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FINANCE AND DEBT IN EAST-WEST RELATIONS
POLICY CHALLENGES IN AN ERA OF CHANGE

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I. The Policy Environment

Changing Priorities for National Security

U.S. national security concerns in East-West relations are undergoing profound changes. Traditional worries about flows of capital and technology to the East have not disappeared, but new priorities have emerged. Recent startling and unexpected political changes now hold promise of an elimination of the communist monopoly on power; political pluralism is emerging in four major East European countries--Poland, Hungary, the GDR and Czechoslovakia. And while political pluralism in the Soviet Union does not seem imminent, the changes being introduced by President Gorbachev appear to be leading to significant changes in Soviet domestic and foreign policies. Taken together, these developments point to a reduction in East-West tensions and the beginning of a new era in East-West relations.

There are clear reasons why the United States and the allies should seek to foster such trends, because such changes serve to enhance western security. Put another way, there would be adverse consequences for western security if the economic and political changes underway in many Eastern European countries should fail for lack of adequate support from the developed world. But not all reforms can be expected to work and the possibilities of setbacks or even Chinese-style reversals are evident.

Differentiating among the many efforts at reform, weighing the associated prospects for success of each and determining how best to help is a daunting task--one that has so far received little serious attention in the West. While the West has had over forty years to learn how one acts in context of "cold war" relations, the rapidity of change in Eastern Europe is transforming East-West ties before new institutions and structures to mediate relations in the new environment are in place.

The Financial Times, for example, recently reported that Jacques Delors, the president of the European Commission (which has been assigned the role to coordinate loans and aid to Poland and Hungary), was startled to discover before his first trip to Hungary in November 1989 that the EC had no representative in Budapest [1]. The purpose of Delors' trip was to finalize details of a ECU 1 billion loan ($1.2 billion), the first loan ever to a country outside the EC. Without effective on-the-scene monitoring, the special conditions attached to the loan--above and beyond the usual IMF conditions--lack credibility [2]. The Wall Street Journal, meanwhile, reported U.S. government concerns that the $8 billion in loans and other grant aid being discussed for Poland and Hungary may lack proper coordination and organization [3].

The Role of Finance and Debt

New western initiatives toward the East have a common denominator--they all cost money. Since the political changes in the East spring from economic crises, resources must be found to underwrite such political changes and bolster their legitimacy. Until new economic structures are created and put into place which can provide the economic gains that have been lacking, money and other economic concessions in the fields of trade and investment will be essential.

A key policy issue for western countries is to determine the desired scope and terms and conditions of future resource flows to the East. Restrictions on resource flows would presumably be retained in countries where desired political changes are lacking, e.g. China and Rumania. In other countries, however, the challenge now is to use western resources to help facilitate the political transition now taking place. There are two priority goals: 1) short-term economic stabilization -- to cushion the initial impact on living standards of the economic dislocation associated with political change; and 2) transformation of the economic system into one where state ownership and control is substantially reduced in favor of an increased role for private property and markets.

How can the West use its economic resources to best advantage to promote desired political changes in the East? And what sort of balance is appropriate between public initiatives and private-sector activities? These questions highlight two critical linkages which will determine the success of future policies: 1) the connection between western economic assistance and political developments in the East, and 2) the interplay of private and public interests in East-West relations.

The role of international debt and financing is central to both issues. New financing and the management of the existing debt will play a key role in western assistance policies. One major issue that awaits better definition is the appropriate mix and coordination of bilateral and multilateral credit. And since approximately 50 percent of the existing $190 billion of debt owed by the East is held by commercial banks, the evolution of private strategies in regard to the debt are central to western policies defining desired resource flows to the East. A related issue is whether western governments should offer private banks inducements such as credit or investment guarantees in order to encourage their lending to priority countries.

A final consideration with regard to financing is how it is used. This brings in the knotty issue of conditionality. Given all that is wrong with the economic systems and policies in the East, how do we ensure that new resource flows are used efficiently? After all, the $190 billion in existing debts failed to bring adequate improvements in economic performance and living standards, despite the borrowers' past good intentions. Why should we expect that an additional $10-20 billion in new money will bring radically different results? And if policy shortcomings on the part of the new governments are evident, what then--a suspension of new lending?

Before exploring these issues, the debt situation in the East is reviewed.

II. Overview of the Debt

The State of Creditworthiness in the East

The total debt of Eastern Europe, the Soviet Union and China is estimated to have grown from approximately $105 billion at the end of 1981 to $188 billion at the end of 1988. In order to provide a perspective on the burden represented by such debts, Table 1 presents data on the net-debt-to-export ratio for each country. This ratio is a convenient measure of a country's total debt, net of hard currency reserves, compared with the country's earnings from sales of exports and services for hard currencies which is available to service the debt. As a rule of thumb, any ratio over 2.0 indicates an excessive debt burden (with a high probability of default and rescheduling), while a ratio below 1.0 indicates a modest debt burden. In order to draw any overall judgement on creditworthiness though, these data must be supplemented with other information on a country's domestic economic policy and performance.

During the 1981-88 period, three of the countries were forced to reschedule: Poland in 1981, Romania in 1982 and Yugoslavia in 1983. Poland was unable to generate sufficient foreign exchange to service the interest on its debt, and as a result its total debt rose from $25 billion to $38 billion as interest arrears (primarily to government creditors) accumulated and were converted into new loans. Although interest service on debt owed to commercial banks continued current until September 1989--when the new Solidarity-led government defaulted on these obligations, only a few new trade-related credits from banks were forthcoming.

Banks do not view Poland as creditworthy; thus, the prospect of new bank lending in the foreseeable future is slim. The key issue with regard to the bank debt is whether a Brady-type debt reduction agreement is feasible. Since banks account for less than 25 percent of the total debt, any agreement along the lines of Mexico's debt reduction bonds would have to be accompanied with comparable debt reduction from official creditors, who hold the bulk of the debt. Alternatively, Poland may be able to use resources from multilateral institutions and governments to buyback bank loans or provide 100 percent guarantees on any debt reduction bonds the banks may be asked to accept. European banks, especially German banks, may be expected to take the lead in discussions with Polish authorities on these issues.

By contrast, Romania ran current account surpluses during these years and paid down its debt, reducing total debt from over $11 billion to under $2 billion and eliminating all long-term loans owed to commercial banks. Romania has announced its intention to avoid new borrowings in the future. The costs of this policy of export-at-any-cost, though, have been severe on the domestic economy. Thus, although Romania is unlikely to borrow in the foreseeable future, banks would also be reluctant to extend new term loans to the country. Bank activity is restricted to modest short-term financing lines.

Yugoslavia was able to service all interest obligations, thanks to continuing current account surpluses and modest amounts of new money from banks and governments. Total foreign debt stabilized during 1984-87 and during 1988-89 a marked decline in debt was achieved as net repayments were made to the IMF and World Bank and bank debt was reduced via debt-to-export conversions and buybacks.

Although Yugoslavia's debt burden has dropped in impressive fashion during recent years, banks remain reluctant to extend new credits. In large part this is due to the worsening domestic political and economic situation in the country. Inflation has surpassed even Brazilian levels and is now running at over 40 percent per month. Meanwhile, domestic political squabbles among the republics appear to be worsening.

Yugoslavia's debt burden cannot be considered high and most banks do not believe that debt reduction by itself will help solve current problems. Yugoslavia clearly cannot continue on its present course; domestic economic stabilization is needed and the impetus for such reforms must come from within Yugoslavia itself. Given such reform initiatives, it would be up to western governments to respond with assistance appropriate to the circumstances, e.g. IMF and World Bank programs, and rescheduling and new money from the Paris Club governments. The appropriate role for commercial banks with regard to the debt could only be defined after these key components are in place.

All the other Eastern European countries and China retained access to international credit markets during this period. Several distinct patterns are evident in these countries' debt-to-export ratios. Hungary and Bulgaria, for example, saw rapid rises in their debt ratios as new borrowings far outstripped export growth. Both countries were able to tap new financings, though as the ratios approached the "danger" zone, it has become increasingly difficult to raise new loans. Indeed, many bankers consider Hungary a candidate for rescheduling; were it not due to the substantial support being received from West Germany and the EC, Hungary would likely have been forced into rescheduling by now.

The remaining countries -- Czechoslovakia, the GDR, the Soviet Union and China -- have successfully maintained debt-to-export ratios in the moderate range. The trend in the ratio has generally shown a tendency to fall during 1981-84, followed by a modest rising trend. With the exception of China, these countries enjoy relatively free access to international credit markets.

China's access to international credit was severely curtailed after the government's crackdown on the pro-democracy movement in June 1989. Although several small syndicated credits were arranged for Chinese state companies since then, Japanese banks -- by far the largest lenders -- have been conspicuous by their absence in such deals. New lending from the World Bank and the Asian Development Bank have also been put on hold. Future bank lending to China will closely mirror western governments' own policies. When the loan windows at the World Bank and ADB reopen, banks are apt to begin a cautious renewal of term lending. It seems doubtful, however, that such lending will match past trends.

Evolving Patterns of Bank Lending to the East

A new perspective on the debt is gained when these same data are disaggregated by creditor groups. Table 2 provides a breakdown of the debt for 1981, 1984 and 1987 by major creditor group-- official bilateral (government), commercial banks, multilateral institutions and other (mostly supplier credits).

The claims of commercial banks rose about 25 percent in nominal terms (excluding China). The commercial bank share in total debt declined only moderately, from 59 percent to 53 percent of the total. The share of official bilateral claims in the total rose modestly during this period from 25 percent to 29 percent and a similar increase took place in lending by the IMF and World Bank -- from 2 percent to 6 percent of the total.

Disaggregation of these data by creditor is possible only for claims by commercial banks, and for 1981 such data is only available for five countries -- fortunately the key countries. The data are taken from individual country reports to the Bank for International Settlements [4]. Several important caveats must be kept in mind when reading the Charts. Data for Japanese banks include only medium and long-term exposure, thus understating the overall exposure. If the maturity structure of Japanese bank lending is similar to that of other banks, then the understatement is substantial -- at end-1988 short-term claims (less than one year) of all banks accounted for 32 percent of total claims on Eastern Europe and China.

A second problem concerns the 1981 data. The exposures of German banks do not include a substantial volume of claims booked in Luxembourg, thus outstandings on that date are understated. The 1988 data do include these exposures. The comparison of 1981 and 1988 exposures of German banks, therefore, overstates the actual expansion of such lending. A final caveat is that loans, bonds and private placements held by non-banks are not included in the data; such lending activity has been significant for Japanese institutions (life insurance and leasing companies), especially in Hungary, the GDR and the Soviet Union. The data used to generate the charts are shown in an Appendix Table.

The aggregate data, shown in Charts 1-3, tell a story of substantial divergences in bank lending strategies in different countries. Since both Poland and Yugoslavia rescheduled their bank debt, declines in claims most probably represent net sales or write-offs of such debt [5].

Although U.S. banks were quite active in lending to Eastern Europe in the seventies, there was a sharp reversal in their activity after 1980. In 1988, U.S. banks accounted for only 3.4 percent of total claims, and if lending to Yugoslavia is excluded, the U.S. share drops to 1.7 percent. A similar, though less marked, shift is evident for the U.K. banks.

By contrast, German and Japanese banks have expanded their lending dramatically. Such lending was concentrated in Hungary, the GDR and Bulgaria, where German and Japanese banks are the leading creditors, and in the Soviet Union, where French banks hold the leading position (see Charts 4a-4h). As may be expected, Japanese banks hold the leading position in claims on China (Chart 4i).

Charts 5a-5d show the same data rearranged by creditor country. The U.S. data, for example, show declines in claims for every country, including China. The reductions in Poland and Yugoslavia were achieved though write-offs and sales of debt at a discount. The other declines represent a net repayment of principal.

Decisions by U.S. banks to reduce exposures were taken in response to deteriorating credit conditions, slim profit margins and limited U.S. trade with the countries in the area. These decisions were further influenced by the generally high exposure of U.S. banks to problem LDC credits in Latin America. Given their relatively large LDC exposures and pressure on their capital bases, the U.S. banks could not justify to maintain long-term lending to the East at the interest rate margins prevailing in the market.

This pull-back from international lending was also part of an overall reorientation in strategies by U.S. banks which found some focusing on domestic banking opportunities and others on international underwriting instead of long-term foreign lending. As as rule, the declines in exposure to the USSR and China were motivated primarily by the low profitability of such lending, while declines in other countries were more a response to U.S. banks' perceptions of worsening creditworthiness.

The activities of German and Japanese banks reflect many parallels -- sharp increases in lending to the USSR, China, Hungary and the GDR; significant, though less marked, increases in loans to Bulgaria and Czechoslovakia. The increase in German bank lending to Poland was due primarily to swaps of their Latin loans for Polish claims in the secondary market -- many German banks felt more comfortable with Polish risk than with Latin risk.

