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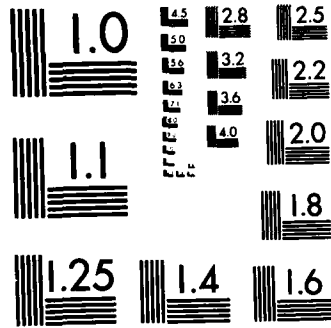
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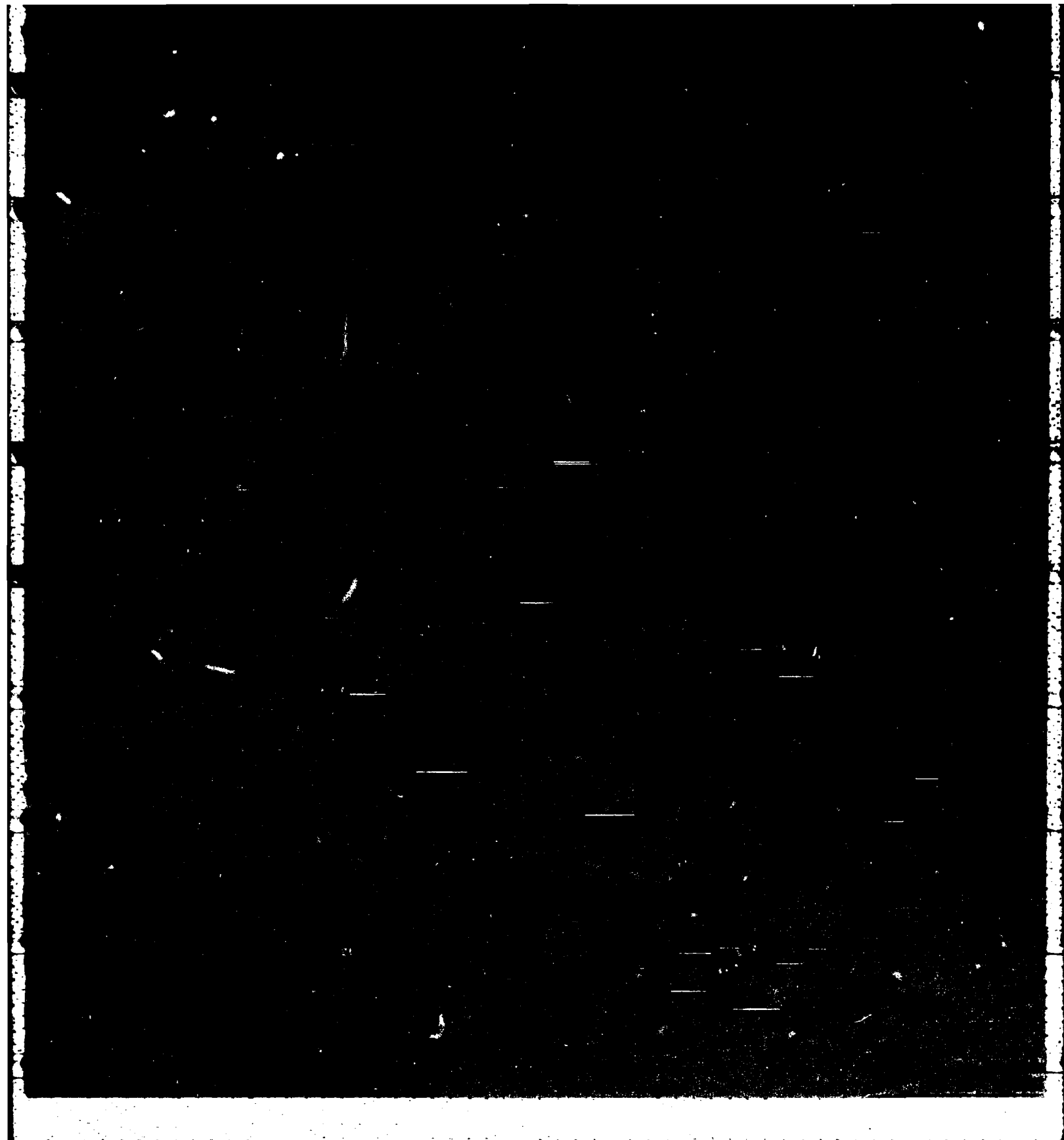
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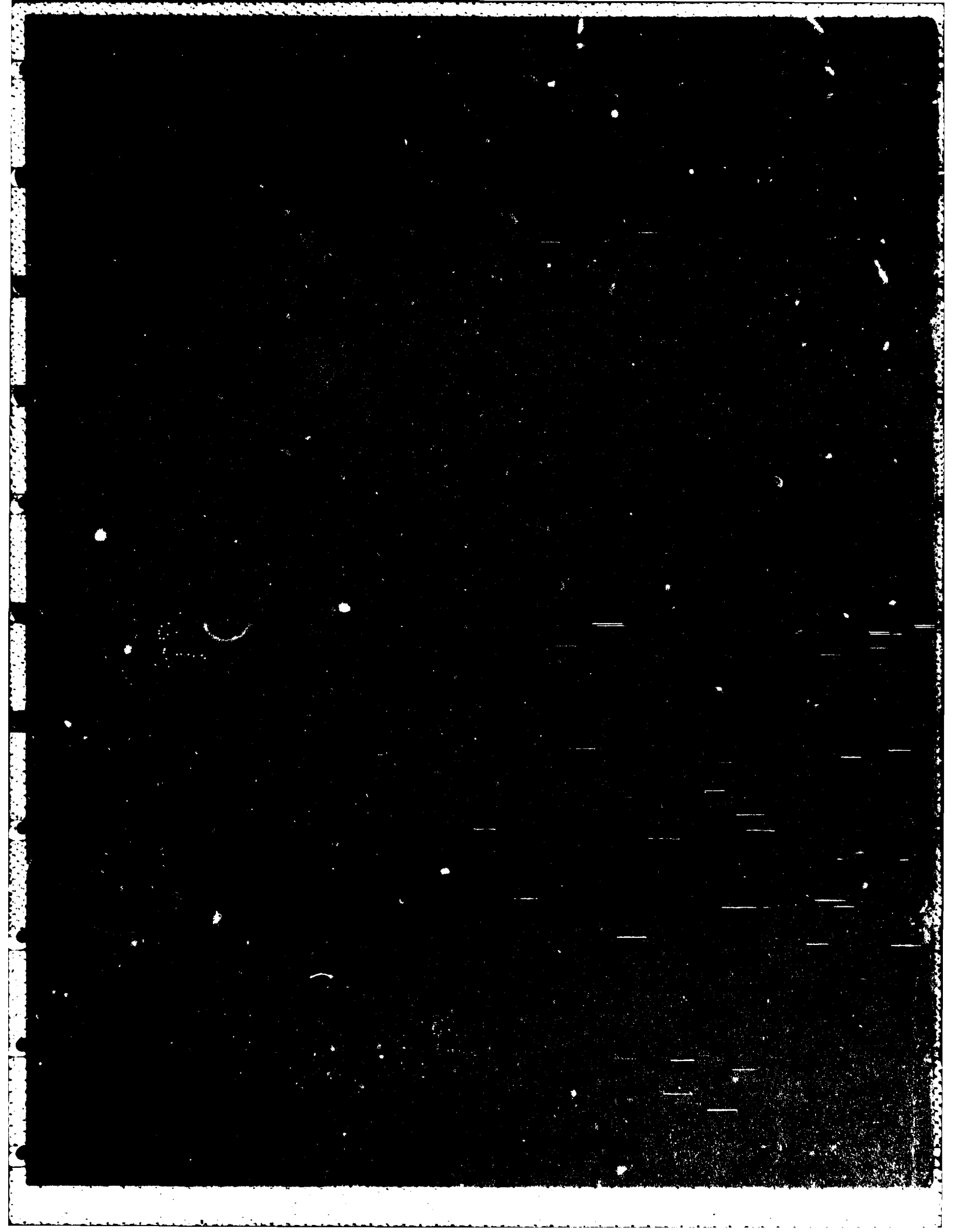
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ERRATUM

N-1877-USDP, "East-West Economic Relations and the Soviet Union's Defense Posture: Report of a Rand Conference, March 20, 1982," C. Wolf, et al.

p. 6 -- Third line from bottom should read: restricted; or they might adopt a more accommodating and


p. 7 -- Paragraphs 4 and 5 should read:

4. In light of the sharp and largely unforeseen deterioration in recent years of the international credit position of several CMEA economies, it is important to develop improved methods of analyzing the balance of payments prospects and potential credit-worthiness of Hungary, Rumania, Czechoslovakia, East Germany, and the Soviet Union, for the 1980s.
5. It may be useful to formulate scenarios of possible Eastern European debt default: autonomously by the banks, or induced by governments. This analysis should distinguish between the roles, motivations, and legal requirements and constraints that influence banks, regulators, and governments.

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This workshop conference had two principal purposes: (1) to consider and discuss practicable ideas for restricting West-to-East resource flows, while limiting undesirable side effects on the Western Alliance, the international financial system, the peoples of Eastern Europe, and the Third World; and (2) to identify issues in this broad area that may warrant further study and analysis. Section I of this Note distills from the oral discussion its principal implications with respect to policy and research, such as reducing access by Eastern economies to foreign credits, collective action by Western Europe, Japan, and the United States, and looking at several issues relating to the gas pipeline that may warrant further research. Section II contains a digest of the meeting based mainly on rapporteur notes of the oral discussion. Titles of papers given are: "Default versus Deferral of Poland's Debt: Real and Illusory Differences;" "Possible Future Developments in Poland;" "The Polish Crisis and U.S. Policy Objectives;" "The Polish Debt and Credit Controls;" "Western Economic Sanctions and Soviet Military Resource Allocation;" and "Reducing Resource Flows from West to East." 80 pp. (LN)

A RAND NOTE

EAST-WEST ECONOMIC RELATIONS AND THE SOVIET
UNION'S DEFENSE POSTURE: REPORT OF A RAND
CONFERENCE, MARCH 20, 1982

Charles Wolf, Jr., Abraham S. Becker,
Aaron Gurwitz, A. Ross Johnson, Arnold L. Horelick

September 1982

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PREFACE

On March 20, 1982, Rand organized a workshop conference in Washington, D.C., on "East-West Economic Relations and the Soviet Union's Defense Posture." The workshop was convened on short notice at the request of the Office of the Under Secretary of Defense for Policy. The aim of the meeting was to consider various policies for restricting West-to-East resource flows, and thereby to bring pressure to bear, in the longer run, on Soviet resource allocations for military purposes.

To discuss this subject, Rand invited a small group of bankers, academic and government experts, and selected other participants; an agenda and discussion papers were included to guide the proceedings. (Appendixes A, B, and C contain the agenda, list of participants, and discussion papers, respectively.) The discussion papers by Becker, Horelick, and Johnson were based on work drawn from a related Rand study, while the papers by Wolf were drafted explicitly for this meeting. The papers appear in the form in which they were distributed to the participants, several days in advance of the meeting. They were not intended to offer definitive treatments of the subjects, but simply to provide a basis for discussion of the agenda topics.

Section I of this Note distills from the oral discussion its principal implications with respect to policy and research. Section II contains a digest of the meeting based mainly on rapporteur notes of the oral discussion. No attempt was made to arrive at firm conclusions or at agreement among the participants. Consensus did emerge on some points, although a considerable range of differing opinions was

expressed on others. We have tried in the digest to reflect both the consensus and the disagreements. None of the points presented in either section is attributed to any individual participant, and none of the participants would necessarily subscribe to the precise formulations appearing in these sections.

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I. IMPLICATIONS FOR POLICY AND RESEARCH

The workshop conference on March 20, 1982 had two principal purposes: (1) to consider and discuss practicable ideas for restricting West-to-East resource flows, while limiting undesirable side effects on the Western Alliance, the international financial system, the peoples of Eastern Europe, and the Third World; and (2) to identify issues in this broad area that may warrant further study and analysis.

Two aspects of the first purpose require a word of explanation. First, the restrictions being sought are aimed primarily at the USSR, since the proximate goal of such resource restrictions is to put pressure, to the extent possible, on Soviet military expenditures. It is apparent, however, that the USSR bears significant costs in its relations with Eastern Europe, hence that the level of resource flows to Eastern Europe, by easing or aggravating the Soviet burden, may have an effect on Soviet resource allocation policy. At the same time, many Western observers and policymakers believe that a "differentiated" approach should be taken to Eastern Europe--for example, distinguishing between benevolence toward Hungary and severity toward Poland or Czechoslovakia. Therefore, discussion of West-to-East restrictions in what follows should be understood as focused on the USSR, allowing for possible "differentiation" among East European countries, but also conscious of the economic connections between these countries and the USSR.

