Small States Outside World Markets

Bulgaria’s Trade Relations with Germany and the Soviet Union, 1932-1956

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Monetary and trade regimes are not politically neutral. By allowing for international economic cooperation they produce interdependent relationships among states. They also alter the incentive structures within states, which affect domestic politics and institutions. Regimes are neither all-inclusive nor truly global. Alongside global markets that trade multilaterally in convertible currencies there are a number of regional regimes, which operate under alternative rules. Examples are the eastward economic expansion of Germany in the 1930’s; the socialist market led by the Soviet Union 1949-1991; present day China’s regional trade with East Asia and Africa. These regimes of trade and payments are highly political because they centralize international trade at the level of the state.

This project studies the significance of bilateral clearing trade regimes for the domestic politics in small states. In order to bring forward the characteristics of the regime itself and not those of the core country, which promotes it, I take the bilateral clearing regime, which was promoted by two different regional leaders and used in two very different ways. This is the clearing regime of Nazi Germany and the Soviet Union, which for the Eastern European trading partners is a continuous regime rather than two different international trade regimes. The continuity of the regime after the change of the regional hegemonic power means that its significance is greater than simply analyzing bilateral trade relations between a dyad of countries.

I examine the contested relationship between foreign authority and domestic institutions through the experience of the subordinate state that is least like to have a high degree of freedom – Bulgaria. Its preferences for bilateral clearing regime under the different core states reflect structural continuities within its own economy and the expected benefits as defined by its political and economic elites.

The project is motivated by the evidence that small states matter for the durability of international regimes. They have little influence outside their borders, yet their loyalty is appreciated by the big states they support. Their economies depend on external markets and their domestic politics often reference an external authority. Yet, they have a higher degree of authority over their economies even in cases of unstable political structures. It makes a contribution to understanding the small state policy dilemmas in relation to international and domestic hierarchies.[1]

In the way it conceptualizes continuity, the project does not share the assumptions of totalitarian theory nor of the comparative economic systems literature both of which see the international arrangement as rooted in domestic regimes. The explanation that all Communist states are command economies therefore build a bilateral clearing international trade regime is insufficient for two reasons. Bilateral clearing preceded Communism in Eastern Europe and it was used in German – Soviet trade relations before the Second World War. What the project does assume (based on historical evidence) is that the origins of the regime were not domestic politics but international economics and it was a transfer from a previous international arrangement to a next one rather than a transfer from a domestic to an international regime.

The main research question for this study is *how do small states trade their own authority for economic gains both in relations with foreign governments and with local actors*? This is a question about the relationship between international and domestic hierarchies and the structural continuities that result from cooperation.

The analysis unfolds on two levels using a principal – agent approach. The first level is the hierarchical relationship between the small state (agent) and the dominant state (principal). The positions of Germany and the Soviet Union as principals are constant throughout the studied period. What varies is the relative bargaining power of the small state, measured by its ability to extract economic gains or upload its preferences in the form of rules to the international regime. The bilateral clearing regime is conceptualized as an institution of self-restraining hegemonic power. The dominant state advances a regime of bilateral clearing trade within which it is able to extend economic benefits to the small states in exchange for acquiring international authority.

The thesis poses that small states are important for legitimating the hegemonic regime. In an international system of legal equality among states, where international relations are the relations between national governments, the smallness of a state makes it potentially more attractive to a hegemonic power. A smaller state is easier to absorb as an economic partner at the same time its political friendship counts as influence over an entire foreign polity whose positive alliance works towards gaining legitimacy for the regime of the core state. In order to secure this positive authority, the core countries are ready to forgo a marginal opportunity for economic exploitation and to restrain their own power. Authority works both ways, it is granted by the small states in the course of interaction with the central state but authority is also used by the central state to attract small partners and to project in them positive expectations from cooperation. However the Nazi and the Soviet regimes relied on authority to a different extent and used it at different points in time to legitimize their power.

