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8 July 1977

MEMORANDUM FOR: Director of Central Intelligence

FROM : Sayre Stevens
Deputy Director for Intelligence

SUBJECT : Marshall Shulman's Paper on Economic Relations with the Soviet Union

In response to your memorandum of 29 June asking for an assessment of Marshall Shulman's reflective study, "Toward a National Policy on Economic Relations with the Soviet Union," I am attaching the comments of the appropriate analysts of the Office of Economic Research. These matters have been a major concern in OER for many years.

SAYRE STEVENS

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Attachment:
as stated.

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Comments on "Toward a National Policy on Economic Relations with the Soviet Union" by Marshall Shulman

A. General

We agree with Marshall Shulman's thesis that the US currently is not in a position to exercise economic leverage against the USSR. As he points out, the Soviets can obtain most of the advanced technology they want from Western Europe and Japan, or given the time and the willingness to bear the cost could probably develop comparable levels of technology themselves. Possible exceptions to this would be very large scientific computers and very high capacity magnetic disc drives for computers where the US remains a unique source. Also, in the near term, the US is the sole producer of high capacity submersible pumps needed by Moscow for its oil industry.

Shulman is correct in stating that other Western countries have been willing to grant the Soviets the credits needed to cover much of their hard currency imports, and there is no indication that this will change, at least in the short run. Although compensation agreements with the West will lessen the burden of debt servicing by assuring the USSR hard currency sales, they will not diminish the Soviets' need for credits as Shulman implies.

With respect to MFN, Soviet exporters would be little affected by the granting of most-favored-nation status. Most Soviet exports to the US already enter tariff free or carry tariffs little higher than MFN rates. A few million dollars' worth of manufactured goods, notable machine tools, cameras, and watches, would benefit from MFN treatment, particularly if quality and servicing deficiencies were overcome. Otherwise, Soviet desire for MFN is political; they want to be accepted by the United States as an equal.

Finally, Shulman suggests that the US should coordinate its trade policy vis-a-vis the USSR with Western Europe and Japan by the "strongest possible diplomatic efforts" to improve COCOM procedures with regard to high technology sales. The past record on this score has been disappointing at best. Our allies see little or no need to limit Soviet acquisition of technology unrelated to items on the COCOM list. Even in COCOM, they have shown a tendency to push for relaxation of definitions to permit the sale of their own goods while supporting the embargo on those higher technology goods produced in the US. Their reluctance in the past to go along with the United States in controlling anything but the most sensitive technology and equipment affords little hope for consent to broader coordination now.

B. <u>Benefits to the U.S. from Reverse Technology Transfer</u>

The most recent and exhaustive study of the flow of technology from the USSR to the US was presented in May of this year to the Interagency Working Group on Potential for

Soviet Technology Transfer to the West. It concluded that Soviet technology made only a slight contribution to the US economy thus confirming the intuitive judgment of CIA analysts. A rough but generous estimate, from the cited study, of US expenditures to license Soviet technology in the 13-year period since 1964 amounts to about $14 million. This can be placed in perspective by considering that in 1975 alone, US companies paid $434 million in license fees and royalties to foreign companies. 1/

The Soviets have exercised the greatest amount of technological leadership in the areas of metallurgy and, less importantly, in medical equipment, mining, and electric power transmission. There are presently about 30 instances of active transfer to the US of Soviet technological processes which are now in use, offered for sale, or undergoing further development by US firms.

A few Soviet innovations have proved uniquely valuable. These include, inter alia, a surgical stapler used for suturing during certain operations, a mill for manufacturing thin-walled tubing from hard-to-process metals, a process for electroslag remelting (ESR) of hollow steel ingots, 2/

1. Survey of Current Business, BEA, Department of Commerce Volume 6, June 1976.

2. Cabot Corporation is the US licensee. In this case, Cabot devised its own process and then discovered during a patent search that the Soviets had already filed a patent. Cabot was also prepared to purchase the Soviet equipment, but because of difficulties in agreeing on its purchase, they developed their own. In 1976, Cabot began supplying ESR hollow ingots to Watervliet Arsenal to be forged into tubes for 105 millimeter cannons.

and a diaphramless process for producing magnesium from magnesium chloride. Among Soviet processes still under development in the US, such processes as that for extracting alumina from alunite (a non-bauxitic ore) and for casting aluminum ingots in an electromagnetic field hold considerable economic promise.