Second, policies that seek to restrict West-to-East resource flows are likely, if not certain, to have some undesirable side effects. But

the magnitudes of these side effects are very likely to differ appreciably for different policies. For example, consider three broadly different policies with respect to such resource flows: (A) subsidization by governments to encourage such flows; (B) embargoes or sanctions, against them; and (C) removing subsidies, and avoiding or limiting embargoes, while letting the market function to encourage or foreclose particular transactions, in accord with the differential economic conditions and prospects of the Eastern European and Soviet economies. Policy A, subsidization, was the policy pursued by the Western European countries, Japan, and the United States in the 1970s. Both policy B and policy C would represent a restriction of West-to-East resource flows compared with policy A. Yet clearly, the side effects of policies B and C are likely to differ quite sharply; for example, opposition within the alliance to policy C is likely to be more limited than that to policy B. And, of course, various combinations of B and C might be formulated which would also entail differing side effects on the alliance, or on the Third World, and so on.

The following points summarize the principal judgments reached in the discussion, in response to these aims:

A. Restricting West-to-East Resource Flows

1. To minimize the undesirable side effects that might ensue from a policy of restricting West-to-East resource flows, and to gain the required domestic and Alliance support, a clear, simple, and understandable rationale for the policy should be developed. This rationale should make clear the modest, as well as reasonable, objectives that such a policy seeks, should acknowledge the uncertainties that accompany it, and should

reflect the hope that the policy will remedy some of the shortcomings that were associated in the 1970s with the encouragement and subsidization of West-to-East resource flows. The development of such a rationale would also reduce the undesirable side effects, at least on the alliance and perhaps elsewhere, too. Even if U.S. allies, as well as many countries in the third world, do not agree with or endorse the policy, their opposition to it is likely to be moderated by understanding the rationale on which it is based. If the policy is preceded by development of a suitable rationale, as suggested above and described in (2) below, the damage that would ensue for the Alliance is likely to be limited. (Some participants in the conference also observed that the present diminished state of the Alliance already limits the further damage to it that might be inflicted!)

2. The ingredients of this rationale include the following components: (a) Underlying the pursuit of detente in the 1970s was the premise that expanded economic relations between West and East would lead to some moderation of the Soviet Union's international expansionism, some slow-down of the military buildup, and perhaps some relaxation of the system's repressiveness at home. (b) Instead, encouragement and subsidization of West-to-East economic transactions in the 1970s was accompanied by an unabated buildup of Soviet military forces--both nuclear and conventional--, as well as continued efforts to expand the Soviet empire abroad. (c) While these economic transactions presumably did not cause the perverse

Soviet behavior, the net flow during the 1970s of more than \$80 billion of resources from the West to the Soviet Union and Eastern Europe certainly eased considerably the resource constraints faced by the Soviet economy during this period, thereby facilitating both the military buildup and external expansion. (d) Rather than easing these constraints, a major aim of Western economic policy in the 1980s should be to tighten them, thereby making Soviet decisionmakers more clearly aware of the tradeoffs and choices which the Soviet Union faces as among its military buildup, external expansion, and possible remedies for its growing internal economic difficulties. It can be hoped, rather than assumed, that the result of a clearer awareness of these tradeoffs will induce Soviet leadership to pursue a more reasonable and less aggressive stance in the future.

3. While a reorientation of Western policy along these lines is unlikely to have much effect on Soviet military spending in the short run, prospects for such an effect are better in the middle term and longer run. Of course, the result of Western restrictions will depend in large part on their effect on Soviet leaders' perceptions and preferences. But even from a technical economic point of view, any resulting cutback in Soviet military expenditure is likely to be only a fraction of the shrinkage in Western resource flows.
4. A considerable restriction of resource flows to the East has already taken place. The dismal record of Polish debt performance, the precarious financial position of Rumania, and

the generally weak and declining prospects of the Soviet and other Council for Mutual Economic Assistance (CMEA) economies have already had the effect of reducing access by these economies to foreign credits.

5. These natural market responses would be accentuated if the U.S., Western Europe, and Japan were to embark on a policy of selective withdrawal of government subsidies on their trade and credit transactions with the Soviet Union and with the other CMEA countries. Subsidies to be withdrawn should include interest rate concessions, loan and investment guarantees, and preferential tax treatment of income from these transactions.*
6. Even unilateral action by the U.S. along these lines could be expected to have a significant restrictive effect because of the strength and influence of U.S. financial institutions in the international financial system. Foreign banks are less likely to engage in consortium financing if U.S. institutions are unwilling to participate. And if, nonetheless, some foreign banks engage in such financing, their competitive strength is likely to be eroded because the confidence that prospective depositors have in them will diminish. Nevertheless, collective action by Western Europe, Japan, and the United States is likely to be far more effective than unilateral action.

*The resulting financial environment would be one in which credit and trade transactions would impinge differentially on the CMEA countries in accord with their differential economic performance and prospects. If it can be further assumed that their economic performance and prospects are likely to be heavily influenced by the degree of decentralization of decisionmaking and loosening of control which occurs, then perhaps differentiation among the CMEA countries according to economic criteria may be congruent with differentiation according to political criteria.

7. Reducing West-to-East resource flows may be expected to facilitate West-to-South (or North-to-South) resource flows, by freeing up the relatively tight supply of savings and credits in the international capital market.

B. Issues for Further Research

1. If a policy along lines described in point 5 above were to be considered, the following effects would be important to address:
 - o Estimating the costs (to the countries of origin) of all the various forms of subsidies, especially loan and investment guarantees.
 - o Comprehending the mechanisms in U.S. and Euromarket banks and governments for effectuating the denial policy.
 - o Evaluating the effectiveness of the policy if the U.S. were to pursue it alone, or alternatively in concert with some or all members of the EEC and Japan.
 - o Evaluating the differential effects of this policy on the various CMEA countries.
2. Major uncertainties are involved in potential Soviet responses to a policy of restricting West-to-East resource flows. For example: The Soviets may be so provoked by the policy that they might actually devote more effort to military spending and external mischief even though the aggregate resource base is restricted; or they might adapt a more accommodating and conciliatory stance; or their preferences and behavior might be unaffected. A plausible argument can be made in support of

each of these sharply different hypotheses. It would be important and useful to analyze the basis for choosing among them, as well as the possibly different time periods over which each response might ensue.

3. Supply conditions in the international credit market need to be better understood if the policy of restricting resource flows is to work effectively. This work would cover several items:
 - o Competition among creditors, and the market power of large borrowers.
 - o Asymmetries in Soviet borrowing-lending relations with the West and Japan.
 - o The effect of removing all government subsidies, and "letting the market decide," on the differential availability of credit to particular CMEA countries.
4. Analyzing the balance of payments prospects and potential credit-worthiness of Hungary, Rumania, Czechoslovakia, East Germany, and the Soviet Union.
5. Formulating scenarios of possible Eastern European debt default: autonomously by the banks, or induced by governments. In this analysis it would be important to distinguish between the roles, motivations, and legal requirements and constraints that influence banks (American, European, Japanese), regulators (examiners, auditors, etc.), and governments (U.S., France, Germany, Austria, UK, Japan).
6. Several issues relating to the gas pipeline may warrant further study:*

*Several of these points were more timely at the time of the discussion in March 1982 than they are currently.

- o How do the present terms of the pipeline deal look if sharply lower world oil prices are assumed to prevail over the next several years?
 - o Might the terms be made conditional on the oil prices that actually prevail during the period of deliveries?
 - o How might we compensate the Europeans for part of the sunk costs of the pipeline?
7. A neglected issue for investigation is the relation between West-to-East resource flows and West-to-South resource flows, via debt repayment, rescheduling or default of existing Eastern European debt to the West, and via further credit restrictions on West-to-East resource flows. The purpose of this effort would be to examine the quantitative relationships between changes in West-to-East resource flows, and expected changes in the availability of external resources for the developing countries of the South.
8. It would also be useful to analyze the international gold market and factors contributing to its further softening, and hence to reducing the value of the Soviet gold stock and of further Soviet gold production.

II. DIGEST OF THE DISCUSSION

by Aaron Gurwitz

INTRODUCTION

The conference began with a statement of its two principal purposes: (1) to consider actionable ideas for reducing resource flows from West to East and thereby to bring pressure to bear on Soviet military resource allocations; and (2) to formulate ideas for further research and analysis of these issues. (Appendix A contains the conference agenda; Appendix B lists the conference participants; and Appendix C consists of the discussion papers prepared for the conference.)

Reducing West-to-East resource flows entails two categories of questions: (1) What effect would various policy actions have on such resource flows to CMEA countries in general, and the Soviet Union in particular? and (2) What effect would the consequent diminution of net resource flows have on Soviet military spending? Most of the conferees' expertise, and consequently most of the discussion, focused on the first of these questions. The bulk of this digest, therefore, reports the principal points raised, as well as the uncertainties and disagreements revealed in discussions of the potential effectiveness of various means for reducing the net flow of resources from West to East. A concluding section reports the briefer discussion of the second question.

Among the policy instruments discussed were the following: (1) a declaration that Poland is in default on loans that are now in arrears; (2) similar action with respect to loans to other East European

countries that have fallen (Rumania) or might fall (East Germany, Hungary) fall into arrears; (3) a variety of efforts to stop or slow down the construction of the Yamal Pipeline, or to reduce the import revenues for the USSR eventually generated by natural gas sales in Western Europe; and (4) reducing or eliminating explicit government subsidies on West-East transactions, and such implicit subsidies as credit guarantees on loans by commercial lenders to CMEA countries in general and to the Soviet Union in particular.

In general, discussion of these potential actions focused on two factors: the effect, in the short and long run, on the net flow of resources from West to East and the impact on the Western Alliance as a whole or on one or more of its members. The next four sections of this digest will summarize the discussion of the effectiveness of each potential action and the "collateral damage" each might entail.

A DECLARATION OF POLISH DEFAULT

At the date of the conference the Polish debt to Western countries was substantially in arrears. An agreement for rescheduling payments due in 1981 had been reached, but not signed, by the time martial law was declared in Poland on December 13, 1981. The status of that agreement was uncertain, and no negotiations on a rescheduling of 1982 payments had begun. The Poles had been meeting some interest payments on the 1981 debt as a demonstration of good faith, and a limited trade between Poland and the West was taking place on a cash basis. There was no question, however, that, under existing loan agreements, the Poles could be declared legally in default on payments due in 1981 and through 1982 to date. Nor was there any disagreement that if one creditor declared default--the United States Government (USG), for example--

other creditors could invoke the cross default clauses in their own loan agreements and the default could become general.

There was less agreement as to whether or which other creditors would be likely to declare cross default, or as to the effects of partial or general default on the net flow of Western resources to Poland. It seemed to be agreed, however, that any limitation on the continued flow of resources to Poland would exacerbate the decline of the Polish economy, even with an expected substantial increase in aid from the Soviet Union.

Would declaration of default by one creditor lead to a general declaration of default? There was no clear answer to this question. If the first creditor to declare default were able to attach Polish assets in the West (for example, a shipload of Polish coal as it docked in Hamburg), then other creditors might choose or be forced to protect their own claims and follow suit in calling in their Polish loans. If, however, the first declarer's legal claims on "assets" turned out to be tenuous, the European creditors with the greatest exposure might try to preserve the book value of Polish loans by choosing not to invoke the cross default. Another recourse is for creditors to embark on an immensely complex process of international litigation. No probabilities were assigned to the various possible outcomes, but it was generally doubted that attempts to attach Polish assets would be lucrative or would succeed easily.

There was little direct discussion of how general or partial default would affect the flow of Western resources to Poland. Notwithstanding rescheduling of 1981 payments, no new credits are currently being issued to the Poles. Without an inflow of capital from

abroad, it will be extremely difficult for the Polish economy to generate sufficient export earnings to meet even very generously deferred payments. Participants' views of the prospects for recovery of the Polish economy ranged from dubious to gloomy. One estimate presented was that total hard currency liabilities would have to reach \$45 billion before the Polish economy could carry its debt burden. Another estimate indicated that a capital inflow of between \$3 and \$4 billion a year for about five years would allow the Polish economy to "limp along." Without new credits, Polish gross domestic product (GDP) is expected to drop by 15 percent in 1982, on top of an estimated 20 percent decrease in 1981.

Further economic deterioration seems likely in the absence of a large flow of resources from outside. A substantial proportion of those resources are expected to come from the Soviet Union. It was estimated that the net resource flow from the USSR to Poland amounted to about \$4 billion in 1982, consisting of about \$2 billion in direct aid and subsidies and another \$2 billion of trade surplus. The Soviet Union's 1982 trade surplus with Poland is expected to be higher. These figures represent a drain on Soviet resources, although Soviet aid alone is not likely to substitute fully for resource flows from the West. The USSR will not, for example, be able to supply the Polish economy with needed food and spare parts.

