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SUBJECT: Economic Financial Issues Conference

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EXECUTIVE SECRETARIAT

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Executive Secretary

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Proof of article for the National Security Record of The Heritage Foundation, 12/86

Western Security and East-West Finance

Declining hard currency earnings threaten the success of Mikhail Gorbachev's economic modernization program and are hobbling the USSR's ability to compete in the high technology race with the West. The Soviet leadership has responded to its foreign exchange shortfall by cutting imports, stepping up borrowing in international financial markets, and by launching a broad economic offensive toward the West. At the same time, the ability of the Reagan Administration's national security agencies to help manage East-West economic and financial issues has been seriously weakened by the establishment of an economic policy council that periodically excludes them.

Last May, our West European allies administered a major setback to Moscow's long-term strategy of dominating Western Europe's gas markets and increasing its hard currency earnings. The allies decided not to participate in another major gas-for-pipe compensation deal involving the proposed second strand of the huge Soviet gas pipeline that runs from the Siberian fields to Western Europe. The West Europeans instead concluded a $64 billion agreement to develop the Norwegian Troll gas field, as a way of strengthening Western Europe's energy security. That decision alone will eliminate billions of dollars in annual hard currency earnings that Moscow has been counting on for the mid-1990's and beyond. This important development, catalyzed by the so-called "pipeline dispute," is a major policy achievement for the Reagan Administration and the Atlantic Alliance.

Total Soviet hard currency income will fall from about $32 billion in 1985 to an estimated $26 billion this year, further reducing the cash available to Gorbachev to bolster his economic modernization program, to support Moscow's client states, to promote international terrorism, and to run a worldwide intelligence network. The hard currency shortfall also compels Moscow to squeeze the economies of its East European satellites even more than usual.

Unfortunately, the reaction of several Western banks and governments to Moscow's economic and financial overtures has been to offer the Soviets subsidized grain and other products, and large untied loans (not tied to a specific purpose) at extremely favorable rates.

Concerning East-West trade, the ability of the USSR to expand non-strategic trade with the West will be seriously constrained if world energy prices and demand remain depressed. Last year exports of oil and gas represented over half of the USSR's total hard currency earnings. When one adds estimated earnings from arms sales of about $6 billion, these combined earnings jump to between two-thirds and three-quarters of Moscow's total annual hard currency income.

The remainder of Soviet hard currency earnings are comprised of gold sales, interest on assets and miscellaneous exports. With a drop of roughly $6 billion in oil and gas income this year, the USSR's projected hard currency earnings of $26 billion hardly represent an impressive annual income for a superpower. By comparison, General Motors' 1986 revenues should be about three times higher, even in a troubled year for the automaker.

Western Banks to the Rescue

The Soviet Union has three major ways of responding to this sharp decline in hard currency earnings. It can:

- sharply curtail Western imports (or defer delivery and payment for items already contracted);
- sell more gold and arms; and
- increase Western borrowings

Any sustained cut-back in imports, however, could severely impede Gorbachev's economic modernization program, with potentially serious political ramifications for the Soviet leader. The Soviets likewise will be reluctant either to dip into their gold reserves or to unload so much gold on the world market that it might depress the price. Finally, the low price of oil is creating liquidity problems for Iraq, Syria and other countries that buy Soviet arms, reducing their purchases. Although a domestic ruble cost (not hard currency), the estimated price tag of about $900 million for the Chernobyl clean-up also came at a bad time for the Soviet economy.

As a consequence, the Soviets have embarked on a binge of new borrowing on Western financial markets. Soviet borrowing resulted in an increase of roughly $5 billion in the Soviet net foreign debt last year and probably will add another $5 billion by the end of this year. This high level of Soviet foreign borrowing may well persist for the next several years, depending on world energy prices. For example, Plan Econ, Inc., estimates that the gross foreign debt of the USSR will increase from about $29 billion in 1985 to $53 billion by 1990.

Untied Lending to Soviets

An area of East-West finance that requires close scrutiny is that of untied, no-purpose lending by Western banks. This kind of lending permits the Soviets and other potential adversaries to easily divert borrowed funds for any purpose they choose, including activities inimical to Western security interests. Given the Soviets' hard currency shortfall, a cash flow analysis indicates they are using borrowed funds to support a substantial share of their global commitments and activities that require hard currency.

The strategic problems associated with untied lending could be remedied by Western commercial banks, particularly those in Europe and Japan, voluntarily adopting lending guidelines to discipline and monitor the use of borrowed funds. The adoption of such voluntary lending principles would not impede the conduct of legitimate non-strategic East-West trade. This would only involve internal bank decisions to concentrate on traditional forms of lending, such as equipment loans, tightly-structured project loans, and short-term commodity financing with loan maturities matched against the duration of the underlying transaction.

It would also require the careful monitoring of aggregate interbank deposits in Soviet-owned banks. Some commercial banks have always maintained disciplined lending policies with regard to loans to the Soviet Union and Eastern Europe. It is appropriate for these commercially prudent procedures to be adopted by all Western lenders.

The forms of untied lending which comprise the bulk of unguaranteed commercial bank loans to the East include:

- balance of payment loans for no specific purpose;
- loans with excessive maturity structures, for example, three year loans for grain transactions which take only 180 days or less to complete;
- "project loans" that actually are used for other purposes;
- interbank deposits in Soviet-owned banks; and
- the expected underwriting of Soviet Euronotes and bonds, which soon may be an important new instrument of untied Soviet borrowing from the West.

