Economic Leverage on the Soviet Union in the 1980s

Abraham S. Becker

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Rand
1700 MAIN STREET
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PREFACE

This is the final report of a project to reexamine the utility and feasibility of using instruments of international economic relations to develop leverage on Soviet policy. The research was sponsored by the Under Secretary of Defense for Policy.

The report should be of interest to sections of the policy and intelligence communities concerned with U.S. policy toward the USSR and Eastern Europe, East-West economic policy, and U.S. relations with its Western allies.

The author is grateful to his Rand colleagues Michael Kennedy, John Van Oudenaren, and Charles Wolf Jr. for insightful critiques of the draft. Their comments and suggestions were invariably thought-provoking and in many cases led to reworking of the original. Of course, the author alone is responsible for the final product.

SUMMARY

This report presents a reevaluation of the use of leverage on Soviet behavior by means of the instruments of East-West economic relations. A conceptual framework is presented in Secs. II and III, centering on the ideas of leverage and denial as policy tools and on the opportunities and constraints offered by Soviet economic dependence and vulnerability. Sections IV through VI analyze the actual use of the major export instruments—grain, credit, and gas pipeline technology—during the early 1980s. Section VII takes up the issue of consensus in the Western alliance as a condition of successful East-West trade policy.

Economic measures for international *suasion*, to influence a state's policy in particular directions, may be used in strategies of *benefaction*, granting benefits, or *denial*. Strategies of denial aim to impede welfare improvements or economic growth of the target economy or the growth of specific economic sectors, usually the military. The extent of denial, severity of means of implementation, and the accompanying level of international hostility may vary from an effort at total impedance to one of only minimal impedance. Most contemporary discussion is concerned with partial impedance, usually to constrain Soviet military allocation. Partial impedance may be achieved in two channels: selective denial, limitations on specific Western exports thought to advance Soviet military production; and general denial, degradation of aggregate resource availability to the Soviet economy. A *leverage* strategy may be directed toward either impedance or promotion of growth and welfare, as seems politically appropriate, or these purposes may be joined sequentially; it is specifically aimed at changing the target state's behavior. Denial and benefaction policies may also affect the target leadership's calculations and behavior, but the primary purpose of denial is to impede accumulation of the wherewithal to pursue inimical policy; and the purpose of benefaction is to affect behavior only in the long run through the transformation of the society.

Apart from the general problem that is posed by the West's highly imperfect understanding of the Soviet leadership's thinking and the process of top-level policy formation, denial and leverage strategies toward the USSR both have important difficulties. Selective constraints focus on the transfer of technology and aim at impeding the growth of Soviet military capability. An unresolved issue of the debate concerns the proper limits of controls on "dual-use" technology, which may be designed for civil use but can also have military application. Efforts to restrict the flow of "strategic" goods involve more general

denial and face the difficulty of distinguishing permissible "normal" trade from the "strategic" trade that should be controlled. When it aims to curtail the growth of Soviet military power as a route to ultimate behavioral change, denial suffers from the limitation that connections among constraining resource availability, inducing Soviet cutbacks in military spending, reducing Soviet military power, and changing Soviet behavior are uncertain or involve considerable time lags. It is not clear that denial alone, without a prospect of withdrawal of the restriction or even of extending positive inducements, would be sufficient. Leverage also has serious drawbacks—the difficulty of sizing the appropriate "dosage" of denial (with or without the bestowal of benefits) and of defining what Soviet behavior modification would be worth the outlay of a particular "dose."

The ability to carry out strategies of denial or leverage depends in good part on the susceptibility of the Soviet economy to such pressure. Recent estimates indicate that Soviet participation in foreign trade is far higher than was previously thought—the ratio of total two-way Soviet trade to GNP was about 20 percent in 1980. However, most Soviet trade is with other socialist countries and the third world, and participation in trade with the West is much lower. Trade participation is not necessarily trade *dependence*, which might be measured by the opportunity costs of reducing participation. The evidence is not clear cut, but Soviet dependence seems real although not overwhelming. Finally, dependence does not necessarily constitute *vulnerability*, which concerns the structure of the external markets and the Soviet will to resist the foreign pressure and assume the attendant costs. Consideration of the elements making up the difference between dependence and vulnerability suggests that the West's best chance for success in a leverage strategy lies in connecting major economic benefits or penalties with fairly minor political objectives. Most leverage attempts of the past have featured the reverse linkage—weak economic instruments and important political goals—e.g., a minor reduction in grain availability for Soviet withdrawal from Afghanistan. Trade manipulation for less than major political goals is difficult to organize and sustain in a democracy. For all these reasons, Soviet vulnerability is smaller than the statistics of participation and dependence imply.

Three specific economic instruments of leverage and denial strategies are examined: the U.S. sale of grain to the USSR, the Polish debt, and the gas pipeline controversy.

The U.S. sale of grain to the USSR. The 1980 embargo on grain sales attempted to penalize the USSR for its invasion of Afghanistan and to deter further aggressive action. The embargo was largely circumvented with the aid of Argentina, Australia, Canada, and the

European Community. It has been claimed that U.S. farm income and employment generally were reduced as a result, although the claims seem exaggerated. Accordingly, the embargo was viewed as a failure. Continuation of grain sales to the USSR was also justified on the grounds that such sales "sop up" Soviet hard currency earnings, which would otherwise be used to purchase Western technology.

An opposing view argues that Soviet grain imports, contrasted with oil and gas exports, are a rational expression of comparative cost advantages and disadvantages. The Soviets clearly benefit by importing grain from the West, although the size of the gain is limited by Soviet reluctance on political grounds to allow full dependence. The relative resource drain involved in the continuing high level of investment in food production amounts to a partial vindication of the 1980 U.S. embargo, although in terms different from those envisioned at the time. Political arguments can be mustered with equal plausibility for unrestricted sales or in favor of long term embargoes. Neither policy course promises a clearly favorable political outcome for the United States. The issue is moot at the present time. Administrative-legislative action has stripped grain sales of their leverage potential. Legislation passed in 1981–1982 would make an embargo expensive in compensation to farmers and directly prohibits restraints on exports that are scheduled for delivery within nine months. A long term grain agreement with the Soviet Union was signed in August 1983; it assures the sale of 9–12 million tons annually for five years. The U.S. government also explicitly forswore the right to use those sales for foreign policy purposes. However, because Soviet food production problems are likely to endure as will the need for measures short of war to deal with aggressive Soviet behavior, the foreign policy potential of grain sales will probably be reconsidered from time to time.

The Polish debt. Along with the Urengoi-Western Europe gas pipeline, this was the most hotly debated issue in East-West economic relations in 1981–1982. The central question was the wisdom of deliberately triggering default, for which there were two main lines of political justification. The first stressed the need to punish Warsaw for the imposition of martial law, to secure the amelioration of the martial law regime, and to deter further repression in Poland. The second and more popular set of arguments was that default would force the USSR to accept responsibility for discharging Poland's obligations to the West, which would also take its toll on the Soviet military buildup; and it would express a protest against the Soviet Union's moral responsibility for the Polish crisis. Those who opposed declaring default worried about the stability of the international financial system and feared a "credit-panic" that would do more damage to the West than to Poland

and the USSR. The debate was confused by failure to directly address how the default would take place and what effects it would have on the declarer, the other Western creditors, and Eastern Europe and the USSR. These questions were also difficult to answer because of the large uncertainties involved.

Although the flow of new credit to Poland did dry up substantially, Poland succeeded in forcing the banks to recycle much of the interest due on the loans rescheduled in 1982 and 1983. Moreover, the Western governments inadvertently eased Warsaw's balance of payments problem not only by refusing to reschedule the official Polish debt due but also by failing to trigger default. The credit crunch was marginal for the USSR, and the Kremlin cut its direct foreign aid to Poland. It seemed highly unlikely that a declaration of default would induce the Politburo to (a) bail out Poland, whose standard of living was regarded by ordinary Russians as purchased at Soviet expense, (b) save capitalist bankers from the consequences of their own folly, and (c) send a signal of readiness to support other East European economies that might experience financial difficulty (which the USSR could not possibly do). It was much more likely that Moscow would exploit a default declaration to force Poland to bear its own recovery costs.

The Western governments spoke of the Polish debt as providing leverage for the West, but none of them pursued a deliberate and systematic policy of either leverage or denial. Hence, the denial of credit to Poland and the Communist bloc was only partial, and the leverage potential of Polish need for credit was weakly exploited. It is plausible that Poland was too important to the Kremlin for a leverage policy to succeed in restoring the status quo ante December 1981. That, however, was not the only possible goal of a leverage strategy, which could have aimed at amelioration of the martial law regime. If leverage is created by asymmetrical dependence, there could not be many situations with as great potential for leverage as the Polish debt crisis. The West could not even test that potential, because it could not agree on either the desirability of the objective or the strategy for pursuing the goal.

The gas pipeline controversy. There were three elements in the American opposition to the gas pipeline deal: negation of potential Soviet leverage (European dependence on the USSR for gas), generalized resource denial (with regard to Soviet hard currency earnings from gas sales to Europe in the mid and late 1980s), and sanctions for negative leverage (prohibition of sales of gas equipment in connection with martial law in Poland). Europeans were skeptical about the third component because it was not introduced until 1982, penalized them more than the adversary, and was not powerful enough to induce Jaruzelski

and Brezhnev to loosen their hold on so important a prize to the Communist world. American opposition suffered from the additional handicaps of late development of alternative energy plans, failure to offer alternative markets for the sales of pipe and equipment, and European indignation over the U.S. extension of extraterritorial controls on sales of compressors and associated equipment.

An important characteristic of the Poland-related effort at leverage was the unimportant role of positive inducements, contrasted with the reliance on cost-imposing sanctions. Nor was leverage an issue in the pipeline debate before martial law in Poland. The largest project in the history of East-West economic relations was brought into being without an attempt by the West Europeans to act in concert, even for the minimum objective of improving the terms of the agreement, let alone for the purpose of exerting political leverage. The wasting of that opportunity must suggest that leverage, as distinct from benefaction, is a dead issue in Europe; the scope for U.S. action is correspondingly and sharply reduced.

The Western alliance displayed sprawling disarray in response to the challenges of the several international crises of 1980–1982. The roots of the disagreement lie in the far greater importance of East-West trade for Western Europe than for the United States, but more important are the differences in fundamental outlook on East-West relations. In matters of security, arms control, and economic relations, the Reagan administration's policy has been perceived as a threat to the renewal of detente, the Europeans' hope of being able to project some vision as to how the East-West conflict might be transcended.

There are fair prospects for some limited agreement on particular issues—strengthening COCOM and the procedures for controlling transfer to the East of sensitive technology, the need for an alliance energy policy, and limiting the subsidy element in East-West trade. The most useful contribution the alliance can make to dealing with its bedrock conflict on East-West economics is to institutionalize and make permanent the examination of the issues, which was begun in November 1982. The harmonization of views that can be expected in the Atlantic alliance is thus necessarily limited. It is possible to hammer out a compromise on the specifics of policy without agreement on principle; but in the absence of such an agreement, the compromise inevitably will be a lowest common denominator.

Under these conditions of defect inherent in the pure strategies and the disappointing experience of recent years, the only possibility for effective denial over the long term is selective impedance of the Soviet military effort. There appears to be little possibility of patient, obstinate pursuit of long term leverage. Prudence and realism indicate

that economic policy in the 1980s can play only a marginal role in the Western strategy of East-West relations. Feasible objectives of Western policy are limitation of Western economic dependence and vulnerability, reduction of the West's subsidization of the Soviet economy, and narrowing of the direct contribution to Soviet military power. More ambitious hopes of using the West's vast economic power to alter Soviet behavior are sadly incompatible with the realities of Western national and alliance politics.

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I. INTRODUCTION

PLAN OF THE STUDY

This report attempts a reconsideration of the possibilities of exercising leverage over the Soviet Union using the instruments of East-West economic relations. Leverage and East-West trade have been subjects of debate in the West almost since the end of World War II. The literature of the debate is voluminous and still expanding,[1] although there is a clear majority view skeptical of the utility or feasibility of leverage generally and in East-West relations especially. The purpose of the present study is to ask whether economic leverage can yet be an important part of U.S. policy in the light of the East-West and West-West crises of the early 1980s. On the whole, the study arrives at a mixed judgment on the utility of leverage; regrettably, however, it upholds the conventional wisdom on the score of its feasibility.

The analysis is set out in three parts. The first, comprising Secs. II and III, presents the conceptual framework of the study, centering first on the ideas of leverage and denial as policy tools and then on the opportunities and constraints offered by Soviet economic dependence and vulnerability. The second part, Secs. IV through VI, examines the use of the major economic policy instruments—grain, credit and gas pipeline technology—in the Afghan and Polish crises. The emphasis is on the first two instruments, as technology controls have not been much concerned with leverage. Section VII considers the painful issue of consensus in the Western alliance as a condition of successful East-West trade policy.

This is a study of the use of leverage in the 1980s. It seemed useful to preface such a discussion by some historical background. The following brief sketch of the evolution of American policy on East-West trade is intended only to highlight a few themes that seem relevant to examination of the policy problem in the 1980s.

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[1]A companion paper to the present study offers a succinct but pointed review of the English language literature of the debate. Judith C. Fernandez, "Modeling Economic Leverage," The Rand Corporation, N-2065-USDP, May 1984, Sec. III.

EAST-WEST TRADE IN AMERICAN POLICY[2]

From the inception of America's troubled relationship with the world's first communist state, U.S. policy on trade with the land of the Soviets has oscillated between two approaches. One, business-pragmatic, has reflected periodic interest by American business in commercial opportunities, both real and imagined. Another, political-ideological, sought to deny advantages to a mortal adversary or to use trade power to affect his behavior. Changes in Soviet policy and in other exogenous factors have surely contributed to the fluctuating pattern of Soviet-American trade relations, but the bifarious American approach played the largest role in this development in the period after World War II.

For two decades after the final dissolution of the wartime alliance, the cold war and the U.S. controls that were enacted because of it stifled Soviet-American trade. The Soviet Union traded predominantly with its socialist allies. But even as Soviet trade with Western Europe and Japan opened up, the United States lagged behind. With the exception of 1964 (the year of the first major Soviet grain import), it was not until 1972 that the United States began to account for more than 1 percent of total Soviet trade turnover. As late as 1970, U.S. exports to the USSR made up only 4 percent of the total from the "industrially developed capitalist countries" (IDCC), and U.S. imports from the USSR came to only 3 percent of the IDCC's imports. In that year, Great Britain, the Federal Republic of Germany, Finland, and Japan each accounted for 2-1/2 to 3 percent of total Soviet trade turnover, the United States for only 0.7 percent.[3]

The 1960s were a time of reevaluation and slow reorientation of U.S. East-West trade policy. The business community contended that it was being unfairly deprived of trade opportunities that were being snatched up by Europe and Japan. A growing body of opinion saw political benefits in expanded trade. The report of President Johnson's Special Committee on U.S. Trade Relations with East European Countries and the Soviet Union (the "Miller Report") concluded;

> Over a considerable period of time, when taken with the process of change already under way, the intimate engagement of trade can influence the internal development and external policies of European Communist societies along paths favorable to our purpose and to world peace.... In the long run, selected trade, intelligently

[2]This section draws in large part on an unpublished account of postwar East-West trade history compiled by Donne Pinsky of Rand.

[3]Except as otherwise noted, Soviet trade data are derived from the official Soviet yearbooks, *Vneshniaia torgovlia SSSR.*

> negotiated and wisely administered, may turn out to have been one of our most powerful tools of national policy.[4]

Underlying the new interest in reviving contacts with the USSR was a sense that the fundamentals of a cold war trade policy were no longer realistic. The "Miller Report" declared reassuringly that

> gains from nonmilitary trade with the United States are unlikely to release additional resources for Soviet military expenditures. The USSR accords overriding priority to military expenditures. Any change in total resource availability in the USSR through trade would, under present policies, affect its civilian economy, not its military budget.[5]

Pressures for liberalization of East-West trade led to a loosening of the cold war's stringent controls in the Export *Administration* Act of 1969, which replaced and considerably expanded the Export *Control* Act of 1949 and its 1962 amendments. The most important difference was the deletion of export controls for the purpose of restraining the "economic potential" of the trading partner, putting the major emphasis on the restriction of goods that would make a large contribution to Communist *military* potential. Another important change was the new conviction that "foreign availability" (presence of alternative suppliers) would have to be considered in applying national security controls on exports.

In the early 1970s, optimism about the potential for growth in East-West trade was rampant. Secretary of Commerce Maurice Stans, for example, reported after a fact finding visit to Moscow in the fall of 1971 that U.S.-USSR trade, which averaged only $200 million yearly, had a potential of $5 billion both ways by 1975. Several major trade deals did emerge in those years, beginning with the grain and livestock feed sale of 1972 and the half billion dollars worth of heavy equipment sold to the USSR for construction of a truck factory on the Kama River, 600 miles east of Moscow. Others followed and still bigger deals were being negotiated (e.g., the "North Star" project for delivery of huge quantities of Siberian natural gas to the East coast of the United States).

It cannot be said that the liberalization of controls and expansion of contracts led to an actual burgeoning of U.S.-Soviet trade. True, trade turnover rose nine times between 1970 and 1980, but the initial base was insignificant (Table 1). The relative and absolute importance of U.S.-Soviet trade remained small in most years. In the peak year of

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[4]"Report of the Special Committee on U.S. Trade with East European Countries and the Soviet Union," *Department of State Bulletin*, May 30, 1966, p. 855.

[5]Ibid., p. 849.

Table 1

SOVIET TRADE WITH WESTERN COUNTRIES, SELECTED YEARS, 1970–1982

	1970		1973		1976		1980		1982	
	export	import	export	import	export	import	export	import	export	import
Values (millions of foreign trade rubles)										
FRG[a]	231	338	482	764	1,168	1,977	3,096	3,019	4,065	2,913
France	126	287	272	449	774	923	2,242	1,510	2,291	1,267
Italy	191	281	310	304	1,069	709	2,101	934	2,864	1,222
Japan	341	311	622	372	748	1,372	950	1,773	757	2,926
United Kingdom	418	223	541	175	825	408	859	953	813	752
United States	58	103	138	1,023	199	2,007	151	1,352	155	2,072
All IDCC	2,154	2,540	3,750	4,589	7,834	10,824	15,862	15,721	18,849	18,892
All Countries	11,520	10,559	15,802	15,544	28,022	28,733	49,635	44,463	63,165	56,411
Shares of Trade with All IDCCs (percent)										
FRG[a]	10.7	13.3	12.9	16.6	14.9	18.3	19.5	19.2	21.6	15.4
France	5.8	11.3	7.3	9.8	9.9	3.2	14.1	9.6	12.2	6.7
Italy	8.9	11.1	8.3	6.6	13.6	6.6	13.2	5.9	15.2	6.5
Japan	15.8	12.2	16.6	8.1	9.5	12.7	6.0	11.3	4.0	15.5
United Kingdom	19.4	8.8	14.4	3.8	10.5	3.8	5.4	6.1	4.3	4.0
United States	2.7	4.1	3.7	22.3	2.5	18.5	1.0	8.6	0.8	11.0
Subtotal 6 Countries	63.3	60.8	63.2	67.2	60.9	63.1	59.2	60.7	58.1	59.1

SOURCE: *Vneshniaia torgovlia SSSR*, various years.

[a]Including West Berlin.

1976, when grain sales were large, Soviet imports from the United States accounted for 7 percent of its total imports, 19 percent of Soviet imports from all IDCCs. (Two-way trade in that year fell more than $2 billion and 40 percent short of Secretary Stan's forecast for 1975.) Grain sales also brought a temporary peak in 1973. In other years, trade turnover with the United States generally lagged behind that of Germany, Japan, Finland, France, and Italy. The highest level of Soviet exports to the United States was 350 million rubles in 1979, that is, under $500 million; U.S.-Soviet trade was largely a matter of Soviet imports.

Soviet leaders blamed U.S. government restrictions, particularly citing the role of the Jackson-Vanik amendment in preventing the president from granting the USSR's exports most-favored-nation status. The Jackson-Vanik and Stevenson amendments in 1974 effectively closed off the possibility of large credit flows to finance Soviet development. Very likely it was recognition of this prospect that led Moscow to denounce the U.S.-Soviet trade treaty negotiated over the previous two years.

The results of the denunciation of the trade treaty were not as clear cut as might be assumed. With 1974 as the base for comparison, Fig. 1 shows the change in two-way trade at current prices between the USSR and the United States, West Germany, Britain, France, and Japan over the next five years. Soviet-American trade in 1974 was 40 percent below the 1973 level, the year of major grain sales. In the two years after the collapse of the trade treaty, turnover more than tripled; a 30 percent drop in 1977 was followed by an 85 percent increase in the following two years. Overall, the level of two-way trade in 1979 was 3.8 times the 1974 level, whereas for France it was only 2.8 times higher; the increases for Britain, West Germany, and Japan ranged downward to 50 percent. However, in the 1970s Soviet trade with its other major Western partners grew more smoothly than with the United States, whose trade pattern shows much more fluctuation. Oil purchases from the Soviet Union played an important role in German and French trade, where imports from the Soviet Union increased more rapidly than did exports to the USSR. U.S. exports to the Soviet Union, the dynamic element of Soviet-American trade, were heavily grain and food-dependent. It seems likely that had U.S. credit resources been opened to the Soviet Union on concessionary terms, U.S. exports to the USSR would have expanded still more rapidly, but this would have been at least in part at the expense of the other major Western suppliers. There were limits to the Soviet import capability.