It appears, therefore, that while the Poles may be able to limp along for a while meeting a few payments from quarter to quarter, any expectation that a serious repayment schedule will be met presupposes new net credits. Whether this would simply involve throwing good money after bad was not agreed on at the meeting. Only widespread acceptance

of the fact that Poland is in default appears to be consistent with a discontinuation of the net flow of resources to Poland.

A substantial part of the discussion of Polish debt focused on differences between the U.S. view and the views of its major European allies. Even before the imposition of martial law in Poland, European and especially German banks were loath to impose the stringent economic conditions for rescheduling that U.S. banks wished to write into the agreement. Given current political conditions in Poland, the European banks appear unwilling to resume rescheduling negotiations immediately, but they point out that by failing either to defer or declare default, the West is essentially letting the Poles off the hook in the short run. Because of differences in the compositions of their international loan portfolios, U.S. banks tend to be more concerned with the precedents that might be set in a Polish rescheduling agreement for negotiations with other countries currently in arrears in their debt service.

There is a range of views within the Alliance, with the British generally most in sympathy with the "hard line" viewpoint and the Germans most desirous of returning to "normal" East-West financial relations.

POSSIBLE DEFAULT AND RESCHEDULING OF LOANS TO OTHER
EAST EUROPEAN COUNTRIES

Rumania is now substantially in arrears on debt service to the West, and several participants indicated that Hungary and East Germany might find themselves in similar circumstances before very long. There was some discussion of the importance of differentiating among East European countries in handling the options of default versus rescheduling. Several participants suggested that the West might have

an interest in continuing the Hungarian economy's shift away from CMEA. However, there was some concern that by helping to ameliorate economic conditions in any CMEA country, the West might be making the Soviet political role in that region more tolerable.

The actual or potential repayment problems of the other East European countries are apparently different from Poland's. Several CMEA countries have found themselves in balance-of-payments difficulties before and have always managed to extricate themselves and recover fairly quickly. It did not seem that Poland's severe problems and poor prospects for serious repayment without further infusions of external capital were endemic in Eastern Europe.

Discussion of these issues focused on the economic and financial relationships between the USSR and the East European countries. In the 1960s it was generally believed in the West that transactions with Eastern Europe had to be handled, essentially, through Moscow. Now it is less clear. We do not know, for example, to what extent the liabilities of East European countries are, will, or should be taken into account in calculating the "credit worthiness" of the Soviet Union. Equally uncertain is the extent to which denial of new credits to East European countries will effectively reduce the net flow of resources to the Soviet Union. There was some agreement, however, that the linkages between the Soviet economy and the East European economies differed across countries.

As with the Polish debt, the West Germans apparently stand to lose the most, both in terms of assets in balance sheets and forgone future trade, from a reduction in credit flows to other East European countries. In particular, the high political value West Germany places

on its economic relationship with East Germany was mentioned several times. In general, the West Europeans are more interested in maintaining their economic relations with specific East European countries, and the U.S. in reducing the net flow of Western resources to the USSR and its military spending and military investment program. It is not clear just how contradictory these objectives may be.

THE YAMAL PIPELINE

The Yamal Pipeline is of concern to the Western Alliance for two reasons. First, if Western Europe becomes too dependent on the Soviets for energy supplies, the region's political independence may be jeopardized. Second, expected revenues from the sale of natural gas in the West increase the resources available to the Soviet Union, as well as its long-run credit worthiness and, therefore, increase the level of net West-to-USSR resource flows that might be justified on purely financial grounds. The West Europeans share the first concern, but are, apparently, less concerned about the second.

While it was generally agreed that construction of the pipeline would go forward, several suggestions were offered for Western policies that might ameliorate the pipeline's undesirable consequences. The first possibility was to develop alternative sources of natural gas for Western Europe. Current Norwegian, Dutch, and British plans for exploitation of North Sea natural gas, which are, apparently, based on consideration of long-run profit maximization, might be shifted forward as part of a general package of Alliance policies. Timely exploitation of Western European reserves would have two benefits. It would provide a more reliable source of supply and it might help reduce the expected price of natural gas, and hence the Soviets' expected hard currency earnings.

The second suggestion focused on gas prices directly. Building the pipeline is a risky undertaking because it will be profitable only given long-run energy prices above a certain level. No one was certain whether the recently completed agreements for financing the pipeline and for delivery of gas impose much of the risk of declining oil prices on West European consumers. If popular attention in France, West Germany, and Italy could be focused on the fundamental economics of the pipeline, pressure to renegotiate existing contracts might increase enough to induce action.

DENYING EXPORT SUBSIDIES AND CREDIT GUARANTEES
TO THE SOVIET UNION AND EASTERN EUROPE

The Administration's policy objective is not to eliminate East-West trade, but to eliminate both implicit and explicit subsidization of resource flows to the East, and thereby to restrict such flows. There seems to be general agreement within the Alliance that direct subsidies should be eliminated. One participant referred to a possibly biased French estimate placing these direct subsidies at only about \$400 million per year, out of a cumulative total West-to-East flow of resources in the past seven or eight years of over \$70 billion. The elimination of such relatively small subsidies would probably have a small effect on net resource flows (although this "elasticity" is only a conjecture). The indirect subsidies implicit in Western government guarantees of credits issued to the Eastern bloc are probably much larger and more important, but there is less agreement among the allies as to what should be done about these.

Disagreement about credit guarantees appears to center on two issues. First, the West Germans argue that such guarantees are not really subsidies, but essentially standard operating procedure in international economic relations. Denying such guarantees on loans to the USSR or Eastern Europe, the argument goes on, would amount to an act of "economic warfare," and would, therefore, be inadvisable.

Conference participants generally dismissed this view and argued that by insulating loans from a market test, guarantees do subsidize credit flows. Furthermore, official loan guarantees are supplemented by the implication that central governments or central banks would, in the event of default of large unguaranteed loans, act to protect the solvency of major banks by buying up the defaulted assets, whether or not they were guaranteed!

There was less agreement among participants as to the value or importance of these guarantees, especially with respect to loans to the USSR. From one point of view, the implicit subsidy appears to be unimportant: Interest rate differentials between guaranteed and unguaranteed loans are small. Private insurance, albeit of limited coverage, may be available at rates that are not prohibitive. Lloyds of London, for example, will reportedly insure 50 percent of short-term (three-year) loans to some Eastern European countries at a premium of only 1.5 percent of the value of the loan. At the same time, there are some risky loans, for which no private insurance would be available. These loans would simply not be made without (explicit or implicit) government guarantees. In this case, the equivalent market value of the subsidy is extremely hard to calculate.

In any case, with respect to the Soviet Union especially, the economic significance of government loan guarantees may not matter as much as their political significance. Notwithstanding recent evidence of Soviet liquidity problems the USSR may be, in strictly economic terms, a good credit risk as a sovereign borrower: It has large reserves of natural resources and gold, although the value of its gold reserves has severely declined with the break in world gold prices in the past year. In spite of its presumed credit worthiness, however, Western credits were not issued to the Soviets in large magnitude until Western governments signaled their support for such activities. Discontinuation of Western government guarantees of Soviet repayment would transmit the opposite signal.

Even without formal discontinuance of credit guarantees, the shift in the political climate after the declaration of martial law in Poland, as well as the non-servicing of the Polish debt, has substantially reduced the net flow of Western resources to the East, thereby contributing perhaps to the goal of reducing military efforts by the USSR.

Among the participants at the conference, there seemed to be no disagreement with the assertion that the growth in East-West economic relations over the past decade has not had the hoped-for effect of ameliorating Soviet behavior or reducing Soviet military efforts. There were differences as to whether eliminating or reversing the net flow of resources from West to East would have a desirable effect on the Soviet military posture or on the balance of military forces. Both economic and political dimensions are involved in these differing views.

One issue involves the importance of hard-currency credit-flows to the Soviet economy as a whole and to the military economy in particular. Trade with the West is a quantitatively small part of the overall Soviet economy, but there is some evidence that the small size of the hard-currency trade sector may understate its importance to the economy as a whole. Recent Rand work suggests, for example, that a reduction of the flow of net new hard currency credits from a high level of between \$4 and \$5 billion to about \$1 billion, combined with the presumed higher productivity of Western capital goods, would substantially reduce the annual rate of growth in Soviet defense spending if consumption growth were fixed at 2 percent per annum. Nevertheless, the effect on military spending of any immediate reduction of external credits, mediated either by a shrinking of the production possibilities frontier or by an induced shift in the real costs of military production, might be delayed for some time.

When political factors are taken into account, the effects of reduction in net new credits become even more uncertain. If a shift in NATO East-West trade policy were taken by Moscow as a signal of a more hostile international environment, the Soviets might choose to increase military expenditure even though its shadow price had been raised.

Because no one at the conference was certain about the effects of reduced credit flow on the Soviet military posture, it was generally agreed that NATO governments should be selective in the actions they take. There was little disagreement that some steps to limit credit flows should be taken. However, the view was expressed that a credit

limitation policy should be implemented gradually, because the effectiveness of any given action on outcomes of interest to Western Europe might be substantial, or might be perceived as being substantial.

Appendix A

CONFERENCE AGENDA

March 9, 1982
Revised

East-West Economic Relations and the Soviet Union's Posture

Workshop Conference - March 20, 1982, 9am-4pm

AGENDA

- 9:00 am I. Introductory Remarks
- 9:15 am II. Issues concerning Polish debt:
- a. Intelligence update (unclassified)
 - b. Real and illusory differences between default and deferral
 - c. Polish "futures" and prospects for repayment
 - d. Options, and criteria (objectives) for choice
 - o obtaining repayment
 - o restricting access to new credits
 - o avoiding (limiting) undesirable side effects (e.g., alliance, Polish populace and liberalization, international financial system, LDCs)
- 12:00 pm Luncheon
- 12:45 pm III. Issues concerning West-to-East resource flows and the Soviet military posture
- a. Aggregate versus key resources
 - b. Technology transfer
 - c. Yamal pipeline
 - d. Removing all government subsidies
 - e. Resource flows to "East" versus resource flows to "South" (LDCs)
 - f. Gold market
 - g. Arms control possibilities

Appendix B

PARTICIPANTS

The Rand Corporation
2100 M Street, N.W.
Washington, D.C. 20037

EAST-WEST ECONOMIC RELATIONS AND THE SOVIET UNION'S POSTURE

March 20, 1982

ATTENDEES

Robert Aliber
Graduate School of Business
University of Chicago
Chicago, Illinois 60637

Abraham Becker
The Rand Corporation
1700 Main Street
Santa Monica, California 90406

Lawrence Brainard
Economics Department
Bankers Trust Company
529 5th Avenue
New York, New York 10017

Stephen Bryen
Office, Assistant Secretary of
Defense (International Security
Policy)
Department of Defense
Washington, D.C. 20301

Robert Campbell
Department of Economics
University of Indiana
Bloomington, Indiana 47405

Charles Cooper
Exxon Corporation
1251 Avenue of the Americas
New York, New York 10020

L. Richard Fischer
Morrison & Foerster
1920 N Street, N.W.
Washington, D.C. 20036

Donald Goldstein
Office, Assistant Secretary of
Defense (International Security
Policy)
Washington, D.C. 20301

Aaron Gurwitz
The Rand Corporation
2100 M Street, N.W.
Washington, D.C. 20037

Robert Heller
Economics Department
Bank of America
San Francisco, California 90291

Fred Hoffman
Pan Heuristics
4640 Admiralty Way
Marina del Rey, California 90291

Arnold Horelick
The Rand Corporation
1700 Main Street
Santa Monica, California 90406

Fred Iklé
Under Secretary of Defense for
Policy
Department of Defense
Washington, D.C. 20301

A. Ross Johnson
The Rand Corporation
1700 Main Street
Santa Monica, California 90406

Joseph Kirchheimer
E.M. Warburg
818 Connecticut Avenue, N.W.
Washington, D.C., 20036

Marc E. Leland
Assistant Secretary for International
Relations
Department of the Treasury
Washington, D.C. 20220

Andrew Marshall
Director, Net Assessment
Office of the Secretary of Defense
Washington, D.C. 20301

J. Michael Montias
Institute for Social and Policy
Studies
Yale University
New Haven, Connecticut 06520

Richard Portes
Economics Department
Birbeck College
University of London
London WC1E 7HX
ENGLAND

Roger Robinson
Chase Manhattan Bank
One Chase Manhattan Plaza
New York, New York 10015

Henry Rowen
Chairman, National Intelligence
Council
Central Intelligence Agency
Washington, D.C. 20505

Roger Shields
Chemical Bank
20 Pine Street
New York, New York 10005

Donald Green
Chase Manhattan Bank
One Chase Manhattan Plaza
New York, New York 10015

Christine Williams
Office of European Analysis
Central Intelligence Agency
Washington, D.C. 20505

Albert Wohlstetter
Pan Heuristics
4640 Admiralty Way
Marina del Rey, California 90291

Charles Wolf, Jr.
The Rand Corporation
1700 Main Street
Santa Monica, California 90406

Appendix C

DISCUSSION PAPERS

DEFAULT VERSUS DEFERRAL OF POLAND'S DEBT: REAL AND ILLUSORY DIFFERENCES

by Charles Wolf, Jr.

