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The Director of Central Intelligence

Washington, D.C. 20505

National Intelligence Council

NIC 05827-85
22 November 1985

MEMORANDUM FOR: Acting Director of Central Intelligence

FROM:

[Redacted] Acting National Intelligence Officer for Economics

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SUBJECT: NSC Meeting on Senate Bill 812

1. On Monday, 25 November, the President will chair an NSC meeting (originally scheduled for 1 November) to determine the Administration's position on S. 812, the Financial Export Control Act, which would give the President powers to bar lending by US institutions to "controlled" countries.

2. Senators Garn and Proxmire proposed S. 812 (Attachment A) as a way of preventing the Soviet Bloc from using funds borrowed in the United States to finance the transfer of technology or to fund other activities such as support for Nicaragua. The bill was introduced on 28 March as an amendment to the Export Administration Act; hearings will be held on 3 December.

3. In terms of substance, it would, of course, be impossible to stop US funds from flowing indirectly to the Bloc or convince countries in Western Europe to halt additional credits in any "non-emergency" situation. The Justice Department argues that provisions in the bill would allow the President to avoid excessive use of the International Emergency Economic Powers Act (IEEPA), invoked for the Nicaragua sanctions. Others within the Administration say that the President ought to have the power to take actions short of those under IEEPA if the situation warrants. The Secretaries of Treasury, State, and Commerce oppose the controls contained in S. 812, arguing that they would be ineffective, run counter to our aim of improving the dialogue with the USSR, and are inherently against our interests. Defense and NSC are in favor of some powers along the lines of S. 812, although not necessarily in the form provided in the bill. OMB is opposed to the bill but proposes that the Administration find ways of taking such actions short of legislation.

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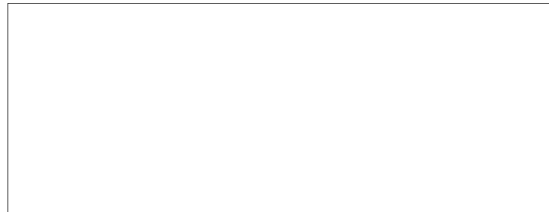
SUBJECT: NSC Meeting on Senate Bill 812

4. Setting aside the above objections, CIA can make the point that this is an appropriate time to consider such powers because the Soviet Union will suffer a substantial decline in hard currency earnings over the next five years, and Western credits will be needed if Moscow is to maintain its purchases of Western machinery, equipment and technology. We might also want to question whether the bill should be targeted at additional areas such as those states that support terrorism.

5. The meeting on Monday will focus on three options, according to a 7 October memorandum prepared by NSC.

1. Giving Administration support to the spirit and intent of S. 812.
2. Having OMB inform the Senate that it will draft administrative procedures to achieve a comparable result.
3. Saying that the Administration is opposed to S. 812 but will work to develop administrative procedures to achieve a comparable result.

The DCI was given a copy of this draft memorandum (Attachment B) and sent it, along with a supportive note, to Weinberger on 28 October.



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Attachments:

- A. Senate Bill 812
- B. Memo and Attachment on Financial Export Control Act
- C. Advanced Industrial Technologies in the USSR: Progress and Problems
- D. USSR: The Role of Foreign Trade in the Economy
- E. USSR: Implications of Reduced Oil Exports
- F. Eastern Europe: Boom Market for Syndicated Lending

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SUBJECT: NSC Meeting on Senate Bill 812

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CONGRESSIONAL RECORD — SENATE

March 28, 1985

By Mr. GARN (for himself and Mr. PROXMIRE):

S. 812. A bill to amend the Export Administration Act of 1979 to authorize controls of the export of capital from the United States; to the Committee on Banking, Housing, and Urban Affairs.

FINANCIAL EXPORT CONTROL ACT

• Mr. GARN. Mr. President, today I am introducing the Financial Export Control Act, a bill authorizing the President to control the transfer of money and other financial resources from the United States to countries

against which we maintain national security export controls.

For the past 8 years the Congress has been reviewing the Export Administration Act in an effort to improve our ability to prevent the transfer of sensitive goods and technology to our adversaries. The Defense Department recently commissioned a private study of the impact of technology transfer on our defense spending. That study, which will soon be released, confirms what we have long feared, that technology transfer to the Soviet bloc costs us tens of billions of dollars annually in increased defense costs.

Mr. President, although a bargain in comparison with our development costs, the Soviets have to pay for the technology they obtain. It is unfortunate but true that the Soviets are successful in gathering Western technology with the help of people living in the Western democracies. But that help has to be bought. In fact, the Western high technology smuggler demands a premium price for everything he delivers, and he will not take payment in rubles. This means, Mr. President, that the Soviet ability to obtain the sensitive goods and technology from the West that are turned against us in Soviet weapon systems is directly related to their ability to obtain hard currency, Western currencies.

There are only a few ways that the Soviets can obtain hard currency. They can export to the West, but the quality of Soviet products is so low that export sales have been limited to exports of raw materials, such as gold and natural gas, and to arms exports.

The other way that the Soviets have in the past obtained what is for them very scarce Western currency is through loans from Western banks. This source largely dried up, however, over the inability of Poland and several other Soviet allies to pay their debts and the furor caused by the realization that Western banks were so deeply involved in lending to the Soviet bloc at the same time that these countries were brutally repressing their own citizens.

Lately, however, Western European banks have resumed their lending to the Soviet bloc. The level of lending reached \$3 billion last year, a three-fold increase over 1983. The only bright spot in this gloomy picture was the fact that U.S. banks were staying out. Now that, too, is ending. American banks are now falling over each other to get back into lending to the Warsaw Pact, and at terms far more favorable than what the Western Europeans were offering. Last year, while West German banks were making largely short-term loans to East Germany at rates 3 or 4 percentage points over the London Interbank offered rate (LIBOR), First Chicago Bank gave the East Germans a \$75 million loan at only 1 point above LIBOR. The Western Europeans have since begun matching those terms.

