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Central Intelligence Agency

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USSR: Expanding Its Financial Horizons

Summary

The Soviet Union could lose as much as $6 billion in hard currency earnings this year as a result of lower oil prices. Moscow's currently strong credit rating allows it the flexibility of covering most of these losses by borrowing at favorable rates in the traditional Eurocurrency market. The Soviet leadership is unlikely to let its debt grow too large, however, out of fear of diminishing bankers' confidence and to avoid increasing its dependence on Western banks. Higher gold sales--a traditional cushion for the USSR in times of hard currency shortages--are likely, but Moscow also will move cautiously in this market in an attempt to keep prices high. [redacted] 25X1

In its efforts to mitigate the effects of the hard currency shortfall, Moscow is pursuing other options as well, in particular increasing its use of secondary financial markets and third-party borrowers. [redacted] 25X1 25X1 These latter initiatives, in all likelihood, stem from the USSR's desire to limit the overall cost of its borrowing and, to some extent, obscure the magnitude of its growing debt. Although Gorbachev's appointees may be more willing than their predecessors to take advantage of a wider range of Western borrowing facilities, financial conservatism, endemic risk-aversion, and the need for centralized control will probably limit Moscow's borrowing through these channels. [redacted] 25X1

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USSR: Expanding its Financial Horizons

Moscow's Financial Bind

The fall in world oil prices has prompted a flurry of Soviet activity in both financial and commodity markets as Moscow seeks ways to counter the financial losses inflicted by its principal hard currency earner. [redacted] Domestic oil production problems in early 1985 and falling prices by yearend resulted in lost revenues of about $3 billion last year. Such losses could possibly double this year in the wake of still lower oil prices. The Soviets' problem has been compounded by a depreciating dollar which has eroded the purchasing power of those oil dollars still flowing in. [redacted] 25X1

Moscow's responses to date have been largely predictable, with the Soviets employing a combination of debt buildup and increased gold sales to limit the size of immediate import cuts. Although hard currency export revenues dropped 15 percent last year--due largely to a 20 percent reduction in oil earnings --the import decline was held to just 5 percent. This was accomplished by increasing gold sales nearly $800 million to $1.8 billion, and boosting net indebtedness from $10.4 billion to $14.4 billion. The USSR also managed a steep buildup of assets in Western banks during the fourth quarter, preventing net debt from climbing to record levels. Both borrowing and gold sales continued at a brisk pace during the first quarter of 1986, which

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helped to keep imports from dropping sharply in the wake of continuing losses in oil revenues. [redacted] 25X1

Indeed, the Soviets' approach to date parallels their response to their financial pinch in 1981 when a weakening oil market also constrained export earnings (see Figure 1). In addition to a debt increase and higher gold sales, Moscow also redirected some oil from Eastern Europe to hard currency markets beginning in 1982. The dilemma confronting Moscow this time, however, is that a severe hard currency crunch could persist until at least the end of the decade should oil prices fail to recover significantly. Under such circumstances, the Soviet leadership is unlikely to continue foreign borrowings at the rate exhibited in the past 18 months, not only to avoid jeopardizing a solid credit rating, but also out of fear of becoming too dependent on Western banks and their governments. Borrowings will continue and the net debt is likely to grow, but import cuts will bear a much larger burden over the next few years. [redacted] 25X1

Although the development and execution of a more prudent import strategy is probably preoccupying the Soviet planners, Moscow also seems to be altering--at least at the margin--its approach to international finance. While not abandoning its financial conservatism by any means, the Soviets at least appear willing to push out the boundaries of their "financial possibilities frontier." Some of Moscow's actions predate the current crunch, but they have taken on added importance as funds dwindle. Such moves are probably not intended to garner

