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MEMORANDUM FOR:

Nancy Bearg Dyke
Assistant to the Vice President
for National Security Affairs

L. Paul Bremer III
Executive Secretary
Department of State

David Pickford
Executive Secretary
Department of the Treasury

Lt Col Robert P. Meehan
Assistant for Interagency Matters
Office of the Secretary of Defense

Raymond Lett
Director, Executive Secretariat
Department of Commerce

Jean Jones
Director, Office of the
Executive Secretariat
Department of Commerce

William V. Vitale
Director, Office of the
Executive Secretariat
Department of Energy

[redacted] 25X1
Executive Secretary
Central Intelligence Agency

Jacqueline Tillman
Executive Assistant to the
United States Representative
to the United Nations

Dennis Whitfield
Executive Assistant to the United
States Trade Representative

James B. Burnham
Executive Assistant to the
Chairman, CEA

Col Charles F. Stebbins
Executive Assistant to the
Chairman, Joint Chiefs of Staff

Gerald Pagano
Executive Secretary
AID

SUBJECT: Versailles Summit (C)

Attached are the final two papers for the National Security Council meeting scheduled for Tuesday, March 30, 1982, 2:00-2:45 p.m., The Cabinet Room:

1. East West Economic Relations

2. Energy Security Paper.

Attachments:
As stated.

Michael O. Wheeler

Michael O. Wheeler
Staff Secretary

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Review 3/29/88

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FINANCIAL AND TRADE ASPECTS OF EAST-WEST ECONOMIC RELATIONS

Summary and Introduction

East-West economic relations was a principal topic at Ottawa and led to progress in the area of strategic trade controls. Ottawa contributed to an enhanced understanding of the need to keep economic relations with the Soviet Union and the Eastern European countries consistent with the broad political-security objectives of the Summit countries. However, follow-up allied actions in the economic area have not proven adequate in light of subsequent developments in the Soviet Union and Eastern Europe.

A high-level meeting of COCOM in January launched a revitalization of common allied restrictions on the export of strategic goods and technologies to the East. But in the other three areas in which better allied coordination was discussed -- contingency planning for economic measures in the event of a crisis in relations with the Soviet Union; joint planning to reduce Western economic vulnerability and enhance Western economic security; and developing common policies to improve Western influence and leverage -- progress has been less visible.

The crisis in Poland has increased the risk that Western differences will be exposed and exploited by the Soviets. However, the Polish situation, and particularly Polish debt, has also created exceptional opportunities to forge coordinated allied positions that will greatly strengthen the West.

There is an urgent need for a joint assessment of the Western course and for joint action. Western taxpayers should not underwrite increased Western defense costs to offset enhanced Soviet military strength from Western technology transfers or the risks of East-West trade that arise from the economic failures and political turmoil of some Communist regimes. Western governments should also develop a strategy for dealing with Eastern European debt issues. Finally, Western governments need to follow up on the COCOM high-level meeting that grew out of the Ottawa Summit.

This paper organizes the objectives for Versailles in the same conceptual framework as that developed in last year's summit document East-West Economic Relations: A Prudent Approach. The objectives are thus grouped under the following four broad areas of concern:

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1. Strategic Controls. Report on the progress following from the Ottawa discussions and the COCOM High-Level meeting. Draw attention to the need for progress in controlling and especially enforcing trade in strategic goods and technologies and give continued impetus to the work of COCOM.

2. Foreign Policy Contingency Plans. Review the effectiveness of allied economic sanctions toward Poland and the USSR.

3. Economic Security. Note that excessive reliance on Soviet energy poses liabilities for the West and explore further safeguard measures and the development of alternative energy sources. Address East-West trade, finance and debt problems, explore ways to reduce Western vulnerability in these areas by controlling credit flows, and reach agreement on an appropriate mechanism to monitor/control credit flows to the Soviet Union.

4. Economic Influence. Reduce harmful competition among Western countries for Eastern European and Soviet business and avoid applying terms (i.e. credit subsidies and countertrade) to East-West trade which contravene widely shared practices among Western countries.

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I. Strategic Controls: COCOM

Convening High Level Meeting

During the past year, important initial steps have been taken towards a revitalization of COCOM and strengthening of controls on the export of strategic goods and technology to the Soviet Union and other Warsaw Pact countries. This process was set in motion in Ottawa when the Summit leaders agreed that consultations and coordination are "necessary to insure that in the field of East-West relations our economic policies continue to be compatible with our political and security objectives." More specifically, they agreed to "consult to improve the present system of controls on trade in strategic goods and related technology with the USSR ", encompassing a commitment to support a high-level COCOM meeting. This, coupled with the agreement of non-Summit COCOM member governments, resulted in the first high-level political meeting of COCOM in over two decades in Paris on January 19-20.