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Not to be outdone, however, New York's Citibank is currently syndicating a loan to East Germany in the amount of \$500 million, at seven-eighths of a point above LIBOR or one-half point above the U.S. prime rate. This loan started out at a mere \$150 million, but there was such enthusiasm for it from U.S. banks that the East Germans were persuaded to increase the amount. Moreover, this loan is for 7 years, with a built-in 3-year grace period.

Mr. President, the prime rate is currently at 10.5 percent, so the Citibank loan to East Germany, in today's terms, would be for a rate of 11 percent. I wonder whether any of my colleagues have any constituents that would like to borrow money at 11 percent. Do they have anyone who would like to buy a home at 11 percent, or obtain credit for farm improvements at 11 percent? Perhaps they have some constituent that would like to start or expand a business with an 11-percent loan, or make an export sale. They very well may have such people, but they are unlikely to find those kinds of loans being offered. Apparently, a family trying to buy a home, a farmer, a businessman in the United States cannot easily get such a rate, but the East Germans can.

What are the East Germans going to do with such a loan? Are they going to expand human freedoms, increase individual opportunity? No. Instead, the East Germans are going to use the money to buy Western high technology. They are concerned by the fact that their Communist economy is falling farther and farther behind the economy of West Germany—and it is worth adding that the East Germans came to Citibank because the West German banks were requiring human rights concessions for the granting of their loans.

The East Germans are also eager for Western technology because their Soviet masters are demanding more high technology imports from the East Germans in exchange for Soviet energy supplies. That is to say, although the loan is going to the East Germans, its benefits are going to the Soviets.

Mr. President, I am not sure how we can best deal with this problem, but I do know that we are making our export control task all the more difficult by lending our adversaries the money with which to obtain our technology. This is a practice that must stop. Our banks may make some profits from the loans, although their troubled East European loan portfolio casts some doubt on that. But whatever profit they may obtain is far short of the expense that it causes us to make up for Soviet bloc military advances made possible by Western technology. What would interest rates be for our people if we could safely decrease defense spending by tens of billions of dollars annually? We cannot make such cuts, however, as long as we

are contributing so directly to Soviet bloc military advances.

I am offering this bill today for consideration by my colleagues in hopes that it will lead to an end to the practice of lending to our adversaries. This bill authorizes, but does not direct, the President to control transfers of capital to countries against which we maintain national security export controls, the Soviet bloc countries. The President would be given full discretionary authority so as to apply such controls in the manner most in keeping with our national interests.

The bill in its current form is a discussion draft. My colleagues may have some other ideas, and some changes may need to be made. Perhaps the problem can be solved without legislation, but I believe that the time has arrived to address this situation directly.

Mr. President, I would also like to mention to my colleagues that I do not intend to add this bill to current proposals to amend the Export Administration Act that are being considered here and in the House of Representatives in connection with the reauthorization of the Export Administration Act. This is a separate item of legislation.

Mr. President, I ask that the text of an article from the March 19, 1985, edition of the Wall Street Journal that details the recent Citibank loan, along with the text of the bill and a section-by-section analysis of the bill, be included in the Record at this point.

There being no objection, the material was ordered to be printed in the Record, as follows:

(From the Wall Street Journal, Mar. 19, 1985)

EAST GERMANS BENEFIT FROM U.S. BANK CREDITS THAT DON'T CALL FOR HUMAN RIGHTS CONCESSIONS

(By Frederick Kempe)

EAST BERLIN.—American bankers' eager resumption of credits to East Germany is helping the country avoid human-rights concessions in its financial relationship with West Germany.

East Germany avoided a Polish-like financial crisis in 1982 and 1983 through two separate credits negotiated and guaranteed by Bonn and extended by West German banks. In return, East Germany ceased restrictions on West Germany visits to the East, and it also last year allowed 40,000 East Germans to emigrate to West Germany.

Western experts now believe that East Germany yielded the short-term human-rights concessions to pursue significant longer-term aims that would spare it from such a vulnerable political position again. It combined the West German credits with a strict austerity program and dramatic import reductions to considerably improve its economic performance and its image among international creditors, who now are competing to give the country money.

CHANGE OF COURSE

Bank of America, Manufacturers Hanover and Citicorp, who were refusing East Germany new credits a little more than a year ago, are managing with the bank of Tokyo a \$160 million credit that has grown to \$500

million largely due to U.S. banks' demand. The loan hasn't any political strings attached, and its terms are the best East Germany has seen since the Polish repayment crisis—½ percentage point over the London Interbank Offered Rate (Libor) or an option for ¼ percentage point over the U.S. prime rate. It is to be repaid over seven years with a three year grace.

"It's all a political business," says Wolfgang Seiffert, economic adviser to the East German government until 1978, and now a professor in Kiel, West Germany. "The attempt of East Germany to get money from American and other banks is an effort to get western finances without liberalization measures. The money will give East Berlin a stronger hand for its political games with West Germany because it doesn't need Bonn's money as much anymore."

West German bankers also complain that the Americans have been driving prices down in their effort to get back into the East Germany lending market that they abandoned in 1981, when Poland cast a shadow over all of Eastern Europe.

Until last year, West German banks were extending the East Germans primarily commercial loans, usually to be repaid after one year at a rate three to four percentage points above Libor. However, East Germany extracted far better conditions from First National Bank of Chicago when it worked its way back into the market last year. First Chicago offered a \$75 million club loan at only one percentage point above Libor, a rate that European banks thereafter were forced to match despite a feeling by many lending officers that the margin wasn't sufficient.