The strategies of U.K. banks represent an amalgam of the above strategies--sharp declines in claims on the GDR, Hungary and Czechoslovakia, but increases in the USSR and China. The declines shown for Poland and Yugoslavia primarily reflect the net reduction of exposure as a result of reserves mandated by the Bank of England.

The major puzzle that emerges from these data is the sharp divergence in lending strategies among German and Japanese banks on the one hand and U.S. and (to a lesser extent) U.K. banks on the other. One possible explanation lies in the pattern of trade flows to the East. Table 3 shows aggregate exports to the East and commercial bank claims on the part of the major western countries.

West Germany holds a commanding lead in total exports, thus providing a plausible explanation for the prominent position of German banks in financing these countries (though the export share far exceeds the share in claims). The relative size of Japanese bank claims exceeds the country's share in total exports and if rough estimates of short-term loans are included, Japan's share of total bank debt rises to about 32 percent (compared with an export share of 21 percent). Factors other than the size of export flows are clearly significant in explaining Japanese bank lending. More striking, perhaps, are the large relative shares of French and U.K. banks in total bank claims. Banks in all three countries appear to view the Eastern market as a safe region for the expansion of financial credits.

III. New Direction in Private and Public Financing

Commercial Bank Strategies in Flux

Two factors will play significant roles in influencing future bank strategies in lending to the East: 1) the perception of worsening credit risk due to political upheavals in the area, and 2) an increasingly active role of western governments in trade and financial relations with the East. There are many common elements in the current environment that faces banks in Eastern Europe, thus a general discussion of such issues is relevant. It should be kept in mind, though, that banks will modify their strategies taking into account country-by-country differences and that any of the points made below may apply to a greater or lesser degree in any given country.

There is little doubt that in the past many banks viewed the lack of political change in Eastern Europe and China as a positive factor in creditworthiness. Most communist governments placed a high priority on servicing foreign debt and they were prepared to act to ensure prompt servicing of external obligations. But, as rapid and far-reaching political changes got underway in many countries, most banks reacted by reducing country risk ratings for countries in the area and by taking a wait-and-see posture.

Whether banks continue to sit on the sidelines or not will be determined by the success western governments have in implementing their new initiatives. If banks perceive that essential structural changes are in fact being introduced in given countries, they will most probably act to extend and deepen their financial involvement. Such activity would, thus, provide further support to the political goals western governments are seeking to translate into reality. On the other hand, there is also a risk that banks may use the opportunity that comes with an increased public role in financing to reduce their own exposure. This would be the case if banks see western aid being used by the recipient country to postpone genuine reforms and the inevitable internal sacrifices. The obvious outcome would be a substitution of public loans for private bank exposure, leaving the country no better off than before.

These considerations underscore the critical role conditionality must play in the new assistance programs under development. The heart of the problem lies in a basic conflict between the dynamics of political change and the requirements of systemic economic change. Even though political structures have changed radically in many countries, the economic systems remain largely unchanged, unreformed and, if anything, more inefficient -- given the current disorder -- than under the previous political regimes.

While the political system is moving to greater pluralism, economic reform requires a coalescing around a central reform strategy. But there is not even a clear vision anywhere of how to change the economic system in a way that is compatible with current political realities which demand quick results. Coherent programs with timetables and priorities setting out the key changes necessary to transform socialist economies into market-oriented, private systems are so far lacking. And past reform failures in Hungary and Yugoslavia, for example, give scant cause for optimism, since a successful transition model is still missing.

A related concern on the part of many banks is the still reluctant attitude in the East to embrace the western capitalistic model. One hears frequent discussion of the "third way," a sort of half-way house between capitalism and socialism. Banks view such talk as hopelessly naive, believing that a radical opening to foreign investment and rapid privatization is only way these countries will be able to "get over the hump" toward a private, market-oriented economic system. But preliminary feedback from Hungary and Poland, for example, indicates that political debates have served to enhance a latent strain of nationalism. Although foreign investment is still sought and welcomed, there are undertones that give potential investors reason to pause, as in the promises not to sell out the country to foreigners.

Private banks are not prepared to support any given list of reform objectives just because new political leaders in Eastern Europe are seen as serious or deserving in the eyes of western public opinion. The banks will support countries that privatize and restructure state enterprises, countries that open to free markets by changing antiquated property laws, but they will not put their money at risk in countries that merely talk about these goals without acting on them.

The banks' emphasis on structural reforms derives from their realization that greater involvement of their domestic clients in East European economies requires such changes. Improved fiscal and monetary policies and reduced trade deficits are all desirable and necessary, because there is little hope of implementing far - reaching reforms without them. But stabilization policies are not enough. Without structural reforms, western direct investment in the East will amount to dribs and drabs, rather than the infusion that can catalyze an economic turnaround. The challenge is to design programs that integrate traditional stabilization efforts with system economic reforms.

The list of structural problems is a long one:

1) the absence of laws defining private property rights of potential foreign or domestic investors
2) inadequate accounting systems and standards, which make valuation assessments problematic
3) inefficient and irrational tax systems
4) the absence of a properly functioning capital market and banking system, which hinders the efficient internal allocation of investment resources
5) labor laws which hinder the operation of a domestic labor market
6) the lack of free, internal markets for industrial inputs which gives rise to monopolies in wholesale distribution

While recognizing that such a list of reform priorities cannot be resolved overnight, banks are still looking for Eastern European governments to develop coherent strategies for dealing with these issues. Lacking such strategies, many banks will respond by cutting loan outstandings.

The implications of the above for public policy are several. Unless public policies toward Eastern European countries embrace these same goals for structural reform and back them up with concrete policies, we will find the public and private sectors acting at cross purposes--public money will simply go to bail out private loans and the hoped for inflow of western investment will fizzle. If the banks pull out their loans, western governments are unlikely to step up their capital infusions to make up the shortfall. This suggests that in order to meet their longer-term goals western governments should seek to create conditions under which private western capital will prosper and thrive, even if this causes eastern policy makers some discomfort in the near-term.

Secondly, western governments should realize that they have little knowledge of how such structural reforms might best be implemented, nor do they have the skills needed in the process. The IMF and the World Bank may clearly play a vital role in this regard, but they must be pushed in this direction and told to broaden and deepen their policy advice to Eastern European policy makers. Governments may also find that banks and other private companies have much to contribute to the process of structural reform; strategies to evolve public-private partnerships for specific tasks could prove valuable, especially in the fields of business management, credit training, accounting and marketing.

Public Strategies for Assistance to East European Reforms

The forces that have acted to shape and spur efforts in the West to aid reform in Eastern Europe have undergone rapid change during 1989. The initial focus of western interest was on Poland, where a Solidarity-led government assumed power, and Hungary, where an agreement was reached to hold free elections for the first time since the war. As work on putting together assistance packages for Poland and Hungary progressed, political changes in the GDR, Czechoslovakia and Bulgaria brought new governments into office. And to top off the year, President Bush announced a significant liberalization in U.S. economic policies toward the Soviet Union during the Malta summit in early December.

Given the rapid evolution of events during 1989, it is difficult to do more than sketch the general trends in official policy at the present time; 1990 will undoubtedly bring new developments, particularly as regards the GDR, Czechoslovakia and Bulgaria.

The basic premise of western policy as it emerged during 1989 was that the European Community should be assigned the central role in coordinating and guiding western assistance to Poland and Hungary. This role would now seem to apply to future western assistance policies toward the GDR, Czechoslovakia and Bulgaria.

The major differences in these cases is the special relationship between the Federal Republic and the GDR and the fact that none of these countries is as bad off economically as either Poland or Hungary, and thus, not in immediate need of emergency aid packages (thought Bulgaria may not be far from needing one). It also appears that Yugoslavia, which has tended to be neglected in the rush of new initiatives, will be added to the list of countries eligible for EC support.

In agreeing to play a secondary role in such initiatives, the Bush administration broke with policies of previous administrations which sought to set out a distinctive U.S. stamp on East-West relations. One reason for this change is the fact that the United States today in not in a position -- given worries with budget deficits and rising foreign indebtedness -- to play a major role in funding new initiatives. The United States seems happy to put priority on IMF and World Bank lending. Such indirect involvement, though, reduces Washington's overall influence on the size and distribution of credit and aid flows one way or the other. A related implication is that the United States will see its influence on the conditions attached to such credits diminish.

It is also significant that the Japanese have supported these initiatives, following in the footsteps of the United States, while carefully calibrating its contribution to an "appropriate" level in comparison with other countries. Japan's $150 million contribution to the Polish stabilization package compares with $250 million from Germany, $200 million from the United States and $100 million from France and the United Kingdom and Italy [6]. Although European comment on Japan's actions noted that Eastern Europe is an area with which Japan has had little contact [7], the data presented earlier show that Japan is Hungary's largest creditor by far and the number two creditor after West Germany for Eastern Europe as a whole. Japan, thus, has a large financial stake (through the exposure of its private banks) in the resolution of these problems.

It is still too early to speculate on the content of initiatives that will be forthcoming in 1990 for the GDR, Czechoslovakia, Bulgaria and Yugoslavia. Since only Yugoslavia is a member of the IMF and World Bank, a logical first step would be to encourage rapid progress toward membership. Czechoslovakia has already begun the application process and could secure membership by mid-year; the other countries will need more time.

The assistance packages being assembled by the EC for Poland and Hungary include:

--for Poland, a $1 billion stabilization loan from 12 countries and other aid and grants from a larger group of 24 OECD countries

--for Hungary, an ECU 1 billion ($1.2 billion) loan from the EC for Hungary.

Both packages are conditional on each country agreeing to IMF standby programs. In addition, many countries have offered substantial official export credit lines. Germany, for example, has offered Poland $1.6 billion in trade credits, Italy has offered $400 million, France some $600 million and other countries will likely follow. German Federal and State guarantees for exports to Hungary have been hiked some $525 million and additional commitments are being made by the United States and other countries. In addition to new credits, Germany is writing off a substantial portion of past official credits to Poland and a part is being converted into zloties to be used for Polish-German projects in Poland [8].

With some $8 billion apparently committed or under discussion for Poland and Hungary [9], the obvious question is how these vast sums are to be used. EC thinking on this critical issue is not entirely clear but seems to focus on three elements:

1) piggy-backing new loans on IMF standby programs, thus introducing a form of cross conditionality (something which has been anathema for LDC borrowers in recent years)
2) encouraging the European Investment Bank and the World Bank to expand project financing in Eastern Europe
3) setting up a multilateral development bank, the Bank for Europe, along the lines of the Asian, African and Inter-American Development Banks, whose owners include both developed countries and the recipient countries from the relevant region [10]

Can such an approach work, given the forces at play in the region which will constrain and shape how East European policy makers act in the future? Unfortunately, the past record does not suggest that western politicians are very skilled in using aid flows to secure needed economic reforms.

The record shows, for example, that western governments bear a major responsibility for the uncontrolled expansion of Polish indebtedness in the period prior to the debt default in 1981. After banks restricted financing beginning in 1979, western governments offered loans with the goal of helping the "reform" efforts of Edward Gierek survive. There was little or no consideration of Poland's ability to use these funds within the country. When the credit squeeze became critical in 1980, both France and Germany made special deals with Poland in violation of long-standing agreements with other countries about export credits [11].

The improvement this time around is that western aid and credits are being tied to IMF and World Bank conditionality. But the Fund's record in Eastern Europe has been less than stellar. Despite a succession of Fund standby's in Hungary and Yugoslavia since the early 1980's, economic performance in each country has deteriorated steadily during the intervening years. The Bank's involvement has likewise been disappointing, especially in the field of structural adjustment lending. Two adjustment loans to Yugoslavia in the mid-1980's were complete failures. The lasting imprint of the Fund and the Bank on economic policy and structural change is difficult to discern today in either Hungary or Yugoslavia.

The point is not to jettison Fund and Bank conditionality, but to improve on it. Western governments need to push the Fund and Bank into designing structural policies to facilitate the hoped-for transition to a market economy. And new thinking is needed on structural issues that go beyond the contributions that the Fund and the Bank can usefully make. The proposed multilateral Bank for Europe, for example, could have a substantial impact in the field of structural policies, provided its creators avoid setting up the vast bureaucracies that characterize the other regional development banks.

A more radical proposal, especially for the U.S. government, would be for the governments to spend their aid money on buying advice for East European reformers from their own private companies. Governments might form partnerships with private firms by creating mixed public/private working groups to tackle specific priority problems in given countries, e.g. accounting and tax systems, property law, banking practices, business management, marketing, etc. Such initiatives are best organized on a bilateral basis.

