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USSR-Middle East: A Survey of Economic Relations



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USSR-Middle East: A Survey of Economic Relations



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A Research Paper

This paper was prepared by [redacted] Office of
Soviet Analysis, with a contribution from [redacted]
[redacted] Office of Near Eastern and South Asian
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may be directed to the Chief, Economic
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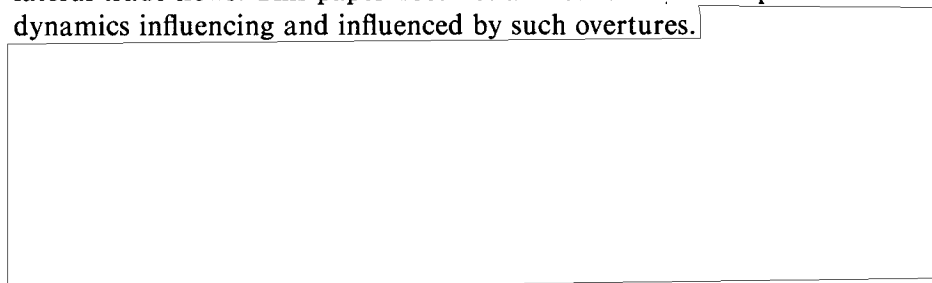
**USSR-Middle East:
A Survey of Economic Relations**



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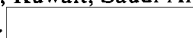
Scope Note

This paper reviews the USSR's economic interaction with the Middle East.¹ Utilizing Soviet trade data and CIA estimates of Soviet military deliveries and economic aid, we have derived a fairly accurate picture of bi-lateral trade flows. This paper does not address the broader political dynamics influencing and influenced by such overtures.



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¹ For the purposes of this paper, the "Middle East" encompasses Moscow's traditional arms clients (Algeria, Libya, Iraq, Syria, North Yemen, and South Yemen), the moderate Arab states (Egypt, Jordan, Kuwait, Saudi Arabia, the United Arab Emirates, Oman, Bahrain, and Qatar), and Iran.



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**USSR—Middle East:
A Survey of Economic Relations**

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Summary

*Information available
as of 4 August 1988
was used in this report.*

As part of an effort to expand its role in the world economy, Moscow has stepped up its economic overtures to the Middle East. While the Soviets are focusing largely on boosting trade—both commercial and military—with the region, they are also seeking to expand technical assistance, financial links, and new forms of economic cooperation such as joint ventures. Moscow's efforts extend beyond its traditional clientele; approaches have been made to more conservative Arab regimes and to other Third World regions, notably Southeast Asia and Latin America.

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Overall, we believe that Moscow's total exports—military and civilian—to the Middle East over the next few years will be \$6.5-7.0 billion annually, some \$1.5 billion better than average 1985-86 sales figures but considerably less than the \$8.2 billion registered in 1983. Arms sales will continue to dwarf all other areas of cooperation in the Middle East over the near term. The high priority Moscow's traditional arms clients—Iraq, Syria, Algeria, Libya, North Yemen, and South Yemen—assign to military procurement probably ensures that weapon purchases will continue to account for roughly 80 percent of Soviet business in the Middle East. We believe, however, that a substantial growth in arms exports to the region is unlikely and that annual arms exports are likely to exceed only slightly the 1987 level of \$5.1 billion.

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Moscow will also have to continue dealing with its customers' inability to pay for arms with hard currency. For example, we estimate Moscow financed 45 percent of its sales in 1980, but the portion of arms exports covered by credits had risen to 60 percent by 1986. Much of the increase in credits can be attributed to Iraqi purchases made since 1985. The expanded use of credits, coupled with delinquent military debts, has taken a toll on Soviet hard currency earnings: we estimate that, of the \$5.6 billion due Moscow in 1986 for both arms deliveries that year and scheduled payments for earlier arms purchases, some \$2.9 billion went uncollected.

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To help offset this lost income, Moscow is now somewhat more accommodating in accepting alternative repayment schemes for past credits. Oil deliveries, in particular, have picked up in recent years, increasing from about 150,000 barrels per day (b/d) in 1982 to 300,000 b/d in 1986-87. At the same time, Moscow appears to be taking a tougher line both with respect to the disbursement of new credits and in its efforts to obtain payment for those delinquent military debts where it feels the customer—for example, Libya—has the ability to make good on its debt.

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The Soviets' nonmilitary forays in the region will have little payoff over the next few years; civilian exports are projected to average roughly \$1.3 billion annually. In particular, Moscow's commercial sales to its arms clients will remain small. The published economic development plans for these countries indicate a continued demand for traditional Soviet machinery and equipment on the order of \$600-800 million annually, mostly in support of large projects. The end of the Iran-Iraq war could provide Moscow with some additional orders from these countries. Various reports indicate that a number of economic projects in both countries for which the Soviets were to provide assistance have been on hold because of the war. Outside of Soviet assistance in economic development projects, however, the traditional arms clients are showing little enthusiasm for Soviet goods in general. [redacted]

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We expect only limited success from Moscow's current efforts to woo the moderate Arab regimes. The USSR's best chance for boosting trade and economic cooperation lies with Egypt, where severe economic problems and Mubarak's desire for more balanced foreign relations provide some opportunities for the Soviets. Moscow hopes to make some inroads by boosting sales of machinery and equipment to Egyptian factories originally built with Soviet help in the 1950s and 1960s. [redacted]

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There are a few other openings in the region that Moscow is trying to exploit:

- The moderate Gulf Arab states are paying a bit more attention to Soviet trade proposals because they are unhappy with what they perceive to be growing trade protectionism in the developed West.
- Jordan's difficulties in securing financing to purchase Western military hardware could make it receptive to attractive Soviet offers, and the US Government's refusal to supply certain weapon systems has lead regimes such as those in Kuwait and the United Arab Emirates to seek similar weapons from Moscow.
- The region's international financial institutions and gold markets are also of growing interest to Moscow because they are markets that the Soviets have not tapped to a great extent. Moreover, Soviet transactions in this region may be less publicized than similar deals in Western Europe, thus helping the Soviets obscure, to some extent, the level of their indebtedness. [redacted]

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Moscow will be lucky to secure more than a marginal increase in economic ties with this group of countries. Most moderate Arab leaders remain worried that an expanded Soviet economic presence and political meddling go hand in hand. In addition, the severe drop in oil revenues has already reduced the region's demand for imports. To the extent they are still buying, the moderate Arab states will continue to look to the West for a host of reasons, including familiarity with capitalist marketing and financing procedures, a preference for Western goods and technology, and the availability of aftersales services and spare parts. At the same time, however, the expanded Soviet presence in these states caused by increased economic dialogue will provide the Soviets with increased opportunities for building political influence, obtaining access to COCOM-controlled technology, and conducting intelligence activities.