It is worth noting that large-scale untied lending was one of the underlying causes of the current international debt crisis, along with a collapse in commodity prices, disinflation, and capital flight. As a result, lenders now require major debtor nations to demonstrate productive uses for borrowed funds and identify specific sources of payback whenever possible. Certainly the same standards that are applied to loans to our friends in Latin America should be applied by Western banks to the Soviet Union and East European borrowers.

Soviet Trade Offensive

In addition to offsetting its hard currency earnings shortfalls with accelerated borrowing in the West, the USSR's Ministry of Foreign Affairs has launched a global "trade offensive" to secure as many commercial benefits from Western partners as possible. Components of this offensive are:

- a serious effort to join the General Agreement on Tariffs and Trade (GATT);
- an exploratory effort to join the International Monetary Fund (IMF) and World Bank;
- the likely issuance of the first Soviet Euronotes and bonds since the 1917 revolution;
- an even more aggressive campaign to increase the illegal acquisition of Western technology;
- the encouragement of joint ventures with Western partners and the decentralization of some economic decision-making; and
- a decision to permit limited private enterprise in the service and agricultural sectors.

The political tactics being employed by the Soviets to secure Western economic and financial concessions are as varied as granting grave visitation rights to Japanese whose relatives are buried on the Soviet-held islands off northern Japan, the release of selected dissidents and members of divided families, a possible increase in Jewish emigration, and a public exaggeration of the significance of economic reform measures.

It would not be surprising if Gorbachev were soon to press the U.S. to grant a one-year "trial" waiver of the Jackson-Vanik and Stevenson amendments to the Trade Act of 1974, which tie U.S.-Soviet trade to freer Soviet emigration. This request could come at a time when Jewish emigration is at its lowest level in over a decade. The selective release of a few prominent, high-visibility dissidents does not appear to indicate a change in the general policy of restrictive controls on emigration. It remains to be seen whether Moscow's desire to secure most-favored-nation trading status and renewed access to official U.S. credits from our Export-Import Bank is strong enough to lead to a policy shift in this area.

The Soviets probably also will seek U.S. support, if not financing, for their ambitious offshore oil development project in the Barents Sea north of the Kola Peninsula, and possibly for other Soviet energy projects as well.

Future untied Soviet Euronotes and bonds eventually could be subscribed to by institutions as varied as banks, brokerage firms and pension funds, as well as individuals. As a result, millions of Western and Japanese citizens could become unwitting underwriters of Soviet global adventurism. From Moscow's perspective, the sale of Soviet notes and bonds to the West may also create influential new groups with vested interests in promoting Western economic and financial concessions to the USSR.

The question is: how will the United States and our Western allies respond to this flurry of Soviet economic initiatives designed to obtain large-scale financing and increased trade concessions? In the case of the U.S., the answer will depend in large part on the dynamics of the government's interagency process and the kind of analysis, options and recommendations placed before the President for decision.

A Flawed Policy Process

Between July 1982 and April 1985, Cabinet-level recommendations on international economic matters with significant foreign policy implications were generated by the Senior Interdepartmental Group on International Economic Policy (SIG-IEP). This Cabinet body, chaired by the Secretary of Treasury, reported through the National Security Advisor to the President. The executive secretary function was handled by the National Security Council staff.

The process worked like this: when a U.S.-Soviet trade issue, for example, had to be decided, the issue would be discussed in the SIG-IEP after which the NSC staff would prepare for the President an analysis of the issue and options for dealing with it that reflected the SIG-IEP deliberations. When appropriate, the national security advisor's own summary recommendation was included. In many cases, a full NSC meeting would be held after the SIG-IEP had completed its work so that Cabinet members could present their views to the President face-to-face.

Once the President had made a decision, a directive was prepared by the NSC and distributed to the relevant agencies, often assigning a particular agency responsibility for implementing the decision. It was under the auspices of the SIG-IEP that the President succeeded in achieving an allied consensus on the key security aspects of East-West economic relations during his first term.

In April 1985 an important change was made in this policy process. The SIG-IEP was collapsed into a new Economic Policy Council (EPC). A major reason for this decision, made suddenly by the White House with minimal inter-governmental consultation, was to streamline the economic policy-making apparatus. Another reason was considerably more subtle and manifested itself in the structure and membership of the Economic Policy Council. The NSC, CIA and the Defense Department, all important members of the SIG-IEP, were excluded as regular members of the new EPC.

The chairman of the EPC is the President when he is in attendance. When he is not, the Secretary of Treasury is chairman. The important secretariat function was transferred from the NSC to the Office of the Chief of Staff of the White House. Taken together, these steps now place foreign economic policy firmly in the hands of officials who often are more concerned about domestic economic and political considerations than about the crucial security dimensions of international economic and financial issues.

Decision papers for the President on foreign economic matters now are predominantly prepared by the Office of the Chief of Staff in coordination with the Treasury Department. The national security agencies (NSC, CIA, and DOD) are invited to attend EPC meetings when the secretariat considers it appropriate, but invitations are often communicated at the last minute, preventing an adequate review of the issues.

Some negative implications of the diminished role of the national security agencies in international economic decision-making are apparent. An example is the President's recent decision to offer subsidized wheat to the Soviet Union, and then to increase the subsidy when the Soviets refused to buy. The list of Cabinet-level opponents of grain subsidies for the Soviet Union was impressive: the Secretaries of State and Defense, the National Security Advisor, and the Director of Central Intelligence all reportedly were opposed. The outcome on this issue tells a good deal about the influence and inclinations of those who now administer the international economic policy process.

The flawed rationale underlying the subsidized grain decision resulted in unnecessarily estranging important allies such as Australia and Canada, establishing an unfortunate precedent for U.S. trade policy, and contravening the spirit of three allied agreements on East-West economic relations. Despite this major U.S. policy concession, the Soviets spurned the U.S. subsidy offer and failed to honor their annual grain purchase obligations for the second consecutive year. It is impossible to say whether the President would have made the same decision if the SIG-IEP still had been in existence, but it is unlikely.