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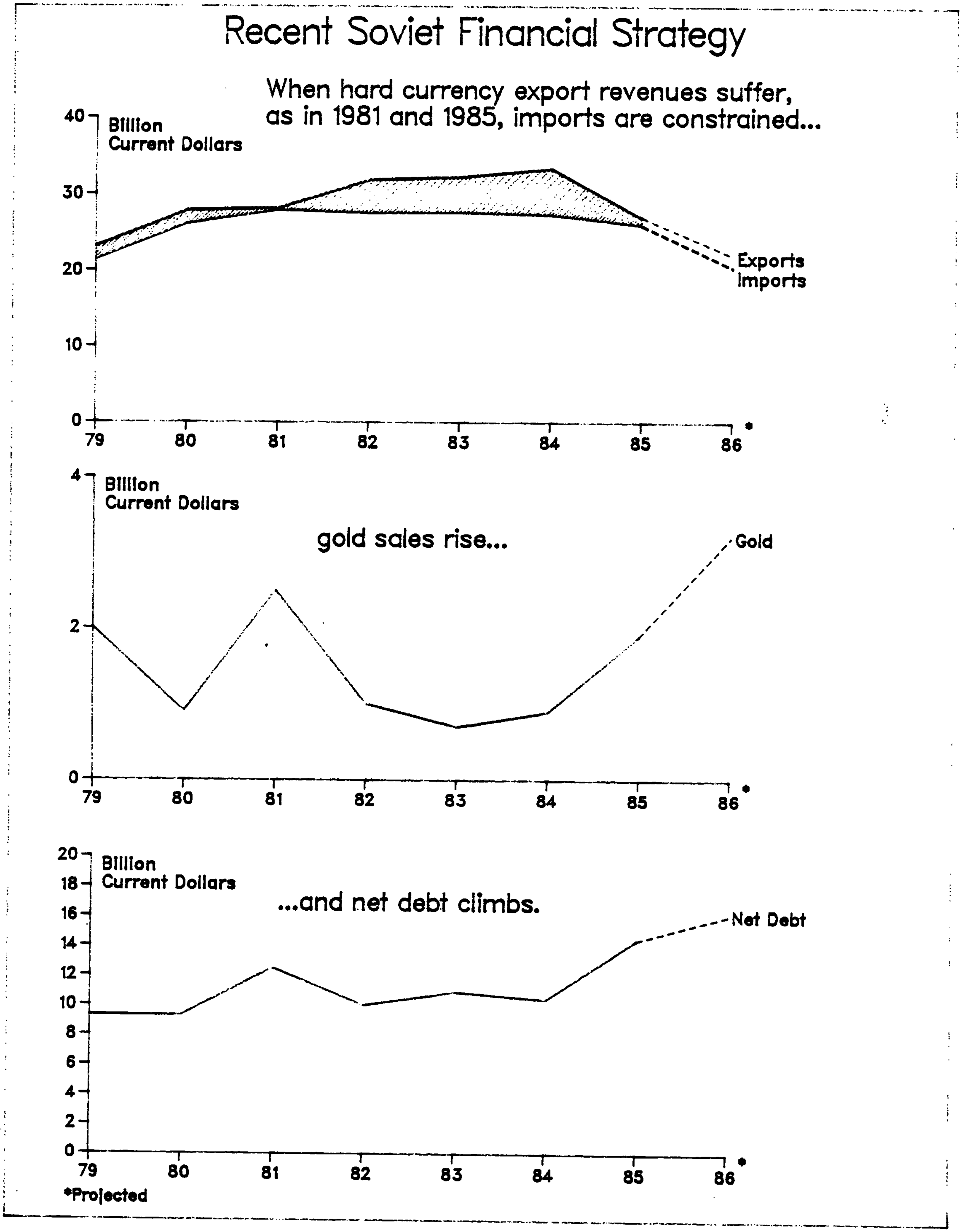
Figure 1



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the funds needed to stave off sizable import cuts. The Soviets already are moving to decrease imports to redress the financial imbalance, with Foreign Trade Minister Aristov stating that imports from the West could be cut between one-fourth and one-third this year. Nonetheless more sophisticated approaches could help Moscow adjust more quickly to changing international conditions and more cheaply obtain the foreign exchange it will require. [redacted] 25X1

Exploiting Old Friends...

Moscow's financial position remains relatively strong despite the setbacks suffered in the oil market. The Soviets have taken advantage of their excellent credit rating and attractive interest rates to arrange more than $1 billion in long-term syndications this year. In fact, the USSR remains such an attractive borrower vis-a-vis most other debtors that three syndications have been oversubscribed this year. [redacted] 25X1

Moscow, nonetheless, probably remains leary of pushing a good thing too far. [redacted] bankers' 25X1
concerns about Soviet creditworthiness are growing as low oil prices continue, with apprehensions somewhat heightened following the Chernobyl' accident. While Moscow will not have any difficulty finding willing lenders, it does face the possibility of higher interest costs. Rather than risk "losing face" by being tagged with a lower financial stature than it deems worthy, Moscow appears to be trying out options beyond traditional, long-term syndications. By "segmenting" financial markets, the USSR

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is insuring adequate money flows while effectively bypassing exposure limits set by the West's major financial institutions, and, to some extent, obscuring its debt position. [redacted] 25X1

One major example of such activity is Moscow's reemergence in the forfaiting markets.[2] After making extensive use of this technique in the second half of the 1970s to finance purchases of machinery and equipment and, to a lesser extent, in the early 1980s to help buy grain, the USSR cut back on such loans in favor of other financing. [redacted] 25X1

