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2 February 1979

MEMORANDUM FOR: Director of Central Intelligence

THROUGH : Director, National Foreign Assessment Center. *RF*

FROM : National Intelligence Officer for Warning *AL*

SUBJECT : NIO "Worry List" for January

This memorandum is drawn from the memoranda prepared for you by the individual NIOs after discussion with other analysts of the Community. Its purpose is to alert you in succinct terms to potential developments that, in the NIO's view, could in the next few months become matters of serious concern. It is not an estimate that these developments are likely to occur; rather it is an attempt to single out the blacker clouds on the intelligence officer's horizon.

1. The most urgent problem.

The Vietnam-Cambodia-China-USSR Imbroglia. The chain of events since the last meeting of community analysts in late November has moved to a point where the possibility of Sino-Soviet armed conflict growing out of these events is now one branch point closer than it was. The Vietnam blitzkrieg overrunning Kampuchea has been followed by both widespread Kampuchean guerrilla resistance and a large-scale Chinese military buildup on the Vietnamese border. The manner of the buildup, its timing and the mix of forces involved have increasingly suggested Chinese offensive intentions. The Soviets have not committed themselves to any particular course of action in response, but might in fact respond to a Chinese move against Vietnam with pressure of some sort on the Sino-Soviet border.

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2. New Concerns I: The Fallout from Iran

Iranian Oil. Any consideration of the uncertainties surrounding future trends in Iranian oil output clearly raises the specter of global market stringencies. It is even conceivable that later this year the world will face economic hardships and political tensions reminiscent of the 1974 OAPEC/OPEC induced crisis. An annex to this memorandum describes possible trends in the global oil market this year and examines the problems that would be created by an oil export short-fall. []

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The Soviet View. One specific contingency is the eventual emergence of full-scale, prolonged Lebanon-style civil war in Iran which would bring the question of Soviet military assistance to one side into play. In the event of an open split in the Army and emergence of a struggle involving armed civilians, it is conceivable that the Soviets would then covertly funnel supplies and other assistance to some forces on the side they favored, while professing nonintervention. It is also possible that under these circumstances the Soviets would move troops to the adjacent frontier, and that they might caution the US against assistance to one side under pain of active intervention by Soviet forces to help the other. []

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✓ Nigeria. Analysts believe that military intervention to derail the process of transition to civilian rule is now more likely in the coming months than it has been heretofore. Also, the Nigerian leadership is giving more serious consideration to using oil as a political weapon than it has in the recent past. Developments re Iran will be the central element here, in that a shortage of oil worldwide would open opportunities for the Nigerians to press the US on southern Africa in a way they have not previously sought to do. Nigeria now provides a significant percentage of US crude imports, but also is heavily dependent on continued sales to finance its own politically important development program. []

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Mexico. As a direct result of events in Iran, Mexico is acquiring new clients for its oil -- notably, France, Japan and Israel. While the US will receive a lower percentage of Mexican oil than previously anticipated, the actual quantity will be about the same because of increased production. Diversification of Mexico's oil exports is likely to make Mexico more independent in its forthcoming negotiations with the US. []

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3. New Concerns II.

Morocco. A series of disturbing events have increased our concern for the stability of the monarchy: more leftist activity (students and labor); continued poor economic performance; its solitary position on the Western Sahara; and deteriorating morale in the Army, bogged down in the Western Sahara. In light of events in Iran, it is worth noting that there exists a certain degree of contagion in the overthrow of monarchies. [redacted]

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✓ Egypt. As in Morocco, there are some disturbing signs about internal stability: the rise in consumer prices; a resurgence of the Muslim Brotherhood; clashes between Copts and Muslims; and the stalled peace negotiations with Israel (which is causing some Egyptians to question Sadat's policy, even though Sadat apparently feels the delay is working to his advantage). In light of events in Iran, Sadat sees himself as the new policeman in the region -- witness his decision to send 200 tanks to Somalia. Sadat is good at balancing problems but he may be getting close to the point when he has too many balls in the air. The regional role he perceives for himself may blind him to internal developments. [redacted]

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✓ Lebanon. Signs in the south are ominous again, and the north is marked by procrastination. With the return of good weather in March and April, we expect to see hostilities being renewed as the Christians again try to get rid of the Syrians. Sarkis' weakness during the current lull in fighting means another wasted opportunity for some sort of solution. [redacted]

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Pakistan. The Supreme Court may return a decision on the Bhutto case this month. Any decision will increase the likelihood of political instability and civil disorder. If Bhutto is executed, his followers may take to the streets; if he is spared, the Army leadership will be reinforced in its unhappiness with President Zia and more inclined to move against him. [redacted]

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4. Continuing concerns.