THE GROWING GAP

U.S. banks are injecting money into the East German economy at a critical time. East Germany considerably reduced imports over the past three years to achieve hard currency trade surpluses and to service debts, but it also dangerously reduced investment. The result was that the technology gap between it and its West European neighbors grew.

Western economists expect the next East German five-year plan, from 1986-1990, to include an ambitious investment program, particularly emphasizing purchases of Western technology.

This is partially a response to a Soviet ultimatum that Moscow is to get Western-quality goods in exchange for the raw materials it provides Eastern Europe, or Moscow will reduce the amounts provided. The Soviets warn that Soviet oil can simply be sold on Western markets and the proceeds used to buy more advanced Western products.

"The East Germans are the largest East European technology sluice and supplier for the Soviets," says Klaus Schroeder of the West German government-sponsored Institute for Science and Policy near Munich. "Soviet demands have put a large amount of pressure on the East Germans to modernize their industry."

GOOD PERFORMANCE

U.S. bankers argue that they have good reason to be wooing the East Germans. First, they say East Germany's economic performance is the best in Eastern Europe. Produced national income (basically, gross national product minus invoices) in 1984 rose by 5.5%, compared to 4.4% the year before. Net industrial production rose 8.5% against 4.6% in 1983. Industrial labor productivity increased 7.7% against 5.8% in 1983.

The bankers also cite a radical improvement in East Germany's external position. While East Germany's debt to Western

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banks of \$10 billion once was worrying to the banks, they now place more emphasis on East Germany's buildup of deposits in Western banks to some \$4.5 billion.

Some also argue that a double umbrella exists over East Germany. They say the Soviets wouldn't allow their most important economic ally to enter into repayment difficulties and hence would bail the East Germans out. The bankers are even more confident about a West German umbrella, following Bonn's financial intercession during East Germany's recent problems.

"The proof is in the pudding," one U.S. banker says. "East Germany is a solid bet. We have been aggressively adding to our exposure."

However, many Western experts believe the banks are making the sorts of errors they did when more than 400 lending institutions scrambled in the 1970s to do Polish business. They are competing to give East Germany even more cash than it is asking for, yet East German economic reporting remains imprecise. The bankers haven't any specific idea what East Germany intends to do with all the money, nor whether it can eventually earn the hard currency to repay the loans.

"Bankers learn very slowly and forget very quickly," says Mr. Schroeder, a former bank economist.

Says Mr. Seiffert, "The economic situation in East Germany has improved, and so no one should have great worries about giving the country credits, but the U.S. banks currently aren't being prudent enough and should only extend credits when linking them to specific projects or investment plans."

SECTION-BY-SECTION ANALYSIS OF THE FINANCIAL EXPORT CONTROL ACT

Section 1 gives the title of the legislation as the Financial Export Control Act.

Section 2 adds to the Export Administration Act of 1979 (EAA) a finding that loans and transfers of capital to the Soviet Bloc add to their ability to acquire sensitive goods and technology.

Section 3 adds to the EAA a statement of policy to restrict transfers of capital to controlled countries in order to further national security export control policies.

Section 4 adds to the EAA a new section 8A, authorizing the President, through the Secretary of the Treasury, to control transfers of capital to controlled countries, and directing the Secretary of the Treasury to conduct negotiations with other countries to obtain cooperation on any such controls imposed.

Section 5 is a conforming amendment, designating the Treasury Secretary as responsible for issuing licenses that may be required for capital transfers to controlled countries.

Section 6 authorizes the Secretary of the Treasury to enforce the controls on transfers of capital to controlled countries.

Section 7 is a conforming amendment to the reporting provisions of the EAA, requiring the Treasury Secretary to issue a report on capital controls, as part of the annual report on export controls submitted to the Congress by the Commerce Secretary.

Section 8 gives the Treasury Secretary the authority to issue regulations.

Section 9 contains definitions.

S. 812

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Financial Export Control Act".

Sec. 1. Section 2 of the Export Administration Act of 1979 is amended by adding at the end thereof the following:

"(10) Loans and other transfers of capital to the Soviet Union and its allies from public and commercial sources significantly increase the ability of those countries to obtain sensitive goods and technology, thereby damaging the security interests of the United States and its allies."

Sec. 3. Section 3 of the Export Administration Act of 1979 is amended—

(1) in paragraph (2)(B), by striking out "and" after the semicolon;

(2) in paragraph (2)(C), by striking out the period and inserting in lieu thereof "and"; and

(3) by adding at the end of paragraph (2) the following:

"(D) to restrict the export of capital, the extension of credit, the making of loans, or the transfer of financial resources to destinations to which exports are restricted in order to carry out the policy described in subparagraph (A) of this paragraph."

Sec. 4. The Export Administration Act of 1979 is amended by inserting after section 3 the following new section:

"CAPITAL CONTROLS

"Sec. 8A. (a) AUTHORITY.—In order to carry out the policy set forth in section 3(2)(D) of this Act, the President may prohibit, curtail, monitor, or otherwise regulate the export or transfer, or participation in the export or transfer, of money or other financial assets, including the making of a loan or the extension of credit, to the government of any controlled country, or to any political subdivision thereof or any organization or association owned by or acting for or on behalf of such government or political subdivision thereof. The authority contained in this subsection shall be exercised by the Secretary of the Treasury, in consultation with the Secretary of Defense, the Secretary of Commerce, and such other departments and agencies as the Secretary of the Treasury shall consider appropriate.

"(b) NEGOTIATIONS WITH OTHER COUNTRIES.—The Secretary of the Treasury, in consultation with the Secretaries of State, Defense, and Commerce, and the heads of other appropriate departments and agencies, shall be responsible for conducting negotiations with other countries regarding their cooperation with controls imposed pursuant to subsection (a)."