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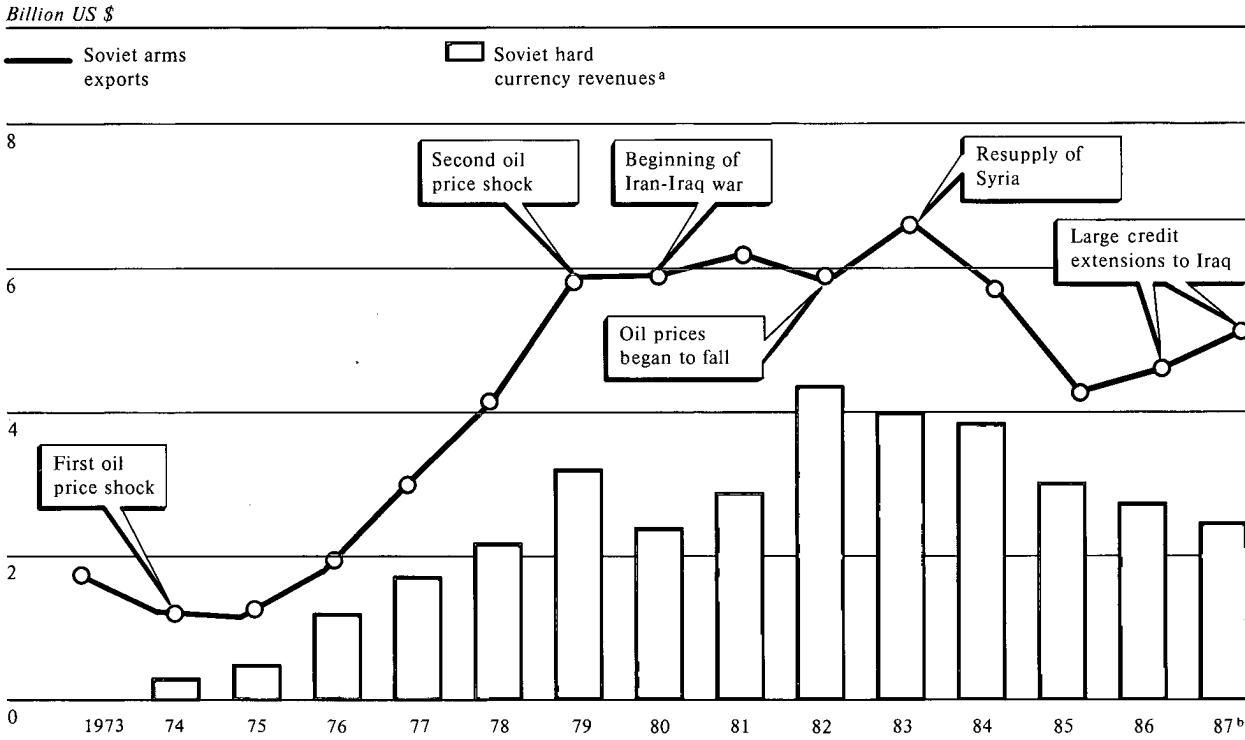
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Figure 1
Chronology of Soviet-Middle Eastern Arms Trade



^a Hard currency revenues are defined as the actual inflow of dollars and the value of oil received as compensation in that year as a result of new contracts and payments on past military debts. Arms exports are the CIA estimates of Soviet arms deliveries less grants and discounts.

^b Preliminary.

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**USSR-Middle East:
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Dominance of Military Trade

Moscow discovered early on that arms transfers were its most direct route to influence in the Middle East, particularly because many newly independent states in the region could not obtain desired military assistance from the West. Offering a wide assortment of weaponry—along with rapid delivery, training, and generous repayment terms—the USSR parlayed its initial secretive deals with Syria and Egypt in the mid-1950s into arms agreements with other Middle Eastern countries such as Iraq and Algeria by the mid-1960s. The Arab-Israeli wars of 1967 and 1973 and rising oil prices throughout the 1970s spurred still more military deliveries to the region. When faced with competition from other suppliers, Moscow has bolstered its supplier credentials by making sophisticated and expensive weapon systems available to its customers on short notice—even at the expense of deliveries to its own forces and Warsaw Pact partners. As a result, estimated Soviet arms exports—less grants and discounts—to the region climbed from \$400 million in 1971 to almost \$6 billion in 1979 (see figure 1 and appendix A). [Redacted]

percent of total Soviet exports to the region (see figure 2). Sales remained brisk because of the relatively high world price of oil, the continuation of the Iran-Iraq war, and the need to resupply Syria following its 1982 losses during the Israeli invasion of Lebanon. By the middle of the decade, however, financial difficulties for many of Moscow's Middle Eastern customers in the wake of weakening oil prices, combined with difficulties in assimilating the vast amount of Soviet weaponry already purchased, began to weaken demand for Soviet arms. Estimated arms exports to the Middle East plunged in 1985 to just \$4.3 billion, the lowest level since 1978. The dollar value of arms deliveries climbed to nearly \$5 billion in 1986 and remained high in 1987, in part because of the depreciation of the US dollar, but also because Moscow was willing to prop up sales through additional credits. For example, we estimate the portion of Soviet arms exports covered by credits rose from 45 percent in 1980 to 60 percent in 1986. Much of the increase in credits can be attributed to Iraqi purchases made since 1985.² [Redacted]

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The rising oil revenues of Moscow's Middle Eastern arms customers after the 1973 OPEC price explosion prompted the Soviets to seek more from their military program than the expansion of political influence. Through a number of initiatives such as increased prices, demands for advance payments, larger hard currency downpayments, and tighter credit, Moscow put its military program on a more profitable footing. These measures helped boost estimated hard currency earnings from Middle Eastern arms sales from roughly \$100 million in 1973 to \$3.2 billion in 1979. [Redacted]

In addition to earning less cash up front, Moscow also found it increasingly difficult to obtain payment for past sales. The Soviets initially took a tough stance, holding back the delivery of some arms purchases to customers with mounting arrearages. Failing to secure sizable repayments through these heavyhanded

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² Soviet military contracts, while payable in dollars, are priced in rubles, and the ruble has appreciated more than 25 percent against the dollar since 1985, according to the rate set by the Soviet State Bank. Estimated Soviet military sales valued in constant 1987 dollars show that deliveries to the region declined in 1986-87. [Redacted]