In addition to the fact that the Soviets lead in very few areas of technology, their technology sales suffer from their failure to develop their innovative ideas into commercialized products acceptable in Western markets. Consequently, their licensees usually find they must do a lot of extra developmental work before they can market the Soviet process or product. The Soviets are further handicapped by bureaucratic obstacles in marketing their innovations. Marketing is not done by the innovating plant or design institute but by a foreign trade organization, and grave problems attend the communications between a potential Western licensee and the Soviet innovator in connection with adaptation of the technology to the US market, agreement on the delivery times, prices for Soviet-supplied equipment, etc.

Some Westerners concerned with East-West trade hold the opinion that the Soviet R&D institutions have a reservoir of technological discoveries that could be commercialized by Western industrial genius, but which are trapped in the early stages of development by Soviet institutional obstacles. This opinion is shared by some Soviets as well, who are also concerned by their lack of ability to analyze Western markets and select appropriate emergent technology for commercial promotion.

Whether this notion is correct or not is now being tested by a US firm that produces technologically advanced electronics products. On Soviet invitation, its engineers are visiting Soviet laboratories to survey the potential for commercialization in the US of Soviet scientific discovery.

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Remarks:

DDI #2558-77/1

Attached are comments on Marshall Shulman's paper, entitled "Toward a National Policy on Economic Relations with the Soviet Union".

STAT

FOLD HERE TO RETURN TO SENDER

FROM: NAME, ADDRESS AND PHONE NO.	DATE
Sayre Stevens, DDI 7E-44 [redacted]	8 Jul 77

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(EXECUTIVE REGISTRY FILE S-17.3)

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Executive Registry
77-1663/1

29 JUN 1977

DDI # 2558-77

MEMORANDUM FOR: Deputy Director for Intelligence

FROM: Director of Central Intelligence

Attached is a copy of a paper on economic relations with the Soviet Union written by Marshall Shulman. I note on page 3, paragraph 4, that he contends that we are receiving some benefits of reverse technology flow from our trade with the Soviet Union. I would be interested in your assessment of whether this really is a useful or important technological input to our economy and any other comments your economists might have on Shulman's thesis.

STANSFIELD TURNER

STATOTHR

Attachment

cc D/DCI/NI

Toze

TOWARD A NATIONAL POLICY ON ECONOMIC RELATIONS WITH THE SOVIET UNION

ER 77-1663

Introduction

This paper is intended as a contribution to the structuring of discussion of the elements involved in formulating a national policy governing the development of economic relations with the Soviet Union. It seeks to bring within a single frame of reference some of the disparate approaches to the subject which have characterized discussions of it within the American business community, in the Congress, and on the part of the Executive branch--approaches which have tended to emphasize different and often conflicting considerations.

From the point of view of the government, the development of economic relations is an important component of the total relationship with the Soviet Union. From the point of view of the individual firms involved in these economic relations, the paramount consideration is the profitability and dependability of the transactions entered upon. The relationship between government and the private business sector regarded as normal in other aspects of our national life requires adaptation to the situation in which the autonomous and pluralistic institutions of the United States engage the centralized institutions of the Soviet Union, and in which a mixture of adversary and cooperative considerations continue to characterize the relations between the two countries. It seems evident, therefore, that the interests of individual firms need to be fitted into a larger framework of national policy based upon a calculus of relative advantages and risks in the expansion of economic relations with the Soviet Union, and that there is a need for a further development of the criteria and institutional arrangements by which these economic relations are to be conducted.