Conclusion

The reduced participation of the national security agencies in the process of formulating international economic and financial policy holds potentially serious risks for U.S. relations with our major allies and for the long-term security of the United States. A new or modified organizational structure should be established by the Administration to restore the role of the security agencies and provide the President with more comprehensive advice from his principal national security advisers on international trade, economic and financial issues.

In addition, the Administration should publicly encourage a more disciplined approach by Western commercial banks to East-West finance and urge our allies to do the same. While more disciplined Western lending policies will not entirely eliminate the improper use of loan disbursements and deposits for purposes potentially harmful to Western security interests, the general adoption of such guidelines would reduce Soviet flexibility to divert borrowed money in this way. Sensible lending policies would also help ensure that every dollar, deutsche mark, and yen loaned to the East-bloc is tied to the creation of Western exports and jobs.

Given present uncertainties in U.S. foreign policy resulting from the controversy over arms transfers to Iran, the Soviets may well follow their historical pattern of seeking to exploit what they may perceive as U.S. disarray with new or bolder foreign adventures. The Administration could slow significantly the Soviet ability to divert borrowings from the West to finance a surge of adventurism by encouraging our allies to endorse voluntary guidelines by Western banks for more disciplined lending to potential adversaries. The Administration's recent decision to ~~publicly~~ oppose Soviet IMF/World Bank membership is a step in the right direction.

possible

publicly

This article is derived in large part from remarks by Roger W. Robinson, President of RWR Inc., and Senior Director for International Economic Affairs, the National Security Council, 1982-85, before the U.S.-Soviet Trade Forum on September 25, 1986.

12/05/86

Mr. Kaneko's Interview
With Roger W. Robinson, Jr. for
Sekai Nippo to be published in January, 1987

Part I - Soviet Economy

Q. What is your view of the present status and direction of the Soviet economy ?

A. First, the Soviet leadership recognizes that improved economic performance can only be achieved by fundamental economic reform. Reform measures are likely to concentrate on improving management, offering more incentives to the work force, and an upgrading of production capabilities. Recent evidence of the Soviet effort to reduce the rigid structural problems caused by a centrally - controlled, command economy is the decision by the Supreme Soviet to permit at least some private enterprise to take place in the service sector (i.e., manufacturing of some consumer goods, repair-work on cars and apartments etc.). In addition, Moscow is likely to continue experimenting with what it views as controllable levels of decentralized economic decision-making.

Nevertheless, these are, as yet, very limited steps in the direction of individual entrepeneurship and greater decentralization. These measures would have to be substantially expanded if they are to bring genuine dynamism and innovation to the Soviet economy.

Q. What do you believe are Mr. Gorbachev's principal objectives in his economic modernization program for the USSR announced last year?

A. Mr. Gorbachev's first priority probably focuses on accelerating Soviet economic growth. The revised Soviet five year plan for 1986 - 1990 calls for average annual growth in national income (roughly equivalent to gross national product) of 4.1%. According to Plan Econ Inc., the USSR's average increase in national income was about 3.1% during the period 1981 - 1985. Gorbachev hopes to achieve this ambitious goal through the intensified use of technology, gains in labor productivity and better management at all levels of the economy. To offset the serious problems associated with aging or obsolescent capital equipment the Kremlin plans to sharply increase investment in fixed capital over the period 1986 - 1990 and probably beyond.

As always, the Soviet military will remain the number one claimant of high quality domestic resources and both imported and illegally acquired technology. Although the Soviets will seek some relief in the substantial pressures on their economy through arms control talks, and the appearance of greater geopolitical conciliation, they will continue to vigorously pursue weapons - related breakthroughs and their own version of space-based military systems.

In short, the Soviet civilian economy will continue to be heavily subordinate to the needs of the military.

Q. What about the ability of the Soviet Union to earn hard currency through exports to the West ? Has this been damaged by the fall in oil prices ?

A. Yes, it has been significantly damaged. The Soviets had total hard currency income last year of about $32 billion. As oil and gas exports to the West constitute about 60% of total Soviet annual hard currency income, that figure will decline to roughly $26 billion this year. It is useful to note that the USSR's total hard currency earnings for 1986 will probably represent less than one-third of the annual revenues of General Motors. This is hardly an impressive income for the only other superpower.

Q. Mr. Robinson, what particular problem do you think the Soviets are most concerned about economically?

A. That's a complicated question. They have a number of choices: For example, the prospect of future declines in oil production (after a slight increase this year) along with a security-minded agreement in the International Energy Agency which, in effect, limits future Soviet gas supplies to Western Europe; the lack of exportable manufactured goods which constrains annual hard currency earnings; the fact that some client states, like Mozambique, are having serious misgivings about the ability of the USSR to meaningfully assist their civilian economies in the future; or a number of other major economic bottlenecks caused by a systemically rigid economy.

But if I were sitting in the Kremlin, I would perhaps be most concerned about the proven failure of a command economy to compete head to head with the U.S. or Japan in technological innovation. I think the implications of the Reykjavik Summit demonstrated to the world, what many observers of the USSR have known for some time - namely that it will be technology breakthroughs that lie at the heart of a successful Strategic Defence Initiative-- whether the Soviets' or our own. The U.S. has a fine historical record in achieving national priority projects, as does Japan and to a somewhat different extent Western Europe. The prodigious pace of technological change in the West must be creating many sleepless nights for those in the USSR mandated to match, much less exceed, these developments.