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✓ Poland. The economic dilemma and growing malaise cited in the last Warning Report have now been strongly underlined [redacted]

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[redacted] He suggested that one eventual outcome could be widescale rioting, possibly leading even to Soviet intervention. While this pessimistic outlook is supported by [redacted] 25X1
 [redacted] it is not the view of all observers; Embassy warsaw, while recognizing the seriousness of the Polish economic position, has concluded that the outlook is far from desperate. [redacted]

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✓ Spain. In the face of escalating attacks by the Basque and -- apparently -- other terrorists, the Suarez government has lost ground this month in its struggle to retain the confidence of the security forces. Ranking military officers have participated in public demonstrations of frustration that have delighted the ultra-right, police commanders have requested reintegration in the army, and tensions in the ranks are high. We see no respite for the government -- either before or after the March elections. The Basque terrorists reportedly have the capability to carry out even more disruptive acts of violence. If the victims were prominent enough and the timing right, we believe the government could find it very hard to control the reaction. Nor in such circumstances do we exclude the possibility of some direct move against the government by elements in the security forces. [redacted] 25X1

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Italy. It is increasingly likely that the Communists will dissociate themselves from the Andreotti government and thereby bring it down within the next few weeks, throwing Italy into yet another serious political crisis. [redacted] 25X1

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✓ Syria-Iraq Rapprochement. In November 1978 we noted the radicalization of the Arab moderates as a result of their weak performance at the Baghdad Summit. We continue to be concerned by the additional steps toward rapprochement between Syria and Iraq. There is a possibility of effective and lasting Syrian-Iraqi cooperation -- military, economic, and political. President Bakr's trip to Damascus next week should produce something tangible in cooperation between the two countries; additionally, the PLO and Jordan may well be brought in on the latter part of the "summit." The implications of all this involve possible future Israeli (military) reaction. The Israelis might not allow the Iraqis to fill the currently unexplained, division-size gap in Syrian defensive positions on the southern Golan Heights. [redacted] 25X1

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5. Areas of lessened immediate concern.

Romania. The Soviets have not yet found an effective response to Ceausescu's spectacular acts of public defiance. By publicly airing sensitive questions of Warsaw Pact expenditures and command and control, Ceausescu had gone beyond previously established limits of his challenge to Soviet authority and this time approached more closely the threshold of Soviet tolerance. For the time being, he appears to have gotten away with it, in the sense that we have no evidence that the Soviets have yet decided to risk the costs associated with measures drastic enough to bring Ceausescu to heel. [] 25X1

Nicaragua. The present delicate state of the mediation effort led by the United States is at the point that the Broad Front (FAO) opposition is beginning to flake apart, while Somoza appears to be at least as strongly entrenched as ever. Somoza's ability to double the strength of the National Guard seems to have demoralized the FSLN, which is limiting its harassment of the Somoza Government to localized attacks. A full-scale FSLN assault on the government now appears unlikely. Meanwhile, other Central American governments are uneasily watching the threats to Somoza. The Government of El Salvador, already beset by terrorist problems, believes it will be next if Somoza falls. [] 25X1

✓ Rhodesia. The more direct assistance relationship which we had anticipated would develop between the Soviets and ZANU has not materialized as we expected. In addition to Soviet caution, there have been objections and counterarguments by the ZAPU leadership, who at least up to now have been the focus of Soviet attentions. The Soviet-ZANU relation may yet develop; but the Soviets certainly show no signs of being in a hurry, if in fact they intend to make this part of their game.

Regarding Cuban activities, we do not see any specific indications that more Cubans are about to arrive in Africa or that those already there will be shifted about in a major way. The "logic of the situation" in regard to Rhodesia still calls, in our view, for additional Cuban participation in the defense of Zimbabwe guerrilla and host government base areas, but, again, we do not see any fundamentally new development with regard to Cubans in the next three months in either southern Africa or the Horn. [] 25X1

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The Beagle Channel. The danger of Argentine-Chilean hostilities has markedly decreased with the beginning of Papal mediation.

South Africa. Concern over the possibility of renewed activity at the Kalahari test facility has abated in the last month

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RICHARD LEHMAN

NFAC No. 0391-79
23 January 1979

Loss of Iranian Oil: Some Global Implications for 1979

Potential Oil Market Problems in 1979

While the global oil market will probably be able to cope with an Iranian oil shortfall in the first quarter of 1979, problems could arise soon thereafter. From spring through summer, oil stocks are usually rebuilt, in contrast to the drawdowns that normally take place during the first quarter. In addition, by spring, OPEC oil production facilities, especially those in Saudi Arabia, will have been strained from months of running at near full capacity.

Although the current uncertainties in Iran make it impossible to predict oil market trends, we can at least examine the range of possibilities. Three plausible scenarios can be envisaged, ranked here in order of increasing risk that serious market stringencies will appear between April and the end of this year.