During the debates that attended the enactment of the Trade Reform Act of 1974 and the extension of the Export-Import Bank legislation in that same year, attention was largely focused on the issue of the relationship of trade policy to the restrictive Soviet emigration practices. If and when U.S. trade policies are reconsidered, it is clear that a broader range of considerations will need to be taken into account in the formulation of a national policy approach to the matter.

Background

The active interest of the Soviet Union in an expansion of economic relations with the United States, as well as with other advanced industrial nations, appears to stem from certain shortcomings in the Soviet economy, particularly in industrial and agricultural productivity, and in the advanced technological sector. These shortcomings reflect structural problems in the Soviet economy, the adjustment of which involved political and organizational resistance, and which will therefore take time to resolve. In the meantime, the Soviet leadership seeks to expand the importation of agricultural products, consumer goods, manufactured goods, capital investment, and advanced technology, to ease shortcomings and to allow time for the internal organizational adjustments required. This interest appears to be an important--although not necessarily a compelling--factor in the present Soviet emphasis upon a foreign policy of reduced tension.

In considering what the United States response should be to this Soviet interest, it is necessary to weigh the U.S. interest in the continuation or further development of this line of Soviet foreign policy, and the benefits and risks to the United States of the flow of goods, credits and technology to the Soviet Union. Since putative effects are involved on both the benefit and risk sides of the calculus for which firm evidence is lacking, the exercise inevitably involves judgments and uncertainties, but it is necessary that we strive for as much clarity as possible about the questions at issue, and the range of uncertainty that can be affected by adjustments in the criteria governing alternative trade policies.

Possible benefits to the United States of expanded trade with the Soviet Union

Among the economic benefits to the United States, the following have been most frequently cited:

1. Employment. It is estimated by the Department of Commerce that each $1 billion of exports generates an average of between 35,000 and 40,000 jobs in American industry. Many of these jobs are said to be in industries and parts of the country in which unemployment has been relatively high.

2. Balance of Trade. Department of Commerce figures show that the favorable balance of trade of the United States in its trade with the Soviet Union was $973.35 million in 1973, $257.84 million in 1974, and $1,555.91 million in 1975.

3. Raw Materials. In 1975, the United States imported approximately $95 million worth of petroleum and petroueum products, crude and partly refined, from the Soviet Union. In addition, 52 per cent of platinum-group metals consumed in the U.S. were imported from the Soviet Union, 22 per cent of chrome ore, 5 per cent of nickel, and 26 per cent of titanium.* An argument has been made that the capital cost of stockpiling such minerals can be reduced to the extent that regularized trade with the Soviet Union can assure a dependable source of supply of such minerals.

4. Reverse Technology Flow. Although advanced industrial technology has been an important element in U.S. exports to the Soviet Union, a number of recent studies have emphasized the importance of technology flow to the United States from the Soviet Union, particularly in energy (transmission of power, underground coal gasification, aboveground oil shale processes, atomic and magneto-hydrodynamic power generation), metallurgy, mining, medicine,

*These and all subsequent figures are from the Bureau of East-West Trade, U.S. Department of Commerce.

and a variety of miscellaneous fields. The number of patents granted by the U.S. Patent Office to the Soviet Union increased from 66 in 1966 to 382 in 1973, and continues to rise substantially.

5. Stabilization of Grain Exports. The agreement providing for annual purchases of grain by the Soviet Union from the United States of between $6 and $8 ~~billion~~ is expected to stabilize the grain market. ILLEGIB

Among the political benefits to the United States, a number of assumptions have been advanced which are difficult to test in practice, and therefore remain matters of judgment. Among these assumptions are the following:

1. The prospect of expanded economic relations is an important factor motivating the present Soviet emphasis upon somewhat reduced international tension, and that it is in the interest of the United States to see this policy direction strengthened and developed, since many international problems in which the United States is involved would be more difficult if US-Soviet relations were conducted at a high level of tension and confrontation.