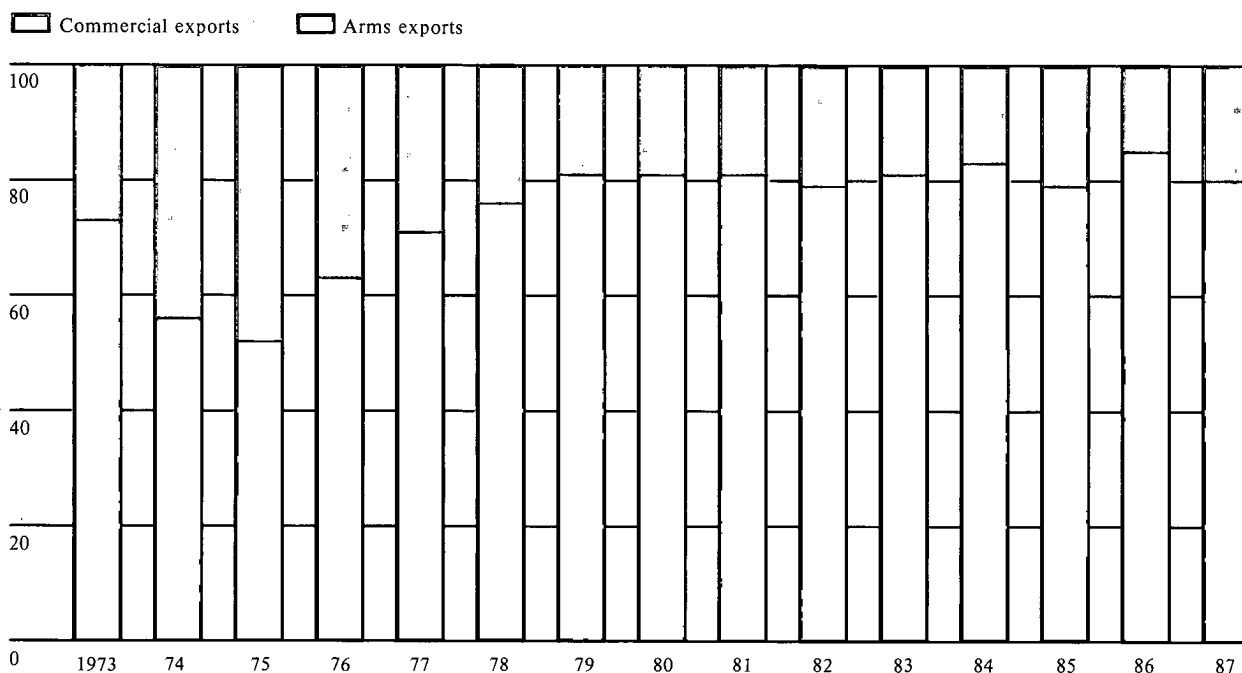
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The USSR's military sales program during the early 1980s continued to be the largest and most profitable element in Moscow's relationship with the Middle East, with estimated arms deliveries averaging 80

Figure 2
Composition of Soviet Exports to the Middle East

Percent



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tactics, Moscow has within the last few years rescheduled the military debts for almost all its arms customers in the Middle East: Iraq, Syria, Egypt, Algeria, North Yemen, and South Yemen. In the case of Syria, repayment prospects were so bad that Moscow canceled some of that debt to improve the political relationship [redacted]. We believe that even Libya, long thought to be a

strictly cash customer, had run up a \$1-2 billion Soviet arms tab by 1986, resulting in serious payment disputes with Moscow. [redacted]

The impact of these developments on arms earnings has been quite dramatic. For example, we estimate that, of the \$5.6 billion due Moscow in 1986 for both

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USSR: Imports of Middle Eastern Oil ^a

Thousand barrels per day

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Total	121	168	136	77	86	153	244	290	262	298	283
Iraq	92	128	76	36	0	2	46	77	65	63	194
Libya	21	31	59	34	34	119	118	125	96	92	52
Iran	0	0	0	0	45	18	44	25	15	0	4
Saudi Arabia ^b	0	0	0	0	0	0	21	38	48	58	0
Syria	8	9	1	6	6	14	15	10	9	17	7
Algeria	0	0	0	1	1	0	0	15	29	68	26

^a Quantities for 1977-85 were estimated on the basis of Soviet foreign trade value data and collateral. [redacted]

^b Saudi Arabia has sold crude oil to the USSR on behalf of Iraq. [redacted]

arms deliveries that year and scheduled payments for earlier arms purchases, some \$2.9 billion went uncollected.³ Thus, hard currency arms earnings from the region in 1986—including the value of oil received as compensation—were only \$2.4 billion, a decline of almost 45 percent from the 1982 peak level of \$4.4 billion. [redacted]

Burgeoning Arms-for-Oil Partnership

Moscow had traditionally demanded cash payments for arms, but eventually agreed to arms-for-oil swaps as a means to avoid long payment delays—or perhaps even a downturn in arms sales. It signed its first large agreement with Libya in 1982, and in the following

³ Difficulties in obtaining payment for arms sales is not unique to Moscow's Middle Eastern customers. Severe hard currency shortages for virtually all its arms clients worldwide have forced Moscow to restructure or reschedule many of its military debts in the last few years. Negative financial developments in the Middle East arms market, however, are of particular concern to Moscow because of the region's relative importance—it has accounted for an estimated 70 percent of total arms sales and some 80 to 90 percent of total hard currency arms earnings in recent years. [redacted]

year Saudi Arabia began supplying oil to the USSR as payment for Soviet arms deliveries to Iraq (see table for Soviet imports of Middle Eastern oil). We believe other large arms-for-oil arrangements have been reached with Algeria and Iraq. This arms-for-oil connection averaged almost 300,000 barrels per day (b/d) between 1984 and 1987—despite a sharp drop in Libyan deliveries in 1987 due to volume and pricing disputes. Of the total, about 95 percent was reexported to third countries, and the rest—roughly 15,000 b/d of Libyan oil—was imported directly into the USSR. [redacted]

Reexports of Middle Eastern oil have played an important role in Moscow's oil export strategy in recent years, accounting for 7 to 8 percent of total oil exports in 1986-87. Should Moscow prove unwilling to continue increasing investment in its domestic oil industry and allow oil production to decline within the

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next few years, we believe that the share in total oil exports of reexported Middle Eastern oil could climb to 10 to 15 percent in the 1990s. [redacted]

Moscow has reexported about one-third of its Middle Eastern oil allotment over the last three years to the developed West for sizable hard currency earnings. We estimate that reexports of Middle Eastern oil to the Western markets in 1985 earned the Soviets \$1.1 billion or 10 percent of total hard currency oil revenues. Although the drop in world oil prices beginning in 1986 has cut these earnings in half, the resale of Middle Eastern oil remains an important asset to counter Moscow's precarious hard currency balance-of-payments position. [redacted]

Moscow has also used Middle Eastern oil to reduce the substantial transportation costs associated with deliveries to India of Soviet-origin oil. On occasion, it has also used Middle Eastern oil to offset shortfalls in deliveries of Soviet-origin oil to Eastern Europe. In 1987, for example, Moscow fulfilled about 5 percent of its East European oil supply obligations in this way. [redacted]

