RESEARCH BRIEF Rand

SUBSIDIZING CREDITS TO THE SOVIET BLOC

The member governments of the Organization for Economic Cooperation and Development (OECD) subsidize credits to foreign purchasers of their export products in two ways: directly, by giving loans at rates below their own cost of funds, and/or indirectly, by guaranteeing repayment to the lender, thus allowing more risky debtors to borrow at a lower, risk-free rate.

This research estimates the full *costs* to the exporting country of such subsidies provided to the Communist world. It thus fills an important information gap that has hampered the policy debate in the past. Export subsidies always involve transferring resources to the importing country. Since it is clearly not the intention of Western governments to subsidize the Soviet Bloc, export subsidies can be justified only if they increase benefits to the exporting countries by an amount greater than their costs. It has usually been assumed that this is the case because the costs of the subsidies were thought to be small. Our analysis suggests that the costs are substantial.

Basic Findings

Direct subsidies are, in principle, easily measured. A gentleman's agreement among the OECD governments sets guidelines for the minimum rates that the governments should charge for export loans. Direct subsidies are simply the difference between the present value of financing costs at these consensus rates and financing costs at rates at which the lending governments would themselves have to borrow funds. For example, in 1981, when the OECD consensus rate was about 8 percent, the U.S. T-bill rate—the risk-free rate at which the United States government can itself borrow funds—was about 12 percent. Thus, by lending at 8 percent interest, the U.S. government subsidized foreign borrowers directly. The total direct subsidies from the West to centrally planned economies, calculated as the savings in financing costs to Eastern Bloc governments, amounted to approximately $1.3 billion in 1981 alone.

Indirect subsidies are more difficult to measure. They are the difference between the rate that a risky borrower would pay on a guaranteed (risk-free) and an unguaranteed (risk-bearing) loan. We estimated the Western perception of risk for loans to centrally planned economies from a variety of sources, and used that estimate to infer the risk-bearing rate. The indirect subsidies to these economies amounted to $1.7 billion.

Thus, in 1981—the last year for which complete data were available—total subsidies granted by OECD governments on loans to the communist world were approximately $3 billion, roughly 20 percent of the total value of new loans granted with government support. About one fourth of this total went to the Soviet Union. Eastern Europe, excluding Russia, received about 60 percent. This substantial share is dominated by Poland, which has a very high indirect subsidy component because it is considered a very risky borrower. It is likely that for years other than 1981, these numbers vary considerably.

Methodology

Estimating indirect subsidies requires knowing the hypothetical rate at which private lenders would loan money to risky borrowers *if the loans were not guaranteed.* We can infer this rate if we know how risky Western borrowers perceive loans to the Eastern Bloc to be. Of the various data sources we considered, the most appropriate was forfaiting discounts applied by private banks.

Forfaiting is a European banking practice whereby banks buy securities from exporters or from other banks, forfeiting their right of recourse to the original lender. The bank that purchases the securities at the discount assumes all the risks. We used the discount rates that the banks apply to these forfaiting transactions to compute the probability of default at which the bank will break even on its transactions. We estimated missing

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data points from a regression of the available forfaiting rates on Institutional Investor ratings.

Figure 1 shows perceived creditworthiness, based on forfaiting rates and Institutional Investor ratings, of some of the most important Centrally Planned Economies (CPE). The creditworthiness of Great Britain and the United States, which are risk-free from a Western lender's perspective, would be at 1 in this figure.

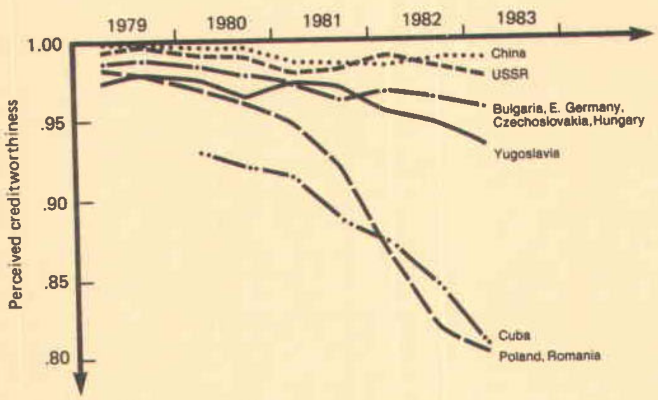

Fig. 1—Perceived creditworthiness of CPE borrowers

The Soviet Union has had high perceived creditworthiness throughout the period; however, it has declined since its peak in September of 1979 and is now at approximately 98 percent.

Bulgaria, Hungary, Czechoslovakia, and East Germany have lower perceived creditworthiness than the Soviet Union, but their positions still look very sound compared to Cuba, Poland, and Romania.

China's progress is rather remarkable. Although it is in many ways still a Third World country, the People's Republic is now considered more likely to repay its debts than the Soviet Union.

Based on these measures of creditworthiness, we calculated the indirect subsidies; these are shown in relation to total loans and direct subsidies in Fig. 2.

Policy Implications

These subsidies are social costs to the economy and must be covered—either by higher taxes or by higher interest rates for domestic borrowers. In most cases, the costs completely offset any benefits that the export subsidization policies convey. On balance, these policies probably maintain far fewer jobs in the export industries than are destroyed in those sectors of the economy that bear the costs.

Thus only the importing countries are net beneficiaries of the subsidies. For example, the $750 million in subsidies to the Soviet Union enable it to increase military spending without reducing domestic spending, or vice versa. We estimate that discontinuing the subsidies would force the Soviet government to reduce military expenditures by about .22 percentage points per annum over the next 10 years were it to maintain the same civilian growth rate.

Export credit and guarantee programs in the West were not created to transfer resources to the East. Nevertheless, they have had that effect, and the sums involved are substantial.

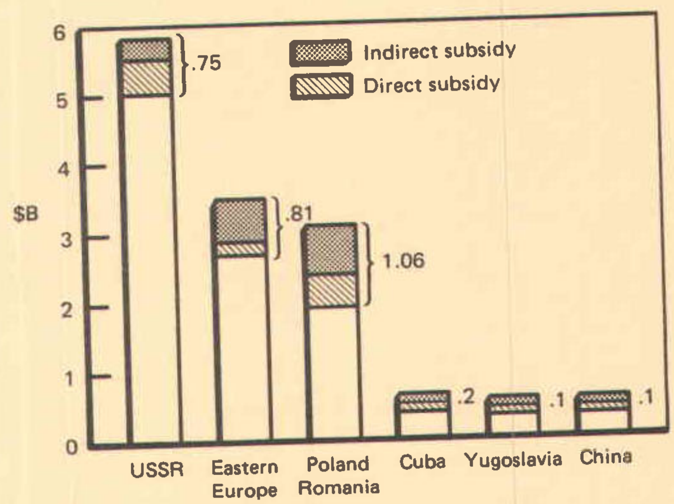

Fig. 2—Western credits and credit subsidies to Eastern Bloc, 1981

The research summarized in this brief was carried out within the National Security Research Division of The Rand Corporation. For more information, see R-3129-USDP, *Economic Cost and Benefits of Subsidizing Western Credits to the East*, Daniel F. Kohler, The Rand Corporation, July 1984, or contact The Rand Corporation, 1700 Main Street, P. O. Box 2138, Santa Monica, CA 90406-2138, (213) 393-0411.