Unless western politicians want to keep pumping public money into the East for the indefinite future, they must seek to create conditions in Eastern Europe under which foreign capital will thrive and prosper. The best way to find out what those conditions are is by working with the capitalists themselves. This is why western governments need to go beyond IMF and World Bank involvement. As vital as their role may be, neither the Fund or the Bank is comfortable in a close working arrangement with private companies. A second reason for seeking closer cooperation with private firms is to minimize the risk that public and private lending strategies work at cross purposes, with public monies bailing out private banks.

IV. Conclusions and Policy Recommendations

It is time to return to the question posed earlier: How can the West use its economic resources to best advantage in promoting the growth of political pluralism and a transition to free markets?

The first rule is for western governments to create a balance between public and private initiatives with regard to Eastern countries. Balance is important to insure that public and private institutions move in the same direction and are mutually reinforcing. More importantly, though, balance is essential to infuse market-based, private-sector conditionality into the process of resource transfer to the East. This is because the acid test of structural reforms will take place in the market place, not in some academic think tank or government office.

The second rule is for western governments to strike a balance between initiatives that involve monetary transfers and those that transfer skills necessary to survive and prosper in the market place. Money is needed, but if countries in the East do not acquire a wide range of private business skills quickly, the reforms will falter and the money will have been wasted. Governments can and should help accelerate the transfer of western skills in the area of accounting, taxation systems, banking, marketing and business management. The best way to do this is by encouraging Rule #1's balance between public and private initiatives.

The third rule is for western governments to seek a balance between multilateral and bilateral initiatives. The multilateral role to be played by the IMF and World Bank should be broadened and deepened to encompass key structural reforms. But governments should go beyond this with bilateral initiatives. Such bilateral initiatives would include the transfer of those skills noted in Rule #2 above, but they should also focus on each country's special interests or talents in other areas, e.g. introducing business school courses or executive training programs, teaching English, organizing student and young professional exchanges, helping with the reorganization of public institutions such as central banks, statistical bureaus, stock exchanges, security and exchange commissions, etc.

There is a danger, though, if bilateral or EC initiatives lead to preferential conditions for western capital from certain countries in the East and for eastern exports in the EC. U.S. and Japanese firms would be disadvantaged, for example, by any terms of a special trade relationship that might be granted to Eastern European exporters to the EC. The United States and Japan each have stake in pushing for further market opening measures in EC on a non-preferential basis. Since many of the protectionist pressures are specifically directed against Japanese companies and given the already significant exposure of Japanese banks in the region, Japan faces important challenges in developing its Eastern European policies.

There are two final considerations for national security policy in the United States. One is that there are promising opportunities for new policy innovations to return the United States to forefront of East-West policy formation and implementation. The way to do this is by focusing on the transfer of those skills outlined above in Rules #2 and #3. The place to start, though, is with Rule #1--by creating a cooperative working relationship with the U.S. private sector on these issues.

A second is that U.S. policy must be recognize that political changes in Eastern Europe are diverting attention away from Latin America and its problems. The expansion of EC initiatives toward the East in the context of continued U.S. inaction toward Latin America will serve to weaken U.S. authority and leadership both in Europe and in Latin America. Now that Secretary Brady's debt initiative has all but killed prospects of new commercial bank lending to many Latin nations, new thinking is required about how the resources necessary for the survival of these struggling democracies can be made available.

Footnotes

1. David Buchan, "Grouping for a New Strategy," Financial Times, December 8, 1989, p. 19. Delors ordered an office to be set up immediately.

2. "EC to Lend Hungary ECU 1 Billion Over Five Years," Financial Times, December 7, 1989, P. 3. The conditions were that Hungary agree to an IMF Standby, implement microeconomic conditions to encourage private enterprise, and that the loan should not by used to replace private credits.

3. Peter Truell, "Concern Mounts Over Tied Credit in Eastern Europe," Wall Street Journal, December 8, 1989, p. A5.

4. Compilations of these data are available from several sources: "Who is Financing the East Bloc: Sources of Commercial Bank Funds Loaned to Eastern Europe and the Soviet Union," PlanEcon Report, August 11, 1989; "Quarterly Review of Financial Flows to Developing Countries," an internal publication of the Debt and International Finance Division of the World Bank.

5. In the United States, banks report exposure net of specific write-offs, even though they still retain the full legal claim. Where such write-offs have been extensive, primarily Poland, the reported claims understate the remaining legal claims. It is unknown what reporting conventions are followed in other countries, but it appears that banks in Germany and Japan report legal claims without regard to write-offs taken or existing reserves, while U.K. banks reports claims net of specific reserves.

6. "Japanese Offer $150 Million for Polish Aid Fund," Financial Times, November 25, 1989, p. 3; "Japanese Tiptoe into East Europe," Financial Times, December 5, 1989, p.3.

7. Ibid.

8. Details of the arrangements mentioned in this paragraph may be found in the articles cited in footnotes 1, 2, 3, 6 and in: "U.S., West Germany Join Forces to Help Reformists in East Bloc," Wall Street Journal, October 20, 1989, p. 9.

9. See footnote 1.

10. "EC Agrees to Set Up East Europe Development Bank," Reuters, December 8, 1989.

11. Lawrence J. Brainard, "Poland's Foreign Debt Crisis--Background and Perspectives," submitted as testimony to the European Subcommittee of the Senate Foreign Relations Committee, January 27, 1982, pp. 7-10.

TABLE 1

NET DEBT TO EXPORT RATIOS FOR EASTERN EUROPE, CHINA AND 15 HIGHLY INDEBTED COUNTRIES

	NET DEBT TO EXPORT RATIO^		1988	
	1981	1988	GROSS HARD CURR DEBT $ Millions	NET HARD CURR DEBT $ Millions
USSR	0.36	0.66	43000	28195
BULGARIA	0.63	1.56	7810	6032
CZECHOSLOVAKIA	0.76	0.62	5520	3848
GDR	1.54	0.60	20730	7572
HUNGARY	1.16	1.80	17349	13880
POLAND*	4.61	4.21	35470	37497
ROMANIA	1.21	0.12	1931	1122
YUGOSLAVIA	1.16	0.89	18683	14296
EASTERN EUROPE	1.03	1.04	150493	112442
CHINA	-0.20	0.24	35020	10929
15 HIGHLY INDEBTED COUNTRIES	1.77	2.73	470700	437200

^ Debt to Export Ratio is defined as: Net Hard Currency Debt divided by Hard Currency Current Account Receipts.

*Poland ratios actually 1982 and 1987 respectively.

Sources: PlanEcon, Trade and Finance Review (July 1989); IMF, World Economic Outlook (Oct. 1989).

TABLE 2

Estimated Distribution of East European Debt By Category of Lender

(percentage share of total)

	1981	1984	1987
USSR			
Official & Guaranteed	61	64	37
Unguaranteed Banks	29	34	59
IMF/BIS World Bank	0	0	0
Other (1)	10	2	4
Bulgaria			
Official & Guaranteed	21	46	29
Unguaranteed Banks	71	53	70
IMF/BIS World Bank	0	0	0
Other (1)	8	1	2
Czechoslovakia			
Official & Guaranteed	17	35	35
Unguaranteed Banks	73	63	61
IMF/BIS World Bank	0	0	0
Other (1)	11	2	5
GDR			
Official & Guaranteed	17	38	28
Unguaranteed Banks	66	53	58
IMF/BIS World Bank	0	0	0
Other (1)	16	10	14
Hungary			
Official & Guaranteed	6	12	9
Unguaranteed Banks	88	66	63
IMF/BIS World Bank	0	12	9
Other (1)	6	9	19

(cont.)

TABLE 2 (cont.)

Estimated Distribution of East European Debt By Category of Lender

(percentage share of total)

	1981	1984	1987
Poland			
Official & Guaranteed	42	42	45
Unguaranteed Banks	36	24	24
IMF/BIS World Bank	0	0	0
Other (1)	22	34	31
Romania			
Official & Guaranteed	14	19	18
Unguaranteed Banks	47	30	35
IMF/BIS World Bank	17	35	34
Other (1)	22	16	13
Yugoslavia			
Official & Guaranteed	18	31	26
Unguaranteed Banks	53	38	41
IMF/BIS World Bank	16	22	21
Other (1)	14	11	12
China			
Official & Guaranteed	22	36	22
Unguaranteed Banks	51	27	58
IMF/BIS World Bank	9	9	14
Other (1)	18	28	6

1. Debts to non-OECD countries (including intra CMEA debts), intra-German debts, a forfait credits and unguaranteed supplier credits.

Source: Financial Market Trends - OECD (February 1989), p.35; World Bank, World Debt Tables.

TABLE 3

WESTERN COUNTRIES' EXPORTS TO AND COMMERCIAL BANK CLAIMS ON EASTERN EUROPE AND CHINA

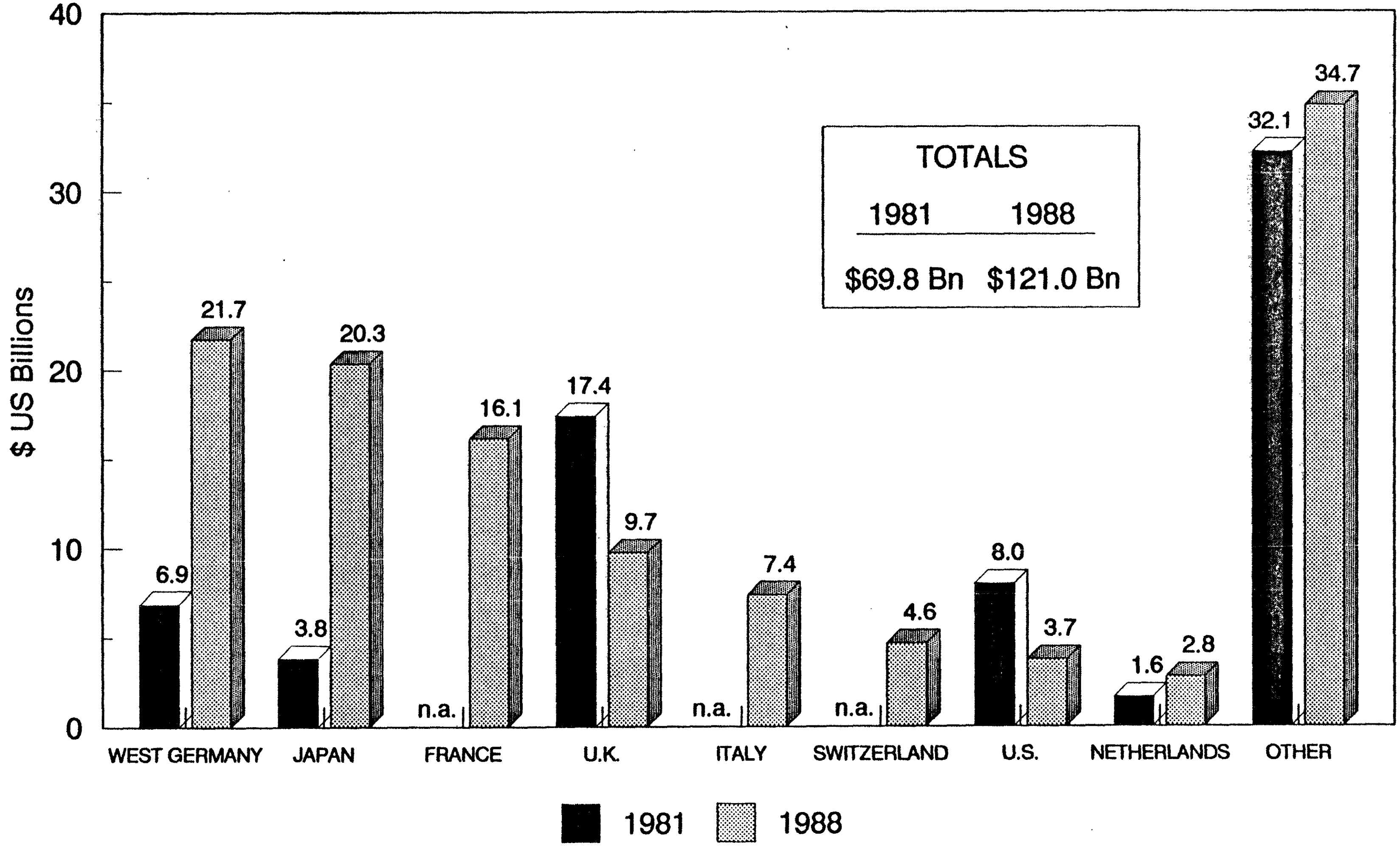
1988 — $ Millions

	EXPORTS	% OF TOTAL EXPORTS	CLAIMS	% OF TOTAL CLAIMS
WEST GERMANY	21583	34%	21709	25%
JAPAN	13513	21%	20336	24%
U.S.	9217	15%	3726	4%
ITALY	6491	10%	7360	9%
FRANCE	4855	8%	16114	19%
U.K.	3230	5%	9736	11%
SWITZERLAND	2426	4%	4640	5%
NETHERLANDS	2042	3%	2760	3%
TOTAL	63357	100%	86381	100%
INDUSTRIAL COUNTRIES	77557			

Source: IMF: Direction of Trade Statistics (1989), bank debt (see text).