The phenomenal expansion of bank and government lending to Eastern Europe and the USSR in the mid-1970s created one of the two

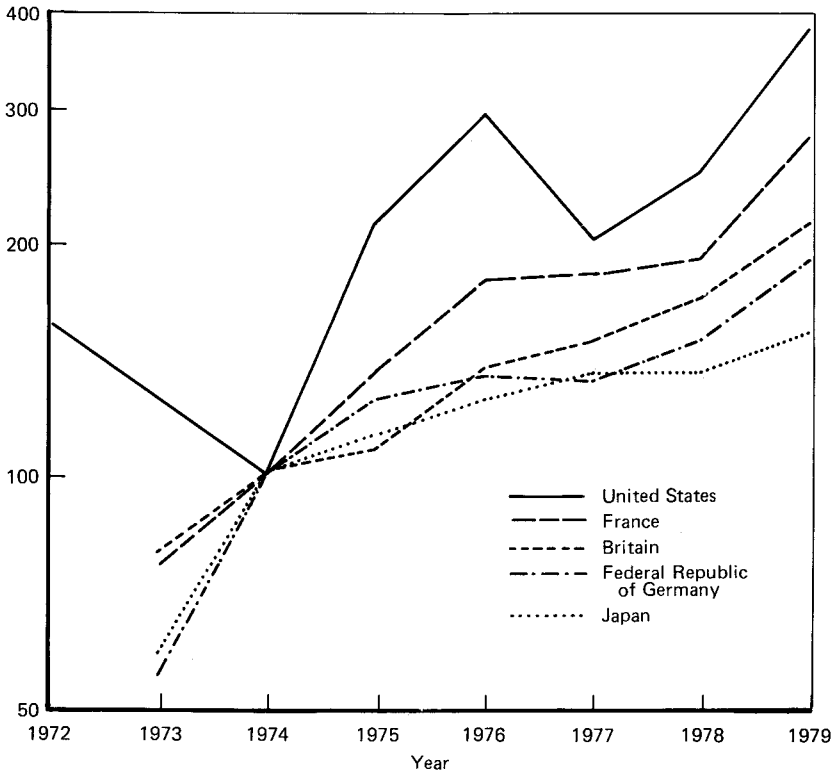

Fig. 1—Two-way USSR trade with the five Western states at current prices, 1973–1979 (1974 = 100)

major problems of alliance policy in East-West economic matters during the second half of the decade. Fears about the East's ability to repay its growing debts became the front running question in East-West economic relations. It became widely accepted in the West that East-West trade growth was bound to slow down markedly. But competitive rivalries in the Western camp and unwillingness to fully credit the few Cassandras warning of impending debt-service problems prevented any coordinated effort to develop a common strategy.

The other major issue of the period was technology transfer, which arose in two contexts. The first and most durable was the growing awareness of the duration and cumulative scale of the Soviet military buildup. Congress as well as the administration began to be more sensitive to the possible contributions of Western exports of goods, ser-

vices, and know-how to the Soviet military buildup. A 1977 report by a Senate subcommittee headed by Senator Jackson warned that "our current situation can be judged as acute hemorrhaging."[6] The second context was the attempt to find leverage in the sales of capital goods and technical know-how to ease Soviet internal repression and control Soviet external aggression.[7] The Carter administration tried to make human rights a centerpiece of American foreign policy, and the repression of Soviet dissidents created a series of challenges to U.S. policy. The issues of the two contexts became intertwined and at times confused, especially under the pressure from the business sector and others worried about the unravelling of detente.

In the late 1970s the balance the U.S. government sought to maintain between its interest in improving East-West relations, centering on the negotiation of the SALT II agreement, and its desire to contain Soviet expansion and defend human rights, tipped perceptibly in the former direction. Then came the invasion of Afghanistan, followed two years later by Polish martial law, and in the early 1980s the U.S. government under two administrations followed a policy of penalizing the Soviet Union for its foreign policy behavior. Detente seemed in shreds.

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[6]*Transfer of Technology to the Soviet Union and Eastern Europe,* Selected Papers, Compiled by the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, U.S. Senate, Washington, D.C., 1977, p. 2.

[7]For the basic statement of the Carter administration's approach, see Samuel P. Huntington, "Trade, Technology and Leverage: Economic Diplomacy," *Foreign Policy,* Number 32, Fall 1978, pp. 63–80.

II. LEVERAGE AND DENIAL AS INSTRUMENTS OF POLICY

WORKING CONCEPTS

This study is about the uses of economic power and economic instruments to further Western interests in the East-West arena of the global competition with the USSR. The major instrument the United States and its allies wield to deter Soviet behavior threatening Western security is military power. Diplomatic contacts with the Soviet Union and with other states, propaganda, and other forms of political persuasion are also used for deterrence or to effect policy change. This study examines a third class of instruments, used intermittently over the period since World War II but drawing particular attention recently—economic measures. The intended purpose of such measures will be called *suasion*, influencing Soviet internal or external policy in particular directions.[1]

In theory, international economic relations can be left to the dictates of the market, but in actuality every government intervenes to shape market flows to some extent. Where purposeful intervention is directed at other states, rather than at domestic actors and for national welfare alone, it is useful to distinguish three strategies of international economic policy—benefaction, denial, and leverage. *Benefaction*—using economic instruments to confer benefits on another state—characterized much of Western thinking in the 1960s on the subject of aid to developing countries. The rationale of benefaction rests on the belief that economic aid results in, or at least contributes to, changes in the economic and political structure of the recipient society that enhance the welfare of both donor and recipient. An analogous set of beliefs characterized the views of many advocates of detente in the 1970s.

Benefaction is usually intended to accelerate growth of the recipient state's economy or to improve the welfare of its population. A sharply

[1]This report is not concerned with the views of those who deny the legitimacy or desirability of exercising suasion through trade. That attitude can be encapsulated in a formula variously attributed to Dwight Eisenhower and Hubert Humphrey: "The United States should trade anything with the enemy that can't be shot back at us." It is a basic assumption of this report that the use of trade to temper Soviet behavior is a valid exercise of U.S. national policy.

contrasting strategy of *denial* would aim to impede welfare improvements or economic growth, either that of the target economy as a whole or of specific sectors of the economy, usually the military. At one end of the spectrum, in terms of extent of denial, severity of means of implementation, and level of international hostility, the impedance sought may be total.[2] The first-order policy objective would be to seal off the target country from international economic contacts so as to deprive it of all gains from participation in international trade. Toward the other end of the spectrum, which must necessarily be fuzzy in definition, the denial would be highly selective and applied reluctantly; the impedance desired would be minimal and directed only against military technology. It is, of course, in between the extremes that most of the interesting cases lie.

Where the impedance sought is total or nearly so, we appear to be dealing with all-out "economic warfare." Charles Wolf has pointed out that this term "does not have a very precise technical meaning, and the loose and diverse ways in which it has been used in the media and elsewhere have not contributed to resolving these ambiguities." Wolf draws attention to the extremely broad definition of the term in the *Encyclopedia of the Social Sciences,* which includes conferral of economic favor (by which "a country may expect in return reciprocal favors in the form of political support, or alliance, or perhaps neutrality"), along with measures of coercion through denial, as the modes of "economic warfare." Wolf rightly notes that under such a definition, subsidization of credits to the benefit of a recipient country could be viewed as economic warfare.[3] Such confusions suggest the usefulness of distinctions like those sketched here.[4]

In most contemporary discussions of denial policies with regard to the USSR, only partial impedance is sought, usually to constrain

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[2]One does not hear many voices calling for such a policy toward the USSR. Perhaps the closest approximation recently is Louis J. Walinsky, "Coherent Defense Strategy: The Case for Economic Denial," *Foreign Affairs,* 61:2, Winter 1982/83, p. 287; "U.S. and Western defense strategy must avoid or severely limit any actions or policies which contribute significantly to the strength of the Soviet Union and its allies or help them to overcome their weakness. In the first instance, this means curtailing in significant degree the flow of Western high technology and industrial goods and food grains, and the credits which facilitate an increase in the volume of this flow."

[3]In his prepared statement published in *The Premises of East-West Commercial Relations,* A Workshop Sponsored by the U.S. Senate Committee on Foreign Relations and the Congressional Research Service, Library of Congress, Washington, D.C., 1983, pp. 150–151.

[4]If by "economic warfare" is meant denial for total or near-total impedance, the policy has been associated in the past with the goal of collapse of the target economy or overthrow of its government. This is another reason why the term "economic warfare" is probably best avoided in a discussion of current East-West relations. It is simply inconsistent with the tenor and possibilities of the present international environment.

Soviet military resource allocation. The constraint may be attempted in two channels: (1) selective denial—limitations on specific Western exports (overt or covert, witting or unwitting) of military end products as well as of goods, services, and know-how that might be used to advance Soviet production of military goods and services; and (2) general denial—limitations on aggregate resource availability to the Soviet economy that would be expected subsequently to affect allocations to the military.

The effect of efforts to promote or impede another state's economic growth or welfare may be to alter the calculations and behavior of its leaders. But this is not the primary purpose of either strategy. Benefaction could only expect to affect leadership behavior in the very long run through transformation of the society; the cardinal goal of denial is to impede the accumulation of the means to pursue inimical policy. A purposeful strategy directly aimed at affecting leadership behavior will be called *leverage.* Leverage may be directed to either impedance or promotion of growth and welfare, as seems politically appropriate, or these purposes may be joined sequentially.

Apart from its direct focus on behavior alteration, the distinctiveness of a leverage strategy is the possible readiness to grant benefits as well as to threaten or carry out threats of denial. Denial has been clearly dominant and the inducement of reward notably absent in the leverage episodes of recent years. The imbalance can be criticized justifiably. However, leverage must be distinguished from benefaction. Leverage may use the inducements of reward, but its rationale requires the implicit threat of penalty, at least of the withdrawal of rewards. Huntington argued that "for the Soviets, as for others, leverage works most effectively when applied in the form of a carrot rather than a stick." But the policy he was advocating included centralized control over East-West relations within the U.S. government and the ability to close the "technological door" to Soviet trade as circumstances required.[5] Leverage too is at bottom a coercive strategy: It "emanates only from the threat, use, or anticipation of use of negative incentives for compliance."[6] The instruments in which negative incentives are embodied may be used interchangeably in either denial or leverage. Depending on the conditions of the problem, the scope of application and the intensity of implementation, embargo, boycott, export controls, credit restrictions, etc. may be found in both strategies. Punitive sanctions alone may be successful only against weak targets; against major

[5]Huntington, "Trade, Technology and Leverage," pp. 72, 75–76.

[6]Ariel Levite and Athanassios Platias, "Evaluating Small States' Dependence on Arms Imports. An International Perspective," Cornell University Peace Studies Program, Occasional Paper No. 16, June 1983, p. 3.

powers, sanctions may have to be balanced by positive incentives. The balance between reward and punishment is the main tactical issue of leverage.

With regard to the time dimension of the three suasion strategies, leverage is often thought of as episodic, where either the attainment or evident frustration of the leveragor's limited objective brings the episode to an end. Leverage with regard to the USSR may also be framed as continuous policy, as in the Kissenger rationale of detente: U.S. rewards and punishments would be meted out in a continuous process, assessing and reacting to Soviet policy. However, another strand of the detente logic is associated with Kissinger: the theme of interdependence, which operates in the long term.[7] The "web of interconnectedness" between East and West is spun over a prolonged period of time; when the strands are clearly perceived, aggressive behavior appears self-defeating because it risks the interruption of valued economic benefits. Such a long term policy runs the risk of sliding into pure benefaction. If short term Soviet noncooperation is explained away or disregarded because of expectations for the longer run, even the implicit threat of denial will become less and less credible. Denial may also be a continuous policy (as in the 1950s); but the goals must be seen as achievable only in the longer term, because the resource flow constraints work slowly if at all. Alteration of Soviet policy and behavior could end the sanctions; a strategy of denial would, thereby, have been converted into one of leverage.

From time to time sanctions are levied against the USSR in reaction to particular crises, as in the cases of the invasion of Afghanistan or the imposition of martial law in Poland. It is necessary to distinguish between actual strategies of suasion, whether leverage or denial, and the expression of outraged opposition. The need to make concrete an unwillingness to accept some act of Soviet aggression in silence responds to domestic and international political realities, but it does not necessarily lead to recognizable strategies of leverage or denial.

THE LIMITATIONS OF SUASION STRATEGIES

A companion study to the present report develops the theory of leverage in an articulated, disaggregated model of its operation; it also contrasts the effects of leverage on production, consumption, and welfare in the target state with the effects of the strategies of benefaction

[7]He believed the U.S.-USSR bilateral cooperation agreements of 1972 "could over time establish vested interests in peace." Henry Kissinger, *White House Years,* Little, Brown, Boston, 1979, p. 1254.

and denial.[8] But all the strategies of suasion have important limitations, and the rest of this section is devoted to that theme.

To begin with, all the strategies have a common constraint. Whatever the approach and the combination of economic (or political) instruments, expectations of modifying Soviet behavior should be limited, even modest. A general problem that any approach to changing Soviet policy must face is the West's highly imperfect understanding of the Soviet leadership's perceptions of the outside world, its mindset and pattern of thinking, and its process of top-level policy formation. The ultimate poverty of Western Sovietology, despite its genuine richness of insight, introduces uncertainty into all considerations of exercising suasion on the USSR.

With regard to the particular strategies, we need deal only briefly with benefaction, which stipulates an endogenous process of transformation of the polity leading to change in external behavior. The rationale of benefaction is, of course, not a scientifically testable proposition. It is particularly speculative applied to the USSR and Eastern Europe. If the West continues to debate the validity of benefaction in East-West economic relations, despite the dubious results of detente in the last decade, it is not because of new evidence on change in communist society. Many Europeans seek to improve relations with the East, but because they fear nuclear war or for other political reasons, they are inclined to support measures of economic aid to the Communist countries to revive detente. Thus, they are led to argue the economic rationale of benefaction because it is the necessary implication of a policy whose motivations are entirely political (see Sec. VII).

Denial for partial impedance may constrain selectively or generally. The selective constraints aim at transfer of technology and restraining the growth of Soviet military capability. Throughout almost 40 years of debate on East-West trade, there has been a consensus on the desirability of preventing transfers of military technology. It is hard to find advocates of selling missiles to Moscow. Machinery and equipment specialized to the manufacture of military hardware are also part of the consensus, as is the know-how of military production. But this narrows the scope of the controversy only slightly. The issues of technology transfer policy remain:

- How does technology transfer benefit the Soviet Union?
- Are contributions to Soviet civil sector development good or bad for the West?

[8]Fernandez, "Modeling Economic Leverage."

- Do benefits accrue to Moscow from transfers of "low" as well as "high" technology? How do they differ?
- How can one differentiate transfers that aid the Soviet military from those that do not?
- Is the Soviet economy capable of profiting from technology imports? If not, do Soviet leaders still believe the transfers are valuable? (In short, does the issue matter at all?)
- Can Soviet interests or needs be exploited to reap Western political gains or is the USSR impervious to external economic pressures?
- What are the costs of manipulating trade for foreign policy or security purposes and how can these costs be minimized?

An enduring issue of the debate concerns "dual-use" technology—designed for civil use but with military potential. A now classic example offered by advocates of stricter controls is the Bryant gear-grinding machines exported to the USSR in the early 1970s, which are said to have contributed to the rapid improvement of the accuracy of Soviet ICBMs. If there is anything new in the recent phase of this continuing debate, it is that much of the U.S. public and the publics of other Western states to a lesser degree believe that the Soviet Union is engaged in a concerted, large-scale effort to obtain Western technology by licit and illicit means, with a view to modernizing its military capability.

Nevertheless, short of shutting off all the taps completely, this does not resolve the "dual-use technology" problem; it only heightens the importance of decisions on where to set the bounds. The most important innovation in this regard was the proposal by the Bucy Report to distinguish between commodities and technologies as objects of control, and to concentrate control energies on the "critical technologies."[9] That approach was incorporated into the 1979 Export Administration Act, and it is now a fundamental of the government's export control system. However, the focus on critical technologies does not solve "dual-use" dilemmas; it only removes them to another level of the input-output hierarchy.

Charles Herzfeld has suggested a scheme for ranking types of trade ordinally by military-strategic importance along with the scale of con-

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[9]Office of the Director of Defense Research and Engineering, Department of Defense, *An Analysis of Export Control of U.S. Technology—A DoD Perspective,* Washington, D.C., February 4, 1976; J. Fred Bucy, "On Strategic Technology Transfer to the Soviet Union," *International Security,* 1:4, Spring 1977, pp. 25–43.

trol appropriate to each.[10] He distinguishes the following categories of trade:

1. General trade
2. Civil technology of minor strategic or military significance (e.g., refrigerators)
3. Civil technology of major economic-strategic significance (oil drilling equipment, food)
4. Dual-use technology (high performance computers, aircraft technology, advanced communications)
5. High-technology, infrastructural materials (microelectronics manufacturing and test equipment)
6. High technology of direct military use.

His visualization of the curve of required controls is shown in Fig. 2. Herzfeld's scheme acknowledges the existence of a broad band of dual-use technology with considerable permissiveness appropriate at the lower ends of the range. He stresses the importance of detailed assessment of the effects of different types of technology and the different levels of sophistication of technology, in particular civil and military uses. Of course, such assessment must necessarily rely on judgment in many cases; this approach therefore retains the potential for dispute over the boundaries between civil and military relevance.

This cursory review of the technology transfer issue as a vehicle of selective denial has focused on the problem of the civil-military continuum. But as Herzfeld's typology of trade reminds us, much of the controversy in recent years has flared around the issue of "strategic" importance. The gas pipeline and related energy issues were fought over in part under this rubric, and Sec. VI examines that controversy briefly.

The transition from "military" to "strategic" importance as a criterion of export controls often marks the crossover from selective to general (or more general) denial. Both may be aimed at the Soviet military effort and constitute modes of partial impedance, but general denial necessarily involves "collateral damage" to civil activities. Credit restrictions, for example, are likely to constrain a range of imports, including purely civil goods and services. (Control of dual-use technology has the same effect, of course.) Advocates of general denial that is in fact directed at the Soviet military effort hope to achieve their goal by affecting Soviet resource allocation policy. But partisans

[10]Charles M. Herzfeld, "Some Aspects of Technology Transfer," in *The Conduct of East-West Relations in the 1980's,* Part 2, Adelphi Paper, London, International Institute of Strategic Studies, forthcoming.

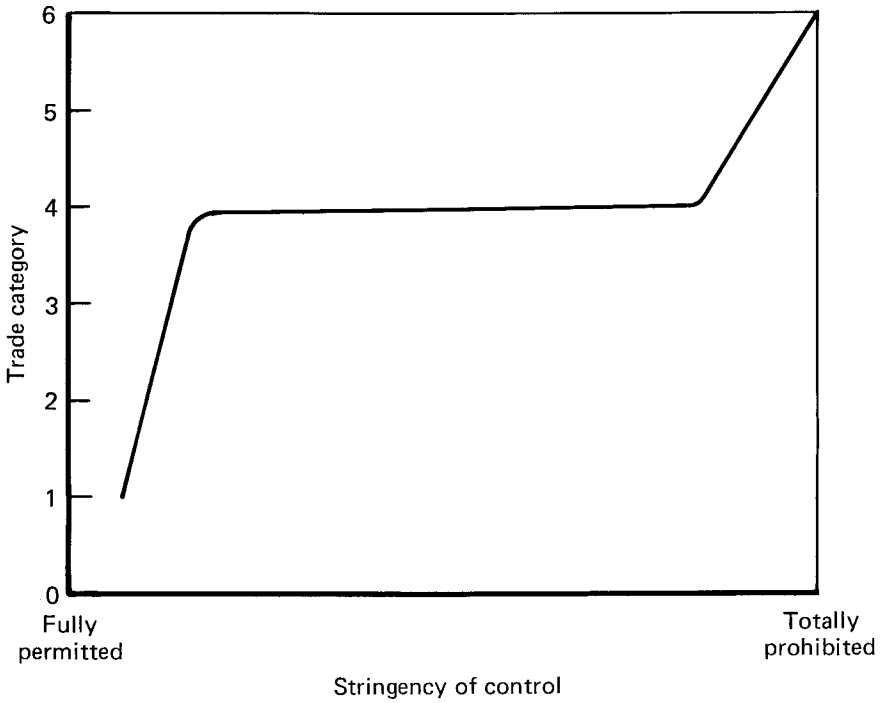

Fig. 2—Herzfeld's curve of technology export control

of controls over "strategic" goods, other than for defined leverage goals, are only incidentally concerned with the structure of Soviet resource use. They appear to proceed beyond concern with Soviet military power to the goal of reduction of Soviet economic power. This was the rationale of the U.S. Export Control Act of 1949 with its subsequent amendments. Many Europeans fear that this is now also the philosophy of the U.S. government.

But if reducing Soviet economic power is the objective, it is pointless to attempt to define and identify strategic goods. If the lines of partition between civil and military are hazy, those between strategic and nonstrategic are veiled in an almost metaphysical fog. Baby diapers seem intuitively nonstrategic but it is hard to be convincing why they differ in kind from food. "What objectively strengthens the USSR the most," a French industrialist queried plaintively, "the sale of wheat to

feed its population or the sale of computers?"[11] The "strengthening," in fact, originates in the gains the Soviet Union derives from trade that involve access to products that cannot be produced at home and improvements in efficiency derived from resource reallocations permitted by trade.[12] Both of these components contribute to moving the USSR to a higher level of satisfaction (higher utility surface, in economists' jargon). It is not self-evident that selling diapers to the Soviets would reduce their gains from trade relative to imports of an equal volume of food or computers. The answer depends on the specific economic conditions—international patterns of supply and demand and relative prices. Thus, proponents of controls to weaken Soviet economic power or reduce its growth should in fact be concerned with all traded goods and services and their relative contribution to Soviet gains from trade.[13]

This approach has the virtue of internal consistency but the disadvantage of political candor; it smacks of "economic warfare," which proponents of denial of "strategic" goods disclaim advocating. They assert that "normal" trade is permissible and even to be encouraged, where economic benefits to the trade partners are mutual and equal. But where the goal is to degrade the power of the adversary, whose hostility is systemic and embodied in the full range of his domestic and foreign policy, it is difficult to define a range of "normal" trade that does not contribute to the adversary's capability. This is an inherent conundrum of general denial that still seeks only partial impedance.