Discussions at this COCOM High-Level Meeting (HLM) reflected a shared recognition that export controls constitute an important element of the collective security of the industrialized democracies. The HLM produced a consensus on a number of key issues related to the multilateral system of export controls. This was clearly reflected in the Agreed Minute unanimously adopted at that meeting.

Agreements at the High Level Meeting

There was a clear acknowledgement that improvements were needed in the multilateral system of export controls. The member governments agreed that the Warsaw Pact countries had made significant progress in the field of military equipment and technology, aided by systematic exploitation "of every means of access to Western technologies" including legal transfers of technology to the Soviet military machine.

There was agreement that COCOM embargo limits must be established based on an up-to-date analysis of the allies' lead over the Warsaw Pact countries in critical strategic areas. With regard to that embargo coverage, COCOM governments agreed to take the following steps as soon as possible: (a) identify specifically the really critical military technologies which are not at present covered or for which present controls are inadequate, taking into particular account information available on the priority defense industries in the Warsaw Pact countries; and (b) delete from the present embargo lists equipment and technologies which are not critical in the Warsaw Pact countries. The HLM also agreed that COCOM should give priority attention to providing embargo coverage to a number of specific strategic areas, including dry docks, robotics and space launch vehicles.

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At the HLM, the member governments noted the need of improving embargo enforcement efforts, both multilaterally in COCOM and at the national level. COCOM was instructed among other things to "propose means to avoid re-export from non-participating third countries of embargoed equipment and technology". The HLM stated that member governments should undertake several steps to improve their enforcement including "facilitating precaution, detection, and prosecution of violations and alerting exporters to the risks of diversions and violations".

The HLM also addressed the need of harmonizing the licensing practices and procedures of the member governments. It was agreed that, even where it might not be possible for national procedures to be identical, they should be of equal effectiveness. The HLM called upon COCOM to convene a meeting of the organization's Export Control Subcommittee to examine means of harmonizing national control measures.

Follow-up to the HLM

COCOM has already initiated activities to follow-up on the agreements reached at the HLM. Negotiations are underway on several proposals for strengthening coverage in certain of the special areas of security concern specified by the HLM. In addition, COCOM has scheduled the comprehensive 1982-83 List Review to begin in October. Member governments are now actively preparing proposals for that review which must be submitted to COCOM in June. COCOM is also scheduling meetings of the Export Control Subcommittee later this spring to discuss the recommendations of the HLM on enforcement and on the harmonization of the licensing practices of member governments.

Role of the Versailles Summit

The COCOM High Level Meeting has been an important first step in the strengthening of the multilateral system of export controls. However, it is only the first step in a lengthy process that will involve many months of detailed discussions of embargo levels and procedural issues. It is important that the momentum created by the HLM be maintained until the COCOM system is truly revitalized. The Versailles Summit could play an important role in this regard.

It would be extremely useful if at Versailles the Summit leaders could: (1) review the results of the HLM which had resulted from their discussions in Ottawa; (2) strongly endorse the agreements reached at that meeting to improve and strengthen the multilateral controls on exports to the Soviet Union and the other Warsaw Pact countries; and (3) seek another HLM in January 1983 to provide additional political impetus to the review process. Since most of the follow-up activities to the HLM will only be getting underway about the time of the Versailles Summit, it would not be appropriate for the Summit leaders to review in any depth what has occurred since the meeting in January. However, they could take stock of the activities underway and strongly urge that recommendations of the HLM be implemented as soon as possible. To emphasize the importance of certain of the key agreements at the HLM, the Summit leaders could agree on a number of specific points related to the revitalization of the COCOM system such as the following:

(1) If there is to be a meaningful and expeditious strengthening of the embargo to cover "really critical technologies" and an associated release of non-critical items, allied governments must assure that priority high level attention is devoted to the review activities. Negotiations on the embargo involve a careful and precise identification of what is of security concern. In this process, allied governments must give a priority to long-range security requirements including the impact of Western technology on Warsaw Pact defense priority industries. Allied governments must work to prevent embargo levels from becoming the lowest common denominator established by perceptions of short-term commercial requirements. At the same time, lists must be sufficiently precise to avoid needlessly inhibiting trade in noncritical items.

(2) Allied governments should give priority attention both in COCOM and at the national level at dealing with the serious problem of diversion of embargoed products through non-COCOM countries. They should also take steps to assure that national penalties and sanctions on export control violations are at a level where they will have a deterrent effect on diversions.

(3) The allied governments should work toward a more open exchange of information both in COCOM and bilaterally to deal with the growing diversion problem.