Part II - Soviet Foreign Economic Relations

Q. How would you characterize Japan's role in the context of the USSR's foreign economic relationships?

A. I believe Japan has achieved, for better or worse, substantial priority in the USSR's overall strategy of expanded trade with the free world. The Soviets are well aware of Japan's enormous proficiency in high technology fields and, accordingly, have targeted Japan for an aggresive program of industrial espionage. In addition, the Soviets have a pressing need for generous Japanese capital flows and joint-venture-type assistance to unlock additional energy resources, as well as, other of their abundant natural resources.

Q. How has this interest in Japan been expressed by actions of the Soviet leadership?

A. I believe Mikhail Gorbachev came to office determined to improve the condesending, rude treatment of Japan by the Soviet Union over the past decades. He clearly sees that Moscow can realize more commercial and financial benefit through the appearance of a more respectful and reasonable Soviet Union in the eyes of the Japanese public. Moscow's decision to permit Japanese to again visit the graves of their relatives on Japan's Soviet - held northern islands is one aspect of this broader Soviet public relations effort.

The sincerity of this effort, however, is severely compromised by the alarming escalation of the Soviet military threat to the nations of the Pacific Basin and to Japan in particular. For example, in one year the Soviets violated Japan's air space with their military aircraft about 940 times.

Q. What should Japan's response be to the Soviet Union's increased economic and political overtures?

A. First, I would not presume to understand Japan's needs better than Prime Minister Nakasone and his very capable government. Second, I am expressing my personal views throughout this interview and not necessarily the views of the Reagan Administration. I would only advise continued caution and a highly realistic evaluation of true Soviet intentions. Like President Reagan, I believe deeds are more important than words. Accordingly the Japanese government might wish to be satisfied that Moscow is concretely reducing its military threat to Japan and improving its' record an human rights prior to proceeding with major new projects of priority interest to the USSR including one bilateral project already underway in the energy field.

I also see no contradiction between Japan seeking sensible opportunities to expand non-strategic trade with the USSR, and continuing to strengthen both Japanese and multilateral controls on the transfer of militarily-relevant Western technology. Concerning this latter point, it seems to me that all Western governments owe it to their taxpayers to do so. Afterall, it's only through a reduced Soviet threat that we can achieve sensible limits on alliance defense expenditures in the future.

Q. Turning to the broader Soviet interest in expanded foreign trade, what do you think we can expect in the monthsahead?

A. I think we are already witnessing the outlines of a Soviet economic offensive toward the West which consists of: a serious effort to join the General Agreement on Tariffs and Trade (GATT); exploratory steps toward membership in the International Monetary Fund and the World Bank; the likely issuance of the first Soviet Euronotes and bonds since 1917; a more agressive campaign to increase the illegal acquisition of Western technology; and, as I mentioned earlier, some very limited experimentation with decentralized decision-making and private enterprise. The Soviets are generally stepping up their negotiations with traditional Western trading partners, including Japan, to secure maximum levels of economic and financial concessions during this difficult period.

Q. Many of your recent published articles and comments have dealt with East-West financial relations and your view that Western borrowings are being used to finance a substantial portion of the Soviet global empire. Could you summarize your concerns in this area and what role, if any, Japan plays?

A. Unfortunately that's correct. As I stated earlier, depressed earnings from Soviet energy exports are compelling the Soviets to finance all of their imports from the West and an impressive number of global commitments from a projected annual income for 1986 of only about $26 billion. Most, if not all, of this amount will be absorbed by Western imports alone. This means that a substantial share of their borrowing from Western banks are probably being diverted to fund activities which are often harmful to Western security interests such as aid to Nicaragua, Cuba and Vietnam and KGB/GRU intelligence operations. The diversion of borrowed funds is made easier by Western banks making loans to the Soviet Union and other potential adversaries for no specific purpose and with loan maturities longer than the needs of the underlying trade transactions. Japan has been an important source of new loans to the USSR over the past two years, but I am not certain of the extent to which these loans were or were not tied to specific purposes.

Q. What is your proposed solution to this problem?

A. I believe that it merely suggests to Western banks, including Japanese banks, to voluntarily exercise more discipline in lending to potential adversaries. For example, untied, no purpose loans, such as balance of payments syndications and the future underwriting of Soviet Eurontes and bonds could be avoided and instead banks could focus on equipment loans, short-term loans tied to commodity exports, and tightly-structured project loans where the use of borrowed funds can be carefully monitored. Western and Japanese bank deposits in Soviet-owned banks, particularly those located in the West, could be more formally recorded as credit exposure to the USSR and also be better monitored. As this issue receives increased public attention, it could be potentially unhelpful for Japan or any other alliance country to be viewed as providing inordinate levels of untied cash loans to the USSR which can be used in any way Moscow chooses. Finally tying East-Bloc loans to Western exports and jobs makes commercial sense.

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TABS C & D!!

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Carol
5 Dec

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DDI- 05245x-86

17 NOV 1986

MEMORANDUM FOR: Director of Central Intelligence
Deputy Director of Central Intelligence

VIA: Deputy Director for Intelligence
Associate Deputy Director for Intelligence

FROM: [redacted] STAT
Director of Global Issues

SUBJECT: Economic Financial Issues Conference

1. Action Requested: Attached for your signature are letters of appreciation (Tab A) to the participants in the 24 October Economic Financial Issues Conference. If you approve, we will also send the attached unclassified summary of the conference (Tab C) discussions and a copy of the speech on Third World economics (Tab D) that you gave to the Center for the Study of the Presidency.