2. A more specific aspect of the previous point is the expectation that the prospect of an expansion of economic relations can serve to restrain Soviet behavior in crisis situations, or at least can strengthen the argument in favor of moderation as Soviet policy-makers weigh the relative advantages and disadvantages of degrees of intervention or of arms shipments into troubled areas. The question of whether the United States can or should try to regulate its economic relations with the Soviet Union in order to achieve this specific effect is examined in the subsequent discussion of leverage.

3. In a longer-term and less specific sense, it is argued that the expansion of economic relations will involve the Soviet Union more deeply and more integrally in the world economy and will strengthen those interests in Soviet political life that have a stake in an interdependent economic

relationship with the non-Communist world. The long-term effect of this development, it is argued, will be to encourage a trend toward the evolution of Soviet policies toward responsible participation in efforts to solve global economic problems. Against this expectation, it has been argued that in the past the Soviet Union has developed external trade relations when its interests required them, and cut them off when its interests changed. The question remains to be examined whether these precedents from the past are applicable to the present, or whether the development of an advanced industrial technology in the Soviet Union will involve the Soviet Union more deeply and more inextricably in the world economy than was the case in the Stalin period. A tentative judgment may be advanced on this point that the Soviet Union has moved in the past five years to an unprecedented extent away from its previous autarkic separation from the world economy and is qualitatively more deeply involved in an inter-dependent relation with other advanced industrial societies; that there are, however, still significant nationalist tendencies in the Soviet Union that would seek to limit or to reverse these trends; and that these tendencies might become ascendent if the prospect of economic relations with Western Europe, North America and Japan were perceived as unpromising, but that this development is otherwise not probable.

Possible risks and disadvantages for the U.S. in expanded economic relations with the Soviet Union.

The most direct risk of expanded economic relations, and particularly in the flow of advanced technology to the Soviet Union, is that this could have the effect of strengthening Soviet military capabilities, either directly, by the military uses of imported manufactures or technology, or indirectly, by making it possible for the Soviet regime to transfer to the military sector resources that would otherwise be required in its industrial sector.

A related apprehension is that imports from the West, including not only manufactured goods and technology but also grains, could strengthen Soviet economic capabilities abroad, and that these could be used to our detriment. An example would be the increased Soviet ability to export grain to India as a result of grain imports from the United States.

In a more general sense, it can be argued that the Soviet import from abroad of consumer goods, manufactures, grains, capital, and advanced technology relieves the Soviet leadership of constraints arising from these shortcomings of the Soviet economy, which would otherwise circumscribe its freedom of action domestically and in foreign policy. This argument raises the question whether an economically isolated Soviet Union, to the extent that this is possible, would become more quiescent or more reckless in world affairs. One can only speculate about the probabilities, but it would appear to be a prudent judgment that the involvement of the Soviet Union in a network of relationships with the world economy is more likely to encourage a long-term evolution of the Soviet system in the direction of international responsibility than would its isolation. Underlying this judgment is the assumption that the upheaval that might result in Soviet politics from a successful effort to overstrain the Soviet system by economic isolation or by the forced pace of military spending would not be likely to produce changes in a direction desired by other countries.

Finally, among the possible disadvantages of expanded economic relations with the Soviet Union, it is argued that a greater degree of dependency upon Soviet sources of minerals or petrochemicals, or the deepening of the Soviet debtor relationship to other countries, would give the Soviet Union a greater capability for political manipulation than it now has.

In summary judgment, while none of the foregoing risks and disadvantages can be dismissed as unimportant or fanciful, they must be weighed against the previously listed benefits and advantages. The calculations on both sides of the ledger are necessarily speculative, and the balance is largely a matter of judgment. In practice, a policy which seeks to maximize the advantages and to limit the risks of expanded economic relations would require a substantial degree of coordination and control, and would have to be administered in accordance with clearly defined criteria. Whether this is possible is discussed in a subsequent section.

Does the U.S. have the economic capability to exercise leverage?