(4) The allied governments should work towards an effective harmonization of their national export control procedures so that differences do not favor the commerce of one country over another.

(5) There is the strong need for a commitment from the allied governments to modernize the COCOM infrastructure and communications. This is required to enhance the professionalism and efficiency of COCOM as well as its status as a unique international forum for dealing with complex and sensitive East-West technology trade issues and policies.

(6) The January 1982 HLM was a useful exercise. It provided the first political guidance to the technical level of COCOM in over 25 years. Prior to 1958 a high level political committee met frequently to provide such guidance. It would help the strengthening process if the HLM recommended again in 1983 to review the progress made during the fall list review and provide additional political guidance.

II. Foreign Policy Contingency Plans

Summit countries may wish to assess the economic and political measures adopted to date in response to the Polish government declaration of martial law and consider what additional measures and/or contingency planning may be appropriate. Contingency controls were discussed at Ottawa as the pace of the Polish liberalization process quickened and Soviet interference mounted. The allies agreed on the importance of coordinated, joint action, particularly in the event of a Soviet invasion of Poland. The GOP declaration of martial law December 13 and ensuing crackdown posed a direct challenge to the Alliance and required a unified Western response.

The NATO allies reacted with a series of individual economic and diplomatic measures adopted as a result of agreement at the ministerial session of the North Atlantic Council on January 11. On the economic side in particular, some countries decided to hold further commercial credits for Poland and negotiations on 1982 debt in suspense and adopted measures directed at the USSR in the areas of imports, maritime and air agreements and commercial representation. Each of our countries acted in accordance with its own situation and laws, but the message was the same: our countries would not continue business-as-usual and would re-examine economic and commercial relations with Poland and the USSR in light of Polish events.

The deterioration in the Polish and Romanian financial situations and general financial weakness throughout Eastern Europe necessitate continued allied policy coordination, and a closer look at the repercussions of possible default on the Western financial system.

III. Economic Security: Controlling East-West Financial Flows

Western economic security is impaired to the extent the Soviets can exercise economic leverage and the West becomes vulnerable to Soviet actions. At the Ottawa Summit, the U.S. raised the issue of the Siberian gas pipeline, European dependency on Soviet energy supplies and the leverage such dependency will accord the USSR. The U.S. continues to believe that the pipeline decision was unwise. To reduce our potential vulnerability it is most important that priority attention be given to the development of appropriate safeguards as well as alternative sources of energy.

The subsequent Polish financial crisis has underscored another source of Western vulnerability and Soviet leverage: the existing large stock of Soviet and Eastern Europe debt owed to the West and the growing Warsaw Pact indebtedness as a result of continuing East-West trade financing. East-West trade, and the credits that finance it, are an inescapable element in considerations relative to Western security. Through its credit policies, the West has enhanced the economic development of the Soviet Union and Eastern Europe and has become more dependent on Eastern markets and resources. This affects Western political, economic and security interests. At the same time, Western credit policies have fostered growing Soviet bloc indebtedness and increased the vulnerability of the Western financial system to financial disruptions in Eastern Europe.

Western Europe is more vulnerable than the U.S., which stopped according official credits to the Soviet Union in 1975. Moreover, Western Europe may become more vulnerable still if governments continue to respond favorably to what could be a growing Soviet requirement for official credits and guarantees over the next five years.

1981 was a watershed year in East-West financial relations highlighted by the Polish, then Romanian financial crises and by the general erosion of Eastern European creditworthiness. Poland declared a moratorium on debt service in March and opened negotiations with official and private creditors on debt rescheduling shortly thereafter. By the end of the year, Romania had accumulated $1.2 billion in debt arrears (and announced a similar moratorium in February 82). Even the Soviet Union, faced with a rising agricultural import bill and stagnant hard currency exports, encountered an unprecedented liquidity bind. Western banks, reacting to the rapid economic and political deterioration in Poland, heightened political concerns over East-West relations in general, and instability in Eastern Europe, began applying the brakes on new medium and long term lending to Eastern Europe in 1981, thus exacerbating its economic/financial dificulties. Syndicated Eurocurrency loans dropped from a peak in 1979 of $6.9 billion to only $2.8 billion in 1981. There have been no major Eastern European syndications since the spring of 1981 when Hungary and the GDR completed $400 million and $100 million Eurodollar loans, respectively.

Western governments, however, have concluded new agreements with the Soviets on major project financing, most notably the Yamal pipeline. In response to the declaration of martial law in Poland, allied consideration of new credits and a 1982 rescheduling was suspended.