Sec. 5. Section 10 of the Export Administration Act of 1979 is amended—

(1) in subsection (a)(1), by striking out "All export license applications" and inserting in lieu thereof "Except as provided in subsection (k), all export license applications";

(2) in subsection (j)(1), by inserting before the period "except in the case of any license that may be required pursuant to section 8A of this Act, in which case the Secretary of the Treasury shall establish such procedures"; and

(3) by adding at the end thereof the following new subsection:

"(k)(1) Any export license applications required pursuant to section 8A of this Act shall be submitted by the applicant to the Secretary of the Treasury. All determinations with respect to any such application shall be made by the Secretary of the Treasury.

"(2) To the extent necessary, the Secretary of the Treasury shall seek information and recommendations from the Government departments and agencies concerned with aspects of the United States domestic and foreign policies and operations having an important bearing on the policy set forth in section 3(2)(D) of this Act."

Sec. 6. Section 12 of the Export Administration Act of 1979 is amended—

(1) in the second sentence of subsection (c)(1), by inserting before the period the fol-

lowing: ", or in the case of information obtained with respect to section 8A of this Act, unless the Secretary of the Treasury so determines"; and

(2) in subsection (e), by striking out "The Secretary" and inserting in lieu thereof "Except with regard to the authority provided under section 8A(a), the Secretary";

Sec. 7. Section 14(a) of the Export Administration Act of 1979 is amended—

(1) by striking out "and" at the end of paragraph (10);

(2) by striking out the period at the end of paragraph (20) and inserting in lieu thereof "and"; and

(3) by adding at the end thereof the following:

"(21) actions taken by the President and the Secretary of the Treasury to carry out the policies set forth in section 3(2)(D) of this Act, as described by the Secretary of the Treasury in a report submitted for inclusion as a part of the Secretary's annual report required by this section."

Sec. 8. Section 15 of the Export Administration Act of 1979 is amended by inserting "and the Secretary of the Treasury", after "Secretary".

Sec. 9. Section 16 of the Export Administration Act of 1979 is amended—

(1) in paragraph (4) by striking out "and" after the semicolon;

(2) in paragraph (5) by striking out the period and inserting in lieu thereof a semicolon; and

(3) by adding at the end thereof the following:

"(6) the term 'extension of credit' includes loans, credit sales, the supplying of funds through the underwriting, distribution, or acquisition of securities, the making or assisting in the making of a direct placement, or otherwise participating in the offering, distribution, or acquisition of securities; and

"(7) the term 'loan' includes any type of credit, including credit extended in connection with a credit sale.".

Executive Registry	
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28 October 1985

Dear Cap,

I understand that one of the things at the NSC meeting this week deals with a proposal to authorize the President to restrict financial flows. I gather that the Attorney General and the NSC and Defense have bought this to give the President additional authority to restrict financial flows to countries whose policies we disapprove of who are stealing our technology, etc.

I will not be at the meeting but will ask John McMahon to attend. Here are some pieces of information and arguments on the issue which you may find useful.

Yours,


William J. Casey

The Honorable Caspar W. Weinberger
Secretary of Defense
Washington, D.C. 20301

Enclosures:

- Memorandum for the President
dated 7 October 1985
- Memorandum-Refutation of
Arguments against S. 812

Executive Registry

85-4263

THE WHITE HOUSE

WASHINGTON

October 7, 1985

MEMORANDUM FOR THE PRESIDENT

FROM: ROBERT C. MCFARLANE *rcm*

SUBJECT: Senate Bill S-812 - The Financial Export Control Act

Issue

Whether the Administration should support legislation expanding discretionary Executive authority to restrict flows of financial capital to destinations to which U.S. exports are restricted.

Facts

On Thursday, September 26, the Senate began hearings on S. 812, the "Financial Export Control Act" -- a proposed amendment to the Export Administration Act (EAA) to authorize controls on the export of capital from the United States to destinations to which U.S. commodity exports are restricted (Tab A). The bill has seven co-sponsors (Senators Proxmire, Garn, Symms, D'Amato, Hecht, Mattingly and Bumpers) and is designed primarily to provide the Executive Branch with a mechanism, short of the International Emergency Economic Powers Act (IEEPA), with which to interdict financial flows to Soviet Bloc countries when deemed appropriate to do so.

Treasury and State (Tab B) and Commerce all oppose the bill on the grounds that (1) it will be ineffective when used; (2) any "non-emergency" restrictions on international capital flows are inherently against the national interest and (3) it conflicts with your commitment to improve the U.S.-Soviet dialogue -- particularly at this time. State and Commerce are particularly concerned that the timing of affirmative Administration action on S. 812 could send the wrong signal to the Soviets. Defense (Tab C) supports the bill as a measured response to the problem of bank lending to the Soviet bloc when contrary to U.S. interests.

Discussion

The hearings on this issue should help to raise public awareness of the potential for adverse impact on U.S. interests of bank lending decisions -- particularly in the East-West context. Beyond that, the policy question revolves around whether the President, acting through his agent, the Secretary of the Treasury, should have the authority to control capital flows to trade-controlled countries in circumstances short of "national emergencies"

cc Vice President

as defined in IEEPA. Justice believes that over-reliance on IEEPA could trivialize this critical Executive Branch foreign policy tool and perhaps lead Congress to perversely attempt to remove some of your authority under it. Some of the measures available under IEEPA could be invoked under S. 812. Thus, that authority could be used to invoke credit controls against nations that support international terrorism or that threaten regional instability. In addition, the bill would provide the potential, under appropriate circumstances, to include financial flows within our present policy of differentiation with respect to Eastern Europe. Although this is an awkward time in the East-West context for S.812 to be debated, the three principal economic constituencies in your Cabinet would probably always oppose it on their respective grounds (State/diplomacy, Treasury/ economic orthodoxy and Commerce/business and trade interests).