In one sense, denial seems to have an important advantage over leverage because it appears less demanding of Western policy capabilities than is leverage: There is no requirement for a Soviet behavioral change that is clearly a concession, whether explicitly acknowledged or not, to external pressure. Instead, the direct effect sought is on Soviet military power, which, it is expected, then leads to behavioral changes. However, denial seems more demanding than leverage in terms of the number of links that must be traversed between constraining resource availability and affecting Soviet behavior:

1. The connection between resource availability and defense spending is uncertain. This is true, first, in the sense that any observed

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[11]Quoted by Jean-Michel Quatrepoint in *Le Monde,* October 21, 1981.

[12]For a discussion of trade strategies in terms of gains from trade, see Fernandez, "Modeling Economic Leverage," Sec. II. International trade, in principle, yields gains to both buyer and seller. How the gains are distributed depends on market conditions.

[13]This would provide a more theoretically defensible, although difficult to quantify, definition of strategic goods—those providing Soviet gains from trade above some accepted threshold.

change or nonchange in military spending can have an ambiguous interpretation: What would have been the case had there been no denial may remain known only to the Politburo. But the link may be weak for important policy reasons. Even if total import resource supply from the West were cut off, the Kremlin might wish to maintain the previous defense level (or growth rate) while cutting back on nondefense. Of course, the Politburo cannot indefinitely squeeze consumption and investment without endangering political stability or future growth, including future defense growth. However, political stability might be protected by measures of discipline—some form of neo-Stalinism, perhaps—which might also raise productivity and ease the resource allocation dilemma. Even if such a change in regime internal policy were not possible and "something had to give," the point at which the change in preferences with respect to external policy would take place cannot be predicted.[14]

2. It has been suggested that denial as a strategy of suasion is likely to be effective, if at all, only in the long run, because the connection between defense spending and military power involves time lags. It is, of course, not the Soviet Union's military spending that concerns us, but its military power. Military power is to military spending somewhat as capital is to investment. Investment growth can fall to zero, yet capital will continue to grow indefinitely. If Moscow froze its military investment (procurement and construction) at any given level, all other characteristics of its military machine kept constant, Soviet military power would continue to increase. If the Politburo decided to cut back the level of spending, an act unprecedented since the 1950s, Soviet military power would decline, but at a slower rate.[15] Soviet *behavior* might not change until considerably after the effects on the stock of military capital became apparent, not only to Soviet leaders, but to adversaries as well. It now appears that the CIA has revised downward its estimates of Soviet military spending in the late 1970s, reflecting a levelling off of the estimated value of procurement.[16] The nature of the estimating process is such that it took a few years for this important change, if such it is, to be observed. There is apparently considerable uncertainty about the causes of the change, but few would

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[14]For a fuller discussion of these issues, see Abraham S. Becker, *The Burden of Soviet Defense: A Political-Economic Essay,* The Rand Corporation, R-2752-AF, 1981, and Becker, "Sitting on Bayonets? The Soviet Defense Burden and Moscow's Economic Dilemma," *Soviet Union,* 10, Parts 2–3, 1983, pp. 287–309.

[15]If operation and maintenance costs were also frozen or reduced, military capital might be less well maintained, thereby affecting military power.

[16]"Soviet Defense Trends, A Staff Study Prepared for the Use of the Subcommittee on International Trade, Finance and Security Economics of the Joint Economic Committee, Congress of the United States," September 1983, p. 6.

argue that it has been accompanied by a mellowing of Soviet rhetoric or behavior.

3. Although reduction of Soviet military power may be viewed as an end in itself, denial as a strategy of suasion aims to curb aggressive Soviet behavior. Undesirable Soviet behavior is not a simple function of defense spending or even of military power. It is not easy to establish a correlation between growth of Soviet power and increases of Soviet nastiness. In the past, the Kremlin's perception of its own weakness was often associated with promotion of international tension.

4. The Soviet leaders would have no incentive to alter their behavior if they were able to cope painlessly with the effects of denial, even or especially in the long run, which allows time for adjustments. Kremlin occupants have a natural tendency to reason that any sign of Soviet yielding would only intensify Western pressure. There is considerable debate about the vulnerability of the Soviet economy to external pressure; that subject is addressed in Sec. III. To induce alteration of the Soviet leaders' behavior, if they are able to adjust successfully to long term resource denial,[17] would at the minimum require a Soviet perception that the West not only has a credible capability to restrict the resources available to Moscow but is also prepared to withdraw the restriction in response to desired Soviet behavior. Depending on the success of the Soviet adjustment efforts but also on the value of the concession required of the Kremlin, readiness to cease inflicting pain might not be sufficient either and might have to be supplemented by positive incentives. In short, denial alone may not be sufficient for suasion. Whatever the international political context of the moment, it is doubtful that denial alone would be able to force alteration of Soviet behavior with respect to issues and areas of "vital" concern to Moscow—for example, in Eastern Europe. The Polish crisis brought this question to the forefront in recent years (see the discussion in Secs. V and VI).

Any leverage strategy will also have limited powers of suasion on the actions of a superpower. There is no consensus among analysts or policymakers as to whether the addition of carrots to sticks would make a difference where "vital" Soviet interests are concerned. (One reason is that a systematic strategy of this kind has never been attempted.) If the Politburo yielded, it might ask itself if the Western sanction would actually be withdrawn or the ante raised—would the West link a dif-

[17]Successful adjustment here means limiting the political damage caused by the output changes forced on the economy by the denial measures. Of course, if the government were also able to limit the reduction in economic potential linked to the act of denial, there would be even less reason to accede to the foreign pressure.

ferent aspect of Soviet policy or behavior to the termination of the sanction or bestowal of benefit? Moscow would be likely to believe that Western success in a leverage attempt would inevitably lead to repeated efforts to exert leverage, with probably more damaging sanctions levied or threatened in succeeding rounds. This logic would probably be offered in Kremlin councils even in regard to Western pressure on minor Soviet interests. With respect to "vital" interests, only extraordinary weakness would prevent the argument from dominating the debate.

Leverage has at least two additional serious drawbacks—the difficulties of sizing appropriate "dosage" of denial (with or without bestowal of benefits) and of defining the Soviet behavior modification that would be worth the outlay of a particular leverage "dose." Konrad Adenauer opposed President Kennedy's grain sale in 1963 except as a quid pro quo for the destruction of the Berlin Wall.[18] These difficulties were in the forefront of the 1974–1975 debate on the linkage of Soviet Jewish emigration and the U.S.-USSR trade agreement.[19] They have remained central in subsequent discussions of the problems of affecting Soviet behavior.[20]

The character of the problems involved may be further illustrated by consideration of the oft-suggested linkage of economic relations and arms control regulations between the United States and the USSR. Could constraints on resource availability of the type discussed here be adapted for use as a tool of arms control negotiations? Resource denial measures might lead to reconsideration by the Politburo of the priority it attaches to defense spending and thereby to greater willingness to make arms control concessions. Thus, denial might be seen as having an arms control payoff. However, using the threat of resource denial, alone or even in conjunction with promises of resource grants, as a tool of leverage in arms control negotiations is unpromising because it is

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[18]Angela Stent, *From Embargo to Ostpolitik, The Political Economy of West German-Soviet Relations, 1955-1980*, Cambridge University Press, New York, 1981, p. 123.

[19]Henry Kissinger complained that the Nixon administration's efforts to develop a strategy of advance in Soviet-American relations on a broad policy front were criticized for the very notion of linkage, when the intended connection was to Soviet foreign policy, but some of the same critics demanded linkage with Soviet domestic structure—"a far more ambitious form of linkage"—on the issue of East-West trade. *White House Years*, p. 1272.

[20]An interesting contemporary example is the discussion of the extent of Soviet responsibility for the spread of revolutionary sentiment in Central America and what the United States can do about that connection. Senator Moynihan, convinced that "the decisions about Nicaragua are made in Moscow," urged threatening the Soviet Union with a grain embargo and a declaration of default on Polish debt, "and as many other unpleasant things as we can arrange." *Washington Post*, July 25, 1983.

extremely difficult to define the "exchange rate" between quid and quo. It is hard enough for each of the negotiating parties to estimate tradeoff rates between different elements of a strategic weapons package—what is the worth of one side's cutting back on cruise missile deployment relative to the other side's dismantling of heavy ballistic missiles? The problem seems insoluble when posed in terms of economic leverage: By how much should the West reduce new credit flows to the East if the Soviets refuse to reduce the number of their heavy missiles by x percent? Not only is the appropriate tradeoff likely to be unclear to the West, but there will be equal or greater uncertainty about its magnitude as perceived in Moscow. If, as many believe, the West is handicapped in its ability to bargain with the Soviet Union under such conditions of uncertainty, there would be a danger of squandering the West's economic benefit coin in these negotiations. Once expended on arms control concessions, the leverage would not be available for other purposes.

There is no denying the difficulty of answering the questions, how much leverage and for what? The difficulty is aggravated by the discordance of views within the United States and among members of the Western alliance, a factor that is a major barrier to the successful prosecution of denial as well (see Sec. VII). Modifying Soviet behavior must surely depend heavily on convincing Moscow that cost-imposing sanctions will not be withdrawn arbitrarily or prematurely and that equivalent penalties are likely to be imposed in any future circumstances similar to those in which the original penalty was levied. There is no cheap substitute for consistency of long term goals and constancy of their pursuit, and American foreign policy has not distinguished itself on either count. This may well have contributed to the "dissensus" in the alliance on East-West relations, but the intra-West conflicts represent a further major obstacle to the development and implementation of successful suasion strategies.

III. SOVIET VULNERABILITY TO EXTERNAL ECONOMIC PRESSURE

Strategies of influencing Soviet behavior by means of economic instruments require that the USSR be responsive to the external economic pressures, positive or negative. Such accessibility would appear to result from the importance to the Soviet economy of foreign economic relations, particularly those that can be influenced by the wielders of leverage or denial. However, raising the issue of the probability of success in affecting Soviet *behavior* introduces a political dimension. The debate on East-West trade policy often fails to differentiate clearly between economics and politics and even among the economic factors alone. This section will attempt to distinguish first between participation in and dependence on trade, and second between purely economic measures of trade importance and what is the ultimate concern of the policy strategist, political-economic vulnerability to external economic pressure.

The first two concepts are straightforward, readily definable economic indicators. *Trade participation* refers to the quantitative importance of foreign trade in the economy and is measured simply as the ratio of the value of foreign trade flows to aggregate output, usually gross national or gross domestic product (GNP or GDP). A more sensitive measure of the economic importance of trade, *trade dependence,* would be the opportunity costs of reducing trade participation, in terms of the costs of substituting domestic goods for imports (a reduction in export proceeds would ultimately translate into an analogous sacrifice). However, even high dependence by the target state need not result in a submission to foreign pressures. *Trade vulnerability*, the likelihood of having to submit, depends on many variables, political and economic, external and internal to the target state. Vulnerability is far more difficult to measure than the purely economic indicators of trade participation and trade dependence, and the discussion below of Soviet vulnerability will necessarily be somewhat general.

SOVIET TRADE PARTICIPATION AND DEPENDENCE

Soviet participation in international trade, especially trade with noncommunist countries, has changed dramatically since World War II. The Stalinist economy was fundamentally autarkic in spirit and

objective. Trade with the external world might periodically increase because of special circumstances—for example, imports of capital equipment for the early industrialization effort (and even exports of grain in the midst of domestic famine to finance that drive). Lend-lease imports during World War II were obviously an emergency measure. But the policy objective was essential self-sufficiency, and the goal contributed to but was also bolstered by pervasive suspicion of the capitalist world. In the 30 years following Stalin's death, Soviet trade policy has been transformed. Trade turnover is almost 40 times higher in current prices and nine or ten times higher in physical volume, according to Soviet statistics. Soviet political leaders and trade officials speak approvingly of the international division of labor and the benefits that the USSR may derive from it. Thus, Soviet attitudes to involvement in international economic relations seem to have turned from hostility and reluctance to positive acceptance. The results of that change are visible in sharply increased trade flows, a network of commercial agreements, participation in trade fairs, exchanges of delegations, etc.

Nevertheless, it remained conventional wisdom that trade played a fairly minor role in the economy as a whole. The USSR was a continental power with a largely self-sufficient economy. The undoubted change in Moscow's view on the utility of economic intercourse with the outside world had not greatly affected the low dependence of the USSR on foreign trade. This view has now been challenged by Vladimir Treml in association with Barry Kostinsky. In Treml's words, "the old perception of the Soviet economy as self-sufficient and isolated from the rest of the world should be revised. The Soviet economy has become relatively much more open to external market forces and displays significant dependence on external markets."[1] This conclusion is based on estimates of the domestic value of Soviet trade turnover that show it to be considerably higher than Soviet published values at "foreign trade" prices. The latter represent essentially world market prices (lagged and otherwise adjusted with respect to Eastern Europe) translated to rubles at the official exchange rates. However, the exchange rates are arbitrary; values at actual domestic prices, estimated by Treml and Kostinsky, depart substantially from the figures at foreign trade rubles.

The participation rates implied by the Treml-Kostinsky estimates, shown in Table 2, are generally higher than rates obtained with trade values expressed in foreign trade rubles. The gaps between the two

[1]Treml, prepared statement in *The Premises of East-West Commercial Relations,* p. 110.

Table 2

RATIOS OF FOREIGN TRADE AT DOMESTIC PRICES TO SOVIET NATIONAL OUTPUT, 1960–1980

(In percent)

	NMP Ratios			GNP Ratios		
	Imports	Exports	Turnover	Imports	Exports	Turnover
1960	8.3	3.7	12.0	6.6	2.9	9.5
1965	8.1	4.3	12.4	6.0	3.2	9.2
1970	8.6	6.3	14.9	6.5	4.8	11.3
1975	15.0	6.3	21.3	10.7	4.5	15.3
1980	20.1	6.9	26.9	14.5	5.0	19.5

SOURCES: Foreign trade values at domestic prices through 1978 were estimated by Vladimir G. Treml and Barry L. Kostinsky and the series extended to 1980 by Treml. See the latter's statement, "Measuring the Role of Foreign Trade in the Soviet Economy," in Committee on Foreign Relations, U.S. Senate, *The Premises of East-West Commercial Relations,* Washington, D.C., December 1982, p. 98. I have calculated the GNP ratios using the Treml-Kostinsky foreign trade values and dividing by CIA estimates of GNP for 1960, 1970, 1976 and 1980, published in CIA, *Soviet Gross National Product in Current Prices, 1960-80,* SOV 83-10037, March 1983, p. 2. A GNP value for 1975 was computed from the 1976 figure using the relative increase for 1976 over 1975 at 1970 prices estimated by CIA, 4.8 percent (Joint Economic Committee, U.S. Congress, *USSR: Measures of Economic Growth and Development, 1950-80*, Washington, D.C., December 1982, p. 58). GNP in 1965 at current prices was calculated on the assumption that the rate of change at current prices between 1960 and 1965 was equal to the product of real growth, 27.8 percent (CIA estimates at 1970 prices from *USSR: Measures of Economic Growth*, p. 53), and the implicit GNP inflator, calculated by CIA as growing at 2.3 percent per year in the 1960s (*Soviet Gross National Product in Current Prices,* p. 6), or 12.04 percent in five years.

NMP = net material product.

sets of rates are relatively large. The ratio of total turnover at foreign trade prices to net national product (NMP) in 1980 is only 20 percent,[2] compared with 27 percent when imports are valued at domestic prices. The participation rates have grown over the past two decades, especially on the import side: Imports were only 8 percent as large as

[2]TsSU SSSR, *Narodnoe khoziaistvo SSSR 1922-1982,* Moscow, 1982, pp. 417, 577. However, the export ratio is higher in foreign trade than in domestic prices from the mid-1970s on.

NMP in 1960 and that ratio has since jumped to 20 percent. Almost all of the change took place in the 1970s, when the Soviet Union became much more involved with international trade than probably in any previous period of its history. The higher participation rates implied by the Treml-Kostinsky estimates place the Soviet Union in a category comparable to some of the major trading nations of the West. The Soviet import rate is lower than those of the European Community nations or Sweden, for example (27 percent in 1980), but it is higher than the U.S. rate (8 percent) or even that of Japan (12 percent).[3]

The Treml-Kostinsky results have been criticized by Jan Vanous of Wharton Econometric Forecasting Associates (WEFA).[4] Vanous argues that a dependency ratio is properly calculated when both trade numerator and output denominator are valued at domestic scarcity (shadow) prices; the Treml-Kostinsky calculation must be greatly biased because of distortions in the Soviet price system. Vanous recalculated the participation rate in 1980 at what he believed to be an approximation to world market prices (and related to GNP rather than NMP), with the following results:

	Participation Rates (%)	
	World Market Prices	Treml-Kostinsky Domestic Prices
Imports	4.1	15.0
Exports	6.0	5.2

Vanous concluded "that the correct interpretation of the Kostinsky-Treml study is that it shows how seriously distorted and irrational the domestic Soviet relative price structure is. The study does not provide good information on the dependence of the Soviet economy on foreign trade." Vanous concedes that the perception of Soviet decisionmakers may be shaped by results like those produced by the Treml-Kostinsky study, but this would show "just how seriously misled the Soviet decisionmakers may be by their own statistics."

[3]Western rates are calculated from values of imports and GNP in dollars in CIA, *Handbook of Economic Statistics 1982*, pp. 38 and 82.

[4]In the WEFA bulletin, *Centrally Planned Economies Current Analysis*, No. 56, July 14, 1982, reprinted in Committee on Foreign Relations, U.S. Senate, *The Premises of East-West Commercial Relations*, Washington, D.C., December 1982, pp. 95–98.

Vanous is of course correct in calling attention to the deficiencies of the Soviet price system, but the solution should have been, in principle, to adjust the ruble values to an approximation of the theoretical requirements, following the lead of Abram Bergson, who adjusted the components of his independent estimates of Soviet national income and product.[5] Vanous's dollar translation instead imposes an alien set of scarcity relations bearing only an incidental relation to those prevailing in the USSR.[6] Treml has counterargued that on "index-number problem" grounds and assuming the USSR imports commodities that are relatively expensive to produce at home, the import/GNP ratio is bound to be lower at external than at domestic prices.[7] It is likely, therefore, that even after adjustment for Soviet price distortions, the calculated import participation rate would be greater than at external prices, and possibly considerably so. Most likely, the export participation rate will not differ much in the two calculations.

Even if the Treml-Kostinsky participation rates are correct, their interpretation in terms of trade dependence of the economy is not self-evident. To begin with, only a third of all Soviet imports come from the West; the other two-thirds originate in Eastern Europe, other socialist countries, and the third world.[8] Soviet rates of participation with respect to trade with the West are consequently much smaller than the figures of Table 2—perhaps half as high in the more interesting case of imports.[9] Second, the guidance supplied by any given participation rate is less clear than that provided by defense/GNP ratios as measures of defense burden. On the whole, low defense/GNP ratios can be taken to signify low real defense burdens; but a low participation rate does not necessarily mean low trade dependence, if dependence means high costs of substituting domestic goods for imports or

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[5]Abram Bergson, *The National Income of Soviet Russia Since 1928,* Harvard University Press, Cambridge, 1961.

[6]As Treml correctly notes in his rebuttal to the WEFA critique, Vanous has in fact calculated a hybrid ratio: Soviet trade at world market prices divided by Soviet GNP at U.S. prices. "U.S. domestic prices of goods traded internationally are probably close to world market prices. However, a large subset of U.S. goods and services is not traded outside of the country and the prices of this subset do not reflect world market forces."

[7]Treml's response, which appeared in a WEFA Current Analysis, August 6, 1982, "Measuring the Role of Foreign Trade in the Soviet Economy," was reprinted in *The Premises of East-West Commercial Relations,* pp. 98–101. See also Sec. IV of his paper, "Soviet Dependence on Foreign Trade," for the 1983 Colloquium of the NATO Economics Directorate, "External Economic Relations of CMEA Countries."

[8]However, part of Soviet imports from Eastern Europe originate in the West too.

[9]The Western-trade participation rate is probably not proportional to the Western share of total imports, because Moscow permits East European exports to the Soviet Union to be overpriced relative to the world market for goods of comparable quality.

doing without exports.[10] This would not be true, for example, if a few commodities (or commodity groups) dominate in either exports or imports, or if the dominant imports have few substitutes in use and constitute a high fraction of total internal supply of these goods. Both of these conditions relate in greater or lesser degree to the Soviet Union.

The basic issue of trade dependence is tradeoffs. As in the case of defense burden, tradeoffs are only crudely measured by shares of national output, even where relative price weights are meaningful. For this purpose one needs some kind of quantitative model of the economy, preferably disaggregated, that explicitly allows for interindustry relations. In such a model, dependence would be gauged by the concrete sacrifices/gains of output that would result from changes in trade flows. Several Western scholars have examined the role of East-West trade, particularly technology transfer, in the Soviet economy. These studies, as Hanson notes, "have varied considerably in scope, aims, methods, and conclusions." Reviewing the major contributions, Hanson finds that macroeconomic analysis provides contradictory and inconclusive evidence on the importance of machinery imports, but case studies of technology transfer to particular industries suggest these imports have much greater utility. "The lesson of the industry case studies," he concludes, "is that the Soviet civilian economy has derived benefits from technology imports that are large enough to carry some weight with Soviet policymakers."[11] The conclusion is measured, befitting the difficulty and ambiguity of the data.

Hanson's review covers the evidence for the 1960s and the 1970s of the objective role of trade and especially technology imports. Evidence on Soviet perceptions suggests that at least for a time in the 1970s the Soviet leadership attached high value to Western imports as a means of accelerating the modernization of the economy. The U.S. government has stressed the importance of Western technology in the Soviet military modernization effort.[12] Presumably, this reflected a recognition of the unfavorable tradeoffs involved in substituting domestic for imported products—the definition of high trade dependence set out at the beginning of this section. More recently, however, there were high

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[10]The converse is less likely to be true: High participation rates tend to signify high dependence on foreign trade.

[11]Philip Hanson, "The Role of Trade and Technology Transfer in the Soviet Economy," in Abraham S. Becker (ed.), *Economic Relations with the USSR, Issues for the Western Alliance,* Lexington Books, Lexington, Mass., 1983, pp. 39–43; the quotations are from the first and last pages of this segment, respectively.