Debt

Poland's debt service problems and the growing risk of default have drawn attention to Eastern European credit-worthiness in general. Gross Soviet bloc debt grew from $8.4 billion in 1971 to over $80 billion in 1981. The USSR and Poland hold by far the largest share of this debt -- $20 billion and $26 billion respectively. However, with $7.0 billion in assets in the West, a gold stockpile worth $25 billion, and significant hard currency exports (oil), Soviet indebtedness is not perceived as a problem; total Eastern European hard currency reserves, on the other hand, were only about $5.0 billion at the end of 1981, and economic performance has deteriorated sharply. In a comparison of Soviet bloc 1981 debt service ratios, the USSR is by far the smallest at 15%, while Eastern European debt service ratios all exceed 30% (except for Czechoslovakia), including 68% for the GDR and 157% for Poland.

On the whole debt owed Western government creditors or guaranteed by Western export agencies represents about one third of total Soviet and Eastern European indebtedness, although the relative importance of official and private debt varies widely from country to country. In Poland and the USSR, official debt represents 52% and 40% respectively of total indebtedness; however, official debt is a relatively small part of total indebtedness for other Eastern European countries -- only 4% of Hungarian debt, for example.

Short and Long Term Prospects

Eastern Europe's 1982 debt service bill amounts to $31 billion, including $6 billion in interest alone. Even assuming a roll over of the short term component of this debt ($11 billion), additional cutbacks in hard currency imports, and drawdown of reserves, Eastern European countries will clearly need access to new Western credits in 1982 to avoid default. Romania has joined Poland in insolvency, and Hungary is now under pressure. Only Czechoslovakia and

Bulgaria, both with relatively small outstanding debt, appear better able to weather the current credit squeeze for the time being.

Long term Eastern European economic prospects appear bleaker still, now that the Western credit prop for the inefficient, overly centralized Eastern European economies and Soviet raw material, fuel and food subsidies are being cut back. Moreover, the USSR also faces a period of hard currency shortfalls as the prices of its exports to the West stagnate or decline, and will need to increase its borrowing from the West to avoid a decline in crucial hard currency imports. Although most of this borrowing will probably come from private capital markets, albeit at higher costs, Western government credits and guarantees may be asked to play a large role.

Policy Implications

The financial choices facing the Soviets this decade provide an unusual opportunity to use credit policy as a means to reduce Moscow's available resource pie and also influence Moscow's trade offs among its key priorities -- enhancing the military, feeding the population, improving the civilian economy, sustaining its Eastern European allies and expanding its overseas influence. Western countries can reduce the flow of capital to the Soviet Union both directly by regulating the availability of government-guaranteed credits, and indirectly by affecting the willingness of the private sector to lend. Indeed, the private market reaction to new Western government limits on credits/guarantees would likely far outweigh the direct impact of official credit restrictions.

Availability of credits. The Soviets borrowed \$3.6 billion in private unguaranteed medium and long term credits and another \$6 billion in short-term credits in 1981. Private credits thus accounted for about 80% of total new borrowing of \$12 billion. For the Soviet Union and Eastern Europe, private credits accounted for 75% of total borrowing. Private capital market decisions on lending to the USSR and Eastern Europe are thus the key to Eastern European finances and creditworthiness. Indeed, private market reactions to the situations in Poland and Romania and the missing Soviet "umbrella" have already led to a retrenchment in new bank lending to the USSR and all Eastern European countries, a shortening of loan maturities and increased interest rates. The Soviets have not borrowed on the Eurodollar market since May 1981. Under these circumstances, it would be unnecessary and even counterproductive for Western governments to attempt to restrict private bank lending directly.

Official Western credits and guarantees to the Soviets amounted to \$2.4 billion in 1981 and are estimated at another $2.0 billion in 1982 (not counting $2.0 billion in Yamal pipeline credits) -- about 6% of total expected Soviet hard currency imports. Official Western lending to the rest of Eastern Europe (except Poland) was only approximately $1.5 billion in 1981 and is considerably less important to Eastern European economies. The FRG, France, UK, Italy, and Japan account for over 90% of the official credits, which are generally used to finance major plant and equipment exports.

Western government credit restraints, if sustained, could moderately reduce the USSR's hard currency capabilities in the next few years, further tightening resource constraints on the USSR and increasing Soviet difficulties in coping with its defense burden. The Eastern European economies would feel the main impact indirectly through the private market reaction to Western government action affecting the Soviet Union. On the other hand, Western government official credits and credit guarantees at the current rate, will increase the Soviet and Eastern European debt burden, and increase Western vulnerability to those countries future debt servicing problems. Moreover, maintaining current official financing levels in the face of general private bank cutbacks would in effect be bailing out the private banks at government expense. For these reasons we recommend increased Western monitoring of official credit flows to the Soviet Union and of Eastern Europe debt accumulation, as well as controls on official lending to the Soviet Union.