Deciding whether or when to declare Poland in default on its debts to the United States, and to other countries, depends on clarifying the different consequences resulting from default, on the one hand, and deferral of repayment (with or without subsequent debt rescheduling), on the other.* In most discussions, however, some of the real differences between the two options have been obscured, while other alleged differences turn out to be illusory.

ILLUSORY DIFFERENCES

First, consider those consequences that have been alleged to be different between the two options, and which turn out not to be so.

1. One of the alleged differences is that default nullifies the chance of repayment, while deferral retains that prospect. In fact, there is no economic or legal reason why default reduces prospects for payment.

If default occurs on debt owed to the government, or on privately held debt that carries a government guarantee, the assets or claims represented by the debt are subrogated to the government, which can

* The dichotomy between default and deferral is a simplification, perhaps an oversimplification. Nonperforming loans come in many different shapes and sizes: accruals; nonaccruals; those that await rescheduling, those without such a prospect, or with less of a prospect, etc. Along the way, the distinctions between default, near-default, and deferral blur. Consequently, regulatory authorities can exercise more or less consistent or arbitrary judgments in deciding where to draw the line.

thereafter exercise these claims against the defaulting government by seizure of assets, litigation, or negotiation. In the case of privately held debt that does not carry a government guarantee, defaulted debts still represent potential claims against the debtor, and these claims can similarly be exercised by attempted seizure or litigation against assets held by or subsequently acquired by the defaulting government. In light of the Polish economy's prospects and its balance-of-payments forecasts over the next half dozen years or more, the yield from this course of action is likely to be limited at best. But this point applies to deferral as well as default, and for the same reason. Of course, an illusion of repayment must be created, to the extent that governments or banks that defer rather than call the overdue Polish obligation thereafter extend additional credits, a part of which is then devoted to repaying the original debt. Such an Alice-in-Wonderland circumstance would not amount to robbing Peter to pay Paul; rather, it would be asking Peter to lend to Paul, so Paul can pay a fraction of what he has previously owed Peter!

2. It is usually presumed that default will hurt Poland's access to further borrowing, while deferral will protect such access.

One form of this argument constitutes a valid and important difference between the two options, and will be discussed later. However, as it stands, the point is seriously misleading. Poland's incomplete repayment of its 1981 interest obligations, and its failure to repay the debt that matured in 1981 and is pending in 1982, have already had major impacts on its access to credits in international markets. It is worth noting that Poland's situation is similar to that

of North Korea, which failed in 1976 to meet interest and principal payments on the \$1.6 billion of hard currency debt it had accumulated in the early 1970s. Though North Korea has never been formally declared in default by its principal creditors (Japan, the FRG, the UK and France), its access to international credit has been dramatically affected, nonetheless: North Korea's credit standing dropped to 99th among the 100 countries listed in the Institutional Investor. As a result, North Korea has been shut off from all "normal" borrowing.* The same result is ensuing for Poland.

3. It is sometimes argued that default will have a "ripple" effect throughout the international financial markets, which deferral will avoid. Actually, both courses of action may have a ripple effect, but the ripples are likely to be small.

Deferral will also have a ripple effect because the international financial market must be aware that the unguaranteed part of the deferred debt represents, at best, severely depreciated assets in the balance sheets of the 500 holding banks (especially, four or five principal German and Austrian banks). These banks are obviously placed in a weaker asset position, with a resulting diminution in their ability to make loans in the future. However, there will be no effect, in either the default or deferral scenarios, on the assets of banks whose loans have been guaranteed by the respective governments because, in effect, the governments (and taxpayers) of these countries will make

* Actually, North Korea managed to obtain in 1981 some additional short-term financing from Japan, notwithstanding the three-year deferral of its 1976 debts, and its failure to meet the obligations of its 1979 rescheduling agreement! Political motivation evidently played a decisive part in the extension of this recent credit.

whole the asset structure of these banks. Even in case of the unguaranteed loans, the "ripple" is likely to be cushioned by several factors: tax-loss writeoffs, reserve provisions previously made and, as a last recourse, purchase by the central bank of the depreciated assets.

Indeed, one might argue that failure to call Poland's debt is no less likely to have a ripple effect than calling the debt, because failure to call will evoke doubts about the subsequent repayment behavior of other debtor countries. Failure to call a spade a spade may lead to market jitters as to whether rakes or hoes (i.e., supposedly "good" loans) may, in fact, be "spades" as well! In effect, default may provide a discipline and an incentive that increases the likelihood that other loans will be fully serviced, whereas deferral may have the reverse effect.

Thus, there is likely to be a ripple effect in either case--default or deferral--but this is likely to be a very small ripple for at least two reasons: First, Poland's total outstanding debt is about \$26 billion, half of which is due by the mid-1980s and the remainder thereafter. This probably represents something less than 5 percent of total medium- and long-term international debt currently outstanding in the international financial market. And second, Poland's debt service ratio is vastly greater than that of the other principal international debtors, e.g., Korea, Brazil, Mexico, Italy. Consequently, there is hardly any basis for expecting the Polish ripple to create waves of any considerable height. To the extent one is concerned about the dynamics of the process, I repeat that deferral can also give rise to uneasiness among lenders and perverse incentives among borrowers. Of course, if the ripple resulting from the Polish situation were to be accompanied by

similar reversals in other Eastern European countries, exposing further leaks in the Soviet umbrella, the consequences could be magnified. But this possibility besets the deferral contingency, as well.

4. Another of the illusory differences is that default will force Poland "closer" to the Soviet Union than would deferral.

Actually, there is little basis for distinguishing degrees of Polish closeness to the Soviet Union that would be affected by either default or deferral. Of course, one has to distinguish between the coercive and the volitional elements of this relationship. With respect to the coercive elements, Poland is already so "close" to the Soviet Union that default can hardly make it more so. On the other hand, as concerns the volitional element in the relationship, Poland's animus against the Soviet Union, as well as its fear of Soviet repression, is not likely to be diminished either by Soviet contributions to repaying some of the defaulted debt, or, alternatively, by Soviet provision of replacement financing as a substitute for it. It is quite likely that Poland's economic stringency will diminish its trade with the West and, at least in relative terms, increase its trade with the Soviet Union. But this outcome can follow deferral of the debt, as well as default.

5. Finally, it is sometimes argued that pressure on the Soviet Union to repay Polish debt will be relaxed if default is declared.

Once again, it is hard to see why there is any difference in the considerable pressure on the Soviet Union that will accompany either default or deferral. In both cases, and perhaps even more strongly in

the case of default, the Soviet Union must be seriously concerned that the outcome will still further reduce the Bloc's access to credit, and thereby increase the claims of Eastern Europe on the Soviet Union for credits, trade subsidies or other forms of assistance. Inasmuch as the claims that would still exist in the event of default would further erode the chances of Eastern European access to international credit markets, default is at least as likely to increase as to decrease pressure on the Soviet Union to repay Polish debt.

REAL DIFFERENCES

What about the real differences? At least two real and important differences in the consequences would ensue from default, in comparison with deferral of Polish debt.

First and foremost, there is one way in which default is likely to impact significantly on Poland's prospective access to outside credit. For example, if the U.S. government or another government or a private bank calls Poland's overdue debt, it thereby acquires a lien or claim on Polish assets wherever they may be located. Hence, any future loan that might be made to Poland by other parties, including loans that might be made to facilitate debt rescheduling, would thereby become Polish assets subject to attachment by seizure or litigation. Efforts presumably would be made by future lenders, as well as by Poland, to evade such attachment. However, the added risk that is thereby associated with any such transaction would surely affect the lender's willingness to lend and the terms likely to be applied to any such loan transaction. The extra jeopardy accompanying such transactions would constrain both their volume and duration. The result is that default would tend to reduce Poland's access to new credits.

Second, if default is called, banks that hold guaranteed loans would be made whole, and the government subrogated to the claims for repayment, as noted earlier. In this case, the asset structure of the holding bank would be unaffected, and its future lending power undisturbed. However, for the unguaranteed loans held by such banks, the effect of such default is to write off, or at least write down, the creditors' asset, thereby reducing the subsequent lending capacity of these banks with respect not only to Poland, but also to other prospective borrowers in world markets. Although the aggregate effect of asset markdown is likely to be small, as noted earlier, it will impinge relatively more on those few German banks (e.g., the Commerzbank, the Dresdner Bank, the Bank fur Gemeinwirtschaft), whose assets are relatively concentrated in loans to Poland. To the extent these assets are bought by Central Banks or Finance ministries, the balance sheets and liquidity positions of the exposed banks would be redressed with two important consequences: (a) claims against the defaulting state (and indirectly against its residual guarantor, the Soviet Union) would be centralized in the hands of government, and hence usable as an instrument of policy in intergovernmental negotiations, including those relating to arms reduction; (b) the recompensed banks, and others observing this "safety net" operation, would acquire a set of distinctly perverse incentives because the bad judgment reflected in their original loans was redeemed by a government bail-out. The implication is that private bank losses should not be fully redeemed even if they are mitigated.

POSSIBLE FUTURE DEVELOPMENTS IN POLAND

by A. Ross Johnson

Any economic policy discussion related to the Polish crisis must make explicit or implicit assumptions about what is likely to happen in Poland. This paper formulates five possible Polish "futures," indicates how likely I judge them to be, and notes the particular issues that each "future" may pose for Western policy.

STATUS QUO ANTE: POLITICAL DIALOGUE

The thrust of NATO's January declaration is that Poland should return to the situation that existed prior to December 13, 1981. This is not going to happen. Declaration of martial law was one of those historic events that might be reversed but cannot be undone. Imposition of martial law has affected fundamentally the perceptions of all the participants in the Polish drama of 1980-1981. Deputy Premier Rakowski (evidently one of General Jaruzelski's closest supporters and advisers) has declared repeatedly that if all the internees were released now, Poland would revert to its pre-December 13 status in no more than a month. From the regime's viewpoint, this is an optimistic forecast. The lesson of December 13 for both Solidarity and the regime is that they should have been tougher. For Solidarity and for Lech Walesa personally, the lesson (in words attributed to him) is that the regime did not negotiate in good faith, at least after September (when the preparations for martial law evidently got seriously under way). Therefore, according to various underground publications and Solidarity representatives in exile, Solidarity should have moved quicker to

consolidate its gains while organizing itself to resist the kind of crackdown that in fact occurred (a militant lesson not to be confused with Solidarity leaders' calls to avoid senseless violence in the present situation). The lesson for the regime, articulated by Jaruzelski, is that it should have been less willing to compromise in dealing with Solidarity. For both the regime and Solidarity, the policy of dialogue pursued until December 13 has been discredited. The pre-martial-law dialogue based on growing political pluralism cannot be resumed, and Western policy cannot expect to alter this fact.

STATUS QUO: MARTIAL LAW

The essential features of the martial law regime introduced on December 13 have now remained in place for three months. The blackout on news to the outside has been partly lifted and a ban on domestic movement has been eased, but internal communications and foreign travel remain severely restricted. Intensified jamming of Western broadcasts continues. An all-military Council of National Salvation exercises supreme power, eclipsing the Party. About two-thirds of the original internees (according to official figures) remain in detention. Solidarity and other non-regime-sponsored organizations that grew up after August 1980 remain suspended or abolished. Non-Communist organizations tolerated long before 1980, particularly the lay Catholic Znak and other groups, remain suspended. Some official media are again appearing, but they are carefully controlled.

Polish military and Party leaders alike would clearly like to end martial law--but on their terms. The aim of martial law, judging by the ex post facto explanations by Rakowski, Jaruzelski, and others, was to administer a "shock"--to interrupt the process of emerging pluralism

(what several Party leaders openly called diarchy: in Leninist terms, the inadmissible sharing of power). Martial law was also designed to substitute a "socialist renewal" that would avoid the errors of the 1970s (and earlier periods), yet permit no political challenge to Party control and carefully channel social self-assertiveness. The alternative seen by the Jaruzelski leadership was that the USSR would itself suppress Solidarity, with great loss of life. The announced indefinite postponement of the end of martial law indicates just how illusory the goal of "socialist renewal" was, just as the absence of programmatic statements indicates how little thought went into its content.