Economic Aid and Civilian Trade

Moscow's economic links to the region developed largely—with the exception of Iran—as a follow-on to its military supply relationship. The Soviets, by and large, targeted a few areas in the domestic economies, often through project assistance on more favorable terms than the West would provide. In retrospect, Moscow gained considerable recognition from a handful of highly visible economic projects in Egypt, Syria, and Iran during the 1960s and 1970s. Soviet assistance helped establish national petroleum industries in Syria and Iraq and a natural gas industry in Iran. It also furnished one-half of Egypt's and nearly all of Syria's electric power capacity and provided irrigation potential for a million hectares of land in the region. [redacted]

The basic characteristics of Soviet economic aid in the Middle East, as with other Third World countries, include:

- Focusing on large heavy industrial projects in the public sector and developing natural resources.
- Tying of practically all commitments to purchases of Soviet equipment.
- Providing very favorable terms: 12-year credits and 2.5- to 3-percent interest rates with repayment in local currency or the output from plants built with Soviet assistance. [redacted]

Moscow's economic aid program progressed along the same lines as its arms sales program, initially providing nontangible political rewards but soon paying off economically. During the 1970s, for example, Moscow received a total of 120,000 to 130,000 b/d of crude oil from Iran, Iraq, and Syria, mostly in return for project assistance. Similarly, Tehran delivered 9 billion cubic meters of gas annually to the USSR for help on pipeline construction. By the late 1970s, repayments from Algeria, Iran, and Iraq exceeded extensions of new economic aid credits in some years. With less affluent states in the region, such as North Yemen and South Yemen, Moscow continued to seek "political gains" to offset costs throughout the 1970s. [redacted]

Over the last decade, however, Moscow has tried, with mixed success, to replace economic aid with commercial deals in its economic dealings in the region. Although the areas targeted for trade were much the same as those provided under the aid program, Moscow's commercial contracts were provided on less concessionary terms and often required payment in hard currency. We believe commercial contracts, which made up no more than 30 percent of total economic development assistance in 1973, constituted 80 percent of the total in 1979 (see figure 3). [redacted]

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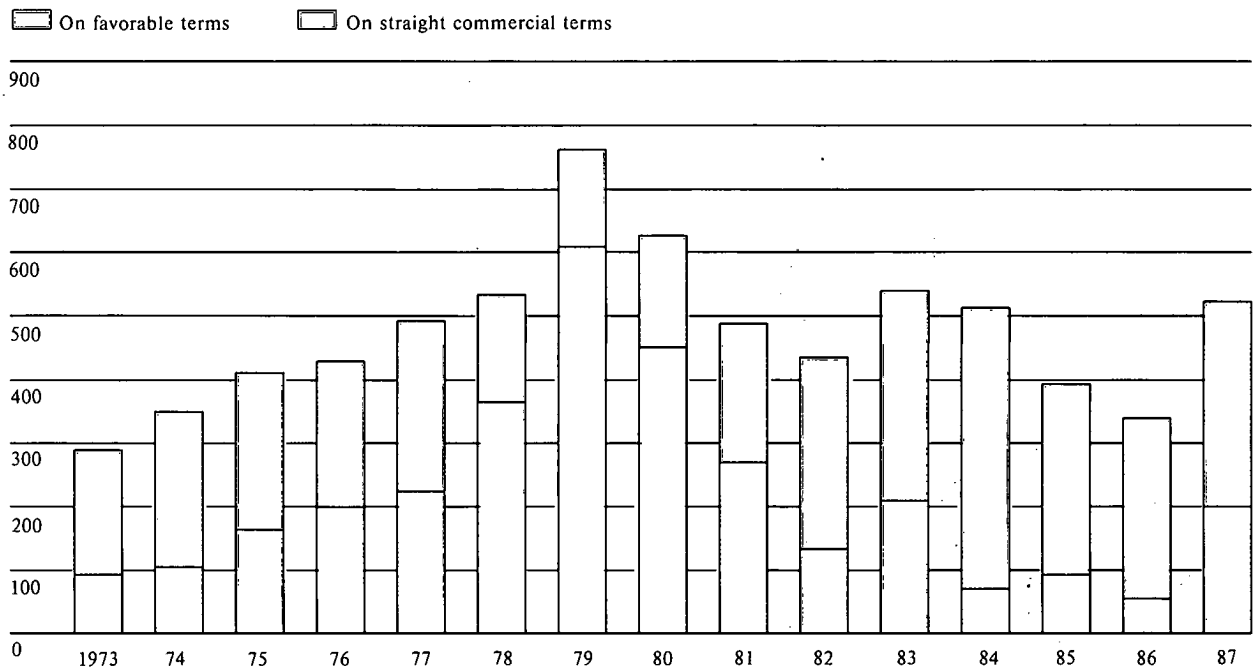
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Figure 3
Soviet Economic Development Assistance to the Middle East^a

Million US \$



^a Values for total economic development assistance are from official Soviet trade statistics. Values for assistance on favorable terms are from the CIA's data base on Soviet aid to the Third World.

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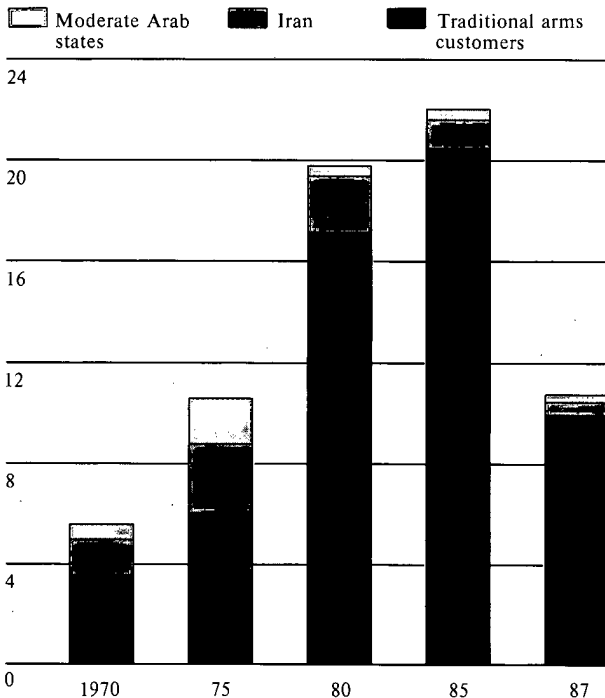
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The USSR has also earned large amounts of hard currency from the technical services of Soviet personnel—mostly administrators, teachers, doctors, engineers, and geologists—provided in conjunction with its aid program and, more recently, from commercial contracts. This effort, which employed only a few hundred Soviets in the 1960s, had evolved into a high-visibility program involving 20,000 Soviet technicians and professionals in the Middle East by 1980 (see figure 4). Although the oil-producing countries of Algeria, Libya, and Iraq have traditionally been the

primary recipients of these services—in part because of their ability to pay hard currency—Moscow also provides some services to such moderate countries as Egypt, Jordan, and Kuwait. We believe that, at the program's peak in the mid-1980s, 22,000 Soviet economic specialists were in the Middle East, earning Moscow as much as \$200 million annually. We estimate that the number of Soviet specialists has dropped dramatically in the past two years because of

Figure 4
Soviet: Economic Specialists in the Middle East^a

Thousands



^aSoviet economic specialists in the Middle East are primarily administrators, teachers, doctors, engineers, and geologists.