If the United States were to withhold advanced technology from the Soviet Union, to what extent would the Soviet Union be able to obtain equivalent technology from Western Europe and Japan? The experience of recent years suggests that, with some qualifications, most of the American advanced technology that has been exported to the Soviet Union would be available to it from Western Europe and Japan, including foreign subsidiaries and licensees of American corporations. The exceptions concern the most recent generation of new technology in some cases, and projects of such a large scale that they cannot be handled without American participation. Computer technology would be an example of the former, oil and natural gas exploration and development of the latter.

This leads to the further question of the extent to which the Soviet Union could develop a comparable level of technology by its own efforts, if this technology were not available from the United States, Western Europe or Japan. The consensus of the American business community appears to be that, given time and the willingness to deflect resources from other needs, the Soviet Union, together with Eastern Europe, could develop equivalent technology. The development by the German Democratic Republic of the ES-1040 computer and related peripheral equipment is cited as an example of this capability. Even granted this capability, however, a number of questions remain for further investigation. How critical is the time factor for the Soviet Union, for example, in the development of its oil and natural gas resources? What are the costs, political and economic, of having to divert resources to achieve this substitution? And from the Western point of view, is it desirable to force the Soviet Union and Eastern Europe to develop their own technology and research capability, rather than to remain dependent upon Western continuing advances in these fields?

In addition to American technology, there is a question of how important, in the calculation of U.S. advantage, is the ability of the United States to extend credits, either through the Export-Import Bank or at commercial rates through private banks. It appears to be the case that so long as Western Europe and Japan are willing to extend large-scale government credits to the Soviet Union, the American business community regards itself as being in a seriously disadvantageous position without the help of Export-Import Bank credits, and many examples can be cited to support this point. However, several factors may have an effect upon this situation in the future. The scale of Soviet indebtedness may be approaching a level at which further West European and Japanese credits will become more difficult to obtain. On the other hand, the development of direct and indirect compensation agreements may lessen the Soviet need for credits. As of the present, there are still strong arguments being made that the absence of Export-Import Bank credits substantially reduces the competitive position of U.S. firms relative to those of Western Europe and Japan, and to that extent reduces the capability of the United States to exert leverage upon the Soviet Union through trade.

The absence of Most Favored Nation status for the Soviet Union, some say, similarly serves to limit the strength of the United States' competitive position, partly for its psychological importance as a symbol of equality, and partly because it limits the prospect of the development of manufactured goods in the Soviet Union and even more in Eastern Europe, for marketing in the West to ease the shortage of hard currency.

One sector of the economic relationship in which the United States is in a relatively strong position is in the sale of grain, and particularly of feed grain, to the Soviet Union. Other sources of grain are available, but not on the ~~scale~~ required by the Soviet Union, especially in the case of feed grain. U.S. economic interests in grain sales, however, ~~limits the~~ utility of relying on grain as a major source of leverage.

<u>What political effects should the U.S. seek to achieve through trade?</u>

In the development of a national policy governing trade with the Soviet Union, the issue most in need of clarification is whether the political benefits to be sought are mainly those that would result from the long-term effects of the economic relations themselves, or whether trade should be made conditional, explicitly or implicitly, upon shorter-term changes in specific aspects of Soviet behavior.

The case for the long-term beneficent effects of the expansion of economic relations, most strongly argued in the business community, is difficult to defend on the basis of historical precedents, and rests upon assumptions that cannot by their nature be proved in any short period of time. Nevertheless, since the alternative course also has its risks, the argument for a measured acceptance of trade as a long-term stabilizing factor in the relationship does not seem unduly imprudent.

The most extreme argument for the use of specific economic leverage is that it should seek to reduce the totalitarian character of the Soviet regime, on the grounds that a "true detente" is only possible if checks and balances and a reduction in secrecy are introduced into the Soviet political process. The main difficulty with this argument is that it exceeds any reasonable scale of feasibility. Even if the Soviet need for foreign trade were much greater than it now is, the Soviet leadership could not be expected to accept conditions for that trade which are patently intended to undermine the system upon which its authority rests.