2. Background: We benefited substantially by assembling a group of businessmen who must deal daily with the practical side of the issues OGI deals with analytically. Their interaction with each other generated ideas and insights that we would not have been able to obtain from one on one sessions with them. Frankly, it was obvious from my conversations with them prior to the conference that it was your participation which enabled us to get the group together.

3. As a result of the Conference, we have taken several initiatives:

- o Financial Vulnerabilities: Given the high level of concern expressed at the Conference I believe we have to do more on this matter. We are accelerating and intensifying our examination of how the Soviets and others could undermine, manipulate, or exploit the financial network. [redacted] STAT In addition:

  -- We have initiated a series of short reports on the physical vulnerabilities of the financial network; [redacted] STAT

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SUBJECT: Economic Financial Issues Conference

-- We are examining the feasibility of developing a computer model of the international financial network--similar to the Persian Gulf pipeline model OGI developed. The financial network model would simulate the fallout from a shock to the international financial structure.

o <u>Technology Vulnerabilities</u>: The conferees expressed substantial concern over large scale technology loss that could accompany massive foreign, [redacted] investment in the United States and our position in specific technologies. [redacted] With this in mind we are commissioning the following:

[redacted]

4. On Third World Issues, the Conference resurfaced the need to identify practical ways of injecting Western know-how and private funds into Third World countries. We have subsequently uncovered some valuable databases that can help on this score. We are drawing on that information and other material to prepare the 20 country studies we are doing as part of the Third World project. [redacted] We still believe the 25X1 25X1

SUBJECT: Economic Financial Issues Conference

entire package can be completed for your review by early January and a conference convened sometime in February. The attached thank you letters (Tab B) invites Messrs. [redacted] to the planned Third World Conference. 25X1 25X1

[redacted] 25X1

Attachments:
A. Thank you letters
B. Thank you/invitation letters
C. Conference summary
D. Third World speech

D/OGI [redacted] 25X1

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Central Intelligence Agency

Washington, D.C. 20505

Executive Registry
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Dear [redacted]

I want to personally thank you for your participation in the 24 October Economic Financial Issues Conference. The broad ranging discussions touched on most of the issues that were on my mind when I first decided to hold the Conference. I know [redacted] have been in touch with you regarding followup work we will be doing on many of the points of concern raised and I welcome any help you can provide. I remain especially troubled about the financial vulnerability issues addressed at the Conference, as well as the question of technology loss and the opportunities both provide the Soviets and their allies. STAT

As I mentioned in my opening remarks at the Conference, I am also quite concerned about how we can bring Western technology, managerial skills, and entrepreneurial capital to bear more effectively on Third World economic development. I view this as an essential element in countering Soviet influence in the Third World, a point I stressed in a recent speech to the Center for the Study of the Presidency. I am enclosing a copy of that speech along with the summary of the 24 October Conference. I would only note that in preparing the summary we avoided the more sensitive areas we will be working on in order to keep the report unclassified.

Again, I want to thank you for your time and help on all of these important matters.

Yours,

William J. Casey
Director of Central Intelligence

Enclosures:
1. Speech
2. Conference Summary

B

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Economic – Financial Issues Conference

On 24 October 1986 the Economic – Financial Issues conference of business and economic leaders was held to discuss the rapid changes in the international financial arena and the possible implications of these changes for the United States. The conference addressed the rapid and unprecedented changes in the international financial arena, the factors responsible for this changing financial environment, and the consequences for international trade and technology flows. This report, organized by topic, summarizes the discussion.

The Nature of the Change of the International Financial Situation

Throughout the conference, participants speculated about the nature of the changes they see in the world of international finance. It was agreed that any study of the issue must be careful to distinguish between those changes that are cyclical and those that are structural. The cyclical trends were identified as the capital and trade imbalances, the strength of the dollar, and the level of world interest rates. These variables are subject to the ebb-and-flow of the world economy and are not direct manifestations of the fundamental restructuring of the underlying economy; it was acknowledged throughout the discussions, however, that the direction, magnitude, and longevity of these cyclical trends are strongly influenced by structural changes.

The structural changes, by contrast, are irreversible. The expanding technologies on which the emerging global financial marketplace are based will continue to affect the world economy in ways that are unpredictable. One participant characterized the basic change as "intellectual" resources overtaking "physical" resources as the driving force behind the economy. In this new environment, intangibles --such as ideas and services--will be the goods that determine national success, while more traditional resource bases--mineral deposits, productive cropland, and manufacturing capacity--will become less crucial. The rising role of "abstract" financial markets in the world economy is one element of this and a prime example of how economic productivity is being uncoupled from employment.

In discussing the nature of these changes, the question was asked, "do exchange rates still determine broader resource flows, such as those of goods and capital?" The answer from the group was yes, but the time required for international market imbalances to respond to exchange rate shifts is being blunted by, among other things, government intervention in the markets. Related to this, several participants noted the increased volatility of the equity and commercial markets and speculated as to whether this was the result of the structural changes that are occurring or is merely characteristic of recent economic events. It was noted that studies show sharply increased volatility on a minute-to-minute basis in most markets, and the participants ventured that this was probably the result of the vastly enhanced capabilities of the system to facilitate and incorporate rapid changes in the perceptions of market players.

Finally, one participant observed that the increasing unpredictability of the changes in the world economy are reducing the utility of such qualities as knowledge and experience, while raising the premium on flexibility and creativity. Although one result of this is accelerated productivity gains, several participants noted that this also led to important positions in government and business being given to individuals without a broad historical perspective or even a well-developed stake in the health of the existing system.

As a corollary, the changes in the international financial environment are outpacing governments' ability to understand where the changes are taking us and are undercutting any efforts to formulate an effective set of policies to cope with the emerging global market. To help the United States operate in this era of rapid structural changes, one participant suggested creating an academic center to formally study the issue, and perhaps use the center to evaluate existing and proposed government policies against the backdrop of the emerging environment.