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hard currency shortages in Middle Eastern countries, the completion of a large nuclear project in Libya, and increased fighting in South Yemen, Iran, and Iraq. [redacted]

Moscow's involvement in the economic development of a number of Middle Eastern countries is reflected in Soviet trade statistics: Soviet commercial exports expanded 150 percent between 1973 and 1983 (see figure 5). In the early 1970s, the composition of these exports to the Middle East was rather diverse, consisting of both capital goods and consumer goods (see

figures 6 and 7). Increased Soviet domestic demand for consumer goods and the region's growing preference for Western consumer products, however, have led to an increasingly higher concentration of machinery and equipment in total exports. Moscow's imports from the Middle East showed quicker growth, rising from \$1 billion in 1973 to \$3.5 billion in 1983. The bulk of the rise, however, can be attributed to oil used to pay for arms purchases. Nonoil imports from the region over the 10-year period increased only about \$100 million from the 1973 level of \$700 million. Moreover, the USSR remains a very small player in the region's trade picture; Moscow's average annual commercial trade turnover with the Middle East, estimated at \$4 billion for 1979-86, was dwarfed by the region's average annual two-way trade with the developed West of some \$200 billion for the same time period. [redacted]

As with its arms program, the profitability of Moscow's commercial ties took a beating in the mid-1980s. The need to adjust to the worsening financial situation that was developing throughout the region forced Moscow to revise the contract terms for many of its Middle Eastern customers just to make sales. For example, Iraq, which previously had paid immediately for most purchases of Soviet equipment and services, received a nearly \$2 billion credit line from the Soviets in 1983-84. Moscow's \$800 million credit allocation to Syria in 1984 was the largest ever to that country. Nonetheless, Soviet nonmilitary exports to the Middle East began to decline in the mid-1980s, dropping from a peak of \$1.6 billion in 1983 to less than \$1 billion in 1986. (The decrease in sales to the Middle East could not have come at a more inopportune time for Moscow, as the value of Soviet exports to other regions of the world—notably Western Europe, South America, and Southeast Asia—was also falling.) Moscow was able to reverse this decline somewhat in 1987, exporting some \$1.3 billion to the region that year. Much of the turnaround in Moscow's export picture last year can be explained by

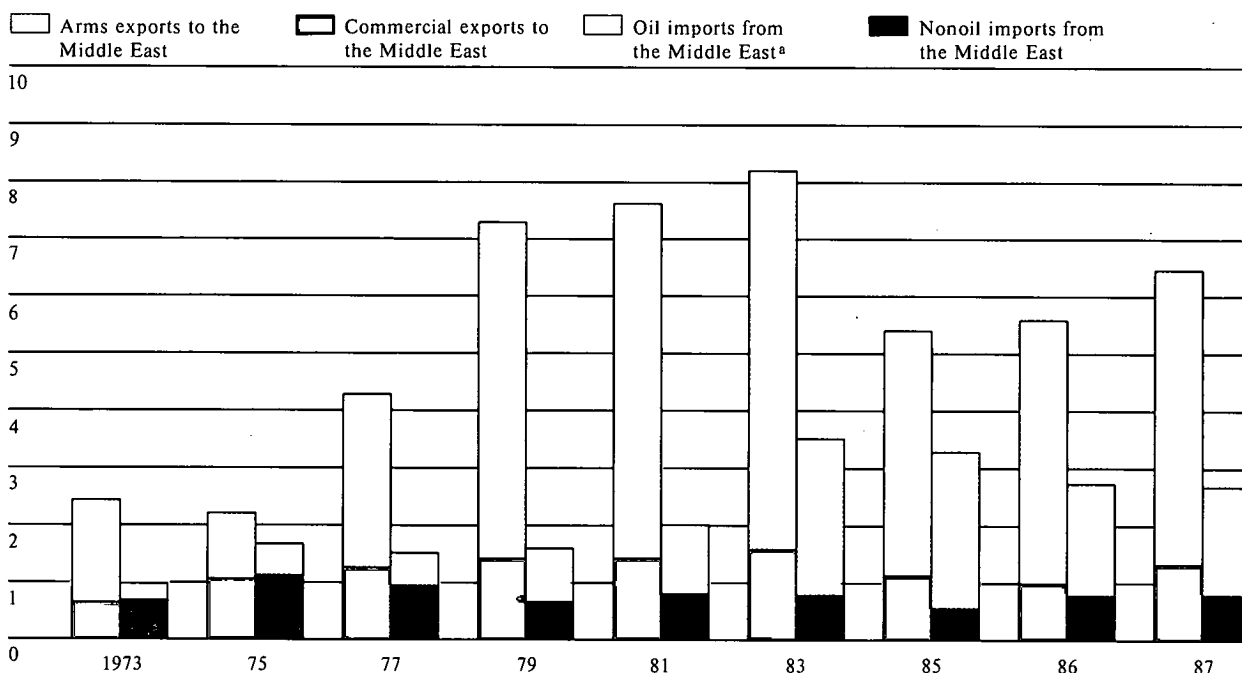
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Figure 5
USSR: Estimated Trade With the Middle East

Billion current US \$



^a A large percentage of which represents partial payment for arms deliveries

[Redacted]

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increased Soviet involvement in Iraq's and South Yemen's oil and gas industries and large oil product sales—just under \$100 million—to Iran. [Redacted]

customers. In particular, Moscow has proved flexible in seeking new arrangements for repaying past credits when the prospects for payment in hard currency are dismal:

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Moscow's Current Game Plan

- According to reports from [Redacted] the US Consulate in Oran [Redacted] the key to the rescheduling of Algeria's military debt last year was