CHART 1

Total Western Commercial Lending to the Soviet Union, Eastern Europe and China



Japan: Excludes claims less than 1 year.
: End-March 1981 and 1988.

CHART 2

Commercial Lending by Four Major Western Nations to the Soviet Union, Eastern Europe and China

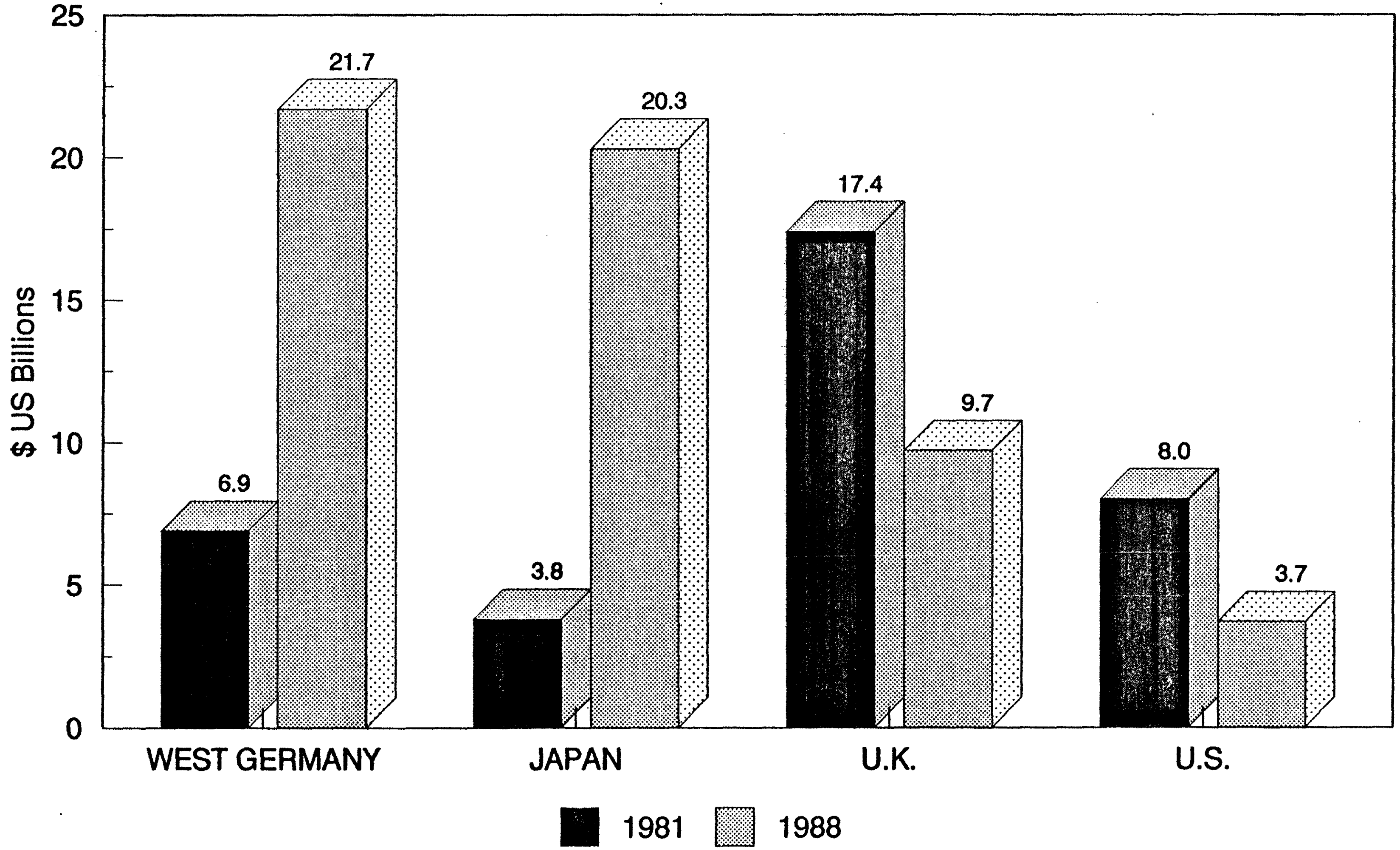
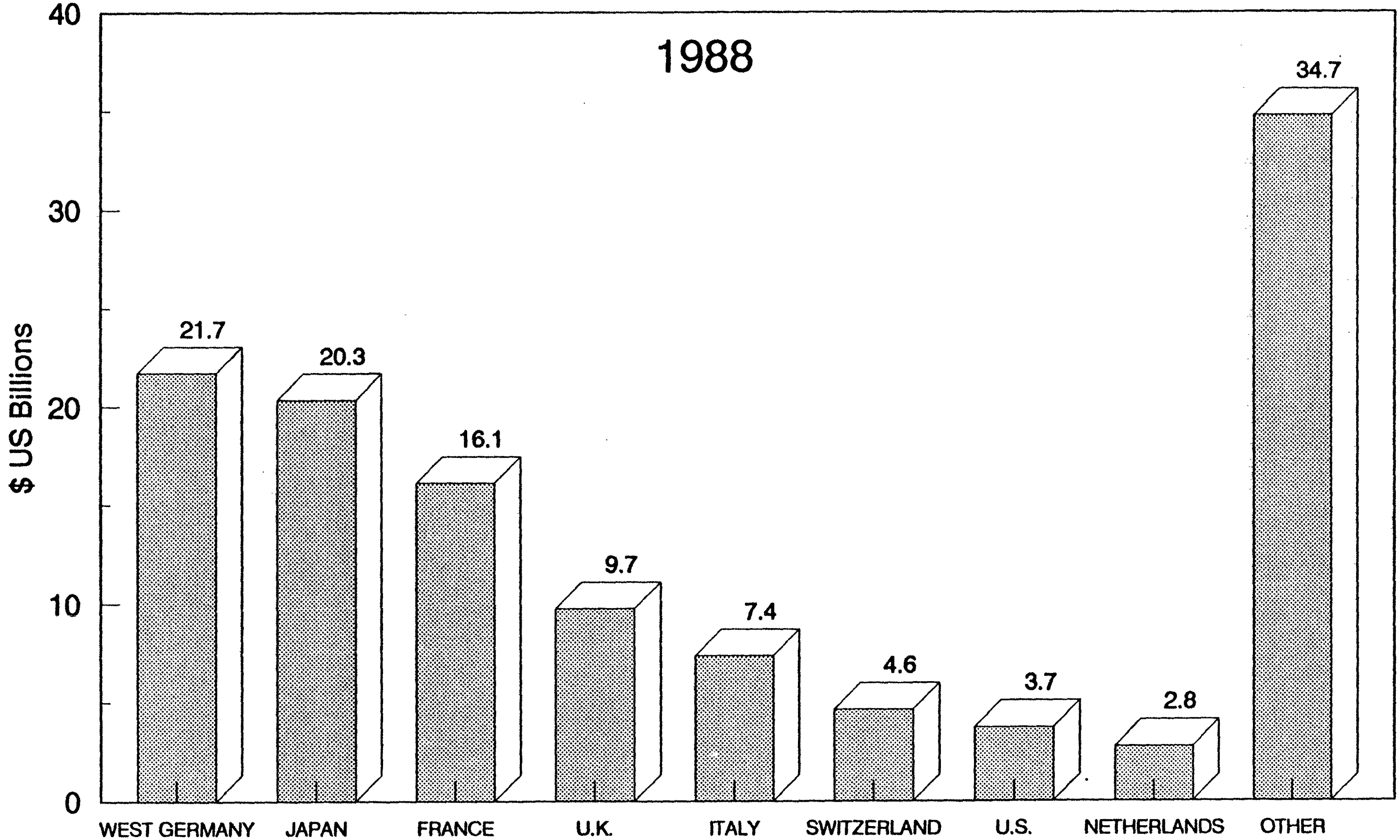


CHART 3

Total Western Commercial Lending to the Soviet Union, Eastern Europe and China



Major Creditor Nations in Commercial Bank Lending to Individual Countries

(Dec. 1981 vs. Dec. 1988)

Chart 4a	Soviet Union
Chart 4b	Bulgaria
Chart 4c	Czechoslovakia
Chart 4d	GDR
Chart 4e	Hungary
Chart 4f	Poland
Chart 4g	Romania
Chart 4h	Yugoslavia
Chart 4i	China