Proposal. Assuming the allies reach agreement on monitoring/controlling credits and credit guarantees to the Soviet Union, an informal institutional mechanism could be established to review Western credit policies in light of Soviet and Eastern European financial developments and allied security interests. Membership in the group might be along the lines of COCOM (i.e. NATO countries plus Japan, minus Iceland). Specific responsibilities of the new "Western creditor club" would include:

-- exchange of specific Western government credit information to ensure greater transparency of Western credit policies;

-- analysis of economic trends in the Soviet Union and Eastern European countries and the economic/financial implications for the West;

-- review of major project financing, e.g. development projects and major plant and equipment sales, both in terms of volume and terms of credits provided and security implications for the West; and

-- coordination of debt policy (in effect absorbing the Polish official creditors task force and expanding it for use in other problem Eastern European countries).

The creditors' group would be independent from the OECD but draw on the existing OECD resource base -- in particular work in the East-West Trade Group and Credit Arrangement -- and coordinate credit policies for action, both inside and outside the OECD. The informal link with the OECD would be essential in involving the neutrals such as Austria, Switzerland and Sweden. The creditors' group could also draw on the NATO Economic Committee data.

The allies should strive to reach an agreement on a credit control mechanism and a reduction in credits to the USSR before the Versailles Summit.

IV. Economic Influence: Using East-West Trade to Affect Soviet Behavior

Western governments should consider how they can best utilize trade and financial relations with the East to influence the economic and political behavior of these countries in ways which are favorable to Western interests. Key agenda items should include joint allied action to raise the costs of Soviet borrowing in the West, allied cooperation in rejecting countertrade demands, and continued allied coordination in dealing with Polish, Romanian and other Eastern European debt problems.

Credit subsidies In addition to progress in limiting official export credits/guarantees, a parallel goal must be to reduce the degree of export credit subsidization to the Soviets. If we do not reduce the subsidy element, we are in effect encouraging further Soviet borrowing (through cheap credits) that leads to increased Western vulnerability as discussed in Section III. Roughly 40% of the USSR's outstanding debt carries terms which are below commercial market rates. Current minimum lending rates under the OECD credit arrangement are 10.5 to 11.0 percent (for Category II countries) depending on the term of the loan. Replacing concessional with market interest rates on the roughly $2 billion a year the USSR now receives in official, medium-term financing could raise Moscow's cumulative debt service costs by over a billion dollars over a five year period. In addition, the $14 billion in Yamal pipeline credits were accorded by the West Europeans and Japanese at under 8% interest with maturities of up to 8 1/2 years. While Western firms have reportedly compensated for some of the subsidy by raising the prices of exports for the Siberian

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pipeline, the differential with private market financing is worth over $4 billion to the Soviets over the payback period of the loans.

Negotiations are already underway within the OECD Export Credit Arrangement that could result in a general reclassification of certain countries, including the USSR, from Category II (intermediate) to Category I (relatively rich) countries. This would result in raising the minimum lending rates to 11 or 11.25% depending on the term of the loan. In addition, a general increase in the Arrangement matrix of minimum interest rates of 1/2 to 1 percent will also be considered in May, and this will affect all countries. The combined effect of these two actions would still leave official government lending rates to the Soviets over 2 percentage points below current Euro-market rates.

An alternative approach would call for the US, Japan and major West European countries to act unilaterally outside the OECD to raise interest rates to the USSR closer to market levels. Action outside the OECD would avoid neutral country objections but leave the path open to undercutting by these countries. Additional measures to raise the cost of lending would include increasing minimum downpayments beyond the 15 percent allowed in the OECD arangement, shortening maturities on medium term lending (most official lending falls in the 5 to 8 1/2 year maturity category), and limiting the extent of short-term official cover.

Debt Policy. The Polish and Romanian financial crises and requests for debt relief make debt rescheduling a key issue in 1982. Moreover, private bank cutbacks on lending to other Eastern European countries, most notably Hungary, if sustained, may force these countries to seek debt relief in 1982 as well. Western influence, not only on these countries but indirectly on the Soviet Union, can thus be exerted through a coordinated Western debt policy. Close collaboration among Western creditor nations is thus necessary.

Countertrade. Countertrade may be generally defined as an international trade transaction where sellers are obliged to accept a supply of products from the purchasing country in partial or total payment. Examples of countertrade are straight barter transactions, buy-back agreements where turnkey facilities are paid for by a plant's resultant output, and parallel but separate contracts linking sales to purchases.