The second level of the study looks at authority as negotiated between the small state and the domestic actors within it. For the small countries the political choices are rarely between alternative ideologies or systems but between economic threats and opportunities in the context of domestic political struggles. They are studied along the three dimensions of Katzenstein's model of "small states in world markets" state centralization, societal centralization and policy networks. Although these dimensions were developed in the context of advanced industrialized democracies, their central meaning is applicable to small states in general including less industrialized and less democratic states. Although I am using a case study in the past, analyzing such states has present day relevance for the small states under this definition and for other international trade regimes which exist as an alternative to the global market.

In the period of Germany-dominated foreign trade the state increased its grip on the economy, control over economic operations became more centralized but at the same time the state acted as an agent of domestic interest groups and advanced some of their demands at international negotiations. These interest groups are seen as a principal. The domestic political economy looks like a state centralization, societal decentralization within a corporatist policy network.

In the second period (1944-1956) the state itself was a principal and domestic actors served as agents who executed the political goals defined by the state. In relation to the previous period we observe higher state centralization, societal centralization and a hierarchical command-based policy network. This part of the analysis concludes that the adoption of foreign models is not a mechanistic process of foreign imposition of domestic institutions or an emulation of the domestic political economy of the big by the small state. It was rather a process dependent on the mode of cooperation between the two.

Bulgaria is chosen as a case study by virtue of being the least likely case – it is geographically small, economically under-developed and lacking resources for its industry, hardly hit by the Great Depression, with chronic balance of payments problems and heavily indebted it was in a weak bargaining position vis-à-vis both core states and most likely to accept choices which did not advance its interests.

In addition both Germany and Russia enjoy traditionally high reputation in Bulgaria. Germany is the epitome of higher culture, technological superiority and not least as the motherland of the Bulgarian king Ferdinand. Russia is the long-awaited liberator of the Bulgarian people from the Ottoman Empire and the closeness of its Slavic culture and Orthodox religion tie into a deep-seated brotherly sentiment. Against the odds of economic weakness and strong foreign authority, the case of Bulgaria is nevertheless a case of choice, which a small state makes for itself in times of crisis. These choices are limited to its domestic sphere and related to the institutional organization of the foreign trade sector in response to external economic cooperation but they are choices worth studying. The thesis demonstrates that even in the case of small countries with limited economic resources and no political influence outside their own borders (and often over their own borders) cooperation in international regimes depends on choices made within the small state.

The first part of the project puts the bilateral clearing regime in the context of alternative trade arrangements in order to understand its specific effects on the institutions of foreign trade in the small state. Unlike free trade and the multilateral payments system, where exporters receive payments in convertible currency and as a rule are free to spend it in different countries, bilateral clearing trade is facilitated in the absence of international money – imports and exports between pairs of countries are to balance out. Exporters can spend their revenues only in the same country where they sell their goods. In order to facilitate this kind of trade the central bank has to control not only the inflow and outflow of national and foreign currency but also in effect controls imports and exports in terms of their importance for the national economy. What became the norm under a Communist foreign trade regime was in fact established ten years prior to it.

The bilateral clearing regime emerged during the Great Depression when regional trade and payments arrangements replaced the global open economy. The immediate measure against capital flight and devaluation in most European countries was the introduction of exchange controls, which limited the use of foreign currency in international trade and the convertibility of domestic currency into foreign exchange. Under these conditions international trade could only continue in the form of barter, immediate compensations between importers and exporters, or bilateral agreements cleared in the domestic currencies of the two countries. Other European powers remained on the Gold Standard (France) or organized bilateral trade based on tariff preferences (Great Britain) and international trade proceeded within a number of regional blocs, advanced by a leading country under different monetary rules.

