrate the Western markets with its manufactured goods.

41. Moscow now realises that things have not turned out exactly as expected for several reasons.

In the first place, Western governments cannot - or will not - influence the course of trade negotiations or commit the private sector to an increase in trade with the Soviet Union. They have certainly not pushed for the development of trade at any price and have been reluctant to import Soviet goods for a number of reasons but principally because they do not correspond to market requirements. Furthermore, so far as the Western firms are concerned, all prospective trading operations must have some element of profitability. Neither has the USSR, contrary to its hopes, succeeded in developing its exports of manufactures. And lastly it seems that technology transfers have not had the fullest effect. But Western technology has certainly had a positive effect

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on the Soviet economy if only by allowing certain branches to be developed (for example 40% of fertilizer production is accounted for by industrial facilities imported from the West) or by shortening the lead time for certain investments. All in all, the Russians have come to realise that their economic system is capable of achieving Western standards of efficiency, productivity, adaptation and continuous modernization in the industrial plant purchased on a turnkey basis, that the economy could not quickly absorb the capital goods imported without creating bottlenecks and that technological progress was not being disseminated as it should.

42. Alongside this more realistic approach to the scope offered by the imported equipment, Moscow has gradually adopted a tighter and more selective financial policy. After large-scale and possibly badly co-ordinated recourse to different forms of credit - particularly commercial credits(1) - in 1975, the Russians adopted after 1976 a much more coherent financial strategy based on the following principles: (i) stricter limitation of the growth of net indebtedness, if necessary by reducing (or postponing until after 1980) industrial projects requiring hard currency funding, (ii) less reliance on Euro-credits and, instead, greater use of officially-backed credits, (iii) the possibility for the Bank for Foreign Trade to veto any commercial transaction with foreign countries and (iv) greater insistence on compensation agreements.

43. In the short-term, Moscow can be expected to adopt a prudent approach to trade with the industrialized market economy countries. There will probably be a renewal of orders, bearing in mind the problems faced by the oil sector, but they (and therefore the deliveries) will certainly be widely time-phased because of the difficulties of absorbing imported equipment. There will be even greater insistence on compensation agreements but perhaps more flexibility towards the commercial conditions laid down by Western firms as a price for their participation. The Soviet Union will also apply a strict financial policy intended to limit to the utmost the growth of its debt, except in the case of credits tied to compensation agreements. Lastly, it will give priority to promoting the global equilibrium of its balance of payment on current account and so accept a certain trade deficit provided that it can be offset by arms and gold sales and net invisible earnings.

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(1) For example, while contracting bank-to-bank loans on the Euro-market, the Russians guaranteed a large volume of promissory notes which were later discounted on the secondary markets. This led to adverse publicity on the indebtedness of the Soviet Union and consequently to a deterioration in the credit terms available to it