The practice has been long promoted by many East European governments who have seen it as a way to reduce hard currency expenditures for needed Western equipment and technology and at the same time find Western markets for their frequently second rate manufactured goods. The East has even tried to promote the idea that long term countertrade

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arrangements are a higher form of economic relations between countries because of their "lasting character." The Soviets have been the largest and most frequent participants in countertrade arrangements, particularly in the energy and chemical sectors. The Romanians have come forth with probably the most burdensome requirements stipulating that Western imports must be balanced by counterpurchases up to 140% of the value of the export contract. The success of Eastern countries in inducing Western firms to enter into countertrade arrangements has also recently encouraged certain LDCs such as Indonesia and Brazil to try and boost exports by introducing counterpurchase requirements.

Summit governments have often criticized countertrade in principle but have not actively discouraged the practice. However, concerns within the OECD, particularly by smaller countries whose small to medium sized forms have a particularly difficult time coping with countertrade demands, has led to a closer examination of the phenomenon within the organization. Member governments endorsed an OECD study made public in the fall of 1981 which reached the following conclusions:

(1) Prospective Eastern payments deficits and a continuing lack of competitiveness of Eastern industrial products will result in continued strong pressure on Western firms to enter into countertrade arrangements;

(2) An attitude of benign neglect should not be adopted towards practices imposed unilaterally by Eastern countries. The arguments which they use to justify countertrade are not acceptable. Except for a few particular transactions, countertrade formulae have trade distorting effects by comparison with normal practices of multilateral trade. They entail unnecessary complications in the transaction process and introduce additional trade risks for eastern firms that are not countered by any significant advantage. Furthermore, the development of compensation deals would accentuate the bilateralism in East-West trade. This would certainly have negative effects on trade expansion;

(3) There is a need for Western countries to analyze the countertrade phenomenon more thoroughly, if only to be in a position to hold a discussion with the countries requesting these types of deals and claiming special merits for them;

(4) Greater efforts should be made to obtain a statistical coverage of the volume of and better knowledge of counter-trade deals;

(5) Eastern governments should be shown that the short term benefits they derive from the system are counterbalanced, even for themselves, by elements which will show up as negative in the medium and longer term;

Countertrade was discussed with Eastern governments at a special ad hoc meeting of the Economic Commission for Europe (ECE) in November 1981. Although Western governments were consistantly critical of Eastern countertrade practices, largely citing the points raised in the OECD study, the East, and particularly the Soviets, rejected these criticisms. The meeting adjourned without any commitment to further discussions in the ECE.

Western steps to discourage countertrade would be timely. Joint action at this juncture could help us resist Eastern pressures for countertrade and possibly help to inhibit the spread of the practice to newly industrializing LDCs. As the OECD study indicated, additional examination and discussion of countertrade is called for. Governments should also consider if measures such as the withholding of government credits and credit guarantees and the erection of special barriers to deal with possible import surges resulting from countertrade would be appropriate.

A possible agreement on countertrade might be as follows:

"The persistence and spread of countertrade in East-West trade and elsewhere is a cause for concern. Countertrade is a retreat towards bilateralism and distorts trade patterns. It inhibits countries from reaping the full benefit of the multilateral trading system based on comparative advantage and the international division of labor. Further examination of countertrade in multilateral organizations such as the OECD and ECE is called for. Governments also should oppose demands for countertrade more actively and consider in the OECD whether specific policy actions would be appropriate."

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Energy Security at the Versailles Summit

Summary

While energy today is not the front page news issue which it was at the Tokyo (1979) and Venice Summits (1980) it still remains a vital element of overall economic performance in Summit countries. Indeed, instead of a constraint on economic development, as we have viewed it in the past, energy may be a factor contributing to recovery. Lower prices for energy bring long awaited relief from inflation and pressure for higher wages and business costs. Economic recovery in turn will bring new opportunities for greater energy investment.

Without confusing optimism with complacency, the time is right to reconsider international energy imperatives in a more positive vein. There are abundant and economically attractive energy resources within the Western community. Developing these resources will allow revenues to stay at home, reduce inflation and bring new employment and economic opportunities. What is needed at the Versailles Summit is a renewal of commitment to develop indigenous energy resources through greater reliance on market forces supplemented by government action when broader Western economic and security concerns are threatened.

Energy security involves both reliance on market forces and a prudent concern for political and strategic factors. The basis of energy security cooperation among the industrialized countries rests on a network of political, economic and strategic commonalities and values that tie the industrialized democracies together and give them a collective strength that is greater than the sum of each individually. A threat to the energy security of one is a threat to them all. In recognition of this fact, the major industrialized democracies have jointly endeavored to develop means within the International Energy Agency and European Community to minimize at acceptable cost the disruptive effects of energy shortfalls when they threaten the common interest of all. The Versailles Economic Summit can renew and strengthen this resolve and provide the foundation for a more economically efficient and more secure energy future.