Senate and Defense concerns reflect a growing range of other considerations. This matter surfaced on the Hill last winter, when U.S. banks began actively participating in the renewed flow of Western loans to the Soviet Bloc. In the wake of the Polish insolvency, and in consideration of subsequent commercial bank concerns over the ability of other Soviet Bloc countries to repay the remaining portion of the \$80 billion in total outstanding hard currency loans, it was generally believed that Western lending to those countries would be curtailed as a matter of sound banking practice. The U.S. banks were criticized by some for having put at risk funds at low interest rates in totalitarian economies where the availability of financial information on which to base lending decisions is severely curtailed.

The issue has been further complicated by the following factors:

- o The growing body of evidence revealing the true extent of Soviet dependency on Western technology and know-how and the realization that the ability of the Soviet Bloc to generate hard currency -- whether earned or through loans -- is a key determinant of its ability to operate effectively (both overtly and covertly) in Western economic and commercial environments.
- o The deepening conflict between U.S. and Soviet interests in Central America and the perceived (by some in Congress and the Administration) cause and effect relationship between U.S. bank lending to the Bloc and its capability to underwrite policies in Central America and elsewhere at the direct expense of the U.S. national interest (e.g., loans to East Germany coincided roughly with announced East German and other Soviet Bloc credit lines to Nicaragua).
- o The growing perception that many bank lending decisions are often subjective and not apolitically market-based,

and that they can adversely affect U.S. interests -- particularly when these activities signify broad-based banking industry policy shifts. Thus, bank culpability in poor lending decisions regarding Latin borrowers in the past and cessation of voluntary lending to most of Latin America at present have adversely affected U.S. efforts to deal with the debt crisis in the region.

OMB argues that administrative action is preferable to legislative action to accomplish the purposes of S. 812, and that we should reject the Senate bill while promising to develop an Executive Branch mechanism to deal with Senate concerns. I suspect, however, that due to the opposition of those in the Administration to S. 812, that this approach probably would result in little or no action in this area without persistent encouragement.

Thus, the issues for your consideration can be broken down into two parts:

- o Whether you support the spirit and intent of S 812, which is to provide you with the legislative authority in non-emergency situations to control financial flows to destinations to which exports are restricted (primarily the Soviet Bloc).
- o If you do support the thrust of S. 812, whether you should direct OMB to work with the Senate on developing a mutually acceptable legislative solution or to reject S. 812 and ask your Cabinet to craft administrative procedures to achieve a comparable result.

Recommendations

OK

No

That you agree with the spirit and intent of S. 812, which would provide you with authority to restrict U.S. financial flows in non-emergencies to destinations to which exports are restricted.

That you instruct OMB to inform the Senate of the Administration's intention to craft administrative procedures to achieve a comparable result.

That you instruct OMB to inform the Senate that the Administration is opposed to S. 812 (the need for legislation) but will work to develop administrative procedures to achieve a comparable result.

Attachments

Tab A	Bill, S. 812
B	Letter from the Department of the Treasury
C	Letter from the Department of Defense

**Prepared by:
David G. Wigg**

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ATTACHMENT D

USSR: The Role of Foreign Trade in the Economy

Foreign trade plays an important, albeit not critical, role in Soviet economic development. Although the Soviet economy is largely self-sufficient--purchases from abroad account for only about 10 percent of GNP--imports have helped Moscow improve consumption, boost productivity, remove industrial bottleneck, and modernize weapon systems.

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East-Versus West as a Source of Imports

The USSR has traditionally favored its communist allies in its foreign trade.

- o About 65 percent of the USSR's machinery and equipment imports come from its Communist allies, mostly the East European countries.
- o These imports represent nearly half of all Soviet purchases from Communist countries. (See Figure 1)

Although East European machinery and equipment is often of lower quality than Western equipment, it is equal to or better than Soviet produced goods in many instances. The USSR also looks to Communist countries for manufactured consumer goods to supplement its own production. More than half of such imports--primarily clothing and furniture--are purchased in Eastern Europe.

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While relying on Eastern Europe for much of its machinery and equipment needs, imports of Western technology and equipment have been essential to expand selected Soviet industries (e.g. chemicals and automobiles), despite difficulties in assimilation.

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- o Imported chemical equipment in the 1970s was largely responsible for the output of ammonia, nitrogen fertilizer, and plastics doubling during this period.
- o Construction of the Kama river truck plant, which is based almost exclusively on Western equipment and technology, has resulted in a roughly 100 percent increase in Soviet heavy truck output over the past decade. [redacted]

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Imports from the West also have played a key role in supporting the energy sector.

- o The rapid construction of the Siberia-to-Western Europe gas pipeline would not have been possible without purchases of Western turbines, compressors, and pipe.
- o Difficiencies in Soviet drilling, pumping, and exploration have promoted Moscow to purchase almost \$20 billion in oil and gas equipment since 1975.

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Imports of grain and other agricultural products have been the largest component of the USSR's western trade, however. A series of mediocre harvest during 1981-84 has pushed agricultural imports to record levels--with average annual purchases of some \$10 billion during this period. Because of the limited ability of Communist countries to expand grain production, Moscow has had to rely almost entirely on Western countries to fill the gap between domestic output and requirements. [redacted]

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Finally, in addition to contributing to specific industrial sectors and overall consumer well-being, acquisition of goods and technology from the West has enhanced Soviet military programs.

- o Access to specific technologies has permitted improvements in a number of weapon and military support systems.
- o Gains from trade, in general, have improved the efficiency of the economy and thereby reduced the burden of defense.

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Foreign Trade Under Gorbachev

Since taking over as General Secretary in March, Gorbachev has made it clear that improved economic performance is his top priority. His plan focuses on modernizing the industrial base with more and better machinery--a strategy which could lead to an increased role in both Eastern Europe and the West.