The status quo--martial law--may continue for three months or longer. The regime would like to return to Party rule; it might even be willing to make some new efforts to obtain popular support, but it fears to try. Yet both internal contradictions and external challenges to the martial law regime make perpetuation of martial law in its present form for six months unlikely. Polish Bonapartism--the overshadowing of the Communist Party by the military--strikes at the roots of the Leninist system; the Polish precedent is unwelcome and is even viewed as dangerous in the rest of the Soviet bloc. Other things being equal, the Kremlin would surely like to restore formal and actual Party rule soon. The task of running Poland distracts the Polish army from its intended primary mission on the Soviet block external front. The internees are a political and psychological anomaly; as time passes, the leadership will find itself under pressure to either release them or arrest and try them. Martial law has put the Catholic Church into a unique and probably unsustainable relationship vis-a-vis the regime; however strong

its desire to avoid bloodshed, the Church could not remain silent about repression and continue its 600-year tradition of espousing the interests of the Polish nation. Yet martial law has not significantly worsened the position of the Church per se; the Church has been provoked but not repressed. Indeed, in recent weeks it has on balance spoken out increasingly sharply. Martial law put into suspense a variety of regime or regime-sanctioned institutions, such as the lay Catholic organizations. These will in time need to be either activated (however reconstituted) or abolished. Social protest is passive but--judging by such indicators as the numbers and sophistication of underground publications--growing. Strikes have ended, but there are numerous reports of work slow-downs. The Jaruzelski leadership evidently takes seriously the protest slogan "The winter is yours but the spring will be ours." In brief, the status quo--martial law as it existed in early March--may continue through the spring, but it is not likely to outlast the summer.

Issues affecting Western policy: Perpetuation of a regime that has been declared responsible for suppressing Solidarity and the Polish people and that detains Solidarity leaders will pose the issue of intensified sanctions (since the situation will not have improved). Further economic deterioration in Poland (which may occur under other "futures" as well) will decrease confidence abroad that Poland can repay any part of its debt. Raw material imports and grain supplies will be a crucial economic bottleneck. Shortages of foodstuffs and medicine could occur on such a scale as to portend mass starvation, which would pose the issue of greater Western humanitarian relief. Less dramatic scarcities of foodstuffs would pose more sharply the issue of private assistance to private Polish agriculture.

A HARDER LINE

Condemnation of martial law repression in Poland on moral and political grounds should not blind us to the fact that things could be (and may well become) worse: The Church, as noted, has been left largely alone; Solidarity leaders have by and large not been tried, let alone executed; the peasantry has been wooed more than threatened. One alternative to the status quo is a further hardening of the regime, not necessarily across the board but in key areas. (Selective relaxation in other areas simultaneously is possible.) Such hardening could result from an increase in passive or active popular opposition to the martial law regime, from economic deterioration, or from infighting within the regime. Popular opposition is likely to grow. Whatever conclusions are finally drawn about the "Solidarity period" between August 1980 and December 1981, this powerful and largely spontaneous outpouring of popular and national consciousness in Poland is unlikely to end with a whimper. It is difficult to evaluate how desperate the economic situation is; some knowledgeable observers foresee the possibility of a "hunger holocaust," and in such circumstances the regime, might turn to draconian measures. Hardliners (Olszowski, or worse, Grabski and Siwak) might, with Soviet support, gain greater influence over or even replace Jaruzelski. The hardliners now openly call for trials of Solidarity activists and for return to a single, transmission-belt trade union.

Such views do not necessarily represent the dominant Soviet line (which showed itself pragmatic enough in Czechoslovakia in 1969 to back the more moderate Husak over hardliners Indra or Rytir), yet they could win some Soviet support. While Jaruzelski may be indispensable to the

Soviets at present, he is hardly the Kremlin's ideal of a Polish leader: He is the Polish Bonaparte, and he is guilty (and stands publicly accused, in the Soviet letter of May 1981) of making "unprincipled compromises" with Solidarity for much too long. Indeed, an initial appraisal of the purge and limited resurrection of the Party apparatus in Gdansk suggests that revival of the Party is likely to bring to the fore elements more hardline than Jaruzelski.

The course of developments sketched here--more, rather than less repression--is a likely alternative to the present situation. It would increase greatly the chances of active and violent popular protest. If the population were sufficiently cowed, economic performance might improve for a time, but given the likely increase in popular opposition to the regime, the longer-run economic (and thus debt repayment) prospects would decline.

Issues affecting Western policy: More severe repressive measures--involving trials of Solidarity leaders, including Walesa himself, repression of the Church, forced agricultural purchases and forced labor, and renewed limitation on communications and movements--would clearly signal in American and most European eyes a worsening of the domestic Polish situation and trigger or facilitate additional sanctions. Prospects for debt payment would decline.

LIMITED RELAXATION

The development of a "socialist renewal," as discussed above, is what the Jaruzelski leadership prefers--on its own terms. Such a future course assumes that overt popular opposition is reduced; that economic disaster is avoided; and that the Jaruzelski leadership thwarts hardline challenges from within. Martial law would be officially ended, most of

the internees would be released (a minority would be tried and given relatively light sentences, and some would emigrate), and confrontation with the Church would be avoided. A new "captive" Solidarity organized on branch and not regional lines would be chartered, the analogue of the captive "worker self-management" bodies organized in 1958 as a replacement for the genuine worker councils that sprang up in 1956. A technocratic, managerial approach to economic reform would be taken. Indeed, given the current dismal economic situation, military administration of the economy might well increase rather than decrease. This was the implication of Jaruzelski's statements in February. Under such conditions, economic performance (and prospects for debt repayment) might improve somewhat. The Party would reemerge but would remain heavily influenced by the military. These developments could lead to greater accommodation of popular aspirations--but not to a resumption of the political dialogue that had been based on regime weakness and the strength of opposition groups.

Limited relaxation, while possible, seems less likely than a turn toward a harder-line policy. From the regime's point of view, steps toward relaxation run the risk of reducing the fear and paralysis induced by the actions of December 13, encouraging risk-taking by opposition groups, and fostering divisions within the regime.

Issues affecting Western policy: This "future" would present troublesome policy issues. Ameliorative measures on the regime's terms that failed to hold meaningful promise for the play of national and societal aspirations within the Polish system would bring into question the efficacy of the present level of sanctions. Such measures might include the release of most internees (some of whom would recant, some

remain silent, and others emigrate); statements by the Church that the situation was improving; and the official end of martial law and resumption of formal authority by the Party structure. The statements of the Church would be crucial; if the Church described the situation as significantly improving, many in the West would agree uncritically. Prospects for debt repayment would increase.

UPHEAVAL AND SOVIET INVASION

There remains a strong possibility that the Polish situation will deteriorate drastically. Attempts at greater repression by the regime would be likely to induce greater and more active opposition. Selective relaxation would also be likely to embolden Solidarity leaders and others who might see relaxation as a sign of regime weakness (this alternative becomes less likely the longer martial law is extended in its present guise). Hunger or a street incident could escalate into major violence--a possibility that has existed since August 1980. On a limited scale, unrest could be put down by the same internal security forces, especially ZOMO, that spearheaded the December 13 crackdown; however, a second time around more blood might well be spilled. It remains unlikely that intensive domestic violence on a scale too large for the internal security forces to repress could be put down by the Polish army alone; that would probably require Soviet forces. Hence, a Soviet military invasion remains a real possibility, the Polish military crackdown notwithstanding. In any case, under conditions of large-scale violence, fissures would probably appear within the Polish army. However much the popularity of the Polish army has declined in Poland since December 13, Poles evidently still distinguish favorably between the army and the internal security forces. Martial law notwithstanding,

a Soviet invasion could lead elements of the armed forces to resist, and thus could lead to a reforging of ties between the Communist army and the Polish nation.

Issues affecting Western policy: Riots could spread, leading either to a bloody suppression by internal security forces or attempts to use the regular army for this purpose. Dissent and mutiny in the army could occur. Domestic violence could lead to Soviet military invasion. Such dramatic developments would focus the attention of Western governments and publics on the repressive Polish and/or Soviet regimes. Economic catastrophe would loom.

CONCLUSION

In brief, there is no way back to the pre-December 13 Polish political dialogue, whatever Western policies are adopted. Martial law as it presently exists is likely to remain for three months but not six. Limited relaxation on the regime's terms, once it feels itself strong enough to afford it, is possible and would improve the long-term prognosis for some debt repayment, but harder-line policies seem more likely, and these would lower the prospects for debt repayment. At any point over the next six months, large-scale domestic violence is possible and could easily lead to Soviet military intervention.

THE POLISH CRISIS AND U.S. POLICY OBJECTIVES

by Arnold L. Horelick

It is essential to define U.S. objectives regarding the Polish situation in order to:

- o Bound the range of appropriate options
- o Provide a coherent rationale for selecting among them
- o Mobilize and maintain domestic political support for possibly costly measures
- o Maximize chances for securing allied cooperation
- o Provide criteria for gauging progress toward achieving goals

Four sets of U.S. objectives have figured, either explicitly or implicitly, in the debates on appropriate sanctions that have taken place since December 13 inside the government, among the U.S. public, and between the USG and our allies. One set focuses on affecting the outcome in Poland itself (Polish Amelioration); the second looks primarily to making the Soviets pay as heavily as possible for the suppression of Polish pluralism, to enhance deterrence of future similar behavior (Cost Imposition); the third set emphasizes limiting the damage to allied cohesiveness resulting from failure to deter the December 13 crackdown (Damage Limitation); and the fourth set views Polish events primarily as a vehicle for mobilizing the West to take far-reaching political and economic measures that would substantially alter the international environment of the East-West competition (Environment Alteration).

While these objectives are by no means mutually exclusive, some of them point in contradictory directions, and there is a general tension among them which requires the assignment of priorities.

POLISH AMELIORATION

Everybody agrees that improving the situation in Poland is an objective toward which Western policy should strive. The measures taken by the USG and other Western governments since the imposition of martial law have publicly been explained as designed to ameliorate conditions in Poland. But there is underlying disagreement, both with respect to what amelioration means and whether this should be the sole, the primary, or a secondary objective of that policy. The variance in policy positions assumed both within and among Western governments in large part reflects this disagreement.

Amelioration is necessarily an ambiguous policy objective. It implies conditions in Poland that are freer than those under martial law but that fall short of the status quo ante. Restoration of the status quo ante is not a feasible objective of any policy. The essence of the status quo ante was Solidarity's enormous moral and political authority in Poland, buttressed by a pervasive belief in Polish society that the regime could attempt to repress Solidarity only by risking civil war and Soviet military intervention. Solidarity's leverage had been based on the regime's fear of using coercion.

The successful imposition of martial law and the virtually bloodless repression of Solidarity that accompanied it have altered that situation radically and--absent a spontaneous revival of Solidarity--probably irreversibly. Even if Solidarity is restored by

the regime as an "independent" trade union, its bargaining position will be severely weakened both by the statutory limitations that will be placed upon it and, more importantly, by the now credible regime threat to repress unsanctioned union behavior. Thus, the notion that the status quo ante can somehow be restored by regime fiat is a contradiction in terms. Moreover, there are no plausible nonmilitary Western sanctions strong enough to compel the Polish regime or the Soviet Union to risk destabilizing Poland and jeopardizing their dominance.

However, changes in the present situation that most Western observers would regard as improvements (e.g., the lifting of martial law, the release of some/most internees, "negotiations" with a new version of Solidarity) are not only possible, but could occur independently of any Western actions. As noted earlier, both the Polish Communist and the Soviet leaderships, once persuaded that it is safe to do so, will themselves wish to have rule by martial law terminated in Poland. The Polish Party cannot reassert its leading role under a martial law regime. And the Soviets will grow wary of Polish Bonapartism and a potentially less pliable partner regime in Warsaw if military rule is extended longer than deemed necessary in Moscow. Moreover, the Polish regime will want to appear confident enough about its authority to dispense with martial law.

In these circumstances, tracking the effects of Western measures designed to induce amelioration will inevitably be complicated by the need to distinguish real from cosmetic improvements, as well as regime changes that are concessions to Western pressure from those that are not. Specifying a set of context-free steps that we would regard as

"improving the situation in Poland" could lead to manipulation by the Polish regime, self-serving interpretations by allies eager to resume business as usual, and more quarrels in the alliance. For example,

- o Replacing martial law with more traditional forms of repression and intimidation may not be an improvement for the Polish people and could strengthen the position of Party hardliners in the Warsaw regime.
- o The gradual release of some internees, perhaps even as accused resisters are being arrested, could provoke disagreements abroad about how much "progress" was occurring.
- o The resumption of talks between the regime, the Church, and representatives of an "independent" trade union could have radically different meanings, depending on context.

Although Western policies aimed primarily at altering internal conditions in Poland cannot by themselves restore the status quo ante, they could help to accelerate a process of amelioration tolerable to, if not in the interests of, the Soviets and the Polish regime.

COST IMPOSITION

A policy objective of imposing costs on the Soviet Union is not incompatible with seeking amelioration in Poland, but its primary aims would be to punish the USSR for conniving in Polish repression and to deter future provocative Soviet behavior in Eastern Europe and elsewhere. Theoretically, Cost Imposition could be pursued independently of the evolving situation in Poland. It would be less vulnerable than amelioration to relatively minor changes in Poland; but, in practice, allied cooperation--which is essential for successful Cost

Imposition--would be difficult to sustain in the face of what the allies perceived to be substantial improvements in Polish conditions.