CHART 4a
Soviet Union

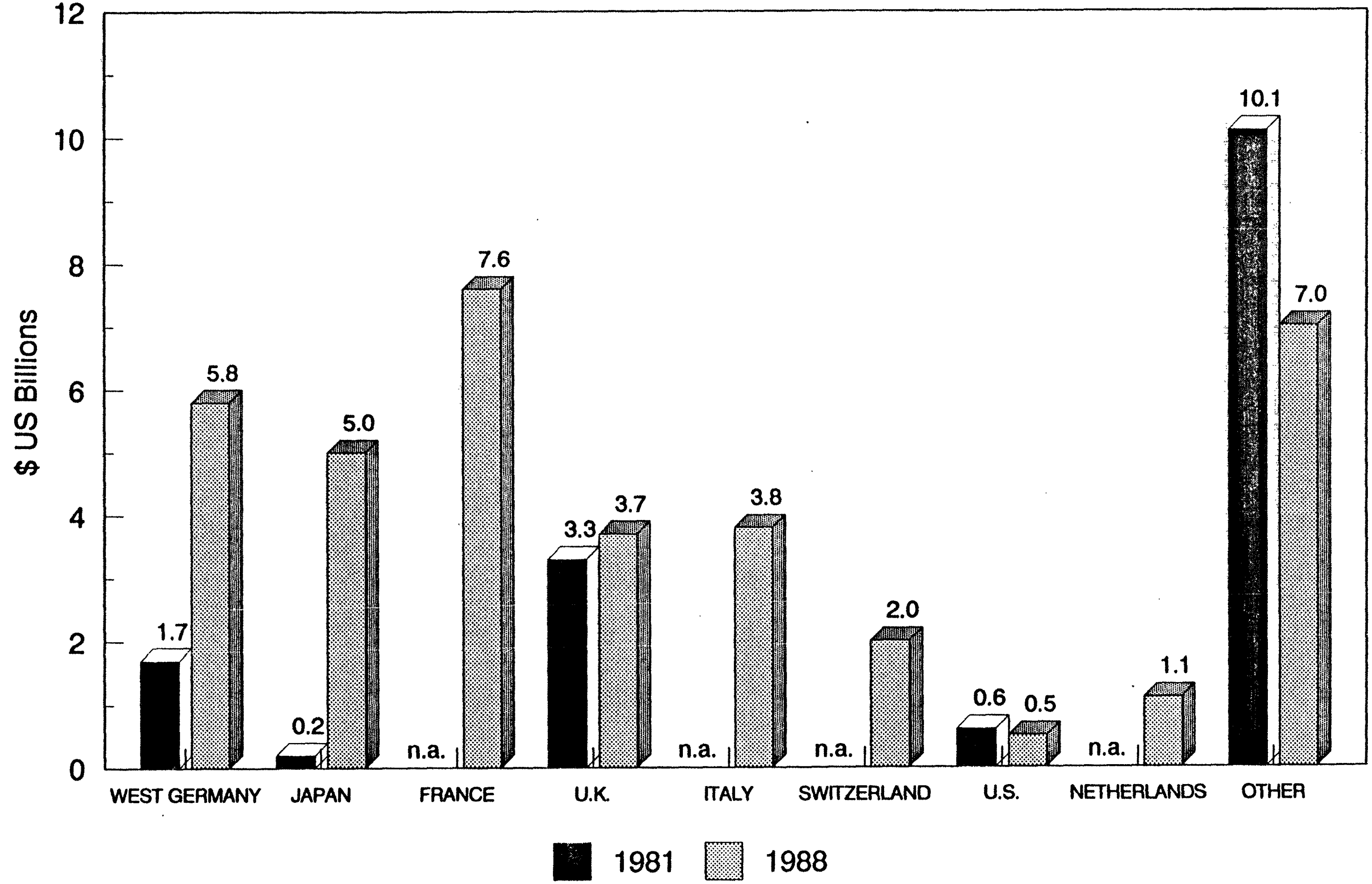


CHART 4b
Bulgaria

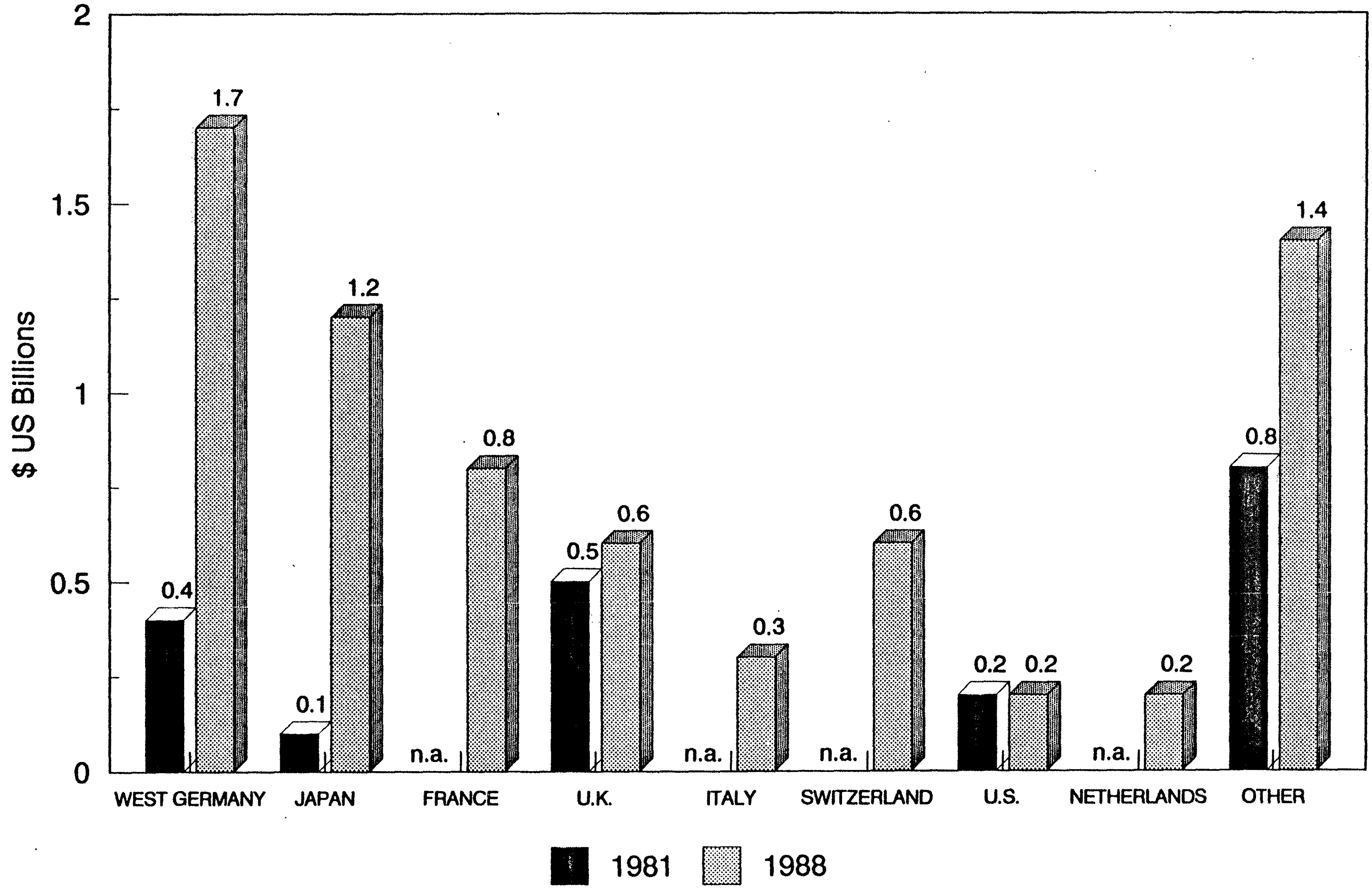


CHART 4c
Czechoslovakia

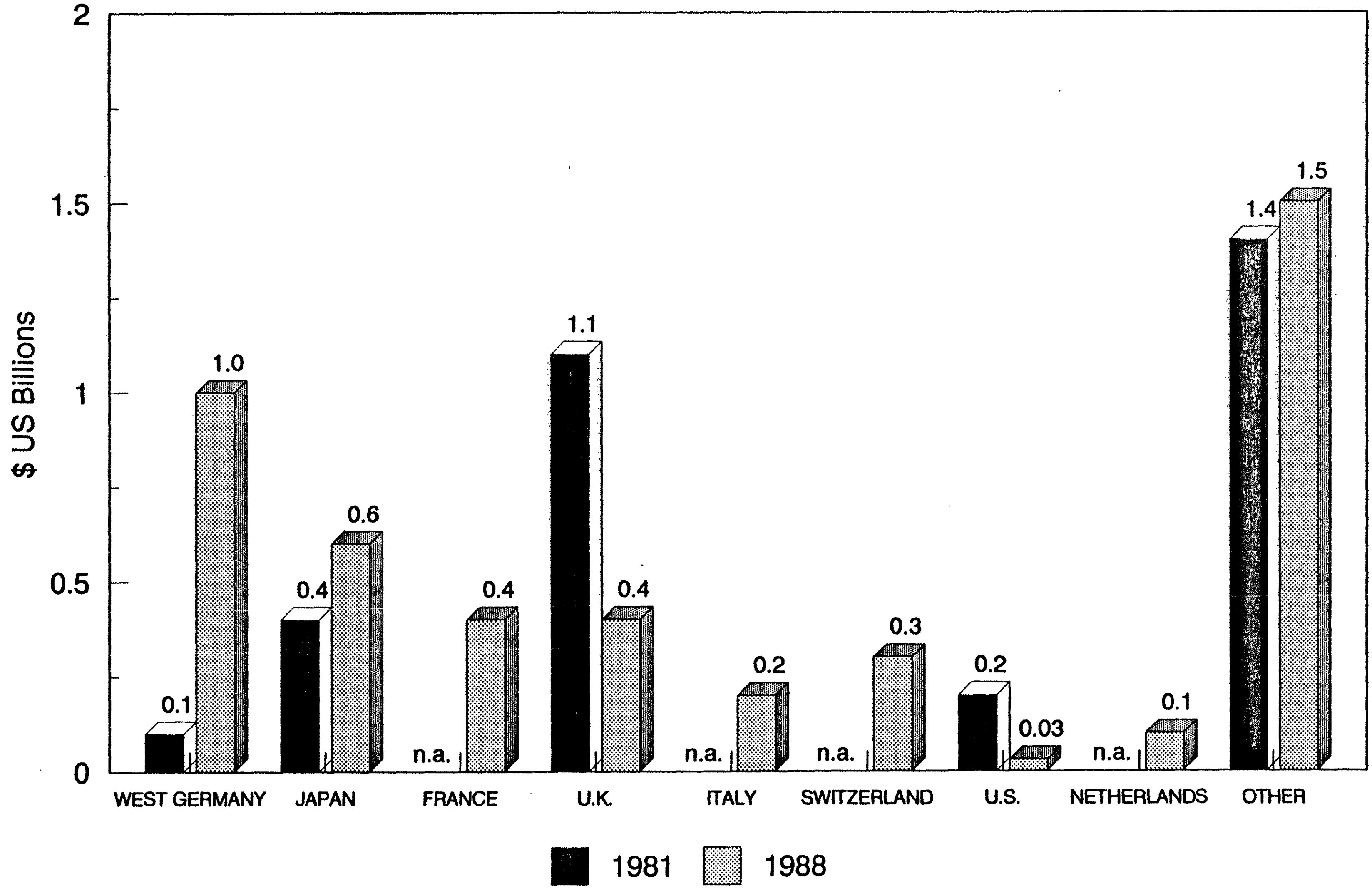


CHART 4d
GDR

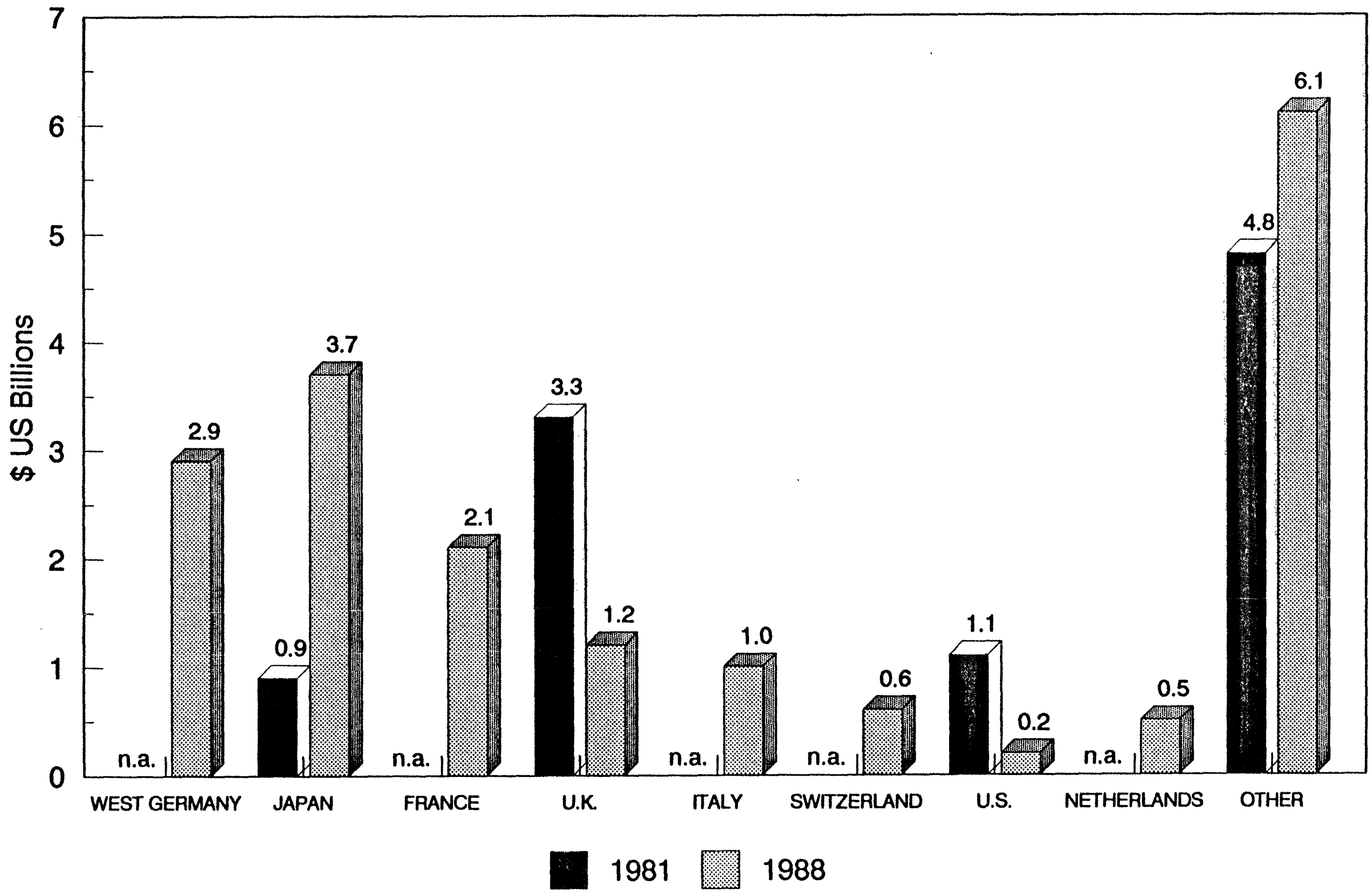

$ US Billions
0
1
2
3
4
5
6
7
n.a.
2.9
0.9
3.7
n.a.
2.1
3.3
1.2
n.a.
1.0
n.a.
0.6
1.1
0.2
n.a.
0.5
4.8
6.1
WEST GERMANY
JAPAN
FRANCE
U.K.
ITALY
SWITZERLAND
U.S.
NETHERLANDS
OTHER
1981
1988