Slight Risk - Iranian oil production is substantially restored by spring. Although fears of a supply shortage would ease, the necessity to rebuild stocks to normal levels would leave the market susceptible to any renewed curtailment of Iranian (or deep cuts in Saudi) output. (This case assumes that a new government in Teheran believes it needs maximum oil revenues to restore economic activity in Iran and/or desires to continue the modernization effort, albeit at a somewhat reduced rate.)

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Moderate Risk - Iranian output averages some three million b/d. Under this scenario market conditions would remain tight even if non-Iranian production remained at current high levels. Thus almost any prolonged sharp drop in output of the other major producers could produce a supply crisis. (This case assumes that the successor government abandons much of the Shah's modernization program but sells enough oil to sustain at least a modest standard of living for the populace.)

High Risk - Iranian oil output remains below one million b/d for most of the period. (This case would stem from either prolonged civil disturbances reflecting continued governmental incapacity, or from the installation of a highly fundamentalist regime which seeks deliberately to isolate the country as completely as possible from foreign influences.)

The above depiction of a range of possibilities suggests that, under all but the most optimistic circumstances, the world market faces a substantial probability of oil stringencies appearing later this year. With tight market conditions, sharp production cuts by any important producer for any reason would cause a considerable price run up. It must be strongly emphasized, however, that the timing of a market crunch, if there is one, will depend more on the behavior of oil consumers and marketers than on projected demand/supply trends. Once these groups believe that they will be unable to replenish stocks, they will be more inclined to hold onto or, even worse, build inventories rather than draw them down. This would make consumption cutbacks necessary earlier than stockpile levels would indicate.

Danger Points and Some Possible Opportunities

Higher Prices Combined with Slower Growth - Without nearly full resumption of Iranian oil production by spring, the odds are high that OPEC oil prices will rise beyond these decided at last month's meeting of the organization. These probabilities climb from near-even with Iranian output averaging 3 million b/d, to almost-certainty under the one million b/d scenario. Any OPEC price hawk could lead the way by unilaterally raising prices above the official level. Those countries producing mainly light crudes could achieve higher unofficial prices by hiking the quality differential between light and heavy crude. Higher prices could also be set officially at an OPEC meeting, and Saudi Arabia -- because it is already operating at near-capacity -- would have little power beyond moral suasion, to hold the line.

A substantial increase in oil prices would, of course, depress expected economic growth. As was the case in 1973, the United States is now attempting a so called "soft landing", whereby the economy would slow somewhat in order to relieve inflationary pressures. With much higher energy prices, the landing could again be "hard", with inflation rates remaining uncomfortably high. The economies of Western Europe are in the best position since the 1975 recession to accelerate economic expansion. Sharp hikes in oil prices would nip this opportunity. Japan, already beleaguered by the difficulties of turning its economy inward and the most dependent on oil imports, may find its economic growth particularly hard hit. In all developed economies, the economic cushion provided by exports to OPEC would certainly be less than in 1974 and 1975. Although OPEC states would once again have vastly increased spending power, only a few would greatly expand foreign purchases.

The troubles among developed countries would inevitably spread to the LDCs. The payments positions of many LDCs, especially "upper tier" ones, are expected to weaken substantially this year, and higher oil prices combined with lower exports to the developed world would unquestionably make conditions worse. The poorest countries would be asking for more aid at the very time the developed countries could least afford such outlays. If the oil price hikes come this spring, they would affect the tone of both the UNTAD V conference in May and the Tokyo Summit in June.

The Saudi Arabian Factor - The pressures facing the Saudi leadership have intensified as the Kingdom's oil export level has increasingly become the critical arbiter of global economic health. This has happened at a time when its latent succession problems are beginning to emerge, its faith in the value of its alliance with the United States is being questioned and its misgivings about sustaining near capacity oil production are sharpening. The Saudis will face the dilemma of having to exert more influence, while feeling more vulnerable. They will be urged, and may be tempted, to use their oil supply leverage to achieve objectives in the Arab-Israeli arena. At the same time, their perceived dependence on their long-time ally, the United States, will deepen, as the uncertainties in Iran add to their anxieties (felt by the Saudi establishment) over the growing Soviet involvement in the region. Given these circumstances, the possibility exists -- at least in principle -- for some trade-off between the future level of Saudi oil output and US security guarantees. If the US extends, and the Saudis agree to, such an arrangement, it might be possible to convince the Persian Gulf sheikdoms, Kuwait and the UAE, to participate in such an accord. The accord might include a provision for temporarily lifting self-imposed production ceilings, a move which would add more than one million b/d to global oil supplies.