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Gorbachev is undoubtedly hoping for an increase in the flow of machinery from Eastern Europe. Since taking over, he has spoken about the need for broader and tighter intergration within CEMA. While such rhetoric is not new--the USSR has long advocated joint production and specialization within CEMA as a means of getting the East Europeans to cough-up more--Moscow

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seems more intent than ever on pressing its allies to make firm commitments on this issue. In this regard,

- o An agreement signed by CEMA Prime Ministers in June pledged multilateral cooperation in designing and producing computer controlled systems.
- o The agreement follows a recent call in PRAVDA for a 50-100 percent increase in the rate of growth in machine-building in CEMA countries during 1986-90.

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Moscow is probably limited in just how much it can get from its allies. Because most East European countries are constrained by their own resource and economic difficulties, any sharp increase in machinery exports to the USSR would have to come at the expense of much needed domestic investment or sales to the West that bring in hard currency. Such a shift would risk undermining growth prospects throughout the area which could cause serious political problems.

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The limited prospects for sharply boosting imports from Eastern Europe increases Moscow's incentive to trade with the West. In particular, Gorbachev probably will look to the West for imports of technology and equipment for selected sectors--energy and electronics, for example--where no good supply alternatives exist. Moreover, Moscow is presently in a good financial position to increase its purchases of Western machinery and equipment--at least in the near-term.

- o With a relatively small debt and approximately \$10 billion in assets in Western banks at yearend 1984,

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Moscow can easily obtain commercial credits to finance new purchases.

- o Most West European countries are also offering generous terms on government-backed credits in an effort to balance trade with the Soviets and spur their own economies.**

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Over the longer term, however, Moscow's financial position is much less certain--falling world prices for oil and declining domestic production could limit Soviet hard currency earning capacity.

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Looking to the US Prospects for an expansion of Soviet purchases of US machinery and equipment appear good--albeit from the extremely low levels of recent years. The share of machinery and equipment orders going to the US doing first quarter 1985--10 percent--is substantially above last years 6 percent figure and, if maintained, would be the highest since 1979. (See figure 4) Moreover, the US-Soviet Joint Commerical Commission talks in May 1985 produced a Soviet pledge to

- o Try to do more business with US firms.**
- o Put interested US firms on bidders lists.**
- o Fully consider US proposals on their economic merit.**

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In this regard, we have seen an improved tenor in US-Soviet contract negotiations since the beginning of the year. The Soviets are currently discussing major deals with US firms for the sale of personal computers, energy equipment, and agricultural technology. Although these negotiations may be

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protracted, some signings appear likely. [redacted]

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Nevertheless, the vast majority of Soviet purchases from the US will continue to be agricultural products. Under the current long-term US-Soviet grain agreement (which expires in 1988), Moscow is committed to purchase a minimum of 8-9 million tons of grain per year, with a value of roughly \$1 billion at current world prices. In poor crop years, Soviet purchases can be expected to be much larger. [redacted]

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Central Intelligence Agency

ATTACHMENT E



Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

4 September 1985

USSR: Implications of Reduced Oil Exports

Summary

Steadily declining oil production in the USSR apparently is preventing the Soviets from sustaining oil exports to the West. Soviet hard currency earnings from oil sales could decline substantially in 1985--possibly by as much as \$3-4 billion, or over 10 percent of total hard currency export earnings. There are few signs that deliveries to Eastern Europe will be cut this year. If the Soviets continue to insulate Eastern Europe from oil disruptions, such a policy would be in stark contrast with the way the USSR handled a tight hard currency situation in 1981-82, when it eventually diverted oil deliveries from Eastern Europe to the West. [redacted]

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Until very recently, Moscow has shown little sign of serious concern about its hard currency situation and we believe that the USSR is in a good position financially to handle the sharp decline in oil export earnings for the balance of 1985. If oil-export earnings remain depressed, however, Moscow probably will soon be forced to take more active measures, including possibly substantially increased borrowing, import cutbacks, and selling more gold. [redacted]

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For the longer term, a continued decline in oil output--and reduced prospects for oil exports--will pose some difficult choices for the leadership. Indeed, Gorbachev is currently visiting the West Siberian oil and gas region probably to get a hands-on feel for the problem before finalizing investment choices for the coming five-year plan.

- o There is little room for increased diversions of oil from the domestic economy in order to boost exports to the West,

This memorandum was prepared by [redacted] in the National Issues Group of the Office of Soviet Analysis. Comments and queries may be addressed to Chief, National Issues Group, SOVA on [redacted]

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a maneuver the Soviets have used in recent years to sustain hard currency exports. Some slight savings from conservation and substitution programs will probably be realized, but the prospect for widespread savings is not bright. Thus, any major cutbacks in domestic oil allocation are likely to result in disruptive bottlenecks that would threaten Gorbachev's modernization program and perhaps cost him some political setback.

- o Substantial cutbacks to Eastern Europe would result in serious economic difficulty to the economies of the region. Moscow will have to weigh carefully the attendant risk of economic instability and increased political tensions in the region that could stem from such cutbacks.
- o The Soviets will need to continue importing sufficient quantities of grain and feedstuffs for the livestock program, and obtain the necessary industrial materials to prevent production bottlenecks. Increased imports of Western machinery also would seem necessary if Gorbachev's industrial renovation targets are to be met.

Facing these conditions, Moscow probably has no alternative but to accept some continuing decline in its oil exports to the West, while trying to reap whatever savings it can from the domestic economy and Eastern Europe. In our judgment, the Soviets will continue to import essential agricultural and industrial goods, and will have sufficient earnings to purchase Western machinery and technology that have the highest priority. But reduced hard currency availability could affect other planned imports of Western equipment at a time when the Soviet demand for such goods is likely to increase as a result of Gorbachev's modernization program.