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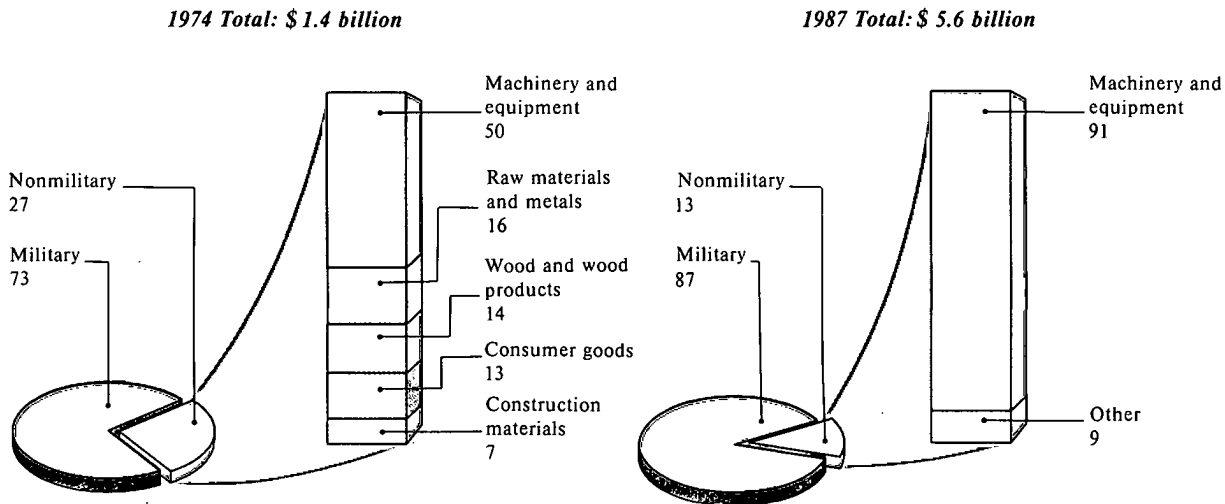
Carrot-and-Stick Approach to Traditional Arms Clients

Returning arms and commercial deals to a more profitable foundation is the cornerstone of Moscow's current economic policy toward its traditional arms

Figure 6
USSR: Exports to Middle Eastern Arab States

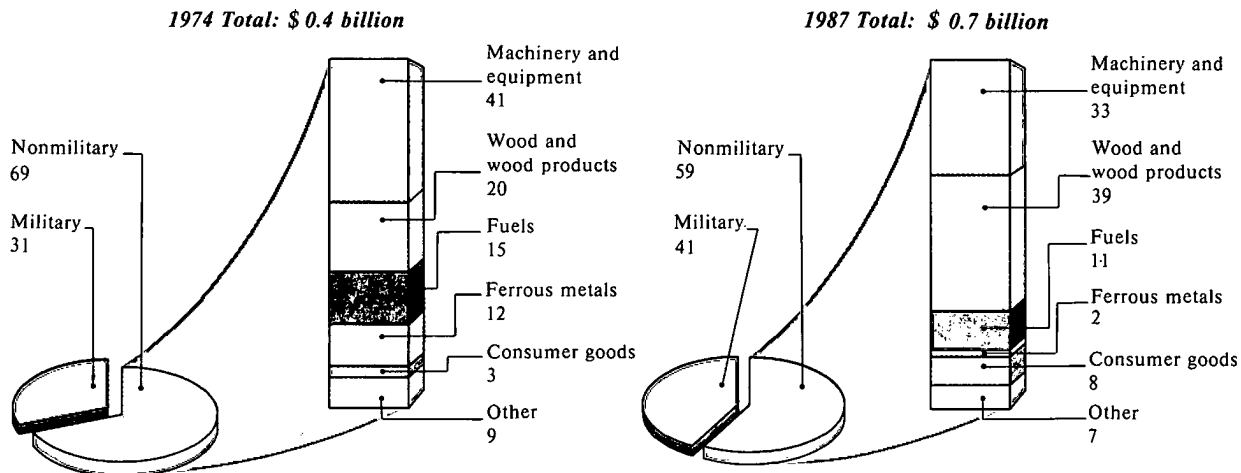
Percent

Traditional Arms Customers^a



^a The traditional arms customers are Algeria, Libya, Iraq, Syria, North Yemen, and South Yemen.

Moderate Arab States^b



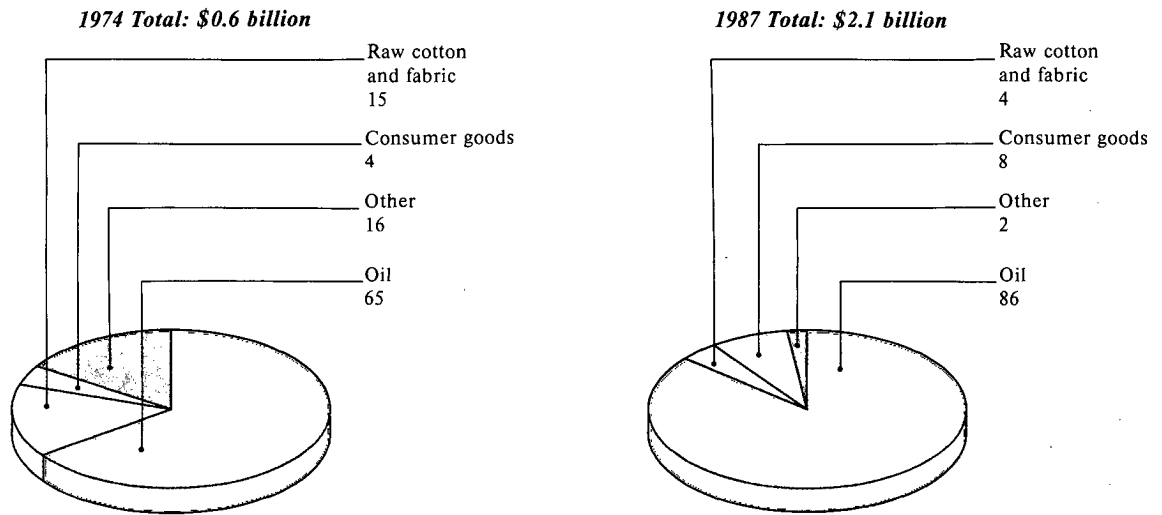
^b The moderate Arab states are Egypt, Jordan, Kuwait, Saudi Arabia, the United Arab Emirates, Oman, Bahrain, and Qatar.