Non-Price Reactions by Oil Exporting States - Some oil producing states may also try to advance their perceived political and economic interests other than through higher oil prices. These could range from efforts by a single state (e.g., Mexico) to link increased oil exports to US trade concessions or US treatment of migrant labor, to efforts by a group of states (e.g., Arab oil producers) seeking to influence the course of development of a settlement with Israel. The scope of action could range from the most subtle verbal hints to open threats of concrete action, such as a limitation on production.* In most cases, however, their actual leverage will be limited. Oil producers will have to cope with weaknesses such as OPEC members' unwillingness to halt the flow of oil for fear of losing needed foreign exchange. Also, each producer will have to weigh any such action in the context of its overall foreign relations.

Competition Among Importing Countries - Competition for oil on the world market could lead to tensions between consumers, especially the United States and its OECD partners. These intra-OECD strains, however, may be significantly less than in 1973-1974. Governments have learned from the earlier experience that a scramble for oil supplies is self-defeating, in that it needlessly drives up prices and leaves the buyer stuck with high-priced oil contracts once supply conditions return to normal. In addition, the International Energy Agreement, adopted by 18 member countries, provides at least a framework for allocating available supplies of imported oil. It has never been tested under actual conditions, however, and it is questionable whether it could function effectively in the context of severe oil stringencies.

A Change in US-Israeli Relations - Israel's sense of insecurity and isolation has already been heightened by the loss of Iran as an ally and oil supplier. This may stiffen its determination to be self-reliant, making a peace settlement more difficult. At the same time, possible oil market stringencies later this year may force Tel Aviv to invoke its oil supply agreement with Washington. A flow of US oil to Israel would come just at the moment when the United States may have to impose domestic restrictions to conserve oil.

Reaffirmation of the Plutonium Economy - The Iranian oil cut-back will strengthen the convictions of those who favor additional R&D on plutonium-based reactor systems predicated on reprocessing. Rapidly rising oil prices would certainly reinforce their position, further complicating US efforts to stall the development of these plutonium-based systems.

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A Serious Global Financial Crisis? - This is a large and complex issue that should be discussed separately. So far the international financial consequences of Iranian instability have been minimal largely because Teheran has such a large cushion in the form of foreign exchange reserves outside of Iran. More serious problems could emerge in the next few months, however. While these could hurt individual banks, the international financial system is able to cope. We do see one remote possibility with wider ramifications. A fundamentalist regime in Iran might decide to abrogate its foreign debts, on grounds they were the product of the Shah's "illegalities". Some Western banks with a large Iranian exposure and a weak financial structure could go under. A chain reaction is then possible if the banks concerned are deeply involved in the unregulated euro-dollar market.

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NIO "Worry List" Items

Nigeria. Analysts believe that military intervention to derail the process of transition to civilian rule is now more likely in the coming months than it was last year. General Obasanjo is trying to keep political agitation and violence within bounds, but his chances are problematic. Nigerian oil production is up, for financial reasons as well as Iran, but the Nigerians may still be tempted at some point to try to find in their oil political leverage over US policies re southern Africa.

Rhodesia. We see no change in the pattern of the armed guerrilla struggle, but possibly an increase in the intensity, although we expect Smith will be able to conduct elections in April as per his timetable. Absent some further settlement, we still think that we will see some degree of increased participation by Cubans in the Rhodesian situation, especially in the defense of the Zimbabwe guerrilla base areas outside Rhodesia. An extension of the warfare into Botswana, or even possibly Tanzania, is a continuing threat.

Zaire. The longer term threat to Shaba remains serious, despite the current disorganization of the ex-Katangan grouping and the cooperation between Mobutu and Neto in Angola. Danger in Shaba could

be especially acute after June, if the inter-African force withdraws. The food, medical, and general economic situation in Kinshasa itself is deteriorating, and we cannot predict when or if rioting might occur against Mobutu's security forces there. Exile elements evidently are trying to take advantage of these circumstances.

The Communist Party's break with the Andreotti government shifts the emphasis in Italian politics back toward confrontation, breaking a long trend that saw the Communists inching steadily toward a fuller and more overt role in the governing process. The Communists feel they must take a tougher line toward Andreotti and his fellow Christian Democrats, yet they will not want to jeopardize their hard-won reputation as a responsible and constructive political force. The Christian Democrats, troubled as always by their own internal factional problems, seem more willing now than in the past couple of years to confront the Communists.

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Because no party's options are clear--and also because decisions in each case will be heavily contingent on the actions of others--all the participants are likely to move very cautiously, and it is unlikely that we will predict in any detail how the crisis will develop. Certain broad trends can be discerned, however. First, it seems likely that relations between the Christian Democrats and Communists will grow more tense in the next few weeks, with increased possibilities for miscalculation by both parties. Second, if this is so, a round of parliamentary elections will be very difficult to avoid. Third, whether or not elections are held, the central fact

in Italian political life is unlikely to change: that it is all but impossible to set up a stable government, much less an effective one, unless Italy's two biggest parties can find a way to cooperate. And fourth, events of the last year have made the Communists much more reluctant to cooperate without some guarantee of an expanded role in the governing process.

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