Production Problems Grow

Soviet domestic oil output fell last year--by about 100,000 barrels per day (b/d)--the first time since World War II. On the basis of the oil industry's recent performance, including 14 months of declining output, we judge that production for 1985 will fall by over 300,000 b/d, or by about three percent.

Moscow is becoming increasingly concerned about its oil

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prospects. Major steps taken by the leadership to prevent declines in oil output have been to no avail. Last year, Moscow increased substantially investment in oil production, and earlier this year it overhauled the management of the oil sector. In early August, the Politburo decided on a 60 percent increase in construction and assembly work for the West Siberian oil and gas complex in the 1986-90 period. Such measures offer some prospect of slowing the longer-term decline in output, but can do little to improve oil output in the next year or two. The high level of concern was most recently reflected in Gorbachev's trip to West Siberia on 4 September, probably intended to give him a hands-on feeling for the problem before finalizing investment choices for the coming five-year plan. [REDACTED]

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Reduction in Oil Exports

The West. Soviet oil exports to the West declined by about 40 percent during the first quarter this year compared with the same period in 1984. This was largely due to the harsh winter, which hampered oil production and sharply increased domestic oil consumption. Although few data are available, oil exports apparently rebounded during the second quarter--but not enough to offset the earlier declines, according to reporting from Western oil traders. [REDACTED]

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Traditionally, the Soviets have substantially accelerated oil exports in the latter months of the year to offset low first-

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quarter deliveries. According to Western journals with excellent contacts in the energy markets, however, oil traders expect the USSR to cut contract deliveries of oil by between one-third and one-half for an indefinite period beginning as early as September.¹ The Soviets have not made an official announcement, but, according to the reporting, have given some customers verbal notice several weeks in advance. Although similar press "warnings" have not been completely borne out in the past, the recent events are unusual.

- o The Soviets generally provide only short notice on reductions or cancellations in contract deliveries. This time, they reportedly informed some customers several weeks ago, which suggests that the export difficulties may be major.
- o When the USSR has claimed "force majeure"² in the past, the declarations were usually accompanied by statements that the disruptions in deliveries will be temporary or made up later. Such qualifications are notably absent this time around.

Some cutbacks are already taking place. Some customers of Soviet oil reported in the Western press that gas-oil deliveries to Western Europe were reduced in August. In addition, in the spot market--where the USSR makes roughly half of its sales to

¹ These cuts suggest that Moscow seriously underestimated the difficulty of turning around the slide in oil production that was evident in late 1984. The Soviet State Planning Committee (GOSPLAN) annually allocates approximate quantities for export to the West. These allocations, in turn, provide the basis for the spate of oil-export contract signings at the beginning of each year.

² Force majeure is a contract clause that exempts a party from fulfilling a contract due to extraordinary circumstances.

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the West--prices for Soviet oil in recent weeks have risen faster than the market as a whole, which probably reflects scarcities of Soviet oil available there. Such movements in prices in the past have preceded a substantial decline in Soviet oil sales. [REDACTED]

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To our knowledge, the Soviets have not tried to boost oil imports from the Middle East for reexport to the West. During the first few months of the year, the reexports averaged about 300,000 b/d, about the same level as during all of last year. The Soviets in recent years have been able to increase oil deliveries from OPEC--particularly from Libya and Iraq in payment for arms purchases--as a way of increasing its overall exports to the West. [REDACTED]

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Eastern Europe. Less information is available on Soviet oil exports to Eastern Europe, but there are only indications of some sporadic and small-scale cutbacks to Yugoslavia and Bulgaria. [REDACTED]

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lower Soviet deliveries of oil and coal this year have forced Sofia to increase its purchases of energy on the international markets. [REDACTED] Moscow told Sofia that the USSR has its "own problems to contend with." [REDACTED]

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Nevertheless, in our judgment, Moscow is doing its best to sustain oil deliveries to the region. The Soviets almost certainly would not make any substantial cutbacks in midyear, as this would be extremely disruptive on any centrally planned economy. Rather, any reduction in such deliveries--as was the

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case in 1982--would be made at the beginning of the following year, in concert with overall economic planning on an annual basis. The absence of grumbling from the East Europeans suggest that reductions in deliveries to the region are only marginal, and that no Soviet announcement has been made of a larger, more general cutback for next year. [REDACTED]

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Implications for Hard Currency Earnings

Near Term. The expected decline in the volume of oil sold to the West, combined with lower world oil prices (which so far have averaged almost 10 percent below prices during January-August last year), could lead to a reduction in hard currency earnings of about \$3-4 billion for 1985 as a whole. This would be a drop of 20 to 25 percent in earnings from oil sales, and a decline of more than 10 percent in the USSR's total hard currency earnings. [REDACTED]

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Moscow cannot compensate for this drop by expanding other exports. Soviet earnings from natural gas sales to Western Europe are not expected to rise substantially this year. On average, Soviet gas prices have fallen somewhat, and the USSR has allowed at least one nation to postpone increases in purchases of Soviet gas. Other exports--including sales of metals, machinery, and weapons--face limited Western or LDC demand and, in some cases, constrained domestic availability. [REDACTED]

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The USSR is probably in a fairly good financial position to

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cope with this year's oil export decline. At the end of March Soviet assets in Western banks stood at a comfortable \$8.8 billion. So far, Moscow has shown few signs of serious concern about the need to compensate for a major drop in oil earnings.