[12]See, for example, Stephen D. Bryen, "Strategic Technology and National Security," *Journal of Electronic Defense,* May 1983 (25), pp. 45–52.

level Soviet criticisms of the policy and some falloff in actual import volumes.[13] However, the aggravated retardation of Soviet economic growth in 1979–1982 and the poor prospects of substantially improving on that record over the rest of the decade may revive Moscow's interest in Western capital and technology.[14] In the meantime, the USSR has concluded a series of long term agreements to insure a steady, if limited, supply of grain (see Sec. IV). Soviet dependence is real if not overwhelming.

DEPENDENCE VS. VULNERABILITY

Whatever the actual level of Soviet dependence or its perception on the part of Soviet leaders, the various efforts at turning this dependence to Western advantage during the last ten years have generally failed. Soviet dependence has not brought with it much vulnerability to external trade pressures. For any given level of dependence, vulnerability depends in part on the structure of the import and export markets—"dependence" is a characteristic internal to the trading economy, but "vulnerability" is partly an exogenous factor. In 1979–1982, the USSR sold an increasing share of its exports (at foreign trade prices) to noncommunist countries. That should have made it more vulnerable, but the behavior of the customers suggests the shoe was on the other foot. In 1979–1981 the Soviets also bought an increasing share of their imports from noncommunist countries. In this share the fraction of hard goods was falling and that of food was rising. But the food suppliers acted as if they were in perfect competition, and the expected Soviet vulnerability faded in the din of the foreign exporters' domestic pressures for maintaining or increasing sales.

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[13]Hanson, "The Role of Trade and Technology Transfer in the Soviet Economy," pp. 30–38, on Soviet views and pp. 24–30, on trade patterns. Nevertheless in the last half of the 1970s, the import participation rate increased from 15 to 20 percent of NMP. According to WEFA calculations based on the Treml-Kostinsky estimates, the share of machinery imports from the West in the equipment component of domestic investment was 3–5 percent in 1965–1974, 9 percent in 1975, and 8–10 percent thereafter. (Daniel L. Bond and Herbert S. Levine, "The Soviet Machinery Balance and Military Durables in SOVMOD," Joint Economic Committee, U.S. Congress, *Soviet Economy in the 1980's: Problems and Prospects*, Part 1, Washington, D.C., 1983, p. 307.) Treml cites Soviet estimates that "around 1980" imports from all sources accounted for 20 percent of investment in machinery and equipment. (Treml, "Soviet Dependence on Foreign Trade.")

[14]Abraham S. Becker, "East-West Economic Relations: Conflict and Concord in Western Policy Choices," in Uwe Nerlich and James A. Thomson (eds.) *The Future of East-West Relations: U.S. and German Approaches to Soviet Power*, forthcoming. To be published also in *Atlantic Quarterly* (London), Vol. 2, No. 1.

Even if the external market structures are favorable to the exertion of pressure, the pressure may not succeed: The factor of difference is the political will to resist the pressure and assume the attendant costs. Vulnerability to economic pressures, much like the importance of the defense burden, is ultimately a political question. The fundamental criterion of vulnerability is therefore political and perceptual rather than statistical or economic, especially because of Western inability to imperil the survival of the Soviet economic system. The issue is what costs Soviet leaders are prepared to accept:

> Any economy experiencing even a total embargo in its trade with the world can, under moderately skillful political and economic leadership, contain the damage caused by that embargo if it is relatively well-endowed with natural resources, can produce most of what it imports (albeit at a higher cost to society), and learn to produce that which it needs, but does not produce at the time the embargo is imposed. The Soviet economy is, like it or not, in that position for all commodities except possibly food.[15]

Even a total interdiction of food exports to the USSR would entail economic deprivation and political costs but would be unlikely to bring about economic or political collapse.

Because vulnerability is really a function of perceptions, the likelihood that trade manipulation will be effective depends on Moscow's evaluation of the costs of yielding. Presumably, the resource costs of accepting (or circumventing) the sanction, the costs of rearranging production plans and substituting for badly needed imports or traditional hard currency earning exports, will play some part in the calculation. But there will be a limit to the escalation of these costs, because even with the severest sanctions, assuming the economic system survives, major disruptions will take place in the short and medium term. With time, as the economy adjusts, the effects will dissipate, probably in exponential fashion. This does not mean that Moscow will never yield, only that the likelihood of yielding will be greater if the political disutility of yielding is perceived to be tangibly smaller than the economic costs of adjusting to the sanction.

Accordingly, the West's best chance for success lies in connecting major economic benefits or penalties with fairly minor political objectives of trade manipulation. The history of such efforts over the last few decades has generally featured the reverse linkage, weak economic

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[15]Ed. A. Hewett, "The Soviets Aren't That Vulnerable to Economical Sanctions," *The Washington Post,* July 16, 1982, p. 15. In fact, food is probably not an exception either. See also Herbert S. Levine, "Systemic Constraints on Economic Leverage: Communist/Command Systems," in R. Bissell and G. McCormack (eds.), *Strategic Dimensions of Economic Behavior,* Foreign Policy Research Institute, forthcoming.

instruments with important political goals of Soviet domestic or foreign policy change—e.g., a minor reduction in grain availability for Soviet withdrawal from Afghanistan. But it is the eye-catching Soviet transgressions that focus Western attention and trigger economic sanctions. Trade manipulation for less than headline crises is difficult to organize and sustain in a democracy.

In the final netting, Soviet vulnerability is smaller than the statistics of trade participation and dependence imply.

IV. GRAIN SALES BETWEEN ENCOURAGEMENT AND EMBARGO

"Only the stupidest calves choose their own butcher." Konrad Adenauer in 1963, opposing the sale of wheat to the USSR.[1]

Ability to exert economic leverage or to deny resources is usually thought to result from an asymmetry of trade dependencies. The target state has a greater dependence on imports (exports) than the state wielding leverage or denial has to export (import).[2] Because food is a basic human requirement, major food producers and exporters have often been seen as having potential power over food consumer-importers. Russia was historically a net exporter of grain on a substantial scale, and with minor exceptions this was true of the Soviet Union as well until the 1970s. But as Soviet farm production failed to keep pace with rapid growth of consumer demand, encouraged by substantial increases in money income, the USSR became a steady net importer of grain, mostly from the United States. There was, consequently, a widespread U.S. belief in the 1970s that Soviet agricultural weakness constituted a vulnerability to external pressure, a basis for exploiting U.S. agricultural strength to the West's political advantage. However, as a result of the grain embargo of 1980–1981 and the subsequent development of American policy, grain sales have been virtually ruled out as a weapon in the competition with the USSR. This section summarizes how that unexpected development came about and examines the logic of the choice.

LEVERAGE EFFORTS IN THE 1970s

The West was slow to recognize the sea change that took place in Soviet grain trade policy as the Soviet leadership became committed to improving the consumer's diet. The major emphasis was on increasing meat production, hence the derived requirement for increasing quantities of feed grain. Periodic harvest shortfalls pointed up the inadequacy of the Soviet agricultural base and moved the Politburo to accept

[1]Quoted by Angela Stent, *From Embargo to Ostpolitik*, p. 123.

[2]Extending the reasoning of the previous section, the wielder of leverage may nevertheless pursue his goal despite higher dependence than that of the target, given sufficient political will.

the necessity for dependence on foreign supplies as supplements to fluctuating domestic output. This picture became clearer only in the second half of the 1970s, and the most serious effort to use grain as a leverage tool came only in 1980. However, on several earlier occasions, Washington perceived Soviet needs for grain imports and attempted to exploit the opportunity to U.S. advantage.[3]

- In June 1971, President Nixon encouraged U.S. agricultural exports to the Soviet Union as a reward for apparent Soviet pressure on Hanoi to be forthcoming on the Vietnam peace plan.
- A year later a similar Soviet effort was rewarded by U.S. action to facilitate negotiation of a grain agreement. On August 1, 1972, the United States agreed to sell the Soviets on credit a minimum $750 million worth of grain over a period of three years.
- U.S. threats to suspend grain sales were seen as curbing Soviet interference in the Middle East disengagement negotiations in the first part of 1974. Washington also believed that the disastrous Soviet harvest of 1975, resulting in the need for substantially increased grain imports, stayed Moscow's hand in the 1975 Middle East peace negotiations.

The size and the purchasing methods of the first major Soviet venture into the international grain market in 1972 were unexpected and triggered cries in the United States of a "Great Grain Robbery." Memories of this incident and nervousness about the domestic price effects of large sales to the USSR led to an "informal" Ford administration embargo on sales in the summer of 1975, on the expiration of the 1972 agreement. Secretary of State Kissinger attempted to convert that act and the Soviet needs into a lever for obtaining Soviet oil at a large discount from the OPEC prices. But he was frustrated by Soviet purchases of grain from other suppliers and intense opposition by the American farm lobby on the eve of the presidential election campaign.[4] The embargo was lifted in October, when Washington and Moscow signed a five year trade agreement. The agreement provided for minimum annual purchases by the USSR of six million tons, Soviet right to purchase an additional two million tons without consulting the U.S. government, and the possibility for negotiating further Soviet purchases.

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[3]These episodes are reviewed in Dermot Healy, *The Grain Weapon,* Centrepieces Number One, Centre for Defense Studies, University of Aberdeen, Spring 1982.

[4]An analysis of the 1975 episode is provided in Roger B. Porter, "The U.S.-USSR Grain Agreement: Some Lessons for Policymakers," *Public Policy,* 29:4, Fall 1981, pp. 527–551.

The 1975 grain agreement was intended to help insure an orderly and reliable market over its five year span, but it also institutionalized a response to a fundamental Soviet need. The regularization of supply could have been viewed as the basis for positive leverage, and the provisions for negotiated, above-minimum sales might have been seen as potential negative leverage. However, no further attempts were made in the 1970s to utilize the leverage potential of the grain agreement. In December 1975 and January 1976 Secretary Kissinger and U.N. Representative Daniel Moynihan urged President Ford to suspend grain sales in connection with Soviet involvement in Angola, but the President demurred for both domestic political reasons and the desire to protect SALT and detente. President Carter was similarly urged by his national security adviser, Zbigniew Brzezinski, to use grain sales as a weapon against Soviet intervention in the Ethiopian-Somali war in the summer of 1978 and the persecution of prominent Soviet dissidents. On the advice of Secretary Vance and in defense of SALT again, the President chose to confine himself to some constraints on technology transfer.

THE EMBARGO OF 1980 AND ITS AFTERMATH

President Carter viewed the Soviet invasion of Afghanistan in December 1979 far more seriously. In January 1980, among other actions, he levied a partial embargo on grain sales to the USSR. At the time of the invasion, the Carter administration had agreed to sell the USSR a total of 25 million tons of grain. President Carter then refused to sell the 17 million tons above the eight million to which the Grain Agreement bound the United States.[5] The Soviets managed to pick up all but perhaps six million tons of the embargoed amount from other producers—particularly, Argentina, Australia, Canada, and the European Community—although at a probably large increase in cost. Inflicting a consumption penalty on the Soviets for their invasion was the prime goal of the embargo, but livestock numbers and meat produc-

[5]There has been some confusion about the amount of grain denied the Soviets because of different estimates of the amount the USSR intended to import. For unexplained reasons, a recent U.S. Department of Agriculture paper indicated that the Soviets were denied only 12 million tons, although 27.5 million were contracted for and the minimum under the Grain Supply Agreement was eight million tons. Angel O. Byrne et al., "U.S.-USSR Grain Trade," in Joint Economic Committee, U.S. Congress, *Soviet Economy in the 1980's: Problems and Prospects,* Part 2, Washington, D.C., 1983, p. 64. The figure of 17 million tons seems widely accepted.

tion were only marginally affected.[6] Because there was also no noticeable change in the Soviet stance with regard to Afghanistan, the world judged the embargo a failure.

A major additional argument of the embargo's detractors was that it caused losses in U.S. farm income, and that charge became generally accepted. The farm lobbies had initially accepted the need for the embargo with some reluctance; but as farm income fell in 1980, they led a vociferous campaign to rescind the sanction. That position was accepted by the Republican Party in the presidential campaign. Fulfilling his campaign promise, President Reagan lifted the embargo soon after assuming office, on April 24, 1981.[7]

The 1980 embargo was by definition an act of denial whose proximate objective was to punish the USSR by reducing its meat supply, but it did not emerge from a strategy of denial. Neither was it an integrated application of leverage. The action could be explained as an expression of protest over the Soviet invasion of Afghanistan. There appeared to be little thought of maintaining the embargo over the long term to force the Soviets into expensive import-substitution, in the hope of putting pressure on the military budget. There was a hope that the costs imposed on the USSR would act as a deterrent against further or future aggression. But the conditions for termination of the sanction were not spelled out—the Carter administration considered it quixotic to link the embargo explicitly to evacuation of Soviet forces from Afghanistan—so the act's leverage potential was undeveloped.

It will be argued below that the embargo was in fact a partial success, although not in terms of the Carter administration's goals or expectations. But even the failure in those terms, resulting from Soviet circumvention of the sales ban, was not preordained. A recent study of the embargo, based on personal interviews with key actors in that experience, suggests that the Soviet circumvention was made possible by maladroit U.S. handling of the negotiations with other suppliers, particularly Argentina.[8] Whatever the validity of that argument, however, the embargo induced the USSR to diversify its grain supply

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[6]Numbers of head of livestock changed as follows in 1980 compared with 1979 and in 1981 compared with 1980: cattle, 0 and +0.7 percent; hogs, −0.7 and −0.1 percent; sheep and goats, −1.3 and +0.7 percent. Meat production declined 1.3 percent in 1980 and increased 0.7 percent in 1981. TsSU, *Narodnoe khoziaistvo SSSR 1922-1982,* Moscow, 1982, pp. 271–275. CIA estimates a 3.2 percent drop in meat production in 1980 and a 1.3 percent recovery in 1981 (*Handbook of Economic Statistics 1982,* p. 36).

[7]However, the other Carter administration sanctions on exports of high technology products and Soviet fishing in American waters remained in force.

[8]John C. Roney, "Grain Embargo as Diplomatic Lever: A Case Study of the U.S.-Soviet Embargo of 1980–81," in *Soviet Economy in the 1980's: Problems and Prospects,* Part 2, pp. 130–133.

base. By now Moscow has concluded bilateral multi-year grain agreements not only with the United States, but also with Argentina, Brazil, Canada, and Thailand; there is an annually negotiated agreement with Australia. As a result, the Soviet Union is assured of about 10 million tons of grain a year apart from the contracted amounts forthcoming from Australia and the United States. In 1981–1982, the United States supplied only a third of Soviet net imports, compared with 65 percent in the period 1975–76 to 1979–80.[9] In the fall of 1982 the U.S. Department of Agriculture expected that the United States would supply only about 10 million tons of wheat and coarse grains combined, out of a total projected Soviet buy of 34 million tons.[10] Should the United States decide again to embargo grain sales to the USSR in response to whatever objectionable Soviet action, this network of agreements will constitute a formidable barrier to securing the cooperation of foreign exporter-producers.

In addition, U.S. policy and law are now clearly set to a repetition of the 1980 episode. Administrative and legislative action since the President's revocation of the embargo has barred the door to U.S. foreign policy use of agricultural exports with a triple lock. Under an amendment to the Agriculture and Food Act of 1981, any future restriction on the export of an agricultural commodity for reasons of security or foreign policy, imposed other than in connection with a suspension or restriction of all U.S. exports, would require extensive compensation to the producers. Further, a December 1982 bill bars the president from prohibiting or restricting the export of any farm commodity under contract at the time he announces any restriction on international trade, if the contract calls for delivery of the commodity within nine months of the imposition of the restriction.[11] The third lock is the Long Term Grain Agreement with the USSR, signed in the summer of 1983. The agreement raises the annual minimum sales level to nine million tons and allows an additional three million tons of sales without consultation. Like the 1975 agreement before it, the 1983 agreement forswears the right to curtail sales of these 9–12 million tons for foreign policy purposes (Article II):

> During the term of this Agreement, except as otherwise agreed by the Parties, the government of the U.S.A. shall not exercise any discretionary authority available to it under United States law to control

[9]Ibid., p. 126.

[10]Byrne and others, "U.S.-USSR Grain Trade," p. 67.

[11]*Congressional Quarterly*, December 18, 1982, p. 3053 and January 15, 1983, p. 87. The bill does allow for an exception in time of war and national emergency, and the president has considerable latitude in deciding what constitutes an emergency.

exports of commodities purchased for supply to the USSR in accordance with Article I.[12]

U.S. farmers are eager to sell and the U.S. government is now bound by law not only to sell the contractual minimum under the grain agreement without political strings, but to execute all agricultural export contracts. An unidentified official of the U.S. Department of Agriculture said that "it would have to be a very serious thing, a national emergency, a severing of diplomatic relations, almost a state of war for the United States to curtail supplies."[13]

Thus, although the Soviet need and willingness to import large amounts of grain create an opportunity for the use of grain trade in support of foreign policy objectives, the objective conditions are highly unfavorable for such a course. But would manipulation of grain sales be justified? Whose national interests are served by selling or not selling to the USSR? Was Adenauer right? These questions are addressed in the rest of this section.

WHO BENEFITS FROM GRAIN SALES?

The analysis below of the advantages and disadvantages of grain sales to the USSR is involved and ultimately inconclusive. The answer to the question, Do the Soviets benefit by importing grain from the West, is surely yes, although the Soviet gain is smaller than it could be. But it is not self-evident that the West would benefit by denying the Soviets grain over the long term. Whether positive or negative responses are appropriate—indeed, whether any conclusion can be more than speculative—depends on several factors, not just the effectiveness of an effort at denial, but also the likelihood that sales or their denial will trigger specific economic or political consequences. However, the economic costs to the United States of levying an embargo, apart from short term adjustment pains, seem to have been exaggerated. Still, if important interest groups believe they have been harmed, whatever the economist's view of the reality, the political consequences can be serious, as was demonstrated in 1980.

The administration's decision to lift the grain embargo in the summer of 1981 aroused much controversy at home and abroad. Critics of

[12]"Text of American-Soviet Grain Pact," *New York Times*, August 26, 1983. The new agreement drops the "escape clause" contained in the 1975 agreement, which allowed the United States to sell less than the minimum stipulated when U.S. stocks fell below a specified level.

[13]Clyde H. Farnsworth, "U.S. Vow on Grain Delivery," *New York Times*, August 26, 1983.

administration policy on East-West trade, particularly in Europe, have accused Washington of hypocrisy in opposing the gas pipeline deal while eagerly selling grain to the USSR. In its defense, the administration made several claims: (1) In the words of a *Wall Street Journal* editorial (September 24, 1982) "the pipeline involves large subsidized credits at a time of heavy burdens on Western capital markets," whereas U.S. grain sales take place for cash or short term, full market-rate supplier credits; (2) The gas pipeline deal will increase the Soviet Union's hard currency earnings, but U.S. sales of grain sop up Soviet hard currency, which would otherwise be spent on importing Western machinery and technology, directly and indirectly benefiting the USSR's military buildup and the extension of its global empire;[14] (3) A U.S. embargo on grain sales would be quickly undercut by other grain suppliers, as was demonstrated in 1980–1981, damaging only U.S. incomes and output. The *Wall Street Journal* found the first of these arguments persuasive, but it is arguably irrelevant: Even if the loans had been at market interest rates, the administration probably would still have opposed the pipeline deal and would have defended its grain sales on the second ground, which WEFA calls the "financial drain" argument. This and the third claim, which might be called the "leaky embargo" argument, are discussed below.

To start with the last claim first, the issue concerns the costs to the United States of refusing to sell. Only the resource costs are considered here. Much was made in the 1980 campaign of the damage done to farm income. Farm income did decline in that year, but that was because of inflation of farm production costs, not the loss of the export sales. The decline was 38 percent, reflecting the combination of almost unchanged gross income and a 10 percent increase in production expenses. However, cash receipts from marketing of food grains and feed crops, partly because of the compensatory measures undertaken by the Carter administration,[15] jumped 24 percent in 1980 and increased a further 7 percent in 1981. The damage to farm income in 1980 occurred in the livestock sector, not in crop production. It is also

[14]The argument that grain sales draw off hard currency from the USSR and undercut its arms buildup did not originate with the Reagan administration. Angela Stent (*From Embargo to Ostpolitik,* p. 122) cites a National Security Council meeting of October 1, 1963, affirming that "the purchase of U.S. wheat diverts Soviet resources from arms to food." In 1980 then Senator McGovern observed that it was for the same reason that "the National Security Council in recent years has strongly recommended enhanced U.S. grain sales to the Soviet Union." *Suspension of United States Exports of High Technology and Grain to the Soviet Union,* Hearings Before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, Washington, D.C., 1980, p. 20.

[15]For a brief discussion of these measures, see Robert L. Paarlberg, "Lessons of the Grain Embargo," *Foreign Affairs,* 59:1, Fall 1980, pp. 147–148.

true that corn exports declined 3 percent in the fiscal year 1980 and a further 10 percent in 1981, but the value of grain exports rose 36–37 percent (wheat and feed grain and their products).[16] As was to be expected given the existence of an international market, increases in exports to other countries at least partially compensated for loss of sales to the USSR.

Surprisingly large claims about the embargo's damage to the economy have appeared in the press. Most of these seem to originate with a report prepared by a Washington-based research firm, Schnittker Associates, for the National Corn Development Foundation (for distribution by the National Corn Growers Association).[17] The report estimates direct costs in the economic sectors affected and to the U.S. government of $6–8 billion, and indirect costs of $11.4 billion in national output, 310,000 jobs and $3 billion in personal income lost. The estimates of the direct costs (particularly on the balance of payments) raise many questions, but the estimate of indirect costs is hard to take seriously: It assumes a 5:1 multiplier attached to the value of the entire volume of embargoed exports to the USSR, as if the grain had never been produced at all! Regrettably, there does not appear to have been an independent estimate of the true economic costs to the United States of the 1980 embargo.[18]

With respect to the "financial drain" argument, the issue is whether sales of grain to the USSR entail a Soviet net resource loss as the administration argued, or an actual gain as some critics claim? The argument that Western sales of grain sop up Soviet hard currency suggests that Moscow goes to market with cash but no shopping list, prepared to buy whatever it is permitted. Alternatively, the image suggests that if there is a list, the quantities desired are entirely responsive to market prices. This would be true only if Soviet grain imports were totally discretionary. Whether that is in any sense the case will be examined below. The other important issue is how Moscow would react to a Western refusal to sell it grain—what would be the implications for Soviet foreign exchange expenditure?