In principle, the goals of Cost Imposition would be to demonstrate to the Soviet leadership that

- o Suppression of pluralism in Eastern Europe is now more costly than in the past and is likely to be more costly still in the future.
- o The Soviet Union must accept greater diversity and liberalization in Eastern Europe if it wishes to enjoy the economic and political benefits of East-West detente.
- o The Western alliance is increasingly capable of concerting a course of punitive action against the USSR in response to provocative Soviet behavior below the threshold of direct military aggression.

The deterrent effect of a policy of Cost Imposition would depend critically on West European cooperation in imposing effective sanctions on the USSR. Sanctions that are likely to hurt Moscow substantially would, of course, require not only material sacrifices by the allies, but also their acceptance of the prospect of heightened tension in East-West relations, including the risk of selective Soviet retaliation. There is therefore an inherent tension between the objectives of Cost Imposition and alliance Damage Limitation (see below).

The limits of even a successfully executed policy of Cost Imposition must be recognized. Credible Western threats to impose severe costs on the USSR (short of military action) are unlikely to deter similar Soviet behavior in the future if Moscow perceives a grave

threat to its imperial control in Eastern Europe. Elsewhere in the world, however, where the costs and benefits of some future action may be more evenly balanced in Soviet calculations, a heightened probability of provoking tough Western sanctions could tip the scales against action, or could at least moderate the severity of the action taken.

DAMAGE LIMITATION

The objective of Damage Limitation, while embracing Polish Amelioration and Cost Imposition as desirable goals, gives overriding priority to preserving alliance cohesion in the face of fissiparous pressures that would be generated by aggressive pursuit of the other goals. The case for Damage Limitation rests on the following pessimistic assumptions about alternative goals:

- o Soviet and Polish regime stakes in keeping the lid on in Poland are so high that even successfully mobilized Western leverage would be inadequate to induce leaders in Moscow or Warsaw to risk a destabilizing liberalization in Poland.
- o Strenuous efforts to secure allied support for sanctions that allies perceive as ineffective with respect to Polish Amelioration and disproportionately costly to themselves with respect to Cost Imposition would at best produce half-hearted measures, and could generate rancor that would cause more harm to the alliance than to the Soviets.

The pursuit of Damage Limitation objectives calls for sanctions that maintain the dignity and integrity of the alliance in the face of Polish suppression, but that minimize differences among the allies. Some minimum sanctions are necessary to satisfy U.S. demands. A damage

limitation strategy would be likely to produce low-common-denominator sanctions imposed by all, or agreement on a division of labor that in effect would cover an asymmetrical distribution of sacrifices. Such sanctions are likely to be explicitly or implicitly time-limited, or conditions for lifting them could be left vaguely defined, subject to interpretation, as circumstances warrant.

In addition to containing alliance discord, Damage Limitation would seek to minimize the harm to U.S. interests in the Third World and elsewhere in Eastern Europe that might be associated with such measures as forcing Polish default.

Since the sanctions that could be agreed upon if the U.S. were to pursue Damage Limitation objectives would not be severe, the costs imposed on the Soviets are likely to be small and the deterrent effect on their future behavior marginal. If Western actions not only fail to impose significant costs on the Soviets, but also fail to prevent discord in the alliance, the deterrence effects may in fact be negative.

ENVIRONMENT ALTERATION

A more ambitious set of objectives would look beyond the situation in Poland per se and would seek to exploit the Soviet-backed suppression of Solidarity as a mobilizing vehicle for a general toughening up of the West's competitive posture vis-a-vis the USSR. This alternative assumes not only that the Polish status quo ante cannot be restored by Western pressure, but also that Polish Amelioration is inherently too ambiguous and not sufficiently rewarding to warrant making it the primary objective of Western policy. Measures that might be taken for the limited purpose of responding to Polish events are deemed unlikely to be sufficiently severe to damage Moscow substantially or to strengthen

deterrence of future transgressions. Under a policy of Environment Alteration, Polish events would primarily provide an opportunity to mobilize the U.S. and Western allies to take a series of measures to alter the environment of the East-West struggle by making the West, or at least the United States, a more militant and effective competitor. Goals of a policy pursuing this objective might include:

- o Delivering the coup de grace to lingering illusions of detente in the West
- o Restoring anti-Soviet discipline to the Western alliance
- o Organizing the alliance to conduct systematic economic denial against the Soviet Union
- o Impeding the Soviet military buildup by constraining relevant resource flows from the West
- o Strengthening the rationale for and momentum behind Western rearmament.

Pursuit of a policy in support of such objectives would be risky, particularly if the Polish crisis is resolved short of direct Soviet military intervention. In the event of any other outcome, domestic support--not to speak of allied cooperation--would be difficult to mobilize. Even if the Soviets were to take military action in Poland, the risks to alliance cohesion would be great if the United States, attempting to lead the allies into a post-detente environment, got very far out in front of the West Europeans. In that case, however, some might argue that a showdown with the allies would be unavoidable and perhaps even salutary.

While Polish Amelioration could clearly not be the primary objective sought under this alternative, to the extent that progress could be made toward realizing the larger objectives described above, enhanced Western leverage on the Soviet and Polish governments might be acquired which could be employed to affect conditions in Poland. However, for the West to have such usable leverage implies an altered international environment in which the Soviets perceive that the West has acquired a credible capability not only to deny the Bloc the economic and political benefits which it has come to expect and to rely upon, but also a readiness and capability to make them available in a controlled and measured way in response to desired Soviet behavior.

THE POLISH DEBT AND CREDIT CONTROLS

by Abraham S. Becker

STATUS OF THE PROBLEM

The U.S. government must make a number of decisions on the issue of Polish debt that raise questions concerning appropriate U.S. policy with regard to credits for Eastern Europe and the Soviet Union. Should U.S. banks applying for payments on CCC-guaranteed loans to Poland be forced to declare the borrower in default? Should the USG invoke the "exceptional circumstances" clause of the Paris Agreement and declare Poland in default? Should the USG seek to force U.S. banks to declare default on uncovered loans through various regulatory mechanisms?

Answers to these questions require a comprehensive understanding of the process of default and an assessment of its probable consequences weighed against the alternatives. Debate on this subject is complicated by a lack of reliable information and data. However, there is some bedrock of information on which judgments can be made:

1. U.S. private, uncovered credit to Poland is second only to that held by German banks, but it is still small--some \$1.3 billion distributed, although quite unequally, in about sixty banks. Default, no matter how it takes place, is not likely to place any of the American banks in jeopardy: Evidently, the greatest degree of individual exposure is less than \$200 million and 5 percent of equity capital. However, if several East European states were to go into default as a consequence of the Polish

situation, one or more American banks, whose combined East European exposure is significant, could be in difficulty.

2. The USG can force Polish default by two different means:

First, it could demand default declaration before paying off on government loan guarantees. Some banks might swallow the loss rather than comply: Assuming that declaring default on guaranteed loans to Poland requires an equivalent declaration with regard to all other Polish loans in the bank's portfolio, and if the banks have more uncovered than covered paper, they may want to avoid triggering cross-default, in the belief that preventing formal default increases their chances of eventually being repaid. Second, the USG could invoke the "exceptional circumstances" clause of the Paris Agreement.

At this time, the banks (U.S. and foreign) and the European governments would lobby vigorously against either action. If the Polish situation were to show signs of political "improvement," the allies would probably pressure for relaxation, not stiffening, of sanctions. By the same token, "deterioration" of the Polish situation would presumably ease such pressures. In either case, perceptions will be at issue, rather than objective reality.

U.S. refusal to join other governments in negotiation to reschedule 1982 (and later) official Polish debt probably would not in itself be sufficient to trigger default. After the imminent signing of the 1981 commercial rescheduling, the banks will probably want to begin 1982 rescheduling negotiations. Whether or not they actually do so (the USG presumably has means to try to discourage American banks from participating), the banks will probably be reluctant to sign any

agreement unless there is again a parallel arrangement on official credit. If the Western governments refuse to follow suit, the resulting limbo will contain seeds of instability but need not in itself automatically bring on default.

3. Apart from direct USG action, default could take place in the United States autonomously. There seems to be some disagreement as to the possible role of bank auditors and bank examiners of various regulatory agencies. Even some skeptics do not rule out the possibility that if Polish arrears on 1982 commercial interest reach the legal threshold (60 or 90 days--the regulations vary), some banks could be forced to declare default. It has been suggested that the Comptroller of Currency could place such banks on a "criticized list," but this seems unlikely if the 1981 rescheduling agreement is signed in the near future. The blacklisting would then appear to be based solely on foreign policy grounds, and the banks might feel confident that they could safely refuse to go along.

If the process should drag out sufficiently, stockholders could pressure a bank's management to take the tax writeoff rather than wait indefinitely for a dubious repayment. Perhaps one or more banks would decide to break ranks because they perceived a unique and fleeting opportunity to recoup a significant fraction of their outstanding loan balances by access to particular Polish assets. One or more of the sixty banks could very plausibly see reasons to seek refuge for themselves. This theoretical possibility is magnified by the involvement of another 400 to 450 banks abroad. In this network, there

would appear to be nontrivial possibilities for triggering the alarm that would spread through cross-default. The probability of autonomous default action is inversely related to the expectation of extracting interest and principal payments from the Poles. The passing of time without formal rescheduling would act to erode such expectations.

The likelihood of autonomous default also depends on one's interpretation of the cement holding the banks together. Apart from embarrassment at the acknowledgment of bad judgment that default implies, and the general calculation of a creditor when faced with a debtor with few assets but some earning power, bankers may fear a possible international credit crisis--the so-called "ripple effect"--that could be set off by default. That fear might stay the hand of larger or stronger banks who would otherwise be tempted to take their tax writeoffs and run, but it may be less effective in constraining smaller or weaker banks.

4. Several foreign governments and banks are more deeply enmeshed in the Polish quagmire than are the USG and U.S. banks. Some observers believe that the danger of a credit panic is substantial, to the degree that existing intercentral-bank safety mechanisms may not be adequate to contain and dampen the shock to Euromarket flows that could result from wholesale declaration of default on the Polish debt. Others assert that contingency plans in fact exist and can be implemented in timely fashion. Given the substantial state involvement in banking in France and Austria, it may be expected that those governments would intervene at an early juncture. The Federal Republic should be able to find the executive and legislative means to cushion the blow to its lending institutions.

5. Two years of discussion of Polish debt rescheduling, the Polish economic and political crises of 1980-1981, and economic recession with high interest rates in the West have sharply altered East-West credit market conditions. If Poland were formally in default, new credits would be available only after some provision were made for rescheduling and repaying the defaulted debt (ignoring the political issue of the internal Polish situation). This is in fact the case now: Poland is unable to obtain new medium- or long-term loans and cannot even roll over its short-term obligations. Uncertainties about the credit-worthiness of other East European countries have also surfaced, especially since Romania opened negotiations for rescheduling. The supply of credit to these countries is now tight, and the credit stringency affects even the USSR, although selectively. If a general default on Polish debt were declared, the present credit squeeze would get worse and would probably spread to other countries, in roughly descending order of credit risk, perhaps even to the Third World. The West would have to consider whether it wished to try to shield any of the likely victims in the Soviet bloc, such as Hungary or Romania, as well as other possible victims such as Yugoslavia, and how that could be done without benefiting the Soviet Union.
6. Thus, a state of near-default now exists which, in terms of its influence on the supply price of credit to Poland, the rest of Eastern Europe, and the USSR, approaches the situation that would result from actual default. Near and actual default are

also closely related in respect to effects on the lenders. The probability that the West will be repaid depends on Poland's future need for new credit, as well as on its hard-currency earning capacity. If Warsaw could manage without fresh loans from the West, its incentive to fulfill commitments under rescheduling would be sharply diminished and formal default would not substantially reduce the likelihood of repayment. Poland's assets abroad that are available for seizure are small, which decreases both the prospect of payoff from formal default and the debtor's incentive to prevent it.

As already suggested, the difference between default and near-default in terms of effect on the banks depends partly on tax provisions--on the point of the default process at which losses of interest and deferred (fractional) payment of principal can be written off against tax liabilities--and on institutional arrangements of bank financial regulation. The tightening of credit under near-default results not only from downgrading of borrower credit-worthiness but also from reduction in the affected banks' lending ability through depreciation of the assets represented by the delinquent loans. The differences from the state of formal default are a matter of degree.

However, there is a nontrivial possibility of near-default turning into actual default even without U.S. government intervention, a possibility that may grow as time passes if Polish debts are not dealt with in an orderly rescheduling.

OPTIONS AND OBJECTIVES

Given this assessment of the status quo, how can credit control be used for the four objectives set out in Arnold Horelick's discussion paper?