Less extreme, but still directed at internal aspects of the Soviet system, are the arguments that dominated the discussions of the Trade Reform Act of 1974, that the expansion of trade should be made conditional upon the observance of human rights in the Soviet Union, and in particular upon the right of emigration. Our experience since 1974 suggests that such frontal and public demands will not necessarily be successful. Whether less publicly explicit pressures could have useful marginal effects, at least upon such feasible human rights objectives as the reunion of families, is not clear and remains to be tested.

The most reasonable political purpose to which economic relations can be directed is to reduce the danger of war, since this is a paramount objective of national policy. In practice, this would mean that the expansion of economic relations would be encouraged unless the Soviet Union provocatively aggravated local crisis situations, and unless the Soviet Union unreasonably exacerbated the military competition. This would not mean that the Soviet Union could be forced to capitulate to American conditions for the settlement of local crises, or in arms control negotiations, but that a reasonable codification of the restraints to be expected in the acknowledged competitive relationship would be agreed upon and observed. Since this would not require of the Soviet Union restraints greater than the United States itself would be willing to observe, it would not appear to the Soviet Union as an unreasonable or unfair exercise of economic leverage.

A summary judgment on this point would be that although it cannot be confidently asserted that the greater involvement of the Soviet Union in international trade will encourage a long-term evolution in the direction of responsible participation in the international community, it would be a reasonable expectation on which to base American trade policy with the Soviet Union, provided that sufficient coordination can be exercised to limit the risk of strengthening Soviet military capabilities. As a secondary and shorter-term purpose, the measured development of economic relations can reasonably be made conditional upon Soviet restraint in crisis situations and in military competition, again provided that the volume and the content of those economic relations are made capable of adjustment as the situation requires. The effort to use economic leverage for other purposes, with marginal exceptions, would be less effective and would reduce the effectiveness of this primary objective of U.S. policy in relation to the Soviet Union.

Through what instrumentalities can the desired effects be achieved?

Perhaps the most easily adjusted instrument is credit, since it is more flexible, less subject to domestic dislocations, and less subject to domestic political rigidities than trade contracts already undertaken. For this purpose, credits granted on a case-by-case basis for individual export transactions, as was the practice of the Export-Import Bank in the past, provide more flexibility and control than the extension of general lines of credit, as has been the general practice in Western Europe.

The level of advanced technology to be permitted to enter into East-West trade represents another instrumentality capable of adjustment, for the dual purpose of limiting the risk of military application and of responding to changes in the international situation.

As has previously been mentioned, the adjustment of grain shipments for purposes of economic leverage does not appear to be a feasible instrument, because of the humanitarian issues and our own major economic interests.

Control over the total volume of trade through licensing procedures provides some possibility of leverage adjustment, but is of limited value because the cumbersome procedures do not permit "fine tuning," and involve hardship and uncertainties for American firms by complicating and delaying the negotiating process.

Coordination of Trade policy.

It is evident that a measured trade policy which seeks to limit the risks and to maximize the political and economic advantages of expanded economic relations with the Soviet Union requires the establishment of national rules and procedures, and the improvement of instruments of coordination.

Opinions in the business community appear to differ on the question of whether the asymmetries between the centralized trading institutions of the Soviet Union and the pluralism of autonomous firms on the American side require some protection for the latter to ensure an equality of bargaining positions. There is, however, minimum agreement that clarification of the applicability of anti-trust legislation to firms involved in foreign trade is required, to permit a degree of coordination among these firms beyond what is acceptable in domestic trade.

A review is clearly required of the present functions and practices of such instruments as the East-West Foreign Trade Board, the National Advisory Committee of the Export-Import Banks, COCOM, and the licensing procedures of the Department of Commerce, to ensure a consistent and expeditious coordination of trade policy.

Finally, it is evident that the effectiveness of a national trade policy along the lines described in this paper will require improved coordination of policy with Western Europe and Japan. Although the difficulties of achieving full coordination are evident, the strongest possible diplomatic efforts are warranted to improve COCOM procedures and minimum criteria to govern practices with regard to credits and advanced technology.

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