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[16]U.S. Department of Agriculture, *Agricultural Statistical Handbook 1982,* Washington, D.C., 1982, pp. 31, 384, 425, 530.

[17]"Effects of the 1980 and 1981 Limitations on Grain Exports to the USSR on Business Activity, Jobs, Government Costs, and Farmers," processed, February 12, 1982.

[18]Nor has there been much attention to the costs and benefits imposed on or derived by other producers. In any future replay, it is clear that success of a U.S. embargo would depend on agreement by other producers to discriminate against the USSR. Even if such agreement can be worked out initially, it would probably be quickly breached if the United States did not bear the full costs of the embargo in terms of changes in world market prices and the effects on producer-nation incomes. Failure to do so, or collapse of the embargo for other reasons, would be likely to result in the imposition of costs on all producers and the conferral of benefits on the USSR and other consumers.

A 1982 WEFA paper argues that comparative cost analysis refutes the Reagan administration "financial drain" justification. WEFA reasons that producing grain in the USSR is very expensive relative to the cost of extracting oil or gas, and these energy exports are far more valuable per ton than grain on the world market. For example, WEFA estimates that in 1982 the marginal cost of growing a ton of wheat in the USSR was 3-1/2 times the cost of producing a ton of crude oil, whereas on the world market oil was worth 60 percent more per ton than grain. Thus, it would pay the Soviet Union to divert resources from the production of grain and produce more oil, which, when exported, would enable the import of 5.5 metric tons of wheat for each ton of domestically produced wheat curtailed. On this reasoning, grain imports, far from damaging the Soviet economy, save large volumes of resources that would otherwise have to be spent on agriculture and can be allocated for other purposes.[19] "It is hardly surprising . . . that the Soviets have opted for long-term dependence on grain imports from the West. In fact, *what is surprising is that the Soviet Union imports so little grain.*" (Italics in original.)[20] WEFA argues from Western economic theory that it is rational (resource saving) for the Soviet Union to import grain from the West, and also that rationality requires carrying the process further—producing and exporting more oil to produce less and import more grain.[21]

If the Soviets recognize the real state of their comparative international costs in growing grain (or food generally), they certainly do not act on it consistently. They have not curtailed domestic production in favor of increased imports; the foreign low-cost source is, by and large,

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[19]Other critics who deride the administration position as "mercantilist" presumably have in mind an argument of this kind. The administration's position is certainly not mercantilist in the sense of striving for a larger U.S. export surplus; the concern is with the effect of Soviet imports on the Soviet economy.

[20]WEFA, "Comparative Advantage in Soviet Grain and Energy Trade," *Centrally Planned Economies Current Analysis,* 2:73, September 10, 1982.

[21]There are several technical problems with WEFA's calculation of Soviet marginal production costs. For example, the marginal cost of labor and other inputs is taken to be equivalent to the "average production cost in the republic with the highest cost among the 15 republics." This is then blown up to a figure including capital cost through multiplication by the ratio of average procurement price to the marginal cost of only labor and other inputs. Moreover, WEFA does not deduct the costs of increasing grain-port unloading, storage, and rail transportation capacity from its calculation of the benefits to be derived from imports of grain; it merely labels these costs a short run problem. WEFA also acknowledges that the investment required to produce additional oil (or gas) exports so as to increase grain inputs is "a much greater hurdle." But this cost too should be deducted from the estimated benefits of the resource transfer. WEFA, of course, justifies its procedure as a calculation of the long run costs and benefits of reallocation. But then its marginal cost estimates seem inappropriate, as they are essentially short run figures.

still only the supplier of last resort; energy investment is growing rapidly but so is investment in agriculture.[22] Whether "the Soviets have opted for long-term dependence on grain imports from the West," limited as it is, is not yet clear, and the relatively small volume of imports is in fact not "surprising."

The argument about energy-grain tradeoffs is phrased in terms of substitution of grain imports for domestic production. However, only a small proportion, if any, of Soviet imports in recent years belongs in that category. To a considerable extent, the USSR imports grain after the production resources are expended and in good part lost, owing to a combination of bad weather, mismanagement, poor incentives, and bureaucratic organization. Moscow then looks to the world market to make up deficiencies in internal supply. When good weather allows a recovery of harvests, the Kremlin will import to replenish stocks or allow an increase of average livestock weights, but usually at a lower level.

Table 3 shows U.S. Department of Agriculture estimates of Soviet grain production, net imports, utilization, and stock changes over the past decade. Two patterns in the data are noteworthy: First, the Soviet Union tends to import mainly coarse grains—roughly three-fifths of all net imports over the period shown—intended for livestock rather than direct human consumption. Second, in the ten annual changes shown, only twice do net imports of all grains fail to increase after a fall in production or decrease after an increase in production; coarse grain imports behave as expected in all but one year; stocks larger than five million tons (this threshold is used because there is a considerable margin of error attached to such a residual estimate) change in all years as expected—they are drawn down when production falls and replenished when production recovers. Accordingly, the Kremlin has recourse to the international grain market primarily to

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[22]In the late 1970s, investment in energy—meaning largely oil and gas—was accelerated in relation to the growth of industrial investment generally, growing from about 28 percent of industrial investment in 1975–1977 to in excess of 30 percent in 1979. The 11th Five Year Plan apparently contemplated a sharp increase in that share, perhaps to as much as 35–40 percent by 1985. (Thane Gustafson, "Soviet Energy Policy: from Big Coal to Big Gas," in S. Bialer and T. Gustafson (eds.), *Russia at the Crossroads: The 26th Congress of the CPSU*, George Allen and Unwin, London, 1982, pp. 126–127. In the 11th Plan, investment in gas alone appears to take about 16 percent of industrial investment: Thane Gustafson, *The Soviet Gas Campaign: Politics and Policy in Soviet Decisionmaking*, The Rand Corporation, R-3036-AF, June 1983, pp. 38–41). However, this has not been at the expense of investment in agriculture, which is holding its high 27 percent share of investment in the whole economy.

Table 3

PRODUCTION, NET IMPORTS, UTILIZATION AND CHANGES IN STOCKS OF GRAIN 1971-72 THROUGH 1981-82

(Million metric tons)

	Total Grains and Pulses				Coarse Grains[a]			
Year[b]	Production[c]	Net Imports	Utilization	Stock Change	Production	Imports	Utilization	Stock Change
1971-72	181.2	1.4	181	2	72.6	3.4	76	0
1972-73	168.2	21.0	187	2	72.5	6.5	79	0
1973-74	222.5	5.2	214	14	101.0	5.5	105	1
1974-75	195.7	0.4	206	-10	99.7	1.7	100	1
1975-76	140.1	25.4	180	-14	65.8	15.6	84	-3
1976-77	223.8	7.7	221	11	115.0	3.7	116	3
1977-78	195.7	16.8	228	-16	92.6	10.7	109	-5
1978-79	237.4	12.8	231	19	105.0	9.0	113	1
1979-80	179.2	29.7	222	-13	81.0	18.6	100	0
1980-81[d]	189.2	34.3	228	- 5	81.0	18.0	101	-2
1981-82[e]	160.0	46.0	206	0	72.0	25.5	98	0

SOURCE: Angel O. Byrne et al., "U.S.-USSR Grain Trade," in Joint Economic Committee, U.S. Congress, *Soviet Economy in the 1980s: Problems and Prospects*, Part 2, Washington, D.C., 1983, pp. 74-75.

[a]Includes rye, barley, oats, corn and millet.

[b]Beginning July 1.

[c]Calendar year basis.

[d]Preliminary.

[e]USDA estimate.

buffer the oscillations of domestic production rather than in a conscious policy of long term international division of labor.[23]

In the wake of the Carter embargo, the Kremlin did not rush into a crash self-sufficiency campaign, but the policy chosen was surely colored by the embargo experience. The Brezhnev program of heavy investment in agriculture was not accelerated,[24] although the announcement of the Food Program at the May 1982 Central Committee Plenum added considerable political weight. The political framework of the Program was the security threat of excessive dependence on imports, as Brezhnev made clear:

[23]Until the end of the 1970s net imports accounted for less than 10 percent of total supply in all but two years. In the last three years of the period covered in Table 3, the import/supply percentages were 14, 15, and 22 percent. In years of favorable harvest it seems reasonable that the import share of total supply should shrink substantially.

[24]TsSU SSSR, *Narodnoe khoziaistvo SSSR v 1982 g.*, Moscow, 1983, pp. 338–339, 342.

> The Draft [Program] proceeds from the need to reduce imports of food from capitalist countries. . . . As you know, the leadership of certain states is striving to turn ordinary commercial operations, such as grain sales, into a means of putting pressure on our country, into an instrument of political pressure. We have never put up with that, nor are we going to do so.[25]

The objective, however, was to reduce imports, not dispense with them entirely.[26]

Despite the USSR's comparative disadvantage in food production, the Brezhnev regime continued to raise agricultural investment partly out of concern with the external threat to the security of the Soviet food supply. But it did not attempt to achieve self-sufficiency because of the huge costs involved.[27]

The Kremlin's reaction may be seen as partly vindicating the 1980–1981 embargo, although in terms different from those advanced by the Carter administration. In early 1980, it was hoped that the embargo would have a direct effect on Soviet fodder supplies and therefore meat production, forcing a deterioration of a sensitive part of the consumer's diet. In the event, meat production fell slightly in that year, but a long term result was the allocation of a larger volume of resources to agricultural investment than would have been justified by

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[25]*Pravda,* May 25, 1982.

[26]Vladimir Gurevich, an economic observer of the Soviet Novosti news agency, remarked: "The Food Program is largely intended to solve the problem of feed for live stock. The Soviet Union has no intention of ceasing to import grain, but it does plan to make a gradual reduction in the amount purchased." Radio Moscow, August 12, 1983.

[27]The cost of self-sufficiency has both a domestic ruble and an external hard currency component. The domestic costs of such a policy cannot be easily quantified, but it is apparent that any effort to eliminate the multiple exogenous and endogenous causes of harvest failure and fluctuation would have been very high. For even the mediocre actual record of the past decade, the Politburo has poured an enormous volume of resources into agriculture, including more than a fifth of total gross fixed investment. This does not include, among other things, investment in repair enterprises, agricultural research institutions, and agricultural enterprises processing agricultural products. (See CIA, *Soviet Statistics on Capital Formation,* SOV 82-10093, August 1982, Tables 3 and 4.) Even with a more rational use of resources, complete import-avoidance at a moderate level of grain availability would require prolonged allocation to agriculture of a considerably larger fraction of total investment resources.

If successful, the effort would save all the hard currency formerly used to import grain. However, from this total Kremlin cost-benefit calculators would have to subtract the cost of hard currency imports of technology necessary to sustain the self-sufficiency program and the value of hard currency exports that would have to be forgone to the extent resources were drained away from export sectors. (As Padma Desai pointed out in a letter to the *Wall Street Journal,* the WEFA analysis is overly restrictive in limiting the discussion of grain tradeoffs to energy, particularly because of the pervasive disequilibrium in the Soviet economy and, hence, the multiple opportunity costs of grain production.) On the reasonable assumption that the USSR has a comparative disadvantage in grain production, the balance would be negative.

confidence in the reliability of Western supply, in order to achieve a greater degree of self-sufficiency. In a period of sharply reduced overall economic growth in the USSR, that decision necessarily involved cutting into the share of some other claimant on Soviet national output. If that claimant was the military, the result would be directly consonant with Reagan administration objectives. Even if the military were not made to bear the brunt of the reallocation, the action evidently complicated Soviet decisionmaking on resource allocation, and that too is consistent with current policy objectives. Paradoxically, then, a failed embargo pushed Moscow in a direction that seems favorable to Western interests, even as currently viewed by the U.S. government.[28]

To sum up the merits of the "financial drain" argument: Soviet imports of grain do expend scarce hard currency, but the imports are not discretionary. The USSR saves resources buying grain rather than trying for complete self-sufficiency, but fear of external dependence limits the extent of the savings Moscow can reap. The Kremlin buys grain abroad out of perceived need rather than in response to comparative cost and price ratios. By drawing off resources from other sectors, the Brezhnev-Andropov-Chernenko food program amounts to a partial vindication of the 1980 U.S. embargo.

The arguments advanced above are, for the most part, narrowly economic. The political considerations are surely as important but considerably more speculative. If the United States sold as much grain as the Soviet Union was willing to buy at prevailing prices, Soviet consumption levels would rise, thereby possibly strengthening the legitimacy of the regime and the stability of the political system. The same result might ensue from increases in labor productivity and output to which consumption growth could contribute. Also, the self-confidence of the leadership is probably enhanced by their perception of the eagerness of the West to sell. However, some Western analysts believe that economic reform and relaxation of political controls are only possible in a prospering Soviet economy.[29]

Suppose, on the contrary, that the United States refused to sell—or allow others to sell—and had the power to enforce the decision.[30] That

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[28]The vindication of the 1980 embargo is only partial, however, because the embargo's ultimate goal was deterrence of future Soviet aggression. It would be hard to defend the thesis that Soviet policy became more restrained in the early 1980s.

[29]This seems to raise the hoary question of whether "fat" or "lean" communists are better for the West. The intermittent debate in these terms has not been fruitful, and it will not be pursued here.

[30]That is, either by having a monopoly position in the world grain market or by having the political power to persuade other producers to follow the American lead.

is far from the current reality, but at some future point it might appear more likely. In that case, the Soviet Union would have the choice of diverting a large volume of resources to assure minimally desired levels of domestic grain availability or cutting consumption levels. Would Moscow be likely to take the first option? In response to the 1980 embargo, the USSR insured minimum levels of import availability through long term trade agreements with several countries, but it also took steps to try to stabilize and increase domestic production. In the face of an effective future embargo, if Moscow did not yield to the external pressure, it might choose to tighten the national belt and maintain a lower than normally desirable level of supply. Perhaps an additional effort would be made to raise production, but by less than the embargo-induced shortfall in total supply. If the Politburo chose to clamp a lid on consumption, to protect the rate of growth of military spending or of nonagricultural investment, it may be hazarded that there would also have to be a considerable tightening of political controls to assure stability. Most Western writers agree that liberalization of the Soviet system would contribute to a more peaceful world. Few believe that a neo-Stalinist reaction in the USSR would be good for the West.

In short, selling grain to the Soviets has an apparent economic-military disadvantage for the West that may also be a political liability. Refusing to sell, were the refusal to be effective, would have favorable consequences if the Politburo then promoted consumption over investment or defense. However, if the Politburo reversed the priority, the political consequences could be unwelcome to the West. Neither course then promises a clearly desirable political outcome, and Adenauer's charge merits a Scotch verdict.

These are all arguments on the desirability of using grain sales as an implement of a denial strategy. Apart from the residual uncertainty sketched out, general denial as a part of policy in "normal" times would have almost no support in the United States and, despite frequent allied criticism of the rescinding of the embargo, would probably be sharply attacked by America's allies. But what of the possibilities of leverage?

This might be secured by offering the USSR stability of supply over longer periods than five years, with possibly higher tonnage volumes and perhaps a constraint on price fluctuations in either direction. The leverage potential might be embodied in provisions for either annually negotiated above-minimum sales at favorable prices or yearly renewal of the whole agreement, conditional in both cases on a Soviet political quid pro quo. There is, of course, an inherent contradiction in such an arrangement: To attract Soviet interest requires stressing the elements

of stability, but to make possible the application of U.S. leverage requires an opportunity to withdraw the benefits being extended. The more Moscow succeeded in diversifying and stabilizing its sources of supply, the more it could be expected to lose interest in the American lure. U.S. ability to persuade major Western producer-exporters to join it in playing a long term leverage game seems dubious. Even more doubtful is the prospect of winning U.S. farm support for leverage initiatives.

THE FUTURE OF GRAIN SALES AS A FOREIGN POLICY TOOL

In principle, grain sales could be used as a tool of U.S. policy toward the USSR, for either denial or leverage, but the feasibility of either policy in real world application is clearly small. Nevertheless, it is probably wrong to completely write off this instrument of policy. The Soviets will continue to do things the United States (and perhaps its allies too) will want to react to with measures short of war; the West will continue to seek means to influence Soviet policy and behavior. The arsenal of useful, nonviolent actions at the West's disposal for these purposes is always smaller than it would wish. In the late 1980s and even beyond, the Soviet Union will probably still be struggling with its food problem. The U.S. government may well reconsider the foreign policy potential of grain sales. From time to time, in particularly irritating circumstances of Soviet misbehavior, an American president will find recourse to some form of grain denial, as Robert Paarlberg said of the Carter administration, "an unhappy necessity."[31] But like the 1980 episode, any future replay will probably be more an expression of American outrage than a systematic effort at denial or leverage.

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[31]Paarlberg, "Lessons of the Grain Embargo," p. 161.

V. THE POLISH DEBT, 1981–1983

"The West holds a key to future events in Poland, but can't find the lock" (a New York investment banker).

Countries as well as companies have occasionally found themselves unable to meet debt obligations and have sought their creditors' help to reestablish their financial footing. Few of these events ever reached the front pages of the world press in the past. In the early 1980s, however, external debt crises suddenly mushroomed into a central concern of international politics. The West's attention is focused now on South American financial problems, but it all began with Poland and the request by the Polish government in early 1981 to reschedule and restructure its hard currency debt.

From the beginning, the ordinary financial-economic considerations of rescheduling debt in Poland were inextricably linked to political issues. Poland was undergoing extraordinary change in the aftermath of the August 1980 Gdansk agreement but was also threatening to slide into chaos. The economy was in turmoil, the Communist party was rapidly disintegrating, and the government seemed unable either to cooperate with or repress the burgeoning Solidarity movement; the threat of Soviet military intervention loomed constantly. In these circumstances, difficult questions confronted Western policy planners. What forms of "conditionality" should be attached to the Western rescheduling offers? Whom would rescheduling benefit, Poland (Solidarity) or the Soviet Union? Was rescheduling sufficient or did Poland in fact need a vast new infusion of capital to survive? With Jaruzelski's martial law coup in December 1981, rescheduling became an issue of sharp debate in the West because it was now part and parcel of the West's dilemma on how to react to the crushing of the Polish democratic movement. Should the Poles be declared in default to cut off their sources of new credit and force the Soviets to bail them out? Or would triggering default remove the last instrument of Western leverage over Warsaw and endanger the international monetary system to boot? What would be the effects on other East European countries, some of whom (Romania, Hungary) were also in various stages of financial crisis?

This section examines the issue of Western credit to Poland as an instrument of leverage or denial. Along with the Urengoi-Western Europe pipeline, the Polish debt became the most hotly debated issue

in East-West economic relations in 1981–1982. It illuminates some of the key issues of Western policy in this arena, particularly the relation between leverage and denial.

NEGOTIATING THE RESCHEDULING AGREEMENTS

According to Susan Sontag, Poland's current troubles can be ascribed to "tanks *and* banks."[1] It is now conventional wisdom that in the 1970s Western governments and banks showered Eastern Europe with credit that could not be productively absorbed and was in fact largely misinvested. There is considerably more to the East European nonsuccess story than Western largesse and communist ineptness—effects of the Western recession and inflation of the mid and late 1970s, deteriorating terms of trade with both the USSR and noncommunist partners, and internal political constraints, among others.[2] Nevertheless, the Gierek regime's decision to attempt a growth strategy based on imports of Western technology, along with the "liquid" state of Western credit markets, especially after 1973–1974, were the necessary conditions for the enormous growth of Polish debt. Warsaw's gross hard currency debt to nonsocialist countries was $1 billion at the beginning of the 1970s; by 1975 it had risen seven-fold, and in the succeeding five years the 1975 level approximately tripled. Growth of the net debt was even more rapid.[3]

In March 1981, Warsaw declared a moratorium on external debt payments and requested rescheduling from its Western creditors. The action was surely unavoidable at that point and predictable considerably earlier. In 1977 Poland's debt service ratio was already 59 percent, and in the following year it was 79 percent.[4] Ratios of 25 percent or more used to trigger the alarm bells in international bank chambers.

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[1]The *Nation*, February 27, 1982, cited by Josef Joffe, "Mixing Money and Politics: Dollars and Detente," in Abraham S. Becker (ed.), *Economic Relations with the USSR. Issues for the Western Alliance*, Lexington Books, Lexington, Mass., 1983, p. 16.

[2]See Jan Vanous, "East European Economic Slowdown," *Problems of Communism*, 31:4, July-August 1982, pp. 1–19; Morris Bornstein, Zvi Gitelman, and William Zimmerman, *East-West Relations and the Future of Eastern Europe*, George Allen and Unwin, London, 1981; *East European Economic Assessment*, Part 1—*Country Studies*, 1980, Joint Economic Committee, U.S. Congress, Washington, D.C., 1981.

[3]CIA, National Foreign Assessment Center, *Estimating Soviet and East European Hard Currency Debt*, ER 80-10327, June 1980, p. 7; official Polish statistics, cited in *East-European Statistics Service* (Brussels), No. 70, December 18, 1981, p. 6.

[4]Joan Parpart Zoeter, "Eastern Europe: The Hard Currency Debt," in *East European Economic Assessment*, A Compendium of Papers Submitted to the Joint Economic Committee, U.S. Congress, Part 2, *Regional Assessments*, Washington, D.C., 1981, p. 730. The denominator of this ratio is earnings from merchandise exports to all noncommunist countries. The Polish ratio would be only slightly smaller if earnings from invisibles were included in the denominator.