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- The Western press reports that the Soviets also used forfaiting financing this spring to fund a $40 million plastics plant to be built by an Italian firm. Although forfaiting loans are generally medium term (in the neighborhood of 3 to 5 years), this paper carried a long, 13½ year term with a fixed interest rate subsidized by the

[2] The forfaiting market is essentially a market for "indirect" supplier credits. In this market the seller of the note is usually an exporter who is seeking to pass on all the risks and responsibilites for the collection of a debt in exchange for immediate cash payment. The buyer has recourse only to the originator of the note--a Soviet-owned bank in this example--and may resell at any time, discharging his obligation. A ready market exists because of the low risk involved. [redacted] 25X1

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Italian export bank.

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Moscow also appears to be boosting its use of third parties to obtain funds. In particular, the Soviets appear to be looking more toward the banks they own in the West for opportunities to increase access to low-cost funds.

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It is unclear how far Moscow will push these banks. On the one hand, the Soviets have been interested--at least since their last financial crunch in 1981--in extracting as much surplus cash from these banks as possible.[3] [redacted] 25X1 25X1 While the Soviet Union's current needs for hard currency are great, it will probably require these banks to move cautiously before engaging in any activities that could backfire with losses far outweighing potential gains (see Box text). [redacted] 25X1

The Soviets may also be tapping the International Investment Bank (IIB) for funds. The IIB, headquartered in Moscow, generally funds long-term CEMA projects. [redacted] 25X1 25X1

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Boxed Text

Playing the Interbanks

Vneshtorgbank and Soviet-owned banks in the West are active users of the interbank market. This market--as its name implies --involves bank-to-bank transactions in which banks with excess cash can earn a small return or banks with a cash shortage can borrow to meet commitments. Rates worldwide vary, usually slightly below the best commercial rates. There has long been a "gentlemen's agreement" among bankers that deposits, for the most part, will be offsetting so that no bank takes advantage of this relatively cheap source of funds. 25X1

The sometimes lax reporting by banks of the flow of funds through interbank channels as well as a gradual erosion over the years of the "gentlemen's agreement" has prompted some Western observers to claim that Moscow is abusing this market. In particular, it is argued that Moscow obtains low-cost interbank funds and then uses the money to underwrite imports and/or cover the cost of foreign activities. At a minimum, laundering money through intermediaries, it is alleged, would artificially inflate the size of Soviet assets and thus reduce Western estimates of its net debt. The process involves one of the Soviet-owned banks in the West--which is not legally a Soviet bank--borrowing cheaply via the interbank market and then depositing the money in the bank of another country, usually one that does not report its liabilities and assets to the Bank for International Settlements (BIS)--a repository and regular reporter of international money flows. This money is then transferred to VTB, which in turn redeposits it in a Western bank in the BIS reporting area. The end result is that the only transaction that is reported in Western statistics and includes the Soviet Union is the last one, and this is reported as a Soviet deposit in the West. The earlier money flows are either not reported or do not involve--at least according to official records--a Soviet bank. 25X1

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Although we have no evidence of Soviet misuse of the interbank markets, the loophole exists and might be tempting to Moscow during these austere times. We doubt, however, that Moscow will play this game. The money is not free, and, even if the rates are low, costs probably rise as the process becomes more intricate. Moreover, there is a large element of risk in borrowing heavily in what is basically a short term market and using the money for long term purposes. Given that the Soviets can borrow long term at only one quarter percentage point above the interbank rate in London, there is probably little to be gained by paying only slightly lower rates for money that may not be rolled over. [redacted] 25X1

Table

Interbank Deposits by Soviet-Owned Banks

	Percentage of deposits made to:		
	VTB	BIS Banks	Non-BIS Banks
Deposits made by:			
MNB-London	67	30	3
E-W United Bank	64	32	4
Eurobank	47	49	4
MNB-Singapore	89	1	10

End of Boxed Text

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Another third-party operation focuses on Moscow's use of its clearing account arrangements.[4] [redacted] 25X1

...and Exploring New Options

Although the Soviets are still adhering to their long-standing financial conservatism and relying largely on familiar instruments, they do appear more willing to expand their financial horizons. Such a course is by no means a precursor of a significantly larger role for the Soviets in world financial markets. Indeed, Moscow's past activity in global financial markets has almost exclusively been linked to facilitating trade flows, and thus the dollar magnitude of Soviet transactions is likely to contract along with oil earnings. But the scope of Soviet financial activity may well expand as Moscow increases the

[4] A clearing account is method by which trading partners exchange goods on an accounting basis in order to avoid hard currency payments. A tally is kept of the status of the trading arrangement, usually in a soft currency such as the "transferable ruble." [redacted] 25X1