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Figure 7
USSR: Imports From Middle Eastern Arab States

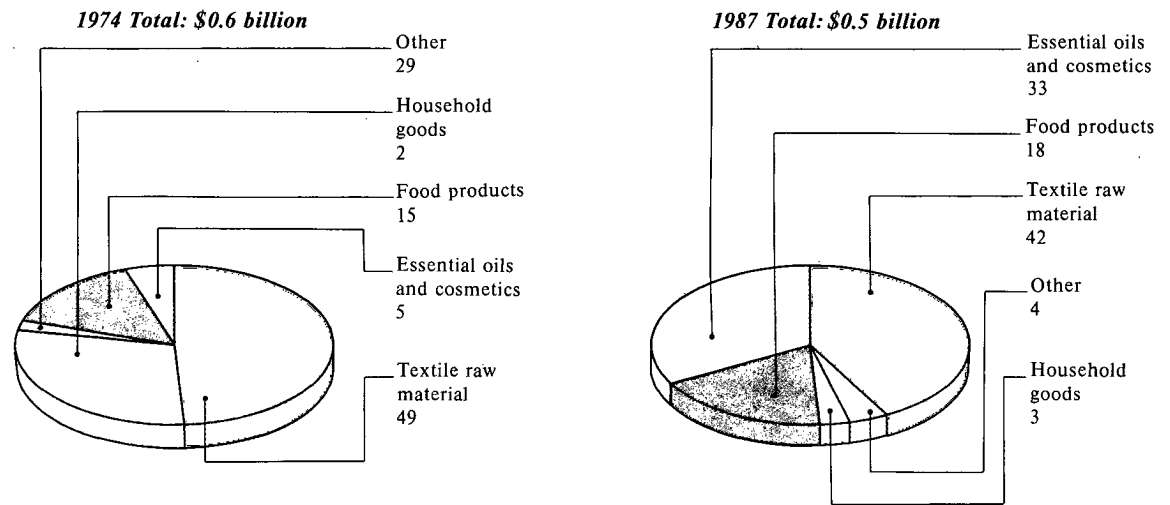
Percent

Traditional Arms Customers^a



^a The traditional arms customers are Algeria, Libya, Iraq, Syria, North Yemen, and South Yemen

Moderate Arab States^b



^b The moderate Arab states are Egypt, Jordan, Kuwait, Saudi Arabia, the United Arab Emirates, Oman, Bahrain, and Qatar.



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the inclusion of a commercial arrangement whereby the USSR would accept finished goods as partial debt repayment, superseding traditional demands for hard currency or oil.

increased competition and continued Arab financial difficulties. Having recently allowed Iraq to join the ranks of its long-term military debtors, Moscow may be on the verge of allowing Libya to follow suit.

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- Syria's severe repayment problems have prompted Moscow to pursue a number of payment schemes to reduce a military debt that [redacted] press articles [redacted] [redacted] have reported to be in the \$13-15 billion range. The Soviets are constructing a naval repair and maintenance facility at Tartus in exchange for some debt reduction [redacted] [redacted] and would like the Syrians to construct hotels and factories in the USSR, according to the US Embassy in Damascus. In addition, [redacted] [redacted] Moscow has recently agreed to supply selected Syrian industries with technicians, spare parts, and raw materials to help increase the likelihood of some form of repayment in the future. [redacted]

[redacted] Moscow appears to be providing military credits to those countries where some form of compensation can be reasonably assured. Iraq's and Libya's oil wealth and Algeria's past good repayment record make them good credit risks over the long term in Moscow's eyes. [redacted]

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Moscow is showing signs that it is increasingly ready to play hardball when repayment cannot be assured. Such is the case with Syria, where repayment prospects look extremely bleak for the foreseeable future.

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However, Moscow has sometimes pushed a harder line regarding delinquent military debts. For example, the Soviets have sought to obtain overdue hard currency arms payments from Syria, Iraq, and Algeria, in some cases sending banking delegations to press their claims. Moscow has reserved some of its toughest treatment for Libya, a policy that is, perhaps, indicative of the growing importance of commercial considerations in its relationship with the Middle East. In a series of bilateral meetings held in 1987 to resolve Libya's mounting arrearages to the USSR, Moscow was adamant that future economic cooperation—particularly arms sales—would be contingent on Libya making arrangements to pay for projects and goods already delivered, according to US Embassy reporting from Moscow. Moscow also made it clear to the Iraqis in March 1988 that, in the future, no aircraft engines or other material would be repaired until payment for past services was received. [redacted]

Moscow's tougher stance with some countries also applies to the disbursement of new economic development credits. We estimate that the percentage of economic development assistance provided on the more profitable commercial terms during 1984-86 did not exceed 20 percent. By 1987 that percentage had risen to 40 percent largely because of the increased accountability Moscow demanded from South Yemen and Iraq in return for assistance in developing their oil and gas industries. In some cases Moscow has refused to provide economic credits under any circumstances. A Syrian trade delegation seeking construction materials on credit for projects slated for 1989-90 returned from the Soviet Union emptyhanded. [redacted]

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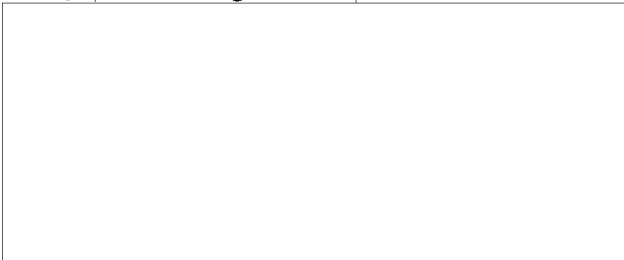
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Moscow's carrot-and-stick approach has carried over to the disbursement of new credits—both military and economic—to these states. Moscow has realized it must continue to provide credits to keep its share of the Middle Eastern arms market in the face of

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In addition to its efforts to bring Middle Eastern debt under control, Moscow has made some initiatives in other areas designed to expand and improve its economic ties to traditional arms clients. The Soviets are increasingly participating in turnkey projects where they manage all phases of project implementation, including the acquisition of labor, materials, equipment, and technical services. Economic development projects for which the Soviets have recently been designated general contractor include the Shabwah-to-Bi'r 'Ali oil export pipeline in South Yemen, the An Nasiriyah-to-Al Musayyib gas pipeline in Iraq, and surface installations at the West Qurnah oilfield in Iraq. [redacted]

To procure more sizable contributions—such as upfront capital—from the host country than turnkey projects generally provide, Moscow is seeking to enter into joint-venture agreements. [redacted]



The Soviets reportedly have also shown some interest in Western-style oil and gas production sharing agreements whereby they would be paid only if they discovered oil. Moscow reportedly has proposed such an arrangement to Syria, according to the US Embassy in Damascus. If concluded, such deals would be a departure from the past Soviet practice of providing equipment and services for an agreed price beforehand, payable regardless of whether oil or gas was discovered. [redacted]

The Special Case of Iran

Moscow and Tehran have used the recent increase in economic dialogue largely as a vehicle for improving overall communications between the countries, in addition to gaining useful propaganda from the appearance of closer ties. Little of economic consequence has occurred to date. Tehran has given much positive public gloss to cooperating with Moscow on such projects as exporting its oil through the USSR via the Iranian gas trunklines (IGAT I and II) and the large-scale swapping of Iranian crude oil for

Soviet refined products. Moscow has allowed these economic discussions to move ahead slowly, apparently using the prospect of expanded economic ties as an inducement for Iran to soften its political animosity. The Soviets apparently view these proposals as complicated and of little near-term economic value, however, and are dragging their feet on negotiations. [redacted]