Stability of the International Financial System

There was a consensus at the conference that the financial system is dangerously unstable. One participant presented his argument that there were "two long-term forces for a breakdown." First, there is the increasing inflexibility of the operating market. The higher speed and volatility of the system, coupled with the "liberating" trends of deregulation, new instruments, and inexperienced players--both individuals and institutions--has resulted in a medium in which the transmission of shocks has become immediate, creating what was called "a potentially dangerous situation." Even false rumors can jar the markets worldwide, and several discussants referred to a possible "domino effect."

The second force was said to be the deteriorating global debt-equity structure, both among firms and among countries. It was noted that 30 percent of US private debt is held by entities that are not showing a profit, and that even controlling for questionable agricultural, Third World, and energy-sector loans, the quality of debt is deteriorating. Moreover, contingent liabilities--which are now off the balance sheet-- are at record levels and growing rapidly.

The argument was put forward that the synergy between these two forces implied that a "crack" in the system could appear quickly because of the nature of the markets, and then spread uncontrollably as highly leveraged loans fail and contingent liabilities are triggered. The November 1985 Bank of New York incident, in which the

Fed extended a $22.6 billion emergency loan to prevent a default as a result of a computer failure, was mentioned as a small-scale event that could lead to a potentially disasterous collapse of the system. In another scenario, an earthquake in Japan--the world's third largest money center--could drag down much of the international financial system. The implications grow, it was noted, as Tokyo's financial importance rises. One participant observed that most of the financial structure we see today--as measured by volume, speed, new debt, types of instruments, new players, and so on--has been "developed, tested, and implemented" during the economic recovery of the last four years and that no one knows how the system will react to--or even withstand--an economic downturn.

Intentional efforts to disrupt the financial system were also discussed. Three possible motives were identified: a terrorist attack for publicity, a covert act by the Soviets during a separate crisis--such as the Cuban missile crisis--to preoccupy Western governments, or simply to make a profit. On a related issue, one participant explained that the combination of growing capital transactions and thin minerals markets made these latter markets vulnerable to manipulation. Less likely, however, is an outright cornering of any mineral, or any significant tampering with the glutted, broader-based oil and agricultural markets. In a dissenting opinion, one participant argued that increased information flows, a broader investor base, and other developments in the international financial system are actually creating a more stable environment. He believed that in the event of a crisis, the Western central banks would act quickly and in concert to limit the damage of an isolated shock.

The effects of a possible collapse of the system was briefly discussed. It was said that much would depend on the reaction of both the Western governments and the private players but that there would likely be an inflationary bias to the recovery as a result of the monetary infusions necessary to restart the system. Moreover, the reactions of the private institutions could very well be counterproductive if the credibility of the Western capital and trade system is seriously damaged as the overall economy contracts from the financial paralysis, even if short-lived. On several occasions, discussants noted the need to better understand the potential for a system collapse and the possible fallout.

Technology Loss: The Competition Issue

When the competitive status of the United States was discussed, one theme dominated: technology loss to Japan. Although the participants acknowledged the importance of the US trade imbalance, the consensus seemed to be that more fundamental issues were at stake. Indeed, one speaker believed that US policy was "overfocused" on trade, while other countries--particularly Japan--were concentrating on the longer-term strategy of securing investment opportunities.

One participant argued that the US Government should be more concerned with what he characterized as perhaps the most crucial technology loss: that of biotechnology. This techology, which includes genetic engineering and pharmaceutical research, has two unique attributes. First, unlike the maturing computer industry, biotechnology is still in its infancy, but like the computer industry, its potential for commercial applications is only beginning to be understood. Second, it is the last technology in which the United States has an undisputed lead in research. Although this is the current situation, the Japanese have targeted biotechnology for future development.

Three suggestions were given for the US Government to maintain the US lead. First, introduce a reciprocal set of domestic sales policies with the Japanese. Under the current trade regimes, Japan has the advantage in gaining understanding of US pharmaceutical research. Second, sharply boost US Government funding of biotechnological research and development. Third, accelerate the current process of approval and funding for government-sponsored projects. Another participant endorsed these suggestions, mentioning that these prescriptions could be adopted for the whole range of high technology research.

Although several economic factors were cited as driving the technology loss--primarily the strong dollar fueled by fiscal deficits--the participants also identified other problems. One speaker referred to US Government efforts to discourage private-sector, joint-venture projects with other countries for national security reasons. One result of this, it was said, is that US industry loses the benefit of foreign skills in applying technologies to commercial uses. Another factor behind technology loss is the opposite phenomenon: the rise of joint ventures in the production of big-ticket items. Technology can be transferred out of the United States through deals, such as the Boeing-Japanese 7J7 aircraft project, or several foreign countries can band together to develop and manufacture a product and then restrict their markets from outside competition in that product--as in the case of Airbus Industries.

Third World Debt: Where Does It Stand?

One speaker observed that it is becoming more difficult to characterize whether the Third World debt situation is improving or deteriorating. On the one hand, participants raised the problem of Mexico, whose recent debt agreement was seen as a move to delay, rather than solve, the potential Mexican debt crisis. On the other hand, it was said that Brazil was approaching the point where it could reenter the Eurobond market. If this happens, and a similar status could be achieved by Argentina, the threat to the overall financial system could be reduced considerably--and we might be close to being "out of the woods."