Agreement with the Western governments was achieved quickly, by the end of April 1981 (the Paris Agreement). Of the estimated $2.6 billion of official debt due in that year, 90 percent was rescheduled with respect to both principal and interest over eight years with a four year grace period. Negotiations with the banks, however, dragged out. Agreement was supposedly reached at the end of September to reschedule 95 percent of the $2.4 billion principal due in 1981, again with a four year grace period and repayment in seven semi-annual installments thereafter; the other 5 percent was to be repaid in three installments over 1982. Unlike the governments, the banks demanded full liquidation of 1981 interest arrears, amounting to $500 million. It was not until March 1982 that Warsaw finally cleared its 1981 interest account and the agreement came into force.

The rescheduling of Poland's debt falling due in 1982 proceeded under quite different circumstances, reflecting the influence of the institution of martial law.[5] In 1981, governments had taken the first step and the quick rescheduling of official debt enabled the banks to begin their negotiations with Warsaw. In 1982, however, the banks were confronted by the refusal of the governments (the NATO ministerial decision of mid-January) to proceed with rescheduling negotiations as a measure of sanction for martial law. For a while the bankers waited for the governments to act first, but when such action was not forthcoming, they reluctantly began negotiations anyhow in the summer.[6]

The basis of the 1981 commercial rescheduling, unlike that for official credits, was full payment of interest arrears before rescheduling of principal. This was still the guideline as the banks entered the 1982 negotiations, although the Poles were demanding recycling of part of the interest. The chairman of the Dresdner Bank, however, was firm: "I can't imagine that Poland would be awarded new credits."[7] But the

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[5]In March 1981, Warsaw formally declared a moratorium and requested rescheduling. There were no subsequent declarations. In 1982 and 1983 there were simply informal moratoriums on the maturities for those years.

[6]"Western Banks' Talks with Poles Are Inconclusive," *Wall Street Journal,* July 8, 1982.

[7]Terence Roth, "Western Creditor Banks Insist Poland Pay Interest Before Accord on Principal," *Wall Street Journal,* July 9, 1982.

Because the role of the recycled interest is of some concern in this discussion, it is necessary to justify the labeling of the recycled funds as "new credits." Rescheduling of interest capitalizes the arrears and adds the amount to the principal outstanding. Recycling, in contrast, involves an actual or accounting two-way transfer: The debtor repays (all or part of) the interest falling due, and the proceeds are then returned to him for the agreed term. It is true that the net value of the transfer is zero, but in effect the debtor is viewed as having met his interest obligation and is given a new short term loan. If the debtor agreed to pay the interest without recycling, he would have to run a surplus in his

banks soon yielded on the principle; the only issue was how much of the interest arrears would be recycled.[8] The Poles demanded 80 percent, the banks offered 50 percent. In the end, the Poles accepted 50 percent but extracted the concession of a three year revolving term, instead of a simple one year term, for the recycled interest.[9]

In coming to an agreement with the Poles, the banks of the NATO countries appeared to have broken both with their governments' and their own previously held firm principle. They not only rescheduled Poland's debt when their governments refused to enter into any negotiations for that purpose, but they extended new loans, which the January 1982 NATO guidelines had explicitly refused to do. Although the November 1982 agreement was not all that Warsaw had sought to achieve, the core represented a deviation from the allied governments' declarative policy. Why did the banks yield?

One reason was probably the Damoclean sword of formal, involuntary default that the bankers perceived to be constantly hanging over them. Some 500 banks made up the coalition, and the German banks in particular were fearful that one of the smaller, regional U.S. banks with little stake in the "larger" goal of international financial stability would trigger a general move to declare default.[10] Some members of the group apparently also believed that the Poles were sufficiently desperate that they would unilaterally declare a moratorium on debt repayments unless they were given new credits. (Actually, Warsaw had

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current account balance of payments (assuming no other capital transactions). With recycling, the obligation can be met with a zero current account balance. The only alternatives, apart from rescheduling, are moratorium, forgiveness, or default on the debt.

[8]It has been reported that the Warsaw government expected the 1981 rescheduling to be followed quickly by new Western credits. For allegedly misrepresenting that likelihood, the President of the Polish trade bank was fired in June. Frederick Kempe, "Polish Debt Puts Western Banks in Bind as They Try to Work Out Rescheduling," *Wall Street Journal,* July 29, 1982.

[9]For the rest, the agreement (November 3, 1982) resembled its 1981 forebear: 95 percent of principal rescheduled for repayment in 7-1/2 years with a four year grace period; an interest rate of 1-3/4 percent over the London interbank lending rate (LIBOR) plus a 1 percent rescheduling fee; the unrescheduled 5 percent of principal was to be paid in two installments in the second half of 1983. See *East/West* (Brussels), No. 303, November 10, 1982.

[10]The 1981 rescheduling provided that the 1982 maturity had to be rescheduled (or repaid) by September 10, 1982, or any participant could void his adherence to the agreement. Cross-default clauses in loans, where a declaration of default by one bank entitles other participants in a loan to do the same, mean that declaration of default by any one creditor can quickly become general. Thus, in the negotiations during the summer of 1982, September 10, known as "cross-default day," came to assume independent weight as a negotiating factor. In the event, agreement was not reached by the date and the deadline was extended for two months. That deadline was met.

some limited exchange resources; it was withholding payments of accrued interest in order to pry a better agreement out of the banks.[11]

A second reason was that the sharp edge of the Polish crisis was being worn off by the development of still larger debt problems in Latin America. "Purely optically, Poland's debts just don't look that awesome any more," remarked a West German banker.[12] Perhaps a more important factor than just the change in perceived relative scale may have been a weakening of the negotiating stance of the U.S. banks. In 1981, they had been harder-nosed than their European colleagues, and the less exposed position of the U.S. banks relative to the Germans had strengthened the American position. U.S. banks were more heavily exposed in Latin America and the German banks were quick to point this out: "We've been taken out of the line of fire," a West German banker said. "Poland's debt is large, for an individual bank here, but it's peanuts compared to what Latin America means to some U.S. banks."[13]

Bankers were also concerned about follow-on reschedulings. It had become clear very quickly that Poland was a long way from an economic recovery that would permit resumption of debt service. Few doubted that almost all of Poland's outstanding commercial debt would have to be rescheduled as it fell due. "There's no sense in forcing them to ruin," a banker declared, "when we have loans coming due in 1983 and 1984 to worry about."[14]

Considering Poland's dismal economic performance in 1982–1983 and its highly uncertain prospects for the future, why would the bankers go through the trouble of prolonged negotiations to postpone payments they might never receive anyhow? According to one Western banker, most of his colleagues did not in fact believe that the Polish loans would ever be repaid. The banks simply had a material interest in postponing the day they were required to write off the loans. The further off that day, apparently, the better: Inflation would reduce the real size of the principal relative to other assets on the banks' balance sheets. In the meantime, of course, the banks would still be getting

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[11]Frederick Kempe, "Polish Creditors Seek Debt Accord Before Sept. 10, When Default Could Be Called," *Wall Street Journal,* August 2, 1982.

[12]Frederick Kempe, "Poland's 'Default Day' Passes in Silence as Bankers Wrestle with Woes Elsewhere," *Wall Street Journal,* September 13, 1982.

[13]Ibid.

[14]Terence Roth, "Poland, Banks Agree on Plan for 1982 Debt," *Wall Street Journal,* September 16, 1982.

some interest. "It's now come down merely to a game we are playing with numbers," the banker said.[15]

Finally, and despite the inconsistency of the banks' behavior with the NATO governments' declaratory policy, it does not appear that the governments were pressuring the banks to act otherwise. Not even the U.S. government was interested in triggering an involuntary default;[16] it was, in fact, paying off the few claims presented to the Commodity Credit Corporation for missed principal or interest installments. The general argument was that the Poles should not be permitted to escape their international financial obligations, and denying them the excuse for a unilateral moratorium or complete default would retain leverage for the West over Polish internal policy. Bankers privately snickered over the latter claim, but for obvious reasons they ardently endorsed the former argument. It was not incredible, therefore, that in the midst of bitter political struggle within Poland and in the arenas of East-West relations, the Polish Finance Minister boasted about his good relations with the bankers. "We speak a common language," he declared. "We never talk about politics when negotiating with the Western bankers. This is good."[17]

In any case, the Polish government drew a lesson from the 1982 experience. It informed the Parliament in early 1983 that *all* of the principal maturing in the three-year period 1983–1985, as well as increasing shares of the interest due, would have to be rescheduled.[18] Moreover, Warsaw asked the banks for rescheduling over 20 years with no payments before 1990; in addition, the Poles requested a larger share of interest recycled as new credit.[19] This was evidently a negotiating ploy, but it worked, for the agreement ironed out in the summer rescheduled (the now-customary) 95 percent of the 1983 principal, but with a five year grace period (up from four years) over ten years (instead of 7-1/2 years), and 65 percent (instead of 50 percent) of the

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[15]Frederick Kempe, "Poland Seeks 20-Year Term to Pay Debts," *Wall Street Journal,* June 14, 1983. See also note 25 below.

[16]This was a presidential decision reached soon after martial law was declared. However, the decision did not eliminate the conflict over the policy between parts of the administration, with the State Department generally ranged against the Pentagon.

[17]David Buchan and Leslie Colitt, "Krzak Nears Debt Deal with West," *Financial Times,* September 15, 1982.

[18]Christopher Bobinski, "Polish Debt Repayment Plans Revealed," *Financial Times,* March 23, 1983.

[19]*Wall Street Journal,* April 26, 1983; and Frederick Kempe, "Poland Seeks 20-Year Term to Pay Debts," *Wall Street Journal,* June 14, 1983.

interest due was recycled. Poland failed only to get a block rescheduling of its 1984 and 1985 debt.[20]

THE DEBATE ON DEFAULT

How should the West have acted in relation to the Polish debt? Or was there no choice? Were the banks and governments effectively prisoners of the Polish crisis ("the debtor always has the leverage in the last analysis"—a New York investment banker[21])? Or was there leverage potential in the crisis that for one or another reason was allowed to slip by unused?

Motivations for Default

The central question in the U.S. public debate in early 1982 concerned the wisdom of deliberately triggering default. Declaring default is on the face of it a demand for payment. For that purpose it makes sense only if the debtor has both an incentive to pay and the means to do so.[22] The first is often—perhaps almost always—present in international borrowing. But the second is frequently absent, hence the rarity of default relative to rescheduling. In the Polish case, none of the proponents of default was under the illusion that the Poles were concealing substantial hard currency assets; it was universally recognized that in the short term Polish ability to pay was at rock bottom.

But was Poland insolvent or merely illiquid? Was the inability to develop a hard currency surplus on current account temporary, because of the dislocations of 1980–1981, or was the stagnation much more deeply rooted in the structure of Polish economic organization?

Poland was obviously illiquid, but some bankers at first hoped that the "discipline" of martial law would quickly remedy the "excesses" of recent years. If cash flow was the only issue, rescheduling might be sufficient as well as necessary. But the gap between Polish trade prospects and the required debt service loomed ever larger, even with martial law and under the repayment schedules that were being discussed

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[20]Peter Truell, "Bankers Agree to Reschedule '83 Polish Debt," *Wall Street Journal,* August 19, 1983. The agreement was signed on November 3. ("Bankers Sign Accord to Reschedule Polish '83 Commercial Debt," *Wall Street Journal,* November 4, 1983.) More recently, the banks have agreed in principle to a block rescheduling of the 1984–1987 commercial debt. ("Progress on Polish Debt Arrears," *Financial Times,* March 23, 1984.)

[21]Robert G. Kaiser, "The Polish Debt Owed to the West Is Classic Two-Edged Sword," *Washington Post,* December 19, 1981.

[22]Declaring a delinquent borrower in default imposes a penalty by denying further access to credit and thereby may also have a deterrent effect on other debtors in similar financial straits.

in 1982–1983. Most Western commentators discounted the much-heralded Jaruzelski reforms. No projections of Polish export earnings indicated a margin over imports in the 1980s sufficient to keep current on the interest due on a $25 billion debt, much less to repay principal.[23] On balance of payments grounds, Warsaw's demands in 1983 for extended rescheduling were hardly surprising.[24]

If Poland was insolvent, the medium term reschedulings of 1981 and 1982 seemed a waste of time and effort, and we can readily understand the sense of some of the bankers that they were caught up in "a game with numbers." If so, why not call a default a default and end the charade?[25]

The motivations for forcing default were largely political, and there were two main lines of argument. The first stressed the need to punish Warsaw for the imposition of martial law, to secure the amelioration of the martial law regime as quickly as possible, and to deter further repressive measures against Solidarity and the population. Declaring default would mean denial of credit to Poland not just in the present but also in the indefinite future; this would accomplish the punishment objective. The goals of deterrence and improvement of the current situation presumably required some expectation that the credit embargo would be lifted—perhaps even that this would be followed by extension of substantial additional credits—but these aspects were not often mentioned by American proponents of default.[26]

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[23]In fact, the debt would be increasing in the mid-1980s, if only because of the recycling of interest. In 1981, Poland balanced its trade with hard currency partners and in 1982–1983 it achieved surpluses of about $1.5 billion annually, according to WEFA (*Centrally Planned Economies Current Analysis,* 4:11–12, February 22, 1984). Including obligations to governments the arrears in interest alone in 1983 were about twice as large as the trade surplus.

[24]The director of the Polish Academy's Institute of Economic Science estimated that a deferral of repayments on the foreign debt until 1990 would increase the size of the debt from about $27 billion to $61 billion! He projected export earnings (presumably, gross rather than net of import payments) at about $8 billion, which would preclude repayment of the debt. John Tagliabue, "Eastern Bloc Losing Markets," *New York Times,* September 19, 1983.

[25]In March 1982, the State Department's Under Secretary for Political Affairs, Lawrence Eagleburger, was said to have acknowledged that most of the Polish debt to the West would probably not be repaid. Bernard Gwertzman, "U.S. Aide Cautions on Soviet Credits," *New York Times,* March 31, 1982.

[26]An interesting variant of the cost imposition argument stressed the political costs of any economic program to restore Polish solvency. The premise of the argument was that Poland could not meet its debt obligations without outside assistance. It was then asserted that the assistance would be useless without the imposition of a draconian economic discipline (an IMF type of conditionality). Those who were associated with such "assistance" would incur the hatred of the population. The West had no possible interest in accepting such a burden and should shift it to the Soviet Union's back by declaring Poland in default. See Felix G. Rohatyn, "We Cannot Create a 'Municipal

The most popular justification of default was the belief that it would force the USSR to discharge Poland's obligations to the West (and perhaps also those of other countries in Eastern Europe that might experience financial crisis). To most proponents of default, the declaration represented a form of protest against the Soviet Union's moral responsibility for Poland's troubles and an effort to force Moscow to pay for its behavior.

> The West has no political or economic interest in making life easier for a neo-Stalinist regime. The blunt message should be that if the Russians insist on having such a regime in Warsaw they should pay the full price for it, which means taking over the full burden of Poland's economy and paying its debts.[27]

To the cost imposition and vaguely deterrent components of this strand of support for default might be added the argument of those who sought measures of general denial of resources to the USSR. If Moscow were forced to shoulder Polish and East European debt burdens, the economic strain would take its toll on the Soviet military buildup: The Kremlin could not afford to continue building up its military forces at 4–5 percent per year while providing extensive aid to Eastern Europe and maintaining domestic consumption standards as well as investment for future growth.[28]

In the range of arguments against declaring default, the most influential if also the most nebulous was the charge that it would threaten the stability of the international financial system. Prominent international bankers spoke of a possible "domino effect"—a panicky move by the banks to impose default on other countries who got behind in their debt repayments. Others used the term "ripple effects" and warned that Polish default might engulf all of Eastern Europe and perhaps spill over as far afield as Brazil or Zaire. There was much talk of "credit panic" with allusions to the 1930s. It was alleged that default would do more damage to the West than to Poland.

It was difficult to maintain clarity in this debate because of the inherent uncertainties of a rare event and the absence of reliable information. Two interrelated aspects of the question seemed particularly murky—the process of default and the effects of default on the declarer, the other Western creditors, and Eastern Europe.

Assistance Corporation' for Poland. Let It Go Bankrupt," *New York Times,* January 11, 1982.

[27]*The Times* (London), March 5, 1982, editorial.

[28]Subsequently, it appeared that the growth of the Soviet military budget had tapered off to about 2 percent per year.

How Would Default Take Place?

If the U.S. government wanted to force Poland into default, the most direct route was simply to invoke the "exceptional circumstances" clause of the April 1981 Paris agreement. It was not self-evident that a U.S. government declaration of default on its loans to Poland would inevitably knock over all the Polish dominoes, public and private. The argument required, first, that the other 15 members of the Paris Club follow the U.S. government in declaring default, that the major banks then invoke force majeure clauses in their loans, and that cross-default provisions come into play to make the default general. There was nothing automatic about this chain. It is quite possible that most of the other governments in the Paris Club would not have followed suit, and perhaps that was an important factor in the U.S. government's decision not to use that privilege.[29]

Alternatively, the administration could have called in loans that became delinquent in 1982, selectively or generally. But if the object was to trigger a more general default declaration, a more direct route was available. The U.S. government could have demanded a default declaration before paying off on government loan guarantees to private banks. Some bankers argued that in such a contingency, they probably would swallow the loss rather than comply: Assuming that declaring default on guaranteed loans to Poland required an equivalent declaration with regard to all other Polish loans in a bank's portfolio, and if the banks had more uncovered than covered paper, they would want to avoid triggering cross-default, in the belief that preventing formal default increased their chances of eventually being repaid. However, some of the smaller banks could probably have been persuaded to accede to the government's demand.

Washington's leverage was weakened by the small exposure of both the private and public U.S. creditors. U.S. government direct credits and guarantees accounted for less than $2 billion of the total $25 billion Polish hard currency debt at the end of 1981; the amount of unguaranteed debt to U.S. private creditors was only $1.3 billion.[30]

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[29]Some opponents of default contended that a unilateral U.S. declaration would result in other creditor governments being paid off first, if and when the Poles were able to repay. However, the sense of the Paris agreement was in fact that those who declared default took precedence in any future repayments over those who did not.

[30]"Treasury and State Department Background Paper on Poland's Financial and Economic Situation for the European Subcommittee of the Senate Foreign Relations Committee," January 27, 1982 (hereafter, "Treasury-State Background Paper"). The official credit outstanding was distributed as follows (billion dollars):

Direct credits and guarantees by the Commodity Credit Corporation	1.6
Export-Import Bank loan	.244
Agency for International Development loan	.006

U.S. refusal to join other governments in negotiation to reschedule 1982 (and later) official Polish debt could not have been expected to be sufficient in itself to trigger default. In the first months of 1982, the banks were reluctant to negotiate a 1982 rescheduling unless there was again a comparable, and previously negotiated, arrangement on official credit. But if the Western governments refused to do so, it would have been foolish to believe that the banks would not initiate negotiations for rescheduling at some point.

In brief, the Reagan administration could certainly have forced a state of default on direct U.S. government loans and perhaps also on government guaranteed credits. But the link to general default on all of Poland's debt to the West was at least uncertain and possibly unlikely.

There was much speculation in early 1982 that default would take place in the United States autonomously. Some pointed to the possible role of bank auditors and bank examiners of various regulatory agencies. Others counted on the likelihood of Polish arrears on 1982 commercial interest reaching legal thresholds (60 or 90 days—the regulations varied), which would force some banks to declare default. It was suggested that the Comptroller of Currency could place banks failing to declare default on a "criticized list," but this seemed unlikely after the 1981 rescheduling agreement was signed: 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 1982 rescheduling dragged out, it was suggested that stockholders could pressure a bank's management to take the tax writeoff rather than wait indefinitely for a dubious repayment. But because the tax writeoff paid less than 50 cents on the dollar, as long as banks could persuade themselves they had an even chance of having the interest payments met, they were better off stringing along with the consortium. Perhaps one or more banks would decide to break ranks because they perceived a unique and fleeting opportunity to recoup a large fraction of their outstanding loan balances by access to particular Polish assets. One or more of the 60 U.S. banks could very plausibly see reasons to seek refuge for themselves. This theoretical possibility was magnified by the involvement of another 400 to 450 banks abroad. In this network, there appeared to be nontrivial possibilities for triggering the alarm that would spread through cross-default. The probability of autonomous default action seemed inversely related to the expectation of extracting interest and principal payments from the Poles. The passing of time without formal rescheduling would erode such expectations.

The likelihood of autonomous default also depended on one's interpretation of the cement holding the banks together. Apart from embarrassment at the acknowledgment of bad judgment and the general calculation of a creditor when faced with a debtor having few assets but some earning power, the bankers' opposition to default rested on the fear of "ripple effects." That fear stayed the hand of larger or stronger banks who otherwise would have been tempted to take their tax writeoffs and run. It might have been less effective in constraining smaller or weaker banks, but they were evidently held in line by their bigger allies.

The Effect of Default on West and East

It is not known whether the U.S. government was fully aware of these uncertainties or how seriously it regarded them. Contemporary reportage indicates that in deciding against a declaration of default in early 1982, the U.S. government was motivated largely by fears for the international financial system and concern about the views of its allies:

> [The administration] consulted Western European leaders and bankers in the United States and Europe. All strongly urged against the default declaration, fearing that it would set off other default declarations against Poland, particularly in West Germany, which has a much larger stake than American banks. If this happened, no one was sure where it might end. The [U.S.] participants were not necessarily convinced that all this would transpire but they recognized that the situation was tricky and full of imponderables, and they were under a great deal of pressure from the banking community and the allies to refrain from declaring a default.[31]

To what extent, in fact, would the Western creditors have been threatened by an American default declaration? How likely was a spillover of default on other East European or even third world debt? The answers were ultimately speculative, but an examination of the size and distribution of the Polish debt provides some insight.

For technical reasons, there is some variance in the figures on the size and structure of the Polish debt appearing in the published sources. Table 4 shows the Polish government's presentation for a general notion of the situation at the end of 1981, as martial law was declared. The total hard currency debt, of all maturities, exceeded $25 billion gross. Of this, a little over $2 billion (apparently all medium and long term) was owed within the communist bloc. The net debt to

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[31]Leslie H. Gelb, "Reprieve on Polish Debt," *New York Times,* February 3, 1982.