Near-default may be viewed as having already fulfilled some of the requirements of Cost Imposition. Although largely a consequence of Poland's (perhaps also Romania's) economic troubles, the credit squeeze on Eastern Europe was probably intensified by Western government's refusal of new loans to Poland and by the bankers' expectation that governments would be reluctant to negotiate further rescheduling of official credit to Poland in the absence of visible "improvements" in the country's internal situation. The Kremlin may recognize that these are costs of the imposition of martial law in Poland. If the credit squeeze persists, Moscow may be forced to bear a still greater share of the burden by augmenting ruble and hard-currency credits, deferring the cuts in subsidized energy deliveries, and generally increasing its trade price subsidies to Eastern Europe. Formal declaration of default would add to these costs, but perhaps not overwhelmingly; direct and explicit limitation of Soviet access to Western credit would. However, this might not be sufficient for deterrence of future Soviet actions, especially of repression in Eastern Europe to maintain military-political domination.

Various Soviet officials have threatened retaliation against any European country that joins an American economic warfare campaign. Eastern Europe's and the USSR's possibilities of relieving the credit squeeze by special arrangements with individual Western countries

(thereby discriminating against others) would depend on conditions in Poland, the state of rescheduling agreements, and the policies of the allied governments. A far more important Soviet or Soviet-inspired counter to formal default--or to near-default--would be the threat or realization of a unilateral declaration of moratorium on debt service to the West. One or more CEMA countries that are not now delinquent might threaten to declare a moratorium on the grounds that the drying up of Western credit was a political act violating understandings and agreements. The threat would be rational from the debtors' point of view because there would be no significant change in their access to new credit, and it could be credible in view of the size of East European-Soviet debt apart from Poland's share. Execution of the threat could inflict considerable pain on some Western banks. There might even be a danger of domino-effect credit panic in the Euromarket system. It is not clear that much contingency planning has been done in the West for such a Soviet bloc counter.

Neither imposing default nor allowing near-default to play itself out is likely to contribute to Polish Amelioration. Having at long last seen the reestablishment of internal control at great cost, Moscow and Warsaw would hardly wish to put Communist authority in Poland at risk again. The threat of enforcing default might have been a deterrent to the action of December 13; but with that action launched and the costs and benefits both reaped, this threat alone is less powerful, especially given the effects of the current state of near-default. Moreover, the threat is not yet fully credible, since Warsaw and Moscow may both believe that intra-West divisions are sharp on this issue (as they are on others). At present, the allies are indeed intent on preventing

default and are probably interested in early resumption of rescheduling negotiations. Pushing for default, therefore, would augment, not limit damage to the alliance. Finally, CEMA may brandish its counterthreat of a unilateral moratorium to negate pressure for political change in Poland.

On the other hand, both Poland and the USSR are vulnerable, in that they need future new credits, although Moscow's need is much less immediate. The Soviet Union's vulnerability is increased by the high opportunity cost of additional economic aid to its allies to cushion the impact of the drying up of Western credits. It seems plausible that a Polish carrot-and-stick combination--credible threats to restrict new credits indefinitely plus promises to refinance (a Polish "Marshall Plan?")--would be more potent and less likely to evoke counterthreats of unilateral moratorium from CEMA. However, it is not self-evident that even such a combination would induce Warsaw and Moscow to permit significant political change in Poland. Because many in the West are eager for signs of "improvement" in the Polish situation, the carrot-and-stick package might court the danger of committing the West to substantial new credits without being able to effect other than cosmetic changes in the Polish status quo. It is also not intuitively obvious that the Western public would be eager to assume the added burden of financing Polish recovery, plus Hungarian, Romanian, or Yugoslav needs.

These considerations raise questions of longer-term importance. In the 1970s, the credit tap opened wide for the Soviet Union and its allies, whose combined gross debt to the West now stands at around \$80 to \$85 billion. Even allowing for inflation and differences in the nature of the commitments, the largesse in this huge lending volume must

far exceed American generosity to Western Europe under the Marshall Plan. The influence the West gained over Soviet bloc developments through this volume of credit extension is highly debatable, perhaps because with few exceptions the tap seemed to turn in one direction alone. Now, for the first time, the spigot has been partially turned off and there is the possibility of formal shutting off of supply. Thus, the West has an opportunity to recapture control over the credit instrument for long-term denial objectives like that of constraining the aggregate Soviet resource flow. This would seem to require a considerable degree of allied planning and coordination, in view of the dominant role of Western Europe in lending to the Communist countries. Such coordination might appear more likely if the Polish situation deteriorated and the European commitment to detente were effectively weakened--in short, the Environment Alteration scenario. However, while punishment can be inflicted with instruments of denial, positive influence over a superpower would seem to require at some point the promise of extension of favor. Thus, a basis would have to be laid for allied coordination of future credit extension (which might be difficult if interest rates do not fall and moderate economic growth does not resume in the West). In contexts short of Environment Alteration, this might also be the only way Cost Imposition through restraints would be compatible with Damage Limitation.

Whatever the political environment, it is difficult to imagine much public support for generous refinancing of Poland without substantial financial commitments on the part of the USSR. The West must not place itself in the position of pulling the USSR's chestnuts out of the fire. Moreover, it is in the Western interest not to relieve the USSR of any

additional burdens that might force the Kremlin to reallocate resources away from military to civilian purposes. That constraint should be eased if there is a possibility of realizing significant political benefits from basic changes in the martial law regime of Poland or of recapturing control over credit as a fundamental instrument of leverage, but it should not be discarded.

The credit squeeze has also adversely affected Romania, Hungary, and Yugoslavia, and this poses more complex issues for U.S. policy. Western interests in maintaining and promoting autonomous tendencies in the first two countries and in protecting the independence of the third suggest the utility of a differentiated approach to Eastern Europe.

WESTERN ECONOMIC SANCTIONS AND SOVIET MILITARY RESOURCE ALLOCATIONS

by Abraham S. Becker

The connection between the two parts of this paper's title can be viewed as taking place in two channels: (1) limitations on specific Western exports (overt or covert, witting or unwitting) of both military end products as well as of goods, services and knowhow that might be used to advance Soviet production of military goods and services (e.g., electronics); and (2) general constraints on aggregate resource availability to the Soviet economy which would be expected subsequently to affect allocations to the military. Together these sets of controls may be thought of as means to constrict Soviet production possibilities or alter regime preferences so as to result in a reallocation of resources *away from defense*. (Of course, preferences could be affected by influences other than on resource availability.) For convenience, let us call the purpose of constraining Soviet resource availability "impedance"--that is, impedance of the growth of Soviet military power, and therefore of aggressive behavior based on such power, through resource denial. This will be contrasted with an alternative approach to Soviet behavior modification, called "leverage," which seeks to influence Soviet leadership calculations by exploiting Soviet economic weakness and U.S. economic power to secure Moscow's cooperation in the international arena.

Three major economic instruments for these purposes have featured in the public debate: credit controls, technology transfer restrictions, and embargo of grain exports. The first is treated

separately in my discussion paper for Agenda Item IID. The other two are discussed in turn in the next section of this paper, in relation to the objectives spelled out in Arnold Horelick's discussion paper. The third section of the present paper considers the effect of combining the various sanctions, including credit controls. A comparison of the relative merits of "impedance" and "leverage" is reserved for the workshop discussion.

CONTROLS ON TECHNOLOGY TRANSFER AND GRAIN EXPORTS

The Yamal Pipeline

The United States government has been considering whether to attempt to prevent the fulfillment of the so-called Yamal Pipeline deal by following up the ban on exports of GE turbine rotors (for assembly by British, Italian, and West German turbine manufacturers) with an effort to prevent:

- o Shipment of GE-licensed turbines that have already been manufactured in Europe or that can be manufactured there with GE-produced parts on hand,
- o Substitution of the banned exports with parts that can be produced in Europe by GE-licensees (primarily Alsthom-Atlantique) for the banned GE parts,
- o Substitution of non-U.S.-licensed, European-made turbines.

The first two items involve issues of "extraterritoriality," geographic extension of U.S. export controls on U.S. technology. The third item concerns the degree to which allies can be pressured to fulfill promises not to "undermine" (NATO declaration) U.S. sanctions, or to avoid any step which would "compromise" (EEC) such sanctions.

Because the Soviets do have the technical possibility of using their own domestically produced (although less effective) turbines in conjunction with imported large-diameter pipe (which does not involve U.S. licenses), and if Moscow is prepared to make that substitution, it does not seem possible for the USG to force termination of the pipeline deal, as long as the West Europeans are intent on getting the gas. Other conditions remaining unchanged, the effect of USG action could only be to delay completion of the pipeline, although perhaps by several years.

Successful USG pursuit of "extraterritoriality" would impose considerable costs on the Soviet Union: at the very least, a significant delay in the readiness of the pipeline and therefore in the arrival of the stream of hard-currency payments for the Soviet gas supplied; at the most, delay plus substantially heavier opportunity costs to Moscow of construction and operation of the line. Advanced in the context of sanctions over Poland, this option appears to be designed for Cost Imposition. Since the public debate has not suggested any objective of deterrence of future Soviet actions, the option seems intended solely for impedance, as part of a long-term economic squeeze on the USSR--to constrict the Kremlin's ability to buy advanced technology from the West. However, the obvious conflict with the goal of Damage Limitation suggests that it would require substantial deterioration of East-West relations--the world of Environment Alteration--before this option could be implemented.

If the USG is to persuade Western Europe to reconsider alternatives to Yamal, Washington will have to deal much more effectively than it has up to now with both lures of the deal: long-term supply of clean energy at reasonable prices and sizable production contracts for the components

of the line, not to mention the banking interests involved in financing both ends of the deal. At a time of growing unemployment, which raises concerns about social stability, and in the context of European-American tensions over nuclear weapons, the exports that would be forgone are probably at least as important a consideration in Western European calculation of the cost of acceding to U.S. pressures as the difficulty of replacing the 40 billion cubic meters of annual gas flow. Soviet contracting for the compressor stations alone had, by mid-January, generated signed orders for about \$3 billion (although the employment-enhancing effect of that figure is reduced by FRG subsidization of Soviet loans to finance these contracts). So far, the public discussion has not revealed any U.S. proposal to reassure West European finance ministers on that account. On energy supply, Europeans seem not to have been impressed by the few attempts made by the USG to outline a program of replacing the Soviet gas. If there is a viable alternative, much more effort will have to go into making it credible. Since such a program would probably involve combinations of at least Norwegian and Dutch gas plus American coal, perhaps including Algerian LPG or more remote possibilities, the political task of achieving the required international agreements is far from simple.

If this formidable challenge could be successfully met, it would indeed sharply transform the Environment of East-West relations. With Soviet oil exports clearly headed for a downturn in the next few years, and arms exports possibly stabilizing, the USSR will depend heavily on Urengoi gas exports to maintain significant imports of capital (and grain, less often discussed in this connection) in the second half of the 1980s. Thus, cancellation of the pipeline deal could be expected to

constrict Soviet production possibilities in these years. In view of the already poor prospects of the Soviet economy and the apparently rising burden of defense, Soviet leadership preferences for defense over non-defense might also be weakened. For these reasons and because of the policy motivation behind it, termination of the pipeline deal would have major political consequences as well.

However, such an effort would probably be incompatible with policies simultaneously aimed at Polish Amelioration. The United States could hardly constrict resource flows to the USSR and expect the latter to react by releasing its grip on Poland and Eastern Europe generally. Neither would it be possible to play a leverage game, offering Moscow a sufficiently attractive short-term (credit) carrot for Polish Amelioration (or other purposes) while fashioning a powerful long-term (pipeline) stick to exacerbate the Kremlin's growth problem. As noted, too, there is a clear conflict with Damage Limitation. To try to reverse the pipeline deal now seems to require a political effort that is likely to be viewed in both Western Europe and the Soviet Union as economic warfare. Also, the intended scope of the warfare and the ends to which it would be pursued are far from clear. Europeans fear that the American strategy seeks to cut off East-West trade entirely, which they sharply oppose, and they see no objective defined whose satisfaction would bring a relaxation of the constraints.

The USG would seem to have two basic options:

- o If it wishes to push "extraterritoriality" now for long-term economic denial, the USG must provide Western Europe with viable energy-supply alternatives and show readiness to share the economic burden of contract cancellation. But the USG will

have to define and limit the scope and objectives for the measures envisioned in order to secure allied toleration, if not actual support. Some damage to allied cohesion is likely to result, at least in the short run. Furthermore, it is unlikely that the USG can successfully pursue Polish Amelioration on a parallel policy track.

- o Alternatively, the USG could be content to impose the costs of delay on the USSR, an action which could be formulated and publicly viewed as a deterrence measure (the resource availability penalty would be small). This would also reduce damage to the alliance and be compatible with a policy aimed at Polish Amelioration, although it would by no means insure the success of such a policy.

Because the gas pipeline contracts are virtually all signed and sealed, and because of Western Europe's apparent determination to proceed, the second option is probably the only real alternative to simple acquiescence with European wishes. Only scenarios leading to Environmental Alteration would make the first alternative viable. In that case, the second option might be a prelude to the first.