Energy security objectives at Versailles should be threefold:

(i) to underscore the importance and effectiveness of primary reliance on market forces in encouraging development of energy supplies and more efficient use;

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(ii) to encourage Summit countries to fully develop on an economical basis the rich resource base of the community of western countries, thereby reducing dependence on insecure sources of supply; and

(iii) to continue efforts to minimize at acceptable costs the disruptive effects of oil and gas shortfalls and/or cutoffs from less reliable exporters.

I. Reliance on Market Forces

Experience has shown us that permitting greater opportunities for operation of market principles is the most effective means to achieve structural adjustment of energy economies. The price increases of the last few years have significantly reduced consumption for energy and, in particular, oil. This illustrates most convincingly the importance of clear market signals to consumers. Likewise, production of indigenous oil, gas and coal has been stimulated where market forces have been allowed to function properly. Exploration activities for oil and deep gas are at an all time high in the United States. Energy prices have historically been high in European economies due in part to higher taxes resulting in lower per capita energy use than in North America, where prices have been relatively lower.

Examples abound as to the importance of the market, yet there are still a number of cases in Summit countries where market impediments are evident: Canadian domestic oil prices remain below international levels; British monopolistic practices keep U.K. gas producer prices at relatively low levels (although this policy may soon change in an effort to stimulate greater exploration and production); the United States continues to regulate natural gas prices; Germany maintains a system of coal import quotas; and in Italy, France and Japan government control slows the response of domestic oil markets to international developments. All of these conditions exist due to specific and perhaps understandable political factors and they will be difficult to change. Nevertheless, Summit countries should commit themselves to remove market impediments and to allow domestic energy prices to reflect international levels. In areas lacking a competitive world pricing standard, such as electricity generation, the marginal economic costs could serve as a guideline for pricing strategies.

II. Accelerate Energy Alternatives in Western Countries and Endorse Freer Western Energy Trade and Investment

Western countries as a whole are well endowed with energy resources. The best means for achieving long term energy security is to develop these resources in an economical manner to their fullest potential and to encourage freer trade and investment in resources among Western countries. The aim should be to reduce the percentage of energy resources coming from potentially unreliable country sources.

(i) Coal is the most abundant resource within the West. Suppliers such as Australia, Canada and the United States are in a position to meet their own growing requirements and the import needs of Western Europe and Japan. Recent figures illustrate that the private sector is making significant progress in the development and shipping of U.S. coal, including increasing port capacity. Coal importing nations should be further encouraged to invest in mines and ports in coal producing countries, thereby enabling all countries to share in the costs and benefits of this key resource. European nations and Japan can facilitate coal trade by promoting construction of receiving terminals and adopting measures to increase coal use in industry and electrical generation. Producers and consumers should reaffirm the need for economically viable long term contracts that will enable sufficient private investment to promote greatly expanded coal production, use and trade.

(ii) Recent large natural gas discoveries in the U.S. (lower 48 and Alaska), Canada, Norway and the U.K. suggest that this convenient and widely accepted fuel exists in abundance within the Western community. We should be able to agree on the desirability of minimizing dependence on gas from the Soviet Union, replacing it where economically feasible from Western and reliable developing country sources. Development and transport of OECD gas reserves will not only provide a source of certain and predictable supply for years to come, but also stimulate economic opportunity and create jobs within industrialized countries.

(iii) Nuclear programs are proceeding relatively well in most Summit countries, although some nations -- notably the United States -- are lagging behind. A strong statement of support by Heads of State can help sustain the momentum of worldwide nuclear energy growth and renew confidence in those countries where programs are delayed. A commitment to strive for pricing electricity at the marginal economic cost could help spur investment. The Summit might mandate the High Level Monitoring Group to devote special attention to nuclear energy over the next year to assess the state of nuclear development and key problems (financial, burdensome regulatory practices, safety, and back-end of the fuel cycle). Heads of State should also consider asking the Nuclear Energy Agency in coordination with the International Energy Agency to assess the feasibility of a joint international waste management project.

(iv) Some potentially promising long term high risk energy technologies have too distant a pay back period to interest private investors. In addition, investment in research and development of sources like fusion tend to be very expensive and too extreme a burden on individual country budgets. Summit countries could consider strengthening their cooperation by reviewing their national efforts to identify opportunities for sharing expenses and expertise to expedite the development of these technologies. This could be done perhaps as part of the French (host country) focus at this Summit on new technologies.

(v) Developing countries could provide a significant part of the world's marginal energy production over the coming years. Summit countries should consider measures which would increase private investment in developing country energy production through such means as an improvement in LDC investment climate and an increased multiplier effect of World Bank lending.