- o Gold sales appear to be up only slightly over the relatively low levels in 1984.
- o While Moscow has borrowed close to \$1 billion from the West so far this year, most of this money apparently has been used to pay off earlier, higher-priced loans.
- o The Soviets turned down a French offer of approximately \$500 million in credits for Astrakhan' and Tengiz energy development contracts, which were signed this spring. [REDACTED]

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The expected erosion of its oil export earnings during the balance of 1985, however, could force Moscow to take more active measures in the near future. Options exercised in the past to deal with hard currency shortages include increases in net borrowing, cutbacks in imports, and larger gold sales. In response to a hard currency bind which developed in the first half of 1981, Moscow cut back hard currency allocations to the foreign-trade organizations in late 1981 and early 1982, causing delays in purchases and payments. In addition, the Soviets substantially increased short-term borrowing (mainly for grain purchases) and gold sales. [REDACTED]

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On balance, we believe that the USSR is financially in a good position to satisfy most, if not all, of its import requirements from the West in 1985. Moscow will be helped this year by a better domestic grain crop and thus substantially

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reduced grain import requirements in the latter half of the year.³ In addition, overall imports of Western industrial goods during the first quarter were lower than during the comparable period in 1984. It is not yet clear whether such imports have remained at reduced levels since then. While Soviet orders for machinery and equipment are up sharply during the first half of the year compared with last year, actual imports of machinery and equipment will not begin to rise until 1986 or beyond, given the usual lags in implementing contracts for large projects. Moreover, many of the deals are financed by long-term credits.



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Nevertheless, there is some evidence that the Soviets are becoming increasingly concerned about their financial situation.



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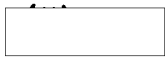


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³ Moscow also should enjoy the benefits of a buyer's market this year in the international grain trade. World supplies are expected to be abundant, largely because of a bumper crop in the United States.



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Longer Term. Beginning in the next year or so, the Soviets will likely have to deal with steadily declining export earnings from oil.

- o Domestic oil output continues to slide despite substantial increases in investment in the oil industry. Although the oil industry management has been overhauled, prospects for a turnaround in output are poor.
- o World oil prices continue to slide with little prospect for a reversal until the late 1980s.
- o Opportunities for boosting arms sales to OPEC nations--the traditional source for increased oil imports--are limited by the ability of these nations to absorb and pay for more arms. [REDACTED]

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Moscow has been hard pressed to compensate for the production decline by reduced domestic consumption. It has been trying to reduce the economy's use of oil for several years, primarily through energy conservation and programs for switching to the use of gas instead of oil in industry. There have been few signs so far that the USSR has, in fact, reduced its oil use. The Soviet press has been mum on successes in this area, suggesting that progress is dragging despite the leadership's emphasis on conservation. In addition, our analysis of the electric power industry--the main target of the gas-for-oil substitution programs--indicates that the oil "saved" at some power plants has been consumed anyway in offsetting major shortfalls in the supply of coal to other power plants and in producing above-plan amounts of electricity. [REDACTED]

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Prospects for limiting demand during the next several years also are not bright. Gorbachev's program for retooling and installing more energy efficient equipment promises substantial savings, but only in the long run and after considerable expense. Over the next several years, the modernization program, vigorously pursued, will itself consume large quantities of fuel. Indeed, given Gorbachev's stated objectives, the mix of output is likely to become more rather than less energy intensive.

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Implications for Eastern Europe

Moscow's allies would have considerable difficulty coping with a cutback in Soviet oil deliveries. Most of the countries in the region--plagued by sluggish export growth, large debt-service obligations, and uncertain borrowing prospects--do not have enough hard currency to purchase a substantial portion of their oil requirements on the international markets. Moreover, securing more oil through barter arrangements has been made more difficult because of a reluctance on the part of Third World countries to increase such deals.

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Moscow repeatedly has told its allies that deliveries will not be cut in 1986-90. It made a similar promise in 1980, however, for the 1981-85 period, but cut deliveries anyway in 1982 when it needed to increase hard currency earnings. In aggregate, oil shipments to the region have not increased since

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then. [REDACTED]

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The East Europeans survived the 1982 cutbacks without much difficulty because the region was reexporting some Soviet oil for hard currency. Cuts during 1986-90 would be much more troublesome as they likely would come out allocations for the domestic economies--at a time when Moscow will be putting more pressure on East Europe to increase production and delivery of energy-intensive goods (i.e. machinery and equipment). Balance-of-payments constraints would limit East European purchases of oil from hard currency sources, and reduced oil consumption in the region would affect economic productivity and growth. Lower growth would increase the likelihood of political instability in Eastern Europe and increased public resentment toward the Soviet Union. [REDACTED]

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Implications for Trade With the West

Moscow probably has little alternative but to accept some continuing decline in its oil exports to the West, while trying to reap whatever savings it can from the domestic economy and Eastern Europe. Faced with prospects for substantially reduced hard currency earnings, the Soviet leadership may be hard pressed to satisfy the entire range of import goals in the coming years. We believe, however, that the Soviets will continue to import sufficient quantities of grain and feedstuffs to keep the livestock program on track and obtain the industrial materials

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needed to reduce production bottlenecks. [redacted]

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The reduced availability of hard currency will probably affect imports of Western machinery and equipment the most. Barring a series of harvest failures and/or an unexpectedly rapid decline in oil production, Moscow should be able to earn enough hard currency through 1990 to purchase Western equipment that has the highest priority--equipment needed to develop oil and gas reserves at Astrakhan' and Tengiz, for example. But any cutback in imports of other Western machinery and technology would be occurring at a time when Soviet demand for such goods is increasing as a result of Gorbachev's modernization program. A less conservative borrowing policy could allow Moscow greater leeway in setting the level of these imports. [redacted]

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Changes in Soviet purchasing strategy may provide early indication of how the Soviets are assessing their prospects for oil production and hard currency exports. Specific indicators might include:

- o Scaling back, stalling, and/or cancelling project negotiations now underway.
- o Insistence that countertrade arrangements be included for all but the highest priority purchases.
- o Greater concentration on domestic projects oriented toward supplying the export market when negotiating purchases from the West. [redacted]

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