Other Technology Transfer

The Polish debt and the Yamal Pipeline are relatively new foci of leverage/sanctions against the Soviet Union: Technology transfer in general is the classical but still unresolved issue of the politics of East-West trade. Over the 35 years of the postwar period, the United States has changed direction several times. It is still far from achieving consensus on strategy and tactics, either domestically or with its allies.

During the cold war, U.S. policy was to impede Communist economic growth. With the coming of detente, the Export Administration Act of 1969 confined export denial to cases where there was "a significant contribution to the military potential" of the Communist countries. In fact, the legislative purpose was to encourage trade with all countries with which the United States had diplomatic relations. Since the mid-1970s, but especially since the Soviet invasion of Afghanistan, the wheel has been turning back to the broader view of the security threat of unfettered technology exports to the Soviet Union.

The core of agreement among the contending schools of thought has been the need to bar Soviet access to Western military hardware and technology. Much of the debate has centered on "dual use" technology--technology intended for a civilian product but which also has military application. The other major focus of controversy is the role of even clearly civilian technology in accelerating Soviet growth or allowing the Kremlin to maintain a high burden of defense (the aggregate resource availability argument). For most of the period in which these issues were debated, the goal was simply denial of benefits to the USSR. As Soviet economic growth showed signs of retardation, another viewpoint was advanced, namely that of "leverage," which was ostensibly made official policy in Presidential Directive 18 of August 1977.

Technology export control provides a poor short-run instrument of leverage. To be sure, the controls are technically easy to turn on and off. However, whereas turning off the switch has an immediate effect, turning it on again is a different matter: Capital-goods production involves some gestation period; once-penalized U.S. suppliers may be

twice-shy when the starting gun is recocked. Thus the link between Soviet concession and U.S. relaxation would be delayed. Perhaps Moscow could be convinced that the flow of benefits would be worth waiting for, but the Kremlin might well suspect that it would have to pay a second political price for the same favor, when the technology transfer control is insufficiently flexible as a tool for short-term leverage. Either another instrument must be substituted or medium- and long-term objectives must be developed for use with technology transfer control.

Even if we define Polish Amelioration in terms of a secular weakening of Soviet control over that country, and perhaps other East European states as well, it probably cannot serve as a long-term objective. Unfortunately, the Soviet grip on Poland would hardly be released just because technology exports were sharply cut. Other conceivable long-term objectives seem to create similar mismatches with the power of the particular instrument. As suggested below, the problems must be viewed in terms of combinations of instruments.

Stricter U.S. controls would probably help reduce the flow of useful technology to the Soviet military, but it is not obvious that imposing significant costs in this category would necessarily deter future aggressive Soviet behavior. Given European hostility to curtailing capital trade with the East, less than complete cooperation with U.S. plans is likely; and lack of cooperation degrades the size of the cost penalty as well as impinging on Damage Limitation. Here as elsewhere, exacerbation of East-West tensions would probably be conducive to policies of systematic denial. However, the Polish crisis does not yet seem sufficiently grave to overcome the Western alliance's divisiveness on this subject.

Grain Export

In the short run, as Europeans continually remind us, the most significant single instrument of Cost Imposition available to the United States is an embargo on grain exports to the Soviet Union. Washington's response has been that the Afghanistan invasion sanctions proved that a grain embargo is useless unless all significant producers are united in enforcing the ban. Actually, this is not quite correct. Moscow succeeded in acquiring somewhat less grain than the volume it desired and at higher cost than anticipated, in part because of the necessity to use smaller-capacity freighters for shipment to the Soviet Union. Whether an embargo would be more successful in the future depends on crop conditions in the major producing countries and particular market commitments. Washington's reluctance to ban grain trade with the USSR may also be connected with the fact that recent legislation now forces a general export embargo to accompany any grain embargo. In any event, grain export is the one case where U.S. denial policy, although tailored for Cost Imposition, might be compatible with Damage Limitation, insofar as the burden would be borne almost entirely by the United States. Indeed, because some Europeans charge that we seek to punish Moscow at their expense, U.S. agreement to levy a grain embargo may be necessary to create the sense of burden-sharing that might permit significant multilateral denial measures.

A grain embargo also seems inadequate on its own for Polish Amelioration. Again, the credible threat of a fairly tight embargo might have been potent before December 13. Now, neither Warsaw nor Moscow is likely to view the costs imposed thereby as weightier than the

risks of losing control again in Poland. This would be particularly true if a Polish-crisis grain embargo proved as leaky as its predecessor. A long-term embargo that was also comparatively leakproof would probably require the political context of Environment Alteration, that is, considerably greater chilling of East-West relations. In the last few years, the U.S. domestic costs of an embargo under less stringent international conditions have created formidable opposition to the use of a grain embargo for Cost Imposition.

THE MAJOR INSTRUMENTS COMBINED

It hardly seems debatable that combinations of instruments would be more powerful sanctions against the USSR than individual measures, alone or even in sequence. Complete refusal to supply grain, technology, and credit would have an undeniably major impact on Soviet resource availability. Applied more or less simultaneously, the sanctions would deny Moscow the opportunity to adjust to each individual measure and would force a review of the Kremlin's resource allocation priorities. Therefore, the application of a combination of instruments would clearly serve the impedance dimension of Cost Imposition. Whether this would also promote Polish Amelioration depends on the nature of the demands for change in internal Polish conditions. At most, however, combined sanctions might induce Warsaw and Moscow to take some small additional risks in an effort to restore a "normal" atmosphere in Poland beyond those which they might contemplate undertaking on their own.

However, because of conflicting interests and perspectives of our allies, the practical difficulties of applying a combination of sanctions make discussion of the probability of effecting Polish Amelioration seem abstract. Our allies declare an interest in a U.S.

grain embargo but are opposed to significant credit restrictions (except in the short term as a Polish crisis measure) and to a major reduction in technology exports. Only if East-West relations deteriorated sharply (e.g., as a consequence of Soviet invasions of Poland) would it be likely that an alliance consensus could be reached on the application of combinations of the chief sanctions. Nevertheless, the present juncture provides one of the few opportunities in recent history to fashion the rudiments of future allied mechanisms of control over East-West economic relations.

REDUCING RESOURCE FLOWS FROM WEST TO EAST

by Charles Wolf, Jr.

The aim of reducing resource flows from West to East is to constrain Soviet allocation decisions, thereby impeding the management and expansion of the Soviet empire and, hopefully rather than assuredly, bringing pressure to bear in the long run on resources devoted to the Soviet military buildup. In the aggregate, resource denial shrinks the possibilities open to the Soviet Union for reconciling continued growth of military capabilities with resource allocations for consumption and investment at home, and with the demands of its expanding empire abroad. Whether such aggregate resource constraints can realistically be expected to exercise much of a check on Soviet military growth over time is arguable. The prospects for doing so are probably increased if restraints on aggregate resource flows are combined with restrictions on Soviet access to key resources, such as GE turbines, Dresser drilling bits, and other technologically advanced equipment. By contrast, limiting controls to "key" resources--technology transfer--without restricting aggregate resource flows seems to be fundamentally inconsistent. Most "key" technologies can usually be obtained at some price somewhere in the world markets. Ready access by the Soviets to aggregate hard currency resources simply increases their capacity to pay the requisite price, and to do so for a wider range of technologically advanced equipment.

The following pages describe three measures for restricting aggregate resource flows to the Soviet Union and Eastern Europe that have been ignored or relatively neglected in prior discussions.

The first measure relates to withdrawing all forms of government subsidy on transactions with the Soviet Union and Eastern Europe--in other words, letting the market decide (except for direct COCOM controls on military-related technology).

The second measure deals with the relationship between debts of the Communist "East" and credit availability for the third-world "South."

The third measure would attempt to weaken the gold market, thereby reducing Soviet liquidity and the value of its gold stocks.

1. The U.S. government, by design or neglect, has provided subsidies of various types and large amounts that distort normal commercial incentives to engage in transactions with the Soviet Union and other CMEA countries. These subsidies--many of which reflect governmental efforts to promote exports and international investment, in general--include the following: lending at preferential rates and providing loan guarantees by the Commodity Credit Corporation; subsidized lending and loan guarantees by the Export-Import Bank; investment guarantees by the Overseas Private Investment Corporation; subsidies to grain producers, resulting in grain export prices about 20 cents per bushel below domestic prices; preferential tax treatment of foreign business income, and preferential tax treatment of personal income received by U.S. citizens working abroad (e.g., in the Soviet Union and Eastern Europe) for 18 months or longer. These subsidies are, of course, borne by American taxpayers largely in the form of higher budgetary (or "off-budget") expenditures. Their dollar value is estimably large (although the estimates haven't been made).

Our European allies provide a similar assortment of subsidies, usually equal to or greater than our own. Subsidized credits for the Yamal pipeline are one example; subsidized government loans and loan guarantees on about half to two-thirds of Poland's external debt are another.

Complete withdrawal of all government subsidies, especially if done in collaboration with our European and Japanese allies, would have a severe and pervasive effect on reducing the volume and raising the commercial costs of transactions with the Soviet Union and Eastern Europe. Moreover, this form of cost imposition--in effect, letting the market decide--would likely be viewed by taxpayers at home as sensible and proper, and would avoid unnecessary rhetorical flourishes that would trouble our allies. The ratio between injury and insult resulting from such measures would be high, indeed higher than that associated with most forms of sanctions. In the midterm and longer run, pressure would be brought to bear on the resources available for the Soviet military and the Soviet empire. Also, the result of letting the market decide, without the distorting effects of government subsidies, would be to differentiate among the CMEA countries according to their genuine creditworthiness: Hungary would likely be favored over Romania and Czechoslovakia.

There remains a question of whether decisions by the market, once the distorting effects of government subsidies were removed, might still be inadequate with respect to the resource denial objective. The question is serious and deserves separate attention. Removing the subsidies would at least be a first step before deciding on further restrictions.

2. The international capital market is closely interdependent. What happens in one part affects other parts, either currently or subsequently. Financial intermediation by banking institutions channels world savings and surpluses from some parts of the market to finance investment and deficits in other parts. To the extent that Poland and other CMEA countries, and their residual guarantor, the Soviet Union, do not pay their debts, the supply of world savings is reduced. As a result, potential third-world borrowers, among others, will be squeezed in the international capital market. Similarly, if new credits were extended to the Soviet Union or to CMEA countries, the result would be to reduce the capital available for third-world development. Access by LDC borrowers would be restricted and interest rates would be higher.

The total outstanding international debt of the Soviet Bloc, over \$80 billion, is between one-third and one-half of the current international indebtedness of the LDCs. Repayment of the Bloc's debt, and avoidance of new loans, is thus of substantial consequence for the borrowing and investment prospects of the LDCs. On the other hand, failure to repay by Poland or other CMEA countries, and any new credits extended to them, will diminish resources for development lending in the third world.

It would be worthwhile for the United States to make known that failure by Poland and other CMEA countries, and their residual guarantor, the Soviet Union, to meet their financial obligations reduces the resources available for the third world. Consequently, the third

world has an interest both in repayment by the Bloc and in reduced credit extensions to the Bloc. Some of our European allies might recognize such an interest, as well.

3. The Soviet Union clearly has a major interest in high gold prices. Soviet stocks of gold are somewhere between two thousand and four thousand tons (probably closer to the lower part of the range), and its annual production ranges somewhere between 200 and 350 tons. At a price of \$400 an ounce (about 15 percent above the current world market price), the value of Soviet gold stocks amount to between \$24 and \$48 billion, and its annual production between \$2.5 and \$5 billion. In 1981 and 1982, Soviet hard-currency earnings from gold exports (including both production and stocks) have been estimated as high as \$9 billion (although this is probably an overestimate), compared with earnings from oil exports of \$10.5 and \$11.5 billion in those years. Hence, any measures which further weaken gold prices will thereby entail significant costs and penalties to the Soviet Union; and conversely, measures that raise gold prices redound to the considerable benefit of the Soviet Union.

One obvious inference is that the U.S. should avoid measures-- of which movement toward a formal gold standard would be an example-- that would tend to boost demand and thereby raise the price of gold. Even the very small move of the President's Gold Commission to establish gold coins as a legal and legitimate form of private asset holding, is a step in the wrong direction from this point of view. In general, the

dollar price of gold seems to vary inversely with rates of interest and to vary directly with rates of inflation.* Of course, bringing pressure to bear on gold prices is not one of the preeminent goals of macroeconomic policy. Nevertheless, while macroeconomic policy should not be governed by the aim of imposing costs on the Soviet Union or depreciating the value of assets held by the Soviet Union, these are ancillary considerations worth further attention in the determination of government policy. A low rate of inflation in the U.S., and relatively high rates of interest are likely to impose consequential costs on the Soviet Union.

*The relative strength of each of these effects needs to be examined empirically.