Regardless of deliberate efforts to manage the crisis--such as the Mexico package and the Baker Plan--certain de facto trends are appearing. One participant focused on the rise of secondary-market sales of existing LDC debt. He noted that such developments are outdistancing regulatory moves to defuse the debt situation by, for example, allowing controlled write-downs of liabilities from banks' books. Depending on one's perspective, it was later noted, this can be seen as either good (the market solving the problem) or bad (regulators and policymakers losing control of the situation).

Despite these developments, several participants raised concerns over what was happening in the Third World--and what could be done about it. One speaker thought there was the danger of more "conciliatory nonpayment" of debts, as in the case of Peru. Another feared that we are now witnessing LDCs' foreign debt problems affecting their domestic economies to such an extent that we will see growing political problems there--which, in turn, could undercut US influence and give rise to fertile ground for Soviet meddling.

Two areas were identified where the US Government could help "manage" the debt crisis and its effects. First, the regulatory authorities could encourage--beyond what they are currently doing--creditor banks to build their real (as opposed to book) asset base. This would make the system more stable in the event of a series of defaults. Second, it was said that a way must be found to increase private investment in the Third World. This would make the LDC domestic situation more stable and also enhance LDC ability to repay foreign loans. When asked what a recession would do to the debt situation, one participant responded, "if we have a worldwide recession we will have bigger problems than the [Third World] debt crisis."

Soviet Participation in the International Financial System

One speaker presented his case that the Soviet Union is financing its global activities--many of which threaten Western interests--through its participation in the Western financial system. It was argued that after funding from exports, the Soviets need to borrow from the West to maintain their overseas commitments, and therefore the West could enhance its own security by denying Moscow untied financing; i.e., loans that the Soviets would not need to account for in specific development projects. Moreover, he argued that the Soviets may be poised for a significant increase in their participation in the Western system, as evidenced by several recent deals and their overtures to the General Agreement on Tariffs and Trade.

Other participants raised questions concerning the thesis. Several noted that the fungibility of money implied difficulty in keeping track of even tied financing, and that although a curtailment of Western cooperation would reduce the resources available to the Soviets, it is less than certain that Moscow would reduce its expenditures in those areas the West deems threatening. Others wondered if there was enough solidarity among Western financial institutions to effectively boycott Soviet untied borrowing, and observed that Third World money centers are emerging that could service Soviet transactions. The ineffectiveness of the grain and gas pipeline boycotts were mentioned in this context. Conversely, one participant was skeptical on the idea that the Soviets could raise their borrowing levels much beyond the current--relatively minimal--amounts.

On a more fundamental level, two participants argued that it is not clear that it is in the West's interest to interfere with or constrain Soviet access for international financial system. By increasing the Soviet Union's stake in the Western system, it was noted, Moscow may develop a stake in the well-being of the system. This would reduce its incentive to disrupt financial markets during an East-West confrontation or to encourage instability in the Third World in cases where shock waves would be sent through the markets. The Soviets could gain influence by joining international economic organizations, but they also would be subject to more responsibility--although they could shirk.

Recurring Themes During the Discussions

Although not explicitly on the conference agenda, several issues resurfaced throughout the discussions:

- Japan. The conference participants repeatedly expressed concern over the growing power of Japan in such areas as technological prowess, trade competitiveness, and sheer financial power. Many thought that these advantages could easily be translated into political power domestically in the United States, in negotiations with the US Government, and throughout the Western and Third World. In considering where Japan is heading, one participant noted that Japan may soon be feeling pressures itself from the emerging economic powerhouses of South Korea, Taiwan, Singapore, et al.

- Political Backlashes. During discussions on largely economic phenomena, it was often noted that such changes created pressures at the street level. On the uncoupling of production from employment, one participant said it may lead to a form of "class warfare" in the industrial countries. In another example, one speaker noted that no one 20 years ago would have predicted that the IMF would have as much political influence worldwide as it has now as a result of the Third World debt crisis. Is there another such example waiting to emerge in the coming years as finance plays a growing international role?

- Third World Stability. Although it was observed that the austerity measures put into place as a result of the LDC debt crisis are creating political stability problems, many participants voiced their belief that new economic realities have forced many LDC governments to become more pragmatic in their economic policies--which is likely to boost stability. One speaker argued that many of the changes we see are cosmetic and superficial, but several others argued that in their daily businesses they could see real, significant improvements on such issues as foreign direct private investment. One speaker noted that the US could take advantage of this to compensate for the resources lost to LDCs as a result of the debt crisis by boosting investments there.

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MEMORANDUM FOR:

D/ExecStaff

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Jim P

Date

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3 October 1986

Memorandum for: DCI

Bill:

The attached letters to participants in the Economic Financial Issues Conference scheduled for 24 October need your signature. [redacted] and I have been in touch with all the invited guests and at this juncture we have full participation. If you need anything more for the Conference, please let [redacted] or me know. I might add that you are the big drawing card.

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[redacted]

Director,

OGI

Office of Global Issues

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FORM NO. 1 FEB 56 241 REPLACES FORM 36-8 WHICH MAY BE USED. (47)

DDI- 04615X/86

Central Intelligence Agency

Washington, D.C. 20505

8 OCT 1986

[redacted] STAT

Dear [redacted]

I was delighted to hear that you will be participating in the Economic Financial Issues Conference I am sponsoring on 24 October in New York City. As you know, I have been greatly concerned about how the financial, trade, and technology imbalances that have emerged in the global economy in recent years are affecting the United States. It is my hope that this Conference will shed light on the forces that are propelling these imbalances, how they interrelate, and, finally, what risks and opportunities they raise for the United States, our allies, and our adversaries.