III. Preparing for Disruptions in Short Term Energy Supplies

Despite a welcome respite from oil market turbulence, the chance of sudden and potentially major disruptions in oil supply still exists. By reducing its imports from unreliable suppliers the U.S. has reduced its vulnerability to oil supply disruptions, but Europe and Japan remain highly dependent on uncertain sources of supply. All Western countries would suffer from the economic and political consequences of a new supply interruption.

In addition, a dangerous blind spot has emerged with respect to the security implications of alternative sources of energy, some of which represent risks equal to that of insecure sources of oil supply (i.e., European dependence on Soviet gas). Thus, Summit countries may wish to address a number of these emergency preparedness problems.

(i) Large scale oil disruptions. The IEA and EC emergency sharing systems remain the principal intergovernmental mechanisms for sharing the burden of major shortfalls in oil supply. Summit countries should reaffirm their support of these systems, recognizing that individual methods of complying with the international sharing schemes should be left to the discretion of each country.

(ii) Smaller oil disruptions. Considerable effort has recently been expended to identify possible responses in the event of a 1979 type market syndrome: a relatively small shortfall resulting in a disproportionate price rise. Because it is not possible to describe accurately remedies for emergencies of an unknown character, the U.S. has encouraged all IEA countries to increase oil stocks. Higher levels of stocks will buy time in the event of a disruption in order to meet at high governmental level and to decide what action, if any, is warranted by the circumstances. The mere existence of these stocks should have a very positive effect in times of crisis. This focus on supply side measures would constitute a salutory corrective to the preoccupation with price and allocation schemes which distort market forces. In the spirit of this premise, the U.S. has more than doubled its Strategic Oil Reserve within the last year; some other countries have increased reserves, but a number have unfortunately lagged behind.

The IEA and EC should continue to carefully monitor individual country stock positions and assess whether they are adequate in light of current oil market conditions. We might also usefully continue discussions within the IEA/EC on how individual countries would use stocks in times of oil market disturbances. Such discussions are likely to conclude that stock sharing schemes in a sub-crisis situation are not workable, nor desirable. This will act as an inducement for each country to build stocks for its own use.

(iii) Natural Gas Security. Given the projected increased role of natural gas imports to Western Europe and Japan, Summit countries should develop with utmost urgency means for achieving enhanced gas security, including increased storage facilities, surge capacity in the OECD area to be tapped in times of emergency, better integration of the European gas grid and more dual-fired capacity among large industrial users. The IEA and EC should continue to coordinate these efforts so that an inter-governmental approach can be taken to complement national efforts.

IV. Draft Energy Security Statement

The following text illustrates the type of agreement which might be reached by Summit countries to emphasize the points made in this paper.

Heads of State:

-- agreed that investment in Western energy resources can accelerate economic recovery and provide for a stable long term energy future;

-- underscored the importance of market principles in encouraging development of energy supplies and more efficient energy use;

-- encouraged Summit countries to develop fully the large and economically attractive energy resource base of Western countries, thereby reducing dependence on insecure sources of supply;

-- noted that freer trade of energy resources within the West should be encouraged; and

-- recognized that the world economic system remains susceptible to sudden energy supply disruptions.

To realize expeditious development of Western energy resources and freer trade and investment they might agree to:

-- commit themselves to the goal of removing market impediments, eliminating obstacles to energy investment and allowing domestic energy prices to reflect international levels. In areas lacking a competitive world pricing standard, such as electricity generation, the marginal economic costs should serve as a guideline for pricing strategies;

-- continue efforts to expand Summit country coal production, use and trade by encouraging viable long term contracts to stimulate private investment. Coal producing countries will welcome investment in mines and ports, thereby enabling all countries to share in the costs and benefits of this key resource;

-- expand Western natural gas production and trade, thereby minimizing dependence on insecure sources of supply and providing economic opportunities within the West;

-- continue efforts to expand nuclear energy worldwide and call upon the Nuclear Energy Agency in coordination with the International Energy Agency to assess the feasibility of a joint international waste management project;

-- review national R and D programs, especially those involving significant funding to see how sharing of costs and expertise might expedite the research; and

-- consider measures which would increase private investment in developing country energy production through such means as an improvement in LDC investment climate and an increased multiplier effect of World Bank lending.

Recognizing that the energy market remains inherently risky, Summit countries also:

-- reaffirmed their commitment to the IEA oil emergency sharing system;

-- agreed that the present relaxed market situation provides an opportunity to build strategic oil stocks and recognized the usefulness of continued discussions on how individual country stocks might be used in time of oil market disturbances; and

-- encouraged the IEA and EC to continue their efforts to coodinate Member Country efforts to enhance Western natural gas security.

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