Table 4

POLAND'S HARD CURRENCY DEBT, END 1981[a]
(Million U.S. dollars)

Gross, medium and long term	24,306
Owed to: developed West	19,446
developing countries	2,669
subtotal:	
nonsocialist countries	22,115
socialist countries	2,191
Gross, short term[b]	1,147
Total gross	25,453
Deposits in Western banks	764
Net, to nonsocialist countries	22,493[c]

SOURCE: WEFA, *Centrally Planned Economies Current Analysis,* No. 70, September 1, 1982, and No. 93, November 23, 1982.

[a]Excluding interest arrears.

[b]Owed mostly to the developed West.

[c]WEFA has evidently added all short term debt to the medium and long term debt before subtracting Polish deposits in Western banks to obtain the figure for net debt. However, between the calculated difference and the net debt figure in the table is a discrepancy of $5 million.

nonsocialist countries was only $0.8 billion less than the gross.[32] According to a U.S. government set of figures, which do not quite match those shown in Table 4 in date (or probably in source), about 40 percent of the total gross hard currency debt was owed directly to official creditors; another quarter represented government-guaranteed loans; the residual 35 percent was unguaranteed private sector credit.[33]

[32]Net debt takes no account of hard currency assets (foreign exchange reserves, gold) other than deposits in noncommunist banks.

[33]"Treasury-State Background Paper."

Accordingly, less than about $10 billion of Polish debt reflected unguaranteed private sector exposure. As already noted, the U.S. commercial exposure was only a small fraction of this amount, $1.3 billion. This was shared by some 60 U.S. banks; individual exposure was at most under $200 million, equal to or less than 5 percent of equity capital.[34]

The exposure of European, particularly German, banks was in many cases considerably greater. A wide range of figures on German bank exposure appeared in the press, but the following figures for the four leading creditors seem credible (million dollars):[35]

Bank	Total Loans	Including Nonguaranteed
Bank fur Gemeinwirtschaft	420	343
Commerzbank	400	265
Deutsche Bank	310	200
Dresdner Bank	300	180

No matter how it took place, default was not likely to place any of the American banks in jeopardy. A few German banks were in somewhat greater danger. If additional East European states would default too, the threat to banks on both sides of the Atlantic could become significant. But what would the effects be? Some observers believed in early 1982 that the danger of a credit panic was substantial, if existing intercentral bank safety mechanisms were not adequate to contain and dampen the shock to Euromarket flows that could result from wholesale declaration of default on the Polish debt. Others asserted that contingency plans in fact existed and could be implemented in timely fashion. Given the substantial state involvement in banking in France

[34]Julie Salamon and Gary Putka, "Doubts Concerning Polish Debt Payments Raise Questions About U.S. Bank Lending," *Wall Street Journal,* December 18, 1981. The Federal Financial Examinations Council reported that in mid-1981 U.S. commercial banks had $2 billion of loans outstanding (guaranteed and unguaranteed) plus an additional $600 million in undisbursed commitments. Of the total, 72 percent were accounted for by the top nine banks (Bank of America, Citibank, Chase Manhattan, Manufacturers Hanover, Morgan Guaranty, Continental Illinois, Chemical, Bankers Trust, and First National of Chicago), or about $200 million per bank. Fifteen banks had an 11 percent share in the total (average exposure, $19 million) and the remaining 17 percent was shared by all other banks. Cited in WEFA, *CPE Current Analysis,* 3:4/5, January 17, 1983.

[35]*New York Times,* January 13, 1982. For other estimates, see *Wall Street Journal,* December 18, 1981, and December 24, 1981 (John M. Geddes, "German Banks Fearful on Polish Loans"); "The German Banks' Sky-High Polish Debts," *The Economist,* December 19, 1981.

and Austria, it was expected that those governments would intervene at an early juncture. The Federal Republic should also have been able to find the executive and legislative means to cushion the blow to its lending institutions.[36]

As for Eastern Europe—or, more remotely, debtors in the third world—the argument of inevitable spread of the default seemed only speculative. Some doubted altogether there would be much of a "ripple effect" in Eastern Europe, on the grounds that the credit market "now expects it and has already substantially discounted it."[37] Among those who took the prospect more seriously, the threat was sensed only vaguely; little evidence was produced in public to sketch out the likely scenarios. Had they been drawn, such scenarios would have built on the psychopathology of international banking, which was so brilliantly illuminated over the last decade: rapid withdrawal from exposure even in markets not immediately threatened succeeding the credit extension binge of the early and mid-1970s. But governments need not have behaved as irrationally. Indeed, they were sensible enough to step in and avert a rescheduling-default crisis when Hungary was almost stripped of short term liquidity in 1982.[38] The presumption of an inevitable domino effect in Eastern Europe therefore depended on a belief in the impotence or indifference of the Western governments. Even in early 1982 the assumption seemed unwarranted. A major debt crisis in the third world on top of the East European troubles, however, could have strained Western government resources in a period of general economic depression. In fairness to the "ripple-effect" opposition to declared default, one must concede that "the situation *was* tricky and full of imponderables" in Leslie Gelb's words, and the costs of guessing wrong seemed high.

Default and Near Default

The necessary condition of fulfillment of the punitive or deterrent purposes of a declaration of default was the curtailment of credit to

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[36]Even before martial law, the 1982 FRG budget allocated DM1 billion to cover anticipated losses from state guarantees on Polish loans. *The Times* (London), October 2, 1981. The biggest German banks set aside special reserves for their risky debts. Reuters, March 31, 1982; Peter Montagnon, "Commerzbank to Raise Polish Debt Provision," *Financial Times,* September 7, 1982. These reserves would not have covered a complete default in 1982, but most observers expected the German central bank and the Bonn government would move quickly to rescue the weaker members of the group.

[37]Richard Portes, "Should Poland Now Go Bust?" *The Guardian* (London), March 30, 1982.

[38]Klaus Schroder, "Rescheduling the Debts of CMEA Countries," *Aussenpolitik,* 34:2183, pp. 152–154. Schroder contrasts Hungary's experience with that of Romania, which was forced to reschedule. It must be said to the bankers' credit that they exhibited more patience and responsibility in the Mexican, Brazilian, and Argentinian liquidity crises.

Poland and, depending on one's preferences, to the other communist countries, including the USSR. East European and Soviet needs for credit were assumed to be large enough to make the denial of new loans a painful sanction and possibly sufficient to force a change in policy.

But if restriction of credit flows was the objective in early 1982, this was already in progress. 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 sharply altered East-West credit market conditions. If Poland were formally placed in default, new credits would become available only after provision was made for rescheduling and repaying the defaulted debt (ignoring the political issue of the internal Polish situation). This was in fact the case in early 1982: Poland was unable to obtain new medium or long term loans and had difficulty even rolling over its short term obligations. Uncertainties about the creditworthiness of other East European countries also surfaced, especially after Romania opened negotiations for rescheduling. The supply of credit to all of Eastern Europe was tight, and the credit stringency affected even the USSR.[39] Loans by the Bank of International Settlements area banks, the major developed country lenders, to Eastern Europe excluding the USSR declined from $55.1 billion at the end of 1981 to $49.0 billion six months later, a shrinkage of 11 percent. Soviet debt dropped 9 percent in the first half and 3 percent in the second half of 1982.[40]

A state of near default developed in 1982 that approached a situation of actual default in terms of its influence on the supply price of credit to Poland and the rest of Eastern Europe (less so with respect to the USSR). Near and actual default were also closely related in respect to effects on the lenders. The probability that the West would be repaid depended on Poland's future need for credit, as well as on its hard currency earning capacity. If Warsaw were able to manage without fresh loans from the West, its incentive to undertake and fulfill commitments under rescheduling would be sharply diminished; formal default would not substantially reduce the likelihood of repayment. With unprecedented shrinkage in total output—net material product declined in each of the four years 1979–1982, and at an

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[39]The shrinkage of credit flows was in progress even before martial law in Poland. Borrowing by communist countries (excluding China) in the syndicated loan market dropped steadily from near $4 billion in 1978 to little over $1 billion in 1981. *Financial Times,* December 23, 1981.

[40]WEFA, *CPE Current Analysis,* 3:45/46, June 17, 1983. There was almost no change in East European loans during the second half of 1982. The reduction in the Soviet debt was partly at Soviet initiative.

accelerating rate in 1979–1981—and considerable dependence on Western imports for current production, Poland badly needed new hard currency loans. In fact, the Jaruzelski regime attempted to extract fresh credits from the West, as we have seen. Its future needs were likely to be at least as great. So long as near default was maintained, the leverage of credit withholding promised to have some weight. Poland's assets abroad available for seizure were small, which decreased 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 where losses of interest and deferred (fractional) payment of principal can be written off against tax liabilities—and institutional arrangements of financial regulation. The tightening of credit under near default results not only from downgrading borrower creditworthiness 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 appear to be a matter of degree.

If near default retained the lenders' leverage without incurring the possibly large damage to the international financial system, the argument for formal declaration of fault seemed undermined. Not so, according to American banker Felix Rohatyn. The credit curtailment would soon evaporate, he predicted. "The dynamics of the present situation inevitably lead to new commercial credits to protect the old ones."[41] To a limited extent, Rohatyn was right, of course, as the commercial reschedulings of 1982 and 1983 showed. He may be proved even more far-sighted in the future.[42] Whether in retrospect this would vindicate the proponents of default is, however, another matter, to which we return shortly.

So far the credit situation has been viewed almost entirely with respect to the banks. It is necessary to look at the government dimension, too. The government actions of early 1982 were intended to tighten the credit constraints on Poland: In fact they appeared to have a different effect.

In the debate in early 1982 on whether to declare default, a major opposing argument was that default would deprive the United States of its leverage over Polish (and Soviet) policy. Of course, default would

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[41]Felix Rohatyn, "The Case for Putting Poland in Default," *Wall Street Journal,* April 19, 1982.

[42]Amity Schlaes, "U.S. Banks Looking to Lend Again in Financially Sounder East Europe," *Wall Street Journal,* March 1, 1984.

not absolve the Poles of their debt service obligations, contrary to some of the claims made at the time; Warsaw would remain legally obligated to pay. Depending on the extent to which other lenders followed the U.S. government action, default would also make it more difficult for the Poles to gain access to new credits without satisfying political conditions. Nevertheless, critics argued, Warsaw could remove the issue of external debt management from its policy agenda until it decided to get back into the credit market and had the means to attract a rescheduling offer from its creditors. Once deployed, therefore, the weapon of default declaration used up the leverage potential contained in the threat to deploy the weapon. Of course, there was a delicate issue of credibility in such a position. If the borrower believed that the lender accepted the argument of loss of leverage on use, the threat to declare default would rapidly lose credibility. Moreover, those who argued the superiority of the threat over its execution avoided specifying the conditions under which the threat would have to be executed, strengthening the impression that they were opposed to declaring default under most foreseeable conditions.

Once the U.S. government decided not to declare default, an embarrassing paradox developed: The public statements declared that default was avoided in order to retain leverage, but the refusal to reschedule Polish loans coming due in 1982 released the leverage. A State Department memo written immediately after the December 1981 coup is supposed to have declared: "We believe our economic leverage on the Poles is maximized if they must contend with meeting their Western debt obligations."[43] And, it was argued, "the suspension of consideration of negotiations on rescheduling 1982 Polish debt allows us to pursue the collection of those debts."[44] But how? Presumably, it was hoped that refusal to reschedule would accelerate the drying up of new credit flows, thereby imperilling Polish recovery chances and inducing Warsaw to make political concessions in exchange for access to Western credit.

Throughout 1982 and well into 1983 the NATO governments held fast to their refusal to negotiate with Jaruzelski on rescheduling until the three conditions of their January 1982 declaration were met. The effect, however, was to free the Polish government of any need to make payments of interest or principal on its official debt. Warsaw struggled through with minimal inflows of new loans. Instead of imposing additional costs on the martial law regime, the NATO government actions

[43]Seth Lipsky, "Officials Argue U.S. Role on Polish Debt," *Wall Street Journal,* January 7, 1982.

[44]"Treasury-State Background Paper," p. 5.

eased Warsaw's balance of payments problem. No default plus no rescheduling added up to a reward for bad behavior.[45] Between the governments' passivity and the banks' growing concessions on rescheduling conditions, near default appeared to be unravelling.

The Bottom Line: Would the Soviet Umbrella Open?

Even if near default continued to operate, the direct effects on the USSR, reduced access to credit, were only marginal; and there seemed to be no force impelling Moscow to help Poland redeem its credit standing. Near default, therefore, seemed to miss the main point of declaring default, which was to impose costs on the Soviet Union and even to alter its behavior in Poland and Eastern Europe. This could have happened only if announcing default forced the Kremlin to assume the debts of its floundering allies. But would Moscow have agreed to extend its umbrella? Little evidence was put forward to support such a prognosis, and much in the Soviet behavior and condition cast substantial doubt on it. Why should the Politburo wish to bail out Poland, whose economic course during the 1970s it viewed with misgivings and whose standard of living was already regarded by ordinary Russians as bought at Soviet expense?

It is now argued that Moscow has been heavily subsidizing Eastern Europe by accepting less than world market prices for exports of Soviet fuel and raw materials and paying better than world market prices for East European machinery and consumer goods.[46] These are therefore implicit rather than direct subsidies and reflect the opportunity costs of Soviet–East European trade flows. The subsidies are largely autonomous consequences of CEMA pricing arrangements—particularly the lag of intra-CEMA oil prices, set on a five year world market average, behind the sharp jumps in OPEC prices during the 1970s. It is evident that a large share of the subsidies generated at those times was unexpected and undesired. Also, as OPEC prices have stabilized, CEMA oil prices have caught up and produced unfavorable terms-of-trade changes for Eastern Europe.

The Soviet leadership is undoubtedly aware of the opportunity costs of its CEMA trade and has allowed the arrangement to persist, so the

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[45]The action of the governments may have also weakened the resistance of the banks to the Polish demands for more favorable commercial rescheduling conditions.

[46]The best known estimates are by Michael Marrese and Jan Vanous, *Soviet Subsidization of Trade with Eastern Europe. A Soviet Perspective,* University of California Institute of International Studies, Berkeley, 1983. A shorter discussion is contained in the same authors' article, "Soviet Policy Options in Trade Relations with Eastern Europe," in Joint Economic Committee, U.S. Congress, *Soviet Economy in the 1980's: Problems and Prospects,* 1983, Part 1, pp. 102–116.

subsidies may "in part, represent a conscious decision by the Soviet political leadership to trade at terms favorable to Eastern Europe."[47] If so, Moscow may conceivably take action to ease the pain of East European countries now experiencing a transformation of the direction of the import subsidy.

Direct Soviet aid to Poland, a factor in 1980–1981, was conspicuous by its absence in 1982–1983. After the institution of martial law, the First Deputy President of Poland's trade bank claimed that Moscow had allowed generous repayment terms, including a five year grace period, on the $1 billion Poland owed the Soviet Union.[48] The Soviet credit of $465 million, given in 1981, he described as a "noninterest bearing nonrepayable" gift.[49] Poland's trade deficit with the socialist countries grew rapidly in 1980–1981. But the Soviet policy was reversed after martial law. Warsaw reported the dollar value of Poland's gross medium and long term debt to all socialist countries as only $2.2 billion at the end of 1981; Wharton estimates that six months later it had decreased by $100 million.[50] Aid embodied in the trade deficit that Poland ran with socialist countries declined sharply. The trade deficit with the Soviet Union was cut 60 percent in 1982; the net inflow of resources from the USSR, adjusted for price change, fell almost 85 percent. This reflected an 8 percent decline in the terms of trade, following a 6 percent decline in 1981.[51]

In Poland's time of acute need Moscow was demonstrating no urgency in coming to Warsaw's assistance. The opposite was true; the Kremlin was cutting its foreign aid to Poland. How could it then be

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[47]Marrese and Vanous, "Soviet Policy Options . . .," p. 105. Marrese and Vanous estimate Poland's share of the accumulated sum of subsidies during 1960–1978 as 85 percent as large as Czechoslovakia's and only 40 percent of East Germany's; Poland's share is, however, 30 percent larger than Hungary's and several times larger than Bulgaria's.

[48]Ibid., p. 106.

[49]Frederick Kempe, "Poland To Complete Payment of Interest Due in 1981, Enabling Debt Rescheduling," *Wall Street Journal*, March 15, 1982.

[50]WEFA, *CPE Current Analysis*, 2:93, November 23, 1982.

[51]Ibid., 3:31/32, April 29, 1983. Poland's 1983 trade deficit with all the socialist countries was about the same as in 1982. The USSR granted no further hard currency loans. WEFA notes that the Soviets did provide indirect aid: by allowing the Poles not to buy Soviet machinery and other manufactures no longer needed because of investment cutbacks in Poland; by exempting Poland from the 10 percent cut in Soviet crude oil deliveries imposed on other East European countries (but refined petroleum sales were reduced); and by "sharply" increasing purchases of a certain category of Polish machinery—"the Soviets dramatically relaxed the pressure for bilateral commodity balancing, which they stress with other East European countries." But Poland was not exempted from the increases in prices of Soviet goods other East European states suffered. WEFA estimates the deterioration in Polish terms of trade with the USSR as 6 percent in 1981, 8 percent in 1982, and 3–4 percent in 1983. "Naturally, this development negated most of the impact of favorable Soviet policies with respect to the commodity structure of trade." WEFA, *CPE Current Analysis*, 4:11–12, February 22, 1984, p. 2.

assumed that a declaration of default would induce the Politburo to do a complete about face? Moreover, why would *Soviet* leaders wish to be seen undertaking to save *capitalist* bankers from the consequences of their folly? A rescue operation for Poland and Western bankers would be all the more undesirable for the signal it would send of probable Soviet readiness to support other East European economies that might experience financial difficulties. It did not take much knowledge of the Soviet balance of payments situation to recognize that even if it wanted to Moscow could not possibly afford to hold its umbrella open for any and all of its allies caught out in the rain.[52]

It was much more likely that Moscow would exploit a Western declaration of default as a means to force Poland to bear the dominant share of its recovery costs. Blaming Western perfidy and drawing a picture of coordinated Western conspiracy in bold strokes, the Kremlin could demand sacrifice for the sake of preservation of the socialist commonwealth, not just from Poland but from the other East European members as well. Poland's trade orientation would surely have turned sharply to the East, and although that was already taking place under the near default conditions of 1982, the effects of formal default could be expected to be much more comprehensive and lasting. It was difficult to find political comfort for the West in such a development.

Failure to declare formal default, then, did nothing to put the Soviet Union on the Polish financial hook. But it seems highly doubtful that declaring default would have succeeded in doing that either.

LESSONS OF THE CRISIS

It is difficult to conclude that Western policy scored a success in the Polish debt crisis. Poland was cut off from sources of substantial new credits, other than short term loans; the credit squeeze did affect most of Eastern Europe and even to some extent the USSR. However, this was less the result of a deliberate allied policy to impose costs on the communist bloc in punishment for the Polish repression than of the shocked reaction of the banks to the Warsaw government's moratorium declaration in early 1981 and their belated recognition of the scale of their overextension. Martial law was lifted in the summer of 1983 and most of the internees were released, but Solidarity has been largely crushed and there is no sign of negotiations among the Church, the government, and free trade unionism. Whatever improvement has

[52]For an examination of Soviet prospects, see Gregory Grossman and Ronald L. Solberg, *The Soviet Union's Hard Currency Balance of Payments and Creditworthiness in 1985,* The Rand Corporation, R-2956-USDP, April 1983.

taken place in the internal political situation may be explained as easily in terms of the regime's domestic consideration as with reference to the pressure of the external sanction. In any case, Soviet control has returned to Poland and appears unchallenged.

A general evaluation of Western policy in East-West relations is not the concern of this report. Our interest is to assess the implications for the use of leverage or denial as policy instruments. The starting point of such an assessment is that although governments, particularly the United States, spoke of the Polish debt as providing leverage for the West, they did not pursue a systematic leverage policy. Neither was there a systematic denial policy. The Polish government claims that Western sanctions cost the country over $10 billion in lost output during 1982–1983.[53] But the primary damage was done by the credit freeze, resulting from the undirected action of banks in many different countries. The banks were not an instrument of U.S. or allied policy and could not have served as such except in pursuit of their private objectives.

Accordingly, the denial of credit was by no means complete and the leverage potential of Polish need for credit was weakly exploited. Several factors must be identified as playing an important part:

- The credit squeeze was "decoupled" from the internal Polish situation by the success of the martial law repression. In both 1982 and 1983, by slashing imports from the West, regardless of the effect on consumption and investment, Warsaw achieved a surplus in its hard currency trade balance. The Jaruzelski government was therefore under less pressure to seek substantial Western economic help.
- Failure of the allied governments to reschedule official obligations relieved Warsaw of a nonnegligible portion of its debt service obligations.
- In the bargaining between the banks and the Polish government, it was the latter that was successful in exerting leverage. In early 1982, it was unthinkable that Poland would be given additional credits. By the end of 1983, 65 percent of interest obligations were being recycled and the other terms of the rescheduling were markedly easier. Poland made no concessions on internal policy for these gains. The Western governments made little or no attempt to influence the banks' positions.

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[53]See, for example, "Polish Debt to West Seen Increasing by 7.2% in '84 to $29.4 Bill," *Wall Street Journal*, January 10, 1984.

- The threat of declaring default could hardly have been taken seriously in Warsaw because it probably recognized both the intense division within the allied ranks and the U.S. government's own hesitations about using the default weapon.
- Ultimately, a serious leverage policy would have had to involve the promise of substantial economic aid along with an effective threat of credit denial or even subsequent to a declaration of default. The threat of denial was limited in scope and credibility, but the promise of aid was conspicuous by its absence. The U.S. government would not consider discussing aid to Poland while the democratic movement was being crushed.[54]

There are seasoned analysts who argue that Poland was too important to Moscow for any sanctions to have made a difference in the Polish events. "To put the matter bluntly," one writer asserted, "U.S. economic incentives cannot hasten nor penalties compel the Soviet and Polish governments to return Poland to the pre-December 1981 status quo."[55] That was not the only possible goal of a leverage strategy, which might more prudently have aimed at a substantial amelioration of the post-December 1981 status. But if leverage is created by asymmetrical dependence,[56] there could be few situations in which the potential for leverage was as great as in the Polish debt crisis. The West was unable even to test the possibilities of exploiting that potential, because it could not agree on either the desirability of the objective or the strategy for pursuing the goal.