The Conference brings together a small group of individuals with extensive knowledge and insight about international economic and financial matters. I am asking each individual to speak briefly on a particular aspect of the issues at hand. I would especially like you to speak on the changing global financial structure, the pressure points this is creating, and the financial market reaction. I would also appreciate your views on the key threats posed by the continuing dramatic changes in the financial structure and system. Naturally, I would also want you to identify any specific areas of concern that you believe deserve our attention.

The Conference will begin at 3:00 p.m. at The Helmsley Palace. I have enclosed the Conference agenda and a list of invited guests. [redacted] Director, Office of Global Issues or [redacted] Director, Office of African and Latin American Analysis, will be in touch with you regarding the Conference. If you need to speak with them they are available on [redacted] respectively. STAT

Yours,

/s/ William J. Casey

William J. Casey
Director of Central Intelligence

STAT

Enclosures

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Economic Financial Issues Conference

The Helmsley Palace
Tower Room
455 Madison Avenue
New York City

24 October 1986

Session I 3:00 - 4:30

Global Financial Structure, Issues and Trends

-- Factors Forcing Change

-- International Pressure Points

-- Financial Market Reactions

Session II 4:30 - 6:15

International Trading System and Pressures

-- Internationalization of Production

-- West-West Technology Transfer

-- The Issue of Competitiveness

Dinner 6:15 - 7:30

The Soviet Union and the Financial System

-- Moscow's International Financial Breakout

-- Hidden use of the System

Session III 7:30 - 8:30

Third World Debt, Progress, and Risks

-- The Need for Innovation

-- Country Vulnerabilities

Session IV 8:30 - 9:00

Wrap-up and Review of Issues

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Central Intelligence Agency

Washington, D.C. 20505

8 OCT 1986

[redacted] STAT

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STAT

Yours,

/s/ William J. Casey

William J. Casey
Director of Central Intelligence

Enclosures

Central Intelligence Agency

Washington, D.C. 20505

8 OCT 1986

[redacted] STAT

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The Conference brings together a small group of individuals with extensive knowledge and insight about international economic and financial matters. I am asking each individual to speak briefly on a particular aspect of the issues at hand. I would like you to be the speaker focusing on the Third World debt problem, the prospects for dealing with it, and the problems and opportunities it poses for the United States. I would appreciate your comments on how US financial imbalances are affecting the debt problem and what innovative approaches would be most effective in dealing with it. Naturally, I would also want you to identify any specific areas of concern that you believe deserve our attention.

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Yours,

William J. Casey
Director of Central Intelligence

Enclosures

Central Intelligence Agency

Washington, D.C. 20505

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Yours,

/s/ William J. Casey

William J. Casey
Director of Central Intelligence

Enclosures

Central Intelligence Agency

Washington, D.C. 20505

[redacted] STAT

8 OCT 1986

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William J. Casey
Director of Central Intelligence

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Washington, D.C. 20505

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The Conference will begin at 3:00 p.m. at The Helmsley Palace. I have enclosed the Conference agenda and a list of invited guests. Director, Office of Global Issues or Director, Office of African and Latin American Analysis, will be in touch with you regarding the Conference. If you need to speak with them they are available on respectively.

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Yours,

/s/ William J. Casey

William J. Casey
Director of Central Intelligence

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Central Intelligence Agency

Washington, D.C. 20505

[redacted]

8 OCT 1986

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The Conference brings together a small group of individuals with extensive knowledge and insight about international economic and financial matters. I am asking each individual to speak briefly on a particular aspect of the issues at hand. I would especially like you to speak during the dinner on your views regarding Soviet use of the international financial system. I know the participants would welcome the opportunity to hear your views firsthand on how the Soviets make subterranean use of the Western banking system. I would also appreciate your thoughts on how far the Soviet international financial breakout will go. Naturally, I would also want you to identify any specific areas of concern that you believe deserve our attention.

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Yours,

/s/ William J. Casey

STAT

William J. Casey
Director of Central Intelligence

Enclosures

Central Intelligence Agency

Washington, D.C. 20505

[redacted]

8 OCT 1986 STAT

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The Conference brings together a small group of individuals with extensive knowledge and insight about international economic and financial matters. I am asking each individual to speak briefly on a particular aspect of the issues at hand. I would especially like you to speak on how the international investment community views the pressures stemming from the economic forces now at play. Your thoughts on the problems and opportunities they create for the United States, particularly in Third World countries, would be especially valuable. Naturally, I would also want you to identify any specific areas of concern that you believe deserve our attention.

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Yours,

/s/ William J. Casey STAT

William J. Casey
Director of Central Intelligence

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October 27, 1986

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Mr. William J. Casey
Director
Central Intelligence Agency
Washington, D.C., 20505

Dear Bill:

Thanks for allowing me to participate in the discussions Friday afternoon and evening. I'm not certain I added very much, largely, I think, because nearly every thought I had was expressed in one form or another by the other participants. Which only proves just how brilliant I really am.

I was struck, however, by the continuing emphasis given to the "volatility" and/or "fragility" of the world's financial markets. Most everyone, when they weren't worried about Japanese competition, etc., came back to that theme. It's certainly one that I agree with but I don't think enough was said about the potential domino effect on the current system due to the enormous interdependence of international financial institutions which has built up rapidly during the past decade.

In my view, this is what makes the system vulnerable to manipulation. There are very few safeguards in the international financial markets today except, of course, human intelligence which often breaks down under the pressures of self-interest.

Also, I think, no one seemed to have any real ideas as to where the system might be most vulnerable, how it would break down, specifically how it could be manipulated or the degree and nature of the global consequences. You can bet the Soviets are trying to figure it out and what we need in the U.S. is a financial "S.D.I."

Again, thanks for including me. It was a stimulating evening even if many of the participants used it primarily as a means of getting their international irritations off their chests.

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