CHART 4e
Hungary

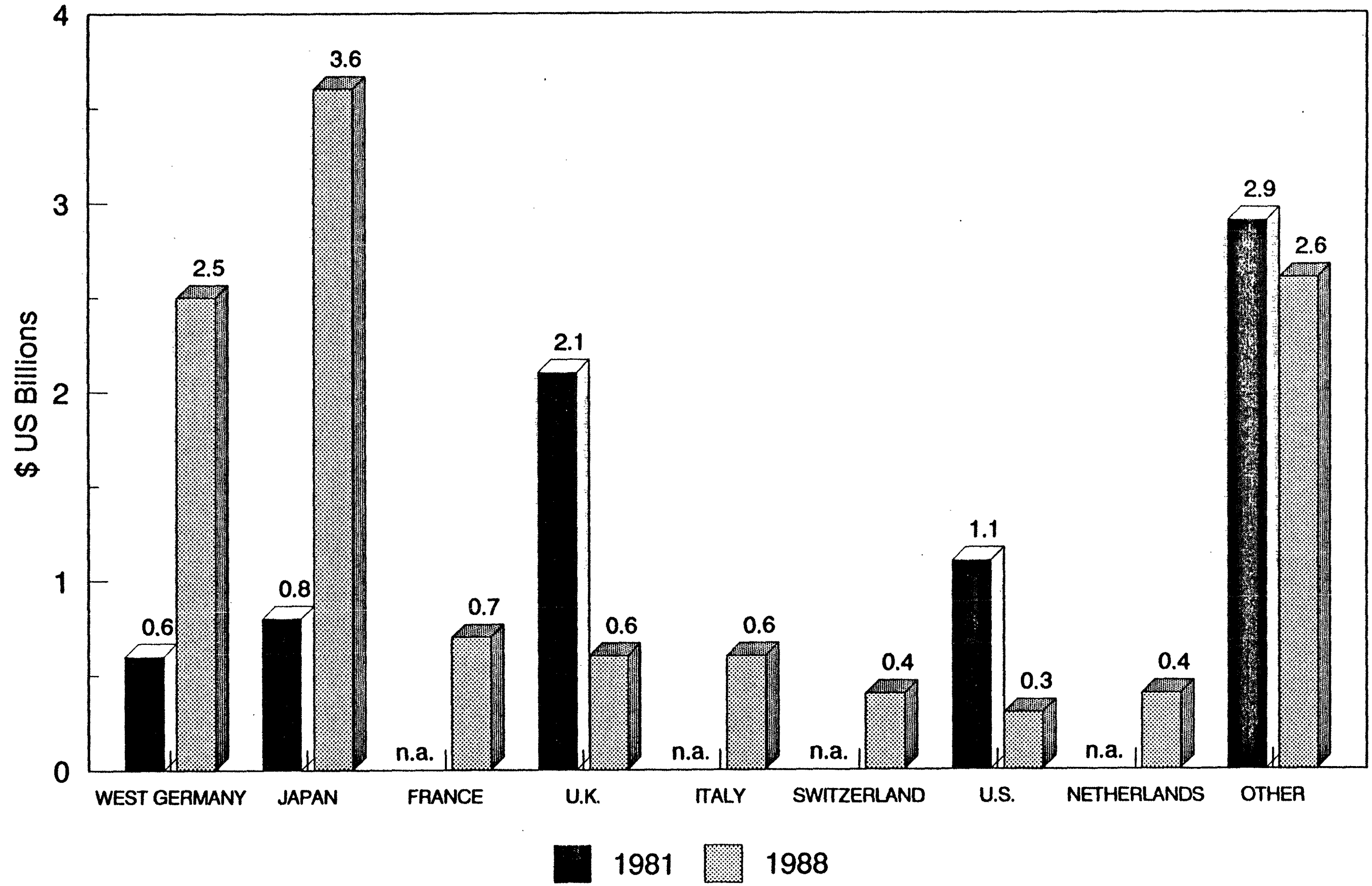


CHART 4f
Poland

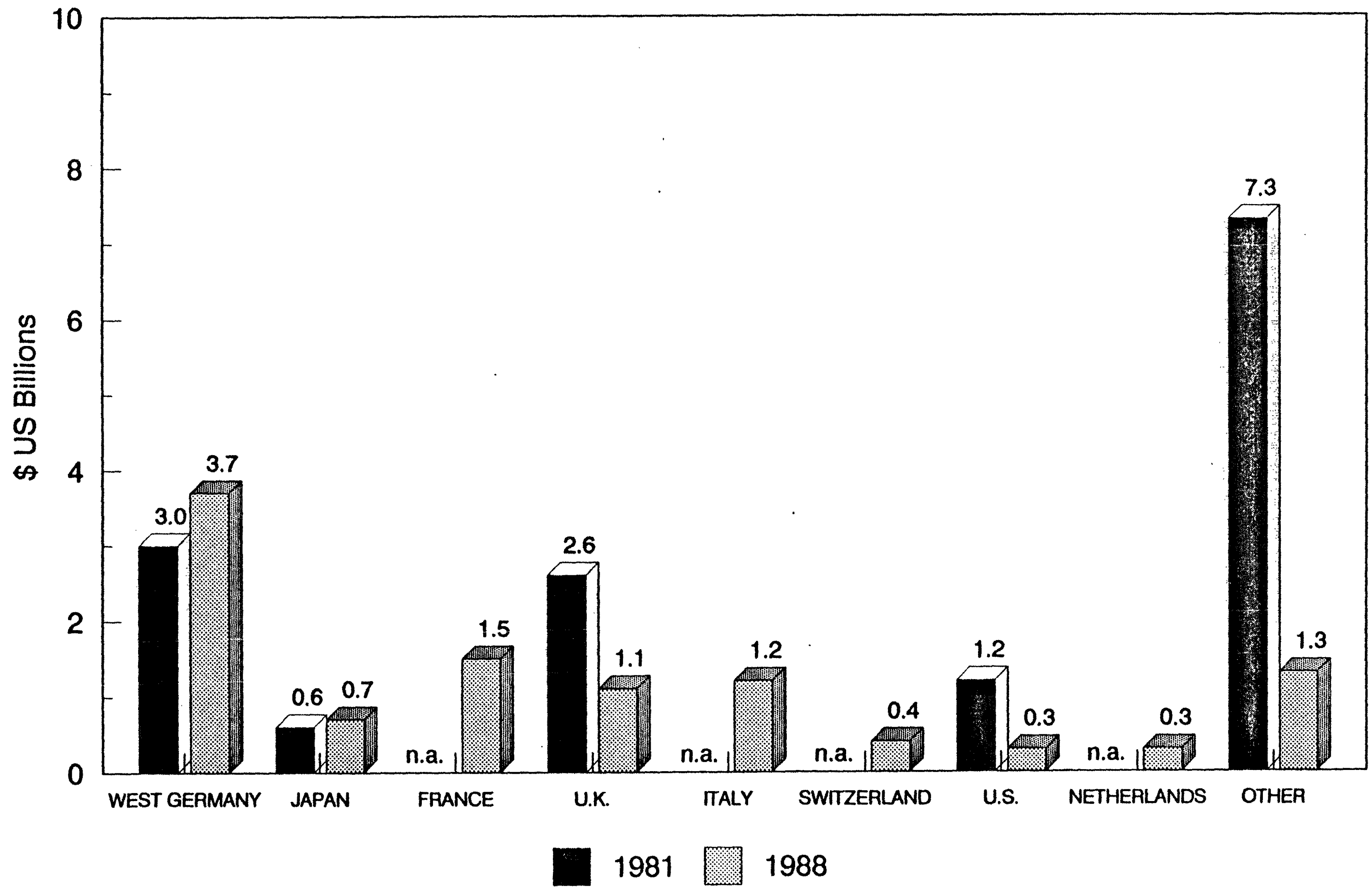


CHART 4g
Romania

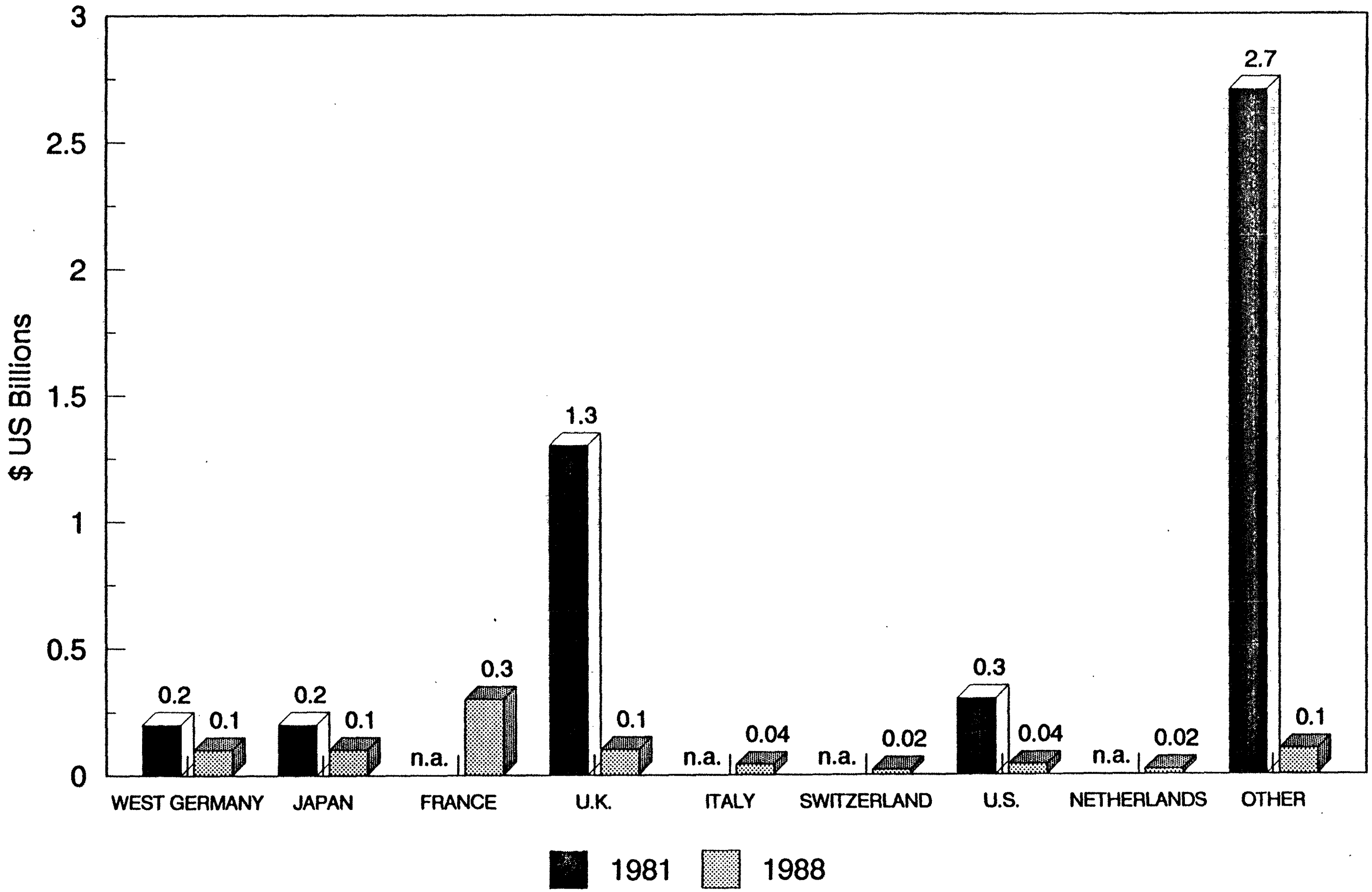
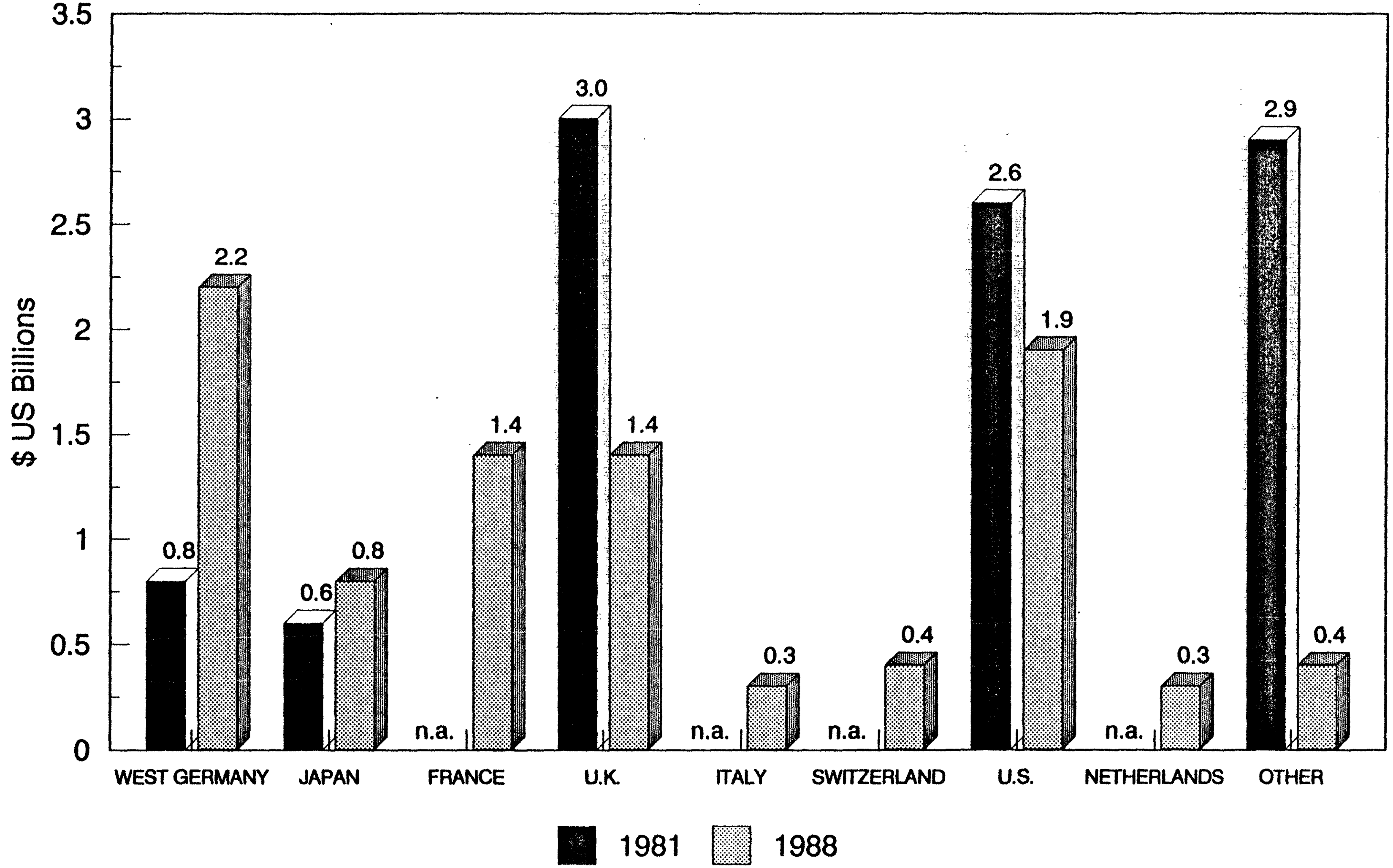
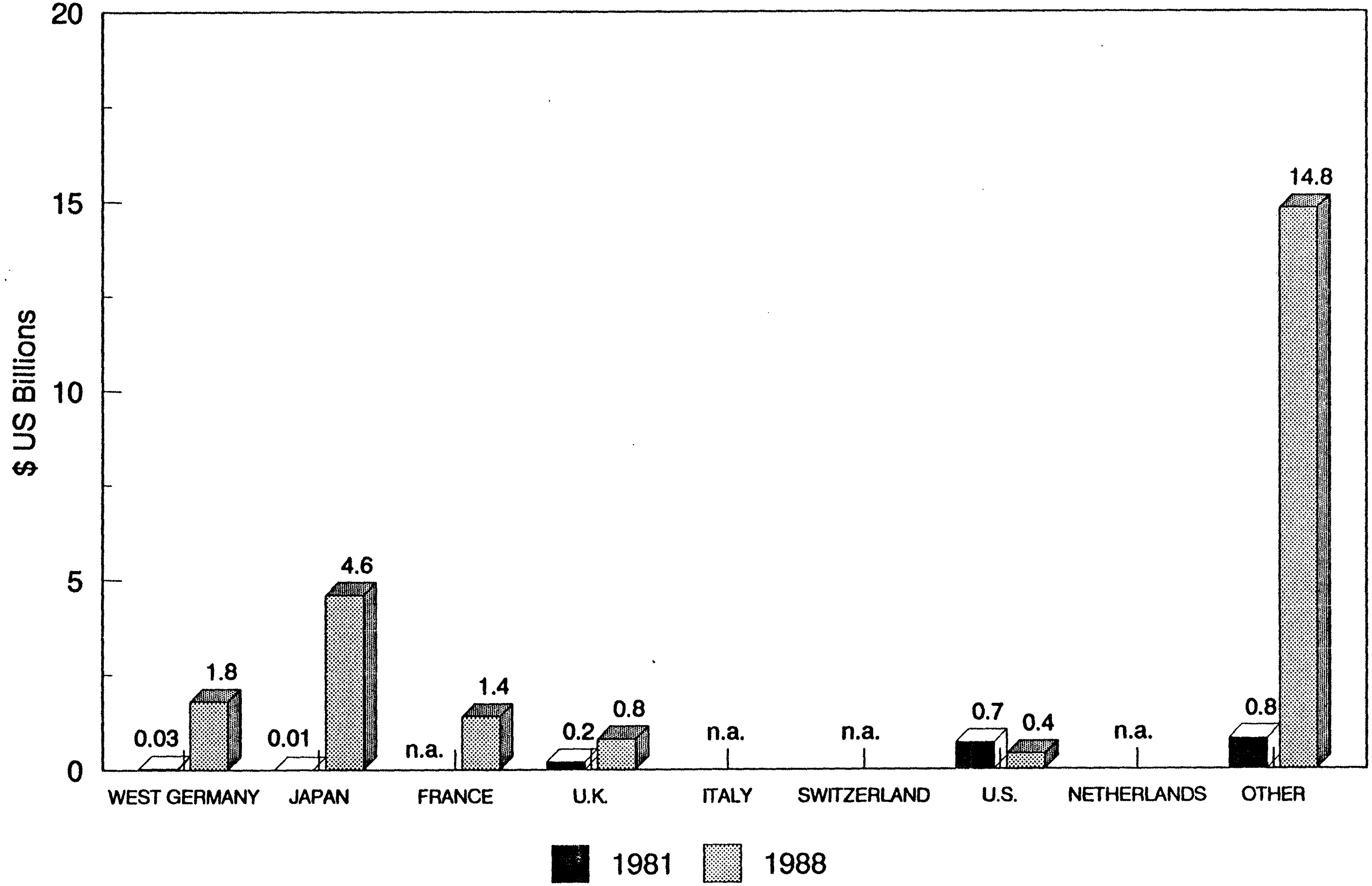


CHART 4h
Yugoslavia



West Germany "1981" is 1982 estimate.

CHART 4i
China



Commercial Loan Portfolio of Each Major Creditor Nation

(Dec. 1981 vs. Dec. 1988)

Chart 5a	West Germany
Chart 5b	Japan
Chart 5c	United Kingdom
Chart 5d	United States