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use of new international financial instruments to maximize the benefits of a smaller pool of funds. 25X1

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The Soviets have been active players in foreign exchange markets for years but are showing signs of increased sophistication in the wake of erratic foreign exchange movements, particularly the need to offset the effect of dollar depreciation. After being persuaded to accept its first ECU-denominated loan in October 1984, the USSR requested ECU financing on several more loans during 1985.[5]

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Lastly, Moscow appears to have recognized that more sophisticated financial dealings entail increasing the number of actors to handle its transactions as well as expanding its role

[5] The ECU--an acronym for European Currency Unit--is an accounting currency based upon a weighted average of exchange rates for all European currencies, lessening the impact of exchange rate fluctuations.

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in world economic affairs in general. [redacted] 25X1

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Meanwhile, Moscow is pushing to obtain observer status in GATT, the multinational group that promotes tariff and trade cooperation, which would increase Soviet exposure to Western trade trends and alliances. [redacted] 25X1

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New Ventures into Gold, Diamonds and Precious Metals

Moscow's financial adventurism also appears to be reflected in its dealings on commodities markets. In particular, gold sales have accelerated this year. At the end of the first

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quarter the Soviets had already sold over 100 tons through conventional means, [redacted] 25X1 25X1

Moscow has traditionally conducted its sales and purchases on the major gold exchanges. Although the heavy volume of Soviet trading has at times helped conceal the level of net sales, the market is now more aware of Soviet transactions so that almost any perceived change in the level of their sales could affect prices relatively quickly. Thus Moscow seems to be seeking less visible ways to market its gold. [redacted] 25X1

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Moscow is also continuing to market diamonds agressively. The Soviets already have an arrangement with DeBeers of South Africa to control the sales of unpolished diamonds, [redacted] Such an alliance may have been instrumental in driving up diamond prices by 7.5 percent after they had fallen early in the year. To help with sales, the Soviets also appear to have stepped up marketing activities, including an advertising campaign on US television. [redacted]

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Moscow also could earn extra dollars in the palladium market even though there is no indication yet of increased sales. Palladium sales account for the bulk of Soviet earnings in the platinum metals, and Soviet exports have risen in recent years and are expected to rise again this year [redacted] Increasing sales from the 1.7 million ounces sold in 1985 to 2 million ounces this year would bring in over $30 million at current prices. Early in 1986, the USSR changed its payment terms for palladium from 90-day credit to cash and abandoned the previous practice of fixed-price offerings, a change [redacted] made to raise the price. [redacted]

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Information on Soviet activity in the platinum market is contradictory. Recent press reporting indicates that the Soviets

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have not yet increased platinum sales, even though demand is strong. In addition, the steadily declining sales over the past decade may mean that the USSR's supply of platinum is insufficient to increase exports. [redacted] 25X1

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[redacted] Moscow could increase platinum sales by 25 percent over the 1985 level. Such sales would amount to an additional 50,000 ounces and boost earnings by more than $20 million at current prices. [redacted] 25X1 25X1

<u>Outlook</u>

At present, the only prospect for earning large sums of new hard currency is increased gold sales--a traditional cushion for the Soviets in times of currency shortages. Some market analysts believe a one-time yearly total sale of around 450 tons is possible without large price effects--if handled judiciously. This level of sales would push earnings from $1 billion to $2.5 billion above the 1985 level. Moscow's other financial activities might generate payoffs totalling perhaps $500 million given current market demand. While these earnings seem inconsequential in the face of a possible $6-billion shortfall in revenues from oil exports, they nonetheless help limit the severity of import cuts. [redacted] 25X1

Moscow probably believes that superpower status requires it to become more active in international economic forums, with the need to become more financially sophisticated heightened by the

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sharp drop in the price of oil and the depreciating dollar. While we believe that Moscow will continue with its current efforts, and even expand them where low risk opportunities are present, we expect this expansion to be deliberate and well thought out. Gorbachev's appointees may be willing to take on new ideas, but conservatism, risk-avoidance, and centrally controlled decisionmaking which characterize past and present Soviet financial activities is clearly antithetical to the full utilization of Western financial markets. 25X1

Moscow's actions in this arena will entail some new forms of cooperation with the West. The extent of the relations will be tempered by reduced trade flows and an unwillingness to let dependence on the West get too far out of hand. In fact, its deteriorating hard currency position may even inhibit Moscow from pursuing some riskier activities. But change already is underway, and the scope of new ventures and the resulting pace at which they proceed may be a good indicator of how seriously the Soviets perceive their hard currency situation. 25X1

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