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[54]Some observers have argued that an offer of substantial economic aid to Poland before martial law could have saved the democratic movement or at least postponed the crackdown. Others are skeptical that the offer, if made, could have been accepted, or that the aid could have come in sufficient time and amount to have made a discernible difference to the actual outcome.

[55]Charles Gati, "Polish Futures, Western Options," *Foreign Affairs,* 61:2, Winter 1982/83, pp. 304–305. Gati believes that when the time comes for "Kadarization" of Poland, the West can exert leverage with both carrots and sticks, to turn the process to the advantage of the Polish people and the West (p. 307).

[56]"It is the asymmetries in dependence that are most likely to provide sources of influence for actors in dealing with one another." Robert O. Keohone and Joseph S. Nye, *Power and Interdependence: World Politics in Transition,* Little, Brown, Boston, 1977, pp. 10–11.

VI. A NOTE ON THE GAS PIPELINE CONTROVERSY

The idea of a major project to ship West Siberian gas to Western Europe emerged in the mid-1970s. A prime attraction to Europeans was the opportunity to diversify energy sources of supply in the wake of the 1973–1974 embargo and explosion of oil prices. But the recession of the late 1970s underscored the second lure of the deal—opportunity for large sales of pipe, compressors, and associated equipment to the Soviet Union. In tandem these apparent advantages created a powerful European drive to consummate the deal in the teeth of American opposition (which, to be sure, did not become adamant until the Ottawa summit conference in July 1981) and in disregard of Soviet domestic or foreign policy behavior.[1]

American opposition suffered from several major handicaps:

1. The professed reasons for opposition varied over time, and the weight accorded different reasons in the later period also varied, thus helping to confuse the Western publics and detracting from the credibility of Washington's posture.
2. An effort to provide a concrete plan to substitute other energy sources was late in developing and was not able to convince European leaders of its relevance. Further, there was no visible attempt to deal with the other attraction of the deal, sales of pipe and equipment.
3. There was no possibility of preventing the pipeline from being built, because the Soviets had the technical and economic capability to use domestically produced (although less effective) equipment to substitute for European and American imports. At best, completion of the pipeline might have been delayed by several years.
4. What ultimately assured the determination of the European governments to proceed with their agreements and the collapse of the American opposition was the U.S. extension of extraterritorial controls on shipment of compressors and associated equipment in June 1982. The action brought a storm of

[1]Actual negotiations on the deal between Moscow and the Europeans began about the time of the invasion of Afghanistan. Completion of the negotiations with different countries took place at different phases of the Polish crisis. The post-Afghanistan period was also one of increasing repression of Soviet dissidents.

indignation in Europe, centered on the alleged violation of sovereign rights but also reflecting the threat to the front-end sales of pipe and equipment to the Soviets. This vehement and widespread European rejection of the American position forced an abandonment of the central effort some five months later.

At this point, our interest is not in the intra-West conflict that developed over the pipeline deal, points 2–4 above, but in the leverage-denial features of the U.S. position. Leverage was not an issue before martial law in Poland. In the bare year that the Carter administration dealt with the question, it was preoccupied with other matters—Afghanistan (to which the pipeline was not unrelated), American hostages in Teheran, and the presidential election. But the focus of whatever U.S. opposition developed was the dependence on the USSR that the gas deal allegedly would have imposed on Europe.[2] As the controversy waxed in the second half of 1981, more was heard of a Reagan administration contention that the gas agreements would bring the Soviets a bonanza of hard currency earnings in the mid and late 1980s, just when oil exports were expected to fall off rapidly, that would make possible equivalent levels of acquisition of Western technology.[3] Finally, after the Jaruzelski coup of December 13, 1981, opposition to the pipeline became part of an effort to punish the Poles and the Soviets and to secure a rollback in Poland to the status quo ante.

Thus, there were three different elements in the cumulative American position: first, negation of potential Soviet leverage; then, selective denial as part of a strategy of generalized resource denial, but still only to impede Soviet military development; and finally, selective denial for negative leverage. Because the third component was not introduced into the trans-Atlantic discussions until 1982, there was considerable European skepticism about the link between the Polish crisis and the gas equipment export controls: If the December 1981 sanctions were triggered by the declaration of martial law, what development in Poland required the extraterritorial extension of June 1982?[4] Moreover, the Europeans claimed, the controls penalized allies far more than they did the adversary, for the pipeline would surely be built with or without the imports of European compressors. Europeans suspected

[2]A forthcoming Rand study by John Van Oudenaren deals with the issue of Soviet "reverse" leverage.

[3]A related complaint dealt with the terms of the agreements—loans to the Soviets at below market rates and easy repayment terms and dubious price protection on the gas purchases.

[4]The U.S. government's response was that it was the absence of any action in Poland to restore the status quo ante December 13 that required further U.S. sanctions.

that the U.S. government's hard-currency-earnings argument was paramount and in reality much broader in aim, that behind the expressed goal of partial impedance of the Soviet military effort lay the true objective of total impedance of Soviet economic stability and growth ("economic warfare"). Finally, it was argued, the sanction was useless in a political sense: Jaruzelski and Brezhnev had reestablished Communist party control in Poland at great cost and risk; no economic sanctions would be powerful enough to induce them to loosen their hold on so important a prize to the Communist world.

Whatever the bedrock reasons for American opposition to the gas pipeline deal in 1981–1982, the minor role of leverage was surely encouraged by European policy. By the time the Reagan administration joined battle with its allies at Ottawa, there was little opportunity to affect the terms of the deal. The Europeans had permitted Moscow to maximize its own leverage by negotiating each element of the project separately—financing, supply of pipe and equipment, and sale of gas—and with each country. It remains a mystery why the largest project in the history of East-West economic relations was brought into being without an attempt by the nations making up the second largest economic power in the world to act in concert, even for the minimum objective of improving the terms of the agreement, let alone for exerting political leverage. The wasting of that opportunity must suggest that leverage, as distinct from benefaction, is a dead issue in Europe. By the same token, the scope for U.S. action is drastically constricted.

VII. ALLIANCE COOPERATION: FACING REALITIES

CRISIS AND CONSENSUS

Three times in the short space of two years, from December 1979 to December 1981, the U.S. government requested the support of members of the Western alliance for measures of economic sanction to punish an act of aggression. Only in the case of the Iranian hostage crisis was a potent sanction, the freezing of $12 billion of Iranian financial assets, under effective U.S. control. But the grudging acceptance of extraterritorial controls applied to Iran foreshadowed America's allies' vehement protests when extraterritoriality was applied in the wake of the Polish crisis in June 1982. In the case of the Afghan and Polish crises, conflicts of interest and view among the allies resulted in actions that undermined the effectiveness of the sanctions. Only Bonn among the Western capitals strongly supported President Carter's symbolic gesture, the Olympic boycott. The noncooperation of Australia, Canada, and the European Community, not to speak of Argentina, helped the Soviets circumvent the far more important sanction, the grain embargo.[1] Trade ties with Moscow were certainly not cut: In 1980, exports to the USSR from France and the FRG increased 26 and 30 percent respectively; imports from the USSR jumped by 57 and 43 percent (all at current prices).

After the declaration of martial law on December 13, 1981, President Reagan announced a group of penalties against Poland and followed that with a set of sanctions against the USSR. It took four weeks of discussion in NATO to enable a joint condemnation of the Polish repression (January 11, 1982). No sanctions were levied against the USSR until the European Community adopted a watered down decision to cut back on trade flows in March. Between January 11 and the arrival of a high level U.S. delegation in Bonn two months later to discuss the problem, half a billion dollars of state-backed loan guarantees on West German exports to the USSR were approved; preliminary approval was given to additional credits of $127 million.[2]

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[1]Europeans retort that the United States continued to sell grain to Eastern Europe, despite the obvious likelihood of direct or indirect benefits to the USSR.

[2]"U.S. Delegation Visits Bonn to Press for Sanctions," *New York Times,* March 16, 1982.

From the European perspective, Washington's Polish-crisis sanctions were long on costs for the Europeans and short on expense for the United States. Few European discussions failed to indict the Reagan administration's rescission of the embargo on grain sales, the mainstay of U.S. exports to the USSR, as the mark of the selfishness and lack of seriousness of the American program.[3] It was Europe that depended on capital exports—the main target of the U.S. sanctions—to balance its imports of oil and gas from the USSR. The climax came with the June 1982 pipeline controls, viewed as a deep affront to national sovereignty and an effort to cut off the front-end European benefits, exports of pipe and equipment.

But the European-American controversy on East-West economics involved a more fundamental disagreement on basic goals and strategy of East-West relations. Had Washington volunteered to reinstitute the grain embargo in mid-1982 to match the European sacrifice on pipeline equipment, the offer would most likely have been rejected as an act of "economic warfare," the bugbear attached to almost all objects of denial except military equipment and technology. Europe's negotiation of the pipeline deal avoided exerting any leverage on the Soviet Union. Sanctions against Poland were adopted with reluctance and little confidence in their utility; sharply limited sanctions against the USSR for its part in the Polish crisis were quickly diluted.

These episodes raised questions in the minds of many on both sides of the Atlantic about the viability of NATO. They certainly put in question the future potential of Western sanctions against the Soviet Union—indeed, whether the alliance could agree on any but a minimalist East-West economic strategy. If so, the range for U.S. policy in this area necessarily would be sharply constrained.

MAINSPRINGS OF DISSENSION

No effort to understand the roots of the Western alliance's sprawling disarray on East-West economic matters in 1980–1982 can fail to note the pronounced differences in East-West trade involvement between Western Europe and the United States. Imports from the Soviet Union by the Federal Republic alone were 25 times larger than those of the United States in 1982. Despite the salience of American grain sales, FRG exports to the USSR were 37 percent larger than the

[3]Almost 20 years before, when the United States jointly with the Federal Republic attempted to head off a competitive credit race in favor of Moscow, the British pointed to the inconsistency between permitting grain sales and refusing to grant credits. Stent, *From Embargo to Ostpolitik*, p. 148.

U.S. volume. German trade with Eastern Europe is similarly much more important than that of the United States. Germans often note that they trade more with Switzerland than with the USSR; but even on a relative basis, East-West trade is far weightier for Bonn than for Washington. Comparing trade with the East with total trade and GNP, the German ratios are 4 and 11 times higher, respectively, than the American ratios.[4] A German analyst notes that "by virtue of its size the export sector has considerable clout in the process of [German] foreign economic policymaking. Its structural economic importance is converted into political influence through a network of well-organized and articulate business associations."[5]

But the inquiry into sources of the alliance discordance must look beyond economics to trans-Atlantic differences in fundamental outlook on East-West relations.[6] It is not just that Europeans[7] tend to frown on sanctions.[8] Many of them sense that they no longer share with the United States a common conception of how to conduct relations with the Soviet Union and Eastern Europe. Detente is for most Europeans not just the approach of a particular period but the only viable mode of managing the vital problem of living on the same continent with the Soviets. It provided the only hope of being able "to project some vision

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[4]*Vneshniaia torgovlia v 1982,* pp. 9–14; United Nations, *Monthly Bulletin of Statistics,* 37:7, July 1983, Special Tables D and I, Tables 52 and 62.

[5]Michael Kreile, "Ostpolitik Reconsidered," in Ekkehart Krippendorff and Volker Rittberger (eds.), *The Foreign Policy of West Germany, Formation and Contents,* Sage Publications, London and Beverly Hills, 1980, p. 134.

[6]This discussion draws on a remarkable extended interview conducted in December 1982 by George R. Urban, currently Director of Radio Free Europe, with Johan Holst, formerly Deputy Foreign Minister in the Norwegian Social-Democratic government and now Director of the Norwegian Institute of International Affairs: "Can We Negotiate Restraint with the Soviet Union?" Holst is a well-known Atlanticist and defender of the alliance. As such, his critique of the U.S. government viewpoint and his support of detente policy illuminate the gulf that has developed between Washington and European elites, many of which are considerably less tolerant of American views than Holst is. Quotations below from Holst's replies to Urban's questions are referenced as "Holst interview" and the page of the original processed report. For a more extended analysis of this general subject, see A. S. Becker, "East-West Economic Relations: Conflict and Concord in Western Policy Choices," Chapter 7 of Uwe Nerlich and James Thomson (eds.), *The Future of East-West Relations: U.S. and West German Approaches to Soviet Power,* forthcoming.

[7]Manifestly, there are differences of view among Europeans, and the collective grouping does violence to that reality. Nevertheless, by contrast with U.S. government attitudes, there is some validity to considering a "European" viewpoint.

[8]"[Economic] sanctions seldom work, and they work particularly badly as an instrument in the hands of liberal democracies. They are, in a way, contrary to the essence of our social order and run counter to the spirit and day-to-day conduct of mixed economies." Holst interview, p. 8.

as to how the conflict might be transcended."[9] The Reagan administration's East-West policy—in matters of security and arms control as well as economic relations—was frequently perceived as threatening these cherished hopes.

Even the utopianism of some of the administration's rhetoric frightened many Europeans. President Reagan vowed before the British Parliament in June 1982 to launch a political struggle against the Soviet Union among the people of the bloc. His fervent conviction that "the march of freedom and democracy" would "leave Marxism-Leninism on the ash heap of history" contributed to the image of American adventurism. Europeans who are fundamentally pessimistic about the East-West struggle reacted to this intended message of hope as a threat to irrevocably seal off the possibility of enlisting the adversary's good will. The first principle in the sacred canon of detente is that East-West relations combine relations of rivalry with those of shared interests. Europeans seek to minimize the former and cultivate the latter. The President's call for political struggle against the communist order was widely regarded as both in dubious taste and dangerously provocative.[10]

It is an irony of history that much of Europe, particularly Germany and to some extent France, was wary of the thawing of U.S. cold war policy under President Kennedy and in the early Johnson years. Pressure by the Nixon administration was necessary to help get the Eastern treaties, the foundation of Ostpolitik, pushed through the Bundestag. Having settled into the nest of detente, with only occasional uneasiness about the ultimate security of this perch, Europeans longed for stability. Indeed, stability was transmuted into another sacred principle ("international security presupposes an orderly, continuous and *predictable* foreign policy"),[11] the more so because of the oscillation of U.S. policy through the rapid succession of one-term presidencies in the 1970s. Germans lamented the *Unberechenbarkeit* (unpredictability, unreliability) of American policy, but what they mourned was the deviation from the shared perceptions of the seventies.

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[9]Ibid., p. 17.

[10]"Personally I find this [dominant] strain [in American thinking] disturbing because it imposes on us a rather belligerent view of the conflict and certain tactics which are inconsistent with our broader identity as liberal democratic societies." Ibid., p. 21. Urban repeatedly asked Holst how the West could deal with Soviet aggression when military force was out of the question and economic sanctions were rejected as useless. Holst's last reply, cited below in its entirety, is instructive (p. 47):

> The fact that we do not want to cut off economic relations and do not want to impose sanctions does not mean there is nothing we can do. I am personally convinced that we should work out an absolutely fireproof agreement on the terms on which we extend credits to the Soviet Union and Eastern Europe.

[11]Ibid., pp. 30–31; emphasis in the original.

WHAT IS TO BE DONE?

The Western alliance is no longer dominated by a single power, a transformation that is likely to be indefinitely durable. The alliance is not yet a consortium of equal partners, nor are the partners now like-minded on important elements of their association. As Holst put it: "We are still groping for the appropriate procedures and machinery to do justice to this new relationship."[12] But the controversy is not about procedures and machinery—although, as suggested below, there are useful measures that might be taken; it is about concept and principle, about history and strategy, on which compromise is notoriously more difficult to achieve.

At the close of 1983, the noisy conflict over East-West economic policy died down, largely because it was replaced by the struggle in the streets of Europe over alliance missile deployments. When the basic identity of the Federal Republic appears to be at stake, East-West economics takes a remote back seat. At the time the pipeline imbroglio was smoothed over by an agreement to study the major economic issues (November 1982), a process was set in motion that was hoped would lead to greater intra-West cooperation. The watchword of this operation was to secure agreement on policy without necessarily being able to agree on assumptions and principles. What are the prospects for limited agreement of this kind?[13] Progress has been made and is likely to continue on strengthening COCOM as an organization and on the procedures for controlling the transfer to the East of the evidently sensitive categories of technology. Perhaps in the next five years there may be visible movement toward development of an alliance energy policy, reducing (or preventing an increase in) the dependence on Soviet supplies. There is now greater sensitivity to the subsidy element in East-West trade deals[14] and the self-inflicted wounds of Western credit competitions. But the dilemma of the benefits and costs of selling dual-use technology is not resolvable by agreement in principle. Nor are traditional European export inducements likely to be abandoned easily.

The November 1982 agreement at least obliged the West for the first time to examine the issues of East-West trade more or less comprehensively and simultaneously. The most useful contribution the

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[12]Ibid., p. 4.

[13]For fuller discussion, see the section on "Prospects" in Becker, "East-West Economic Relations: Conflict and Concord in Western Policy Choices."

[14]On the size of the subsidy, see a forthcoming Rand study by Daniel F. Kohler, *Economic Costs and Benefits of Subsidizing Western Credits to the East*, The Rand Corporation, R-3129-USDP, July 1984.

alliance can make to dealing with its bedrock conflict on East-West economics is in fact to institutionalize and make permanent this examination of the issues. It is regrettable that members of the alliance seem reluctant to adapt the existing economic apparatus to this purpose. Although additional forums for discussion would be necessary to involve non-NATO states, the fundamental issue is the security dimension of East-West economic relations; by definition that belongs in a NATO framework. However, if it is infeasible to place the major responsibility on NATO for developing and managing Western discussions on this subject, it would be useful nevertheless to keep the issues under systematic review within the several forums—NATO, OECD, IEA, COCOM—that have been responsible for the 1982–1983 studies.

These expectations make for limited prospects of Atlantic harmonization, but the limitation was inherent in the nature of the conflict. It is possible to hammer out a compromise on the specifics of policy without agreement on principle, but failing such an agreement the compromise will inevitably be a lowest common denominator.

VIII. CONCLUSION

A German analyst ruefully judged that all the concepts of East-West economic relations are "tired"; they all lack plausibility.[1] The examination of elements of the theory of denial and leverage in this report pointed out important difficulties of both cardinal strategies:

- Selective denial aimed at technology transfer—the persistent dilemma of control posed by the continuum of civil-military use
- General denial
  - — The difficulty of distinguishing "normal" from "strategic" trade
  - — The uncertainties in the multiple links among effective resource constraint, military power, and external behavior
- Leverage—the inevitable arbitrariness involved in deciding on how much leverage and for what objectives.

It was also observed that although the Soviet economy is more dependent on trade than generally believed, a distinction must be observed between dependence and vulnerability. Taking into account the character of the USSR's trade partners and Moscow's willingness to resist external economic pressures, Soviet vulnerability is appreciably smaller than trade dependence arithmetic suggests.

The cases reviewed in this study illustrate many of these difficulties but highlight other critical weaknesses of denial-leverage in operation. The early 1980s saw the failure of attempts to employ economic instruments for leverage in the two major East-West crises, Afghanistan and Poland. Control of supply was the clear proximate reason in the former, but in both crises the more important failure was the inability to agree on the desirability of the goal and on a strategy to reach the goal. Behind this abstract generalization, there is the emotion-intensive controversy among members of the Western alliance on the basic issues of East-West relations. The gulf between Washington and the capitals of its allies appears large, despite the small steps that have been taken to bring the conflict over trade policy under some control. *Osthandel* is an integral part of *Ostpolitik,* we have discovered, and not just in Germany. In only two brief intervals of its short history has the Western alliance had a consensus on East-West policy—at the height of the cold war and in the heyday of detente. With the end of the 1970s Washington became convinced that neither perspective was

[1]Reinhardt Rummel, "Improving the Implementation of Political Strategy," in Nerlich and Thomson (eds.), *The Future of East-West Relations.*

appropriate and searched for a new policy direction. Europe remains unconvinced of the need for a major change, and the alliance has experienced a tug of war for control of the policy rudder.

Under these conditions, the only possibility for effective denial over the long term is to aim at selective impedance of the Soviet military effort. Only on this objective can an alliance consensus be reached. The tendency of the United States to oscillate between flashes of anger, expressed in partial sanctions that are undercut or otherwise abandoned, and efforts to restore relations of cooperation with the USSR leaves little room in this country for the patient, obstinate pursuit of long term leverage. Successful leverage can probably be exerted only with respect to second-order concerns about Soviet behavior, but public support in the United States for the sacrifices involved in the application of leverage is unlikely except for issues that Moscow finds too sensitive for retreat. In Europe, leverage is generally approved only in its dimension of benefaction, which seriously, perhaps fatally, erodes its potential.

Between their conflicts over basic perspectives and the clash of particular national interests, the members of the alliance have appeared paralyzed at critical junctures. Reflecting on the response to the Polish crisis, a respected German newspaper observed that the Western democracies

> know they cannot get up the courage for an appropriate response. But they have no idea, and that is not at all to their dishonor, what an appropriate response should be in such a case. They also know they are too divided for sanctions, and besides have grounds to doubt the effectiveness of sanctions.[2]

In the dualism of confrontation and cooperation, rivalry and shared interests that all members of the West recognize as a living imperative of their relations with the East, Europe wishes to softpedal the former and rebuild the latter. Given also the domestic structural handicaps of U.S. policy formation, prudence and realism indicate that economic policy in the 1980s can play only a marginal role in the Western strategy of East-West relations. Limitation of Western economic dependence and vulnerability, reduction of the subsidization of the Soviet economy, narrowing of the direct contribution to Soviet military power—these are feasible objectives of Western policy. More ambitious hopes of using the West's vast economic power to alter Soviet behavior seem sadly incompatible with the realities of Western national and alliance politics.

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[2]*Frankfurter Allgemeine Zeitung,* cited in the *New York Times,* September 11, 1983, Sec. 4.

RAND/R-3127-USDP