Between 1932 and 1935 Germany initiated a number of bilateral clearing agreements with the countries in Southeastern Europe, which had imposed exchange controls. Bulgaria was the earliest and most dependent on Germany trading partner. It supplied agricultural goods wheat, tobacco and later fruit and vegetables at higher than world prices and imported in exchange machines, military equipment and industrial raw materials. The trade, however, was not balanced and despite the written agreement Bulgaria often exported in advance of payments and credited German consumption. Bulgarian Central Bank and the Ministry of Trade had the choice between waiting for counter-imports from Germany to supply the needed cash for paying the exporters or to finance them through self-generated means. It opted for the latter, which was in line with the growing needs of the German market.

Accepting German authority and bilateral clearing relations result in the emergence of a state corporatist model in Bulgaria, which is not seen as an imitation of the Nazi economy, rather a reaction to it and a consequence of domestic input as well as external demand. Compared to the German “model”, the domestic regime in Bulgaria evolved to a higher centralization of the state but not to as high a centralization of society.

Societal groups in Bulgaria had a higher degree of freedom to express disagreement with the state and to demand that it serves their interests then their German counterparts. These demands and criticisms were exercised within a state corporatist policy network.

The contested relationship to German authority is evident from the attempts of Bulgaria to diversify its international trade partners. Already in 1940 it signed bilateral clearing agreements with the Soviet Union in order to secure the raw materials that Germany failed to supply. It also pursued partial multilateralizing of trade with neighboring Southeastern countries with no success.

Following the end of WWII Bulgaria reoriented its trade towards the Soviet Union on the basis of the 1940 bilateral clearing agreement. The same trade regime continued to operate uninterrupted as the organizing principle of the Council for Mutual Economic Assistance and remained so until the end of the socialist period. From the point of view of Bulgaria the mode of cooperation with their dominant trading partner did not change significantly from the pre-Communist to the Communist period. The domestic regimes differed in the level of state and societal centralization. Under the Communist regime the centralization of the state was even greater than before the War but in addition centralization of society also increased. But while these visible changes of domestic structure were taking shape on the surface, the underlying logic of international trade remained unaltered for decades. The incentive structure for exporters was to direct the low quality goods to the "friendly" countries and exchange them under clearing for similarly selected items and aiming to sell the few competitive goods on the free market for convertible currency. This resulted in a rigid economic structure and a lasting "mindset" of evading competition and quality upgrading.

In its "Small States in World Markets" Katzenstein describes how political stability and economic flexibility produce a competitive domestic structure in advanced industrialized states. In the case of less advanced, under-industrialized and non-democratic states political instability and economic rigidity locks in a structure of perpetual transfer of authority abroad and arbitrary allocation of domestic resources. Arbitrary, however, does not mean random or irrational[2] and certainly points to a domestic source of authority and political will, poorly constrained by domestic institutions.

The comparison of the bilateral clearing regimes in the two periods suggested here is a comparison of the small state position in two very different spheres of influence operating on different economic logics and within different ideological frameworks. It sheds light on processes of continuity and change typical for non-democratic under-industrialized small states in relation to a bigger trade partner.

This analysis is relevant to present day China's bilateral clearing trade with resource-rich countries in Africa. They can be seen as transitioning from the sphere of influence of the USSR and the socialist democracies to the sphere of influence of China, a structural change that is underwritten by the continuity of a regime of non-competitive and non-market-based trade. Taking the analysis back to the macro level of the international system, the project offers a conceptualization of a "shadow regime" which starts to operate where the dominant regime of multilateral trade in convertible currency ends. It also points to the opportunities and limitations small states face in relation to external authority and domestic political economy.

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[1] The framework of hierachy in international relations and definitions of sphere of influence that I follow is based on Lake (2009), Cooley and Spryut (2009) and Clark (1989).

[2] On the meaning of arbitratiness see M. C. Kaser, *Soviet economics* (New York Toronto: McGraw-Hill, 1970): 93.

Preferred citation: Asenova, Vera. 2012. Small States Outside World Markets. Bulgaria's Trade Relations with Germany and the Soviet Union. 1932-1956. In: Re-thinking European Politics and History, ed. A. Pasieka, D. Petruccelli, B. Roth, Vienna: IWM Junior Visiting Fellows' Conferences, Vol. 32.