CHART 5a
West Germany

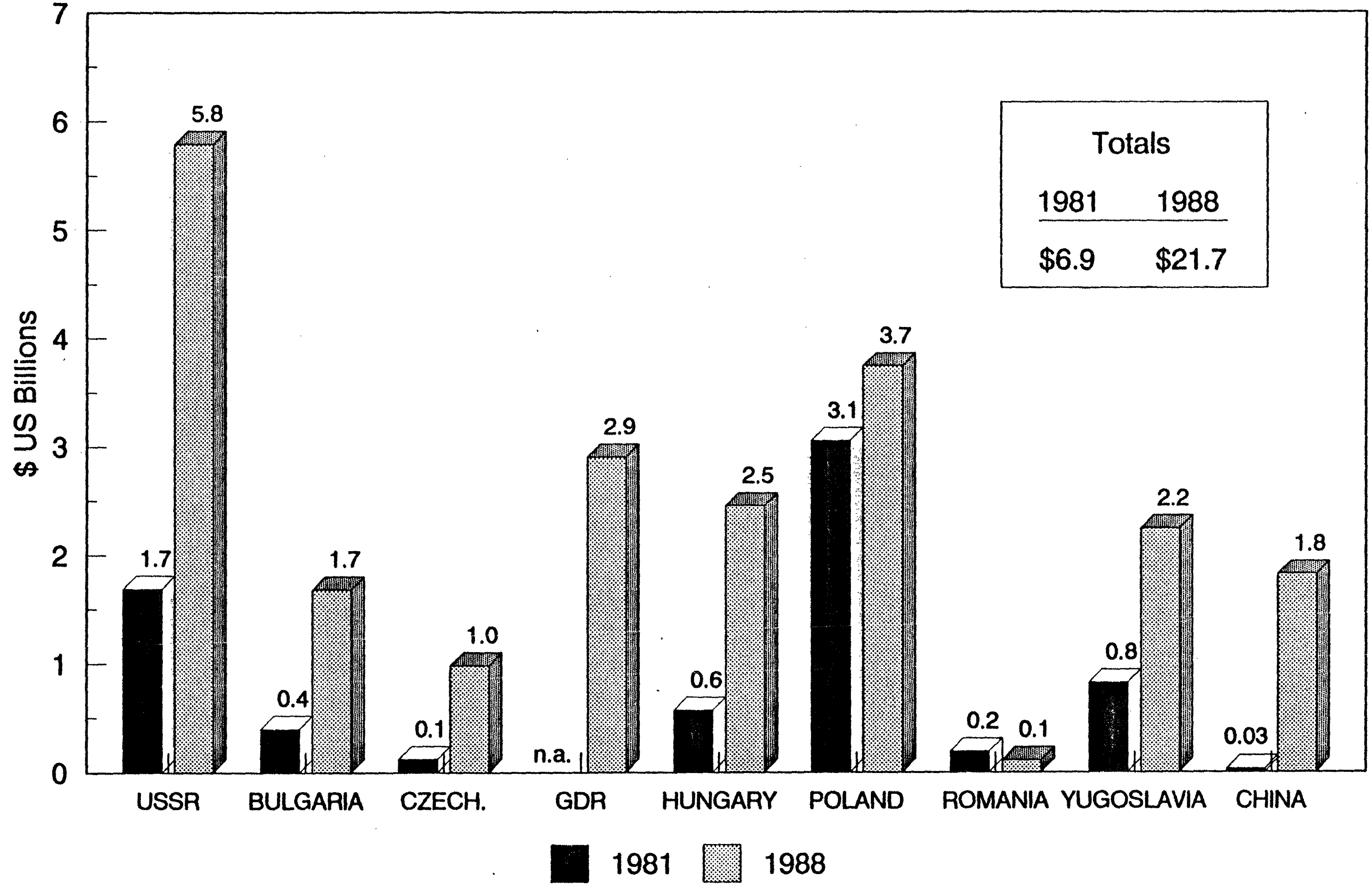


CHART 5b
Japan

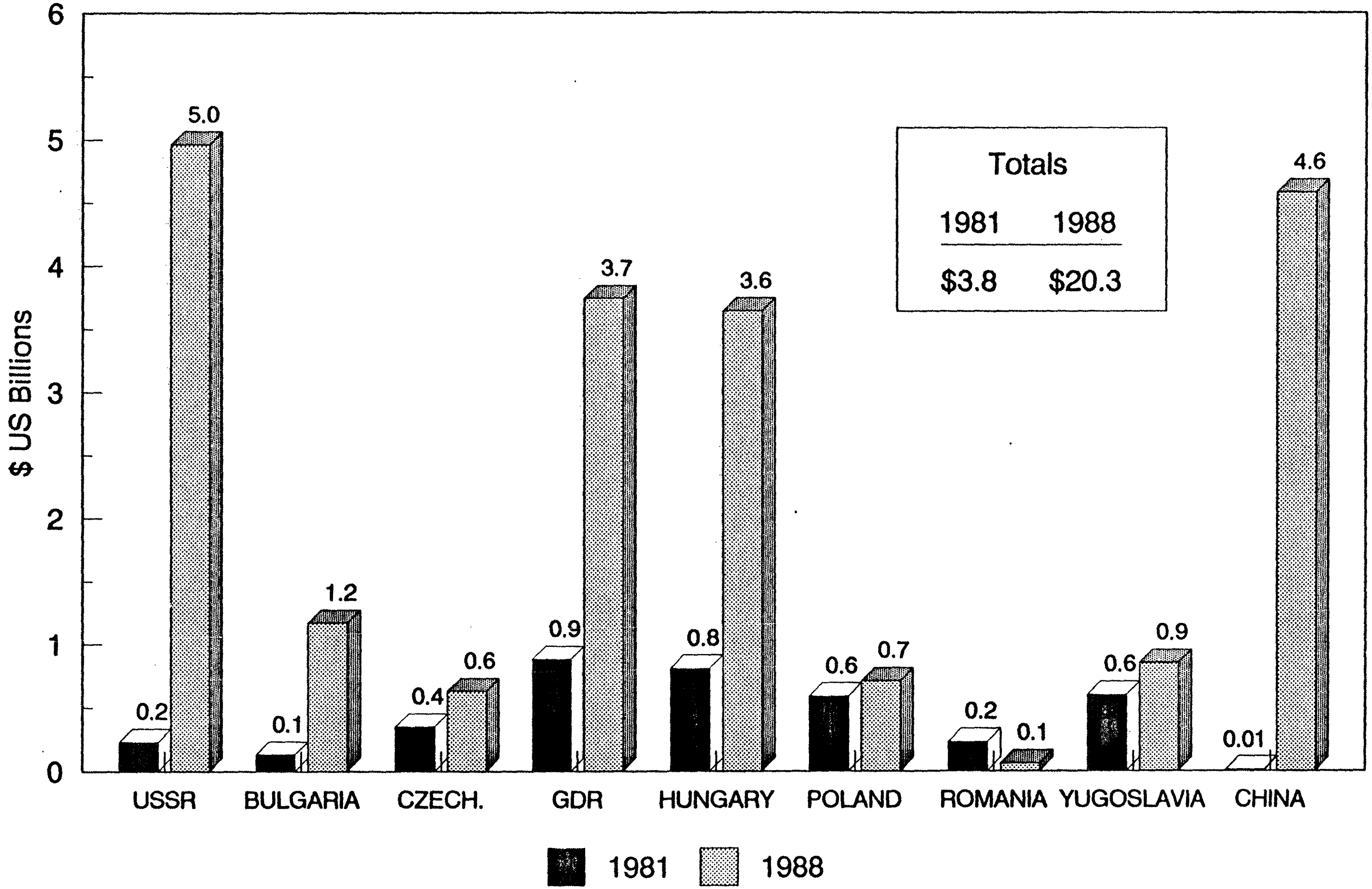


CHART 5c
United Kingdom

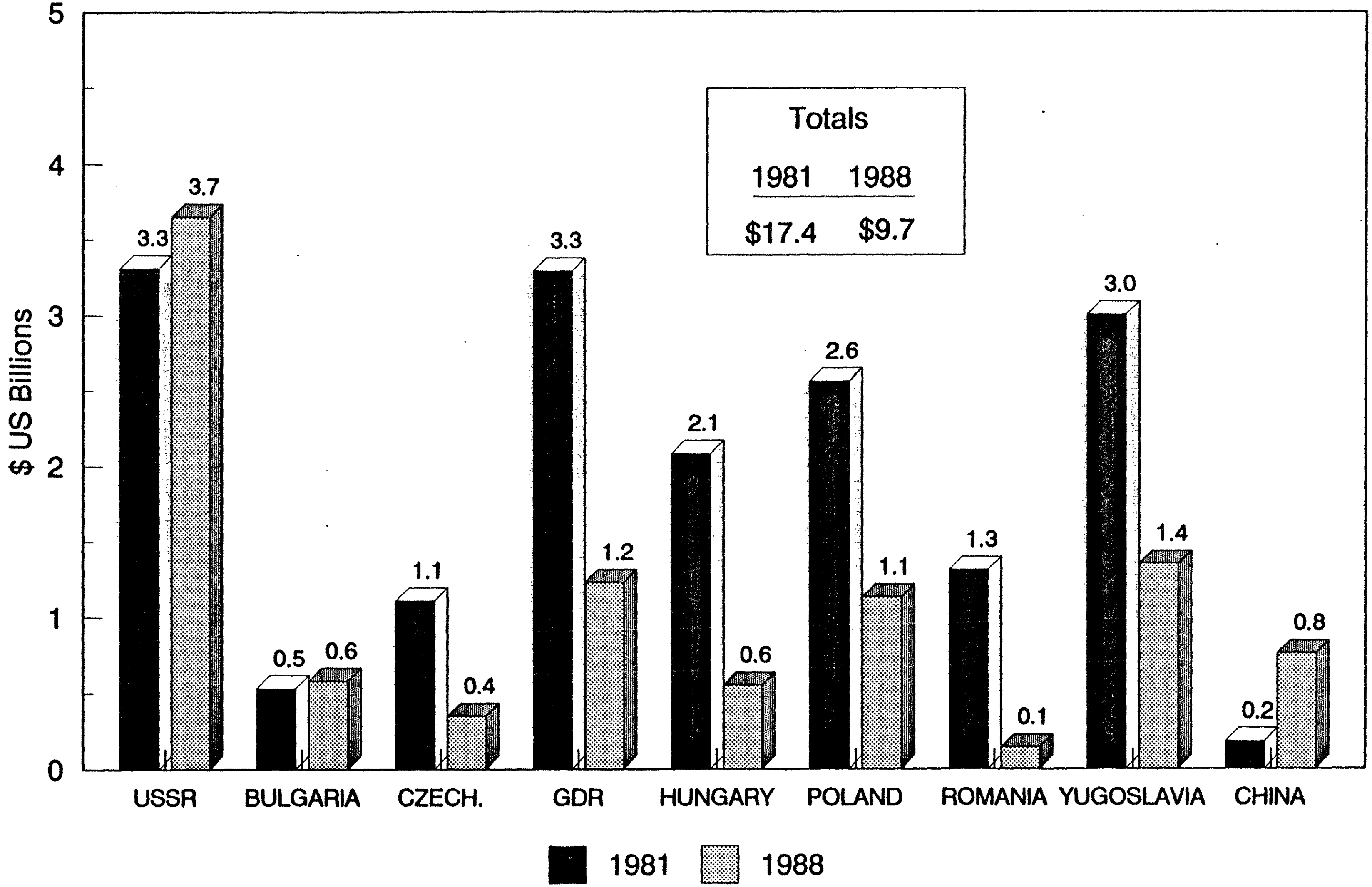
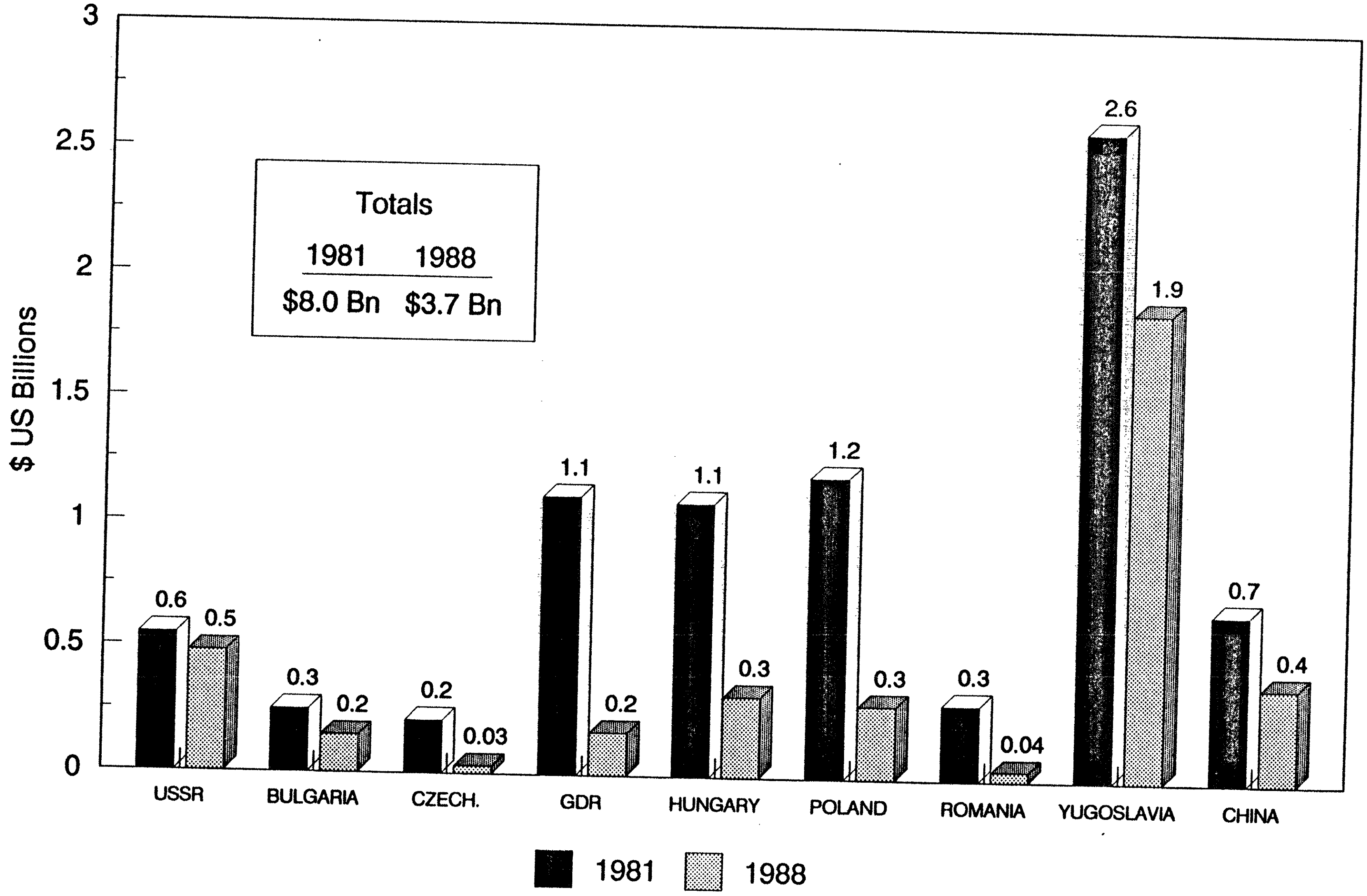


CHART 5d
United States



APPENDIX

BREAKDOWN OF COMMERCIAL BANK DEBT TO
USSR, EASTERN EUROPE AND CHINA

	USSR		BULGARIA		CZECH.		GDR		HUNGARY	
	1981	1988	1981	1988	1981	1988	1981	1988	1981	1988
WEST GERMANY/(3)	1.7	5.8	0.4	1.7	0.1	1.0	n.a.	2.9	0.6	2.5
JAPAN/(1)/(2)	0.2	5.0	0.1	1.2	0.4	0.6	0.9	3.7	0.8	3.6
FRANCE	n.a.	7.6	n.a.	0.8	n.a.	0.4	n.a.	2.1	n.a.	0.7
U.K.	3.3	3.7	0.5	0.6	1.1	0.4	3.3	1.2	2.1	0.6
ITALY	n.a.	3.8	n.a.	0.3	n.a.	0.2	n.a.	1.0	n.a.	0.6
SWITZERLAND	n.a.	2.0	n.a.	0.6	n.a.	0.3	n.a.	0.6	n.a.	0.4
U.S.	0.6	0.5	0.2	0.2	0.2	0.03	1.1	0.2	1.1	0.3
NETHERLANDS	n.a.	1.1	n.a.	0.2	n.a.	0.1	n.a.	0.5	n.a.	0.4
OTHER	10.1	7.0	0.8	1.4	1.4	1.5	4.8	6.1	2.9	2.6
TOTAL	15.9	37.0	2.1	6.9	3.2	4.4	10.1	18.6	7.5	11.5

(1) Excludes claims less than one year.
(2) End-March 1981 and 1988
(3) Yugoslavia 1981 is actually 1982 estimate

POLAND		ROMANIA		YUGOSLAVIA		CHINA		TOTAL	
1981	1988	1981	1988	1981	1988	1981	1988	1981	1988
3.0	3.7	0.2	0.1	0.8	2.2	0.03	1.8	6.87	21.71
0.6	0.7	0.2	0.1	0.6	0.8	0.01	4.6	3.83	20.34
n.a.	1.5	n.a.	0.3	n.a.	1.4	n.a.	1.4	n.a.	16.11
2.6	1.1	1.3	0.1	3.0	1.4	0.2	0.8	17.37	9.74
n.a.	1.2	n.a.	n.a.	n.a.	0.3	n.a.	n.a.	n.a.	7.36
n.a.	0.4	n.a.	n.a.	n.a.	0.4	n.a.	n.a.	n.a.	4.64
1.2	0.3	0.3	0.04	2.6	1.9	0.7	0.4	7.96	3.73
n.a.	0.3	n.a.	0.02	n.a.	0.3	n.a.	n.a.	1.63	2.76
7.3	1.3	2.7	0.1	2.9	0.4	0.8	14.8	32.14	34.74
14.7	10.6	4.8	0.8	9.9	9.0	1.7	23.7	69.81	121.12

Sources:

1981:
West Germany, U.K.: World Bank
Except West Germany,Yugoslavia,1981: is actually 1982 estimate
Japan: JCIF
U.S.: Federal Financial Institutions Examination Council, Statistical Release--June 3,1982
Total claims to Eastern Europe and China: PlanEcon, June 2, 1989

1988:
West Germany, Japan, France, U.K., Italy, Switzerland, U.S., Netherlands, Other: PlanEcon, August 11, 1989
China: World Bank, Financial Flows to Developing Countries; BIS