Some less grandiose arrangements for economic cooperation may eventually take place. [redacted] Iran and the USSR may soon establish a joint shipping line in the Caspian Sea. Other promising areas include Soviet participation in construction of an alumina factory, expansion of steel mills and power plants, and some cooperation in energy areas. For example, press reports indicate that the USSR is likely to continue to provide technical assistance for Iranian oil exploration of the Caspian Sea. [redacted]

Courting the Moderates

Although Moscow is expending a lot of energy to shore up economic ties to its traditional Arab clients, it is not overlooking improving relations with the moderate regimes in the region. The Soviets are focusing largely on boosting exports—both commercial and military—to these countries, but also are seeking to expand technical assistance and financial links (see inset for brief discussion of military trade). While some receptivity on the part of Egypt, Kuwait, and the United Arab Emirates has made them prime targets, the Soviets are also holding discussions with most of the other moderate Arab states. [redacted]

Moscow is seeking, in particular, to renew the extensive ties to Egypt developed in the 1950s and 1960s. The rescheduling of Cairo's military debt in the spring of 1987 and the signing last winter of a three-year trade protocol—the first multiyear Soviet-Egyptian trade agreement in a decade—attests to Moscow's efforts. In addition, a high-ranking Egyptian delegation was in Moscow in May and signed a bilateral economic cooperation agreement. Part of the agreement calls for the establishment of an Egyptian-Soviet Joint Economic Committee (JEC) to oversee the future course of economic ties (see inset on Soviet use of JECs). [redacted]

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Arming the Moderates?

The recent flurry of contacts between Moscow and the moderate Arab states has included expanded sales of Soviet military equipment. [redacted]

[redacted]

[redacted]

[redacted] Jordan has increasingly turned to the Soviets for military equipment because of declining foreign assistance from the Gulf Arab states and shrinking military sales from the United States, developments that are depriving King Hussein of his most important sources of both financing and equipment. [redacted]

Some increase in Soviet arms sales to Egypt also is likely in the wake of the rescheduling of Cairo's military debt last year. Indeed, estimated Soviet arms exports to Egypt of \$100 million in 1987 were about 40 percent higher than average annual sales in 1983-86. We believe trucks and spare parts for past deliveries of major Soviet weapon systems have probably made up the bulk of the increase so far. [redacted]

[redacted]

**Negotiating USSR-Middle East Trade:
The Role of Joint Economic Committees**

Economic interchange between the USSR and the less developed countries is typically managed by intergovernmental mixed commissions on economic and scientific-technological cooperation (joint economic committees or JECs). These commissions include officials of the planning, finance, production, and foreign trade ministries and agencies of both countries, as well as representatives of scientific organizations. Subcommittees and working groups of specialists are set up in principal areas of cooperation such as trade, economic aid, commercial contracts, and joint ventures, and to work on current and long-term problems. In addition to preparing draft cooperation agreements, the functions of JECs include evaluating the results achieved, handling problems as they arise, and exploring new areas for future cooperation. The first JECs between the USSR and the LDCs were created in the 1960s, and by 1986 there were about 20 such committees operating. [redacted]

JECs are currently overseeing commercial and economic cooperation between the USSR and all of its traditional Arab arms clients. Of the moderate Arab states, Kuwait has established a JEC with the USSR, and both Egypt and Jordan have agreed to form one. The Soviets have shown particular interest in using these committees to promote long-term commercial contracts in the Middle East. [redacted]

[redacted] In contrast to ordinary commercial contracts between firms that are used primarily to trade commodities on an annual basis, long-term agreements are concluded as part of intergovernmental agreements and often include credits and the provision of technical assistance in construction and engineering, in addition to the delivery of machinery and equipment. [redacted]

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Moscow hopes to use new trade and economic cooperation agreements to boost sales of machinery and equipment to Egyptian factories originally built with Soviet help. Other areas of economic cooperation the Soviets are likely to pursue during Egypt's second five-year plan (1987-92) include the construction of thermal power stations, power transmission lines, and a coal unloading port. Moscow is also proposing the assembling of Soviet-designed products such as small arms, tractors, and automobiles in Egypt for sale both within Egypt and in third countries. [redacted]



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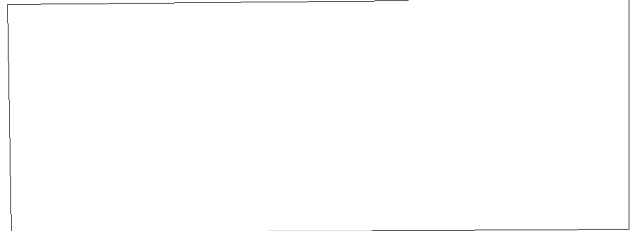
- The visit of a Soviet Foreign Ministry official to Saudi Arabia last February—the first visit of a ranking Soviet official in 50 years—with offers to increase trade and provide assistance in the areas of construction, industrialization, agriculture, and infrastructure. [redacted]

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Moscow has also shown interest in expanding its diplomatic and economic presence in the conservative Gulf states in recent years and has experienced some success. Capitalizing on these states' desire to show some balance between East and West in their relationships, Moscow has been able to conclude a few modest economic agreements that have benefited both sides. For example, an oil and petrochemical swap agreement signed last year between the USSR and Kuwait saves both countries transportation costs. In addition, the Kuwaitis have reported that the one concrete result of the Soviet-Kuwaiti joint economic cooperation commission formed last October is the legal groundwork it provides for developing future cooperation in various economic areas, including oil production, bilateral trade, and joint investment in the USSR, Kuwait, and third countries. [redacted]

The Soviets are going beyond their traditional bilateral trade deals and are also seeking to tap the region's financial and commodity markets. Hoping to build on its success in obtaining Kuwaiti and UAE loans within the last 12 months, Moscow is attempting to secure additional hard currency loans from various banks in the Gulf area. These banks not only offer Moscow a relatively new source of funding, but also, in some instances, provide a degree of secrecy since few Arab banks report their loans. [redacted]

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The Soviets have also had some recent success with the UAE. A visit to the UAE by a Soviet trade delegation in October 1987—the first in four years— included discussions with UAE officials and several private firms on plans for a joint Soviet-UAE trading company to service the Gulf region. A second Soviet delegation reportedly visited the UAE later in the month to discuss technical cooperation in energy and water management. In November, Moscow set up a major exhibit at UAE's Sharjah International trade fair, according to press reports. [redacted]

The Middle Eastern Response

Business as Usual With the Traditional Arms Clients

The high priority the traditional arms clients assign to military procurement, combined with Moscow's willingness to provide financing, probably ensures a continued strong Middle Eastern demand for Soviet arms over the near term:

- Iraq's military requirements are not likely to diminish soon, and, even with the current cease-fire in the Iran-Iraq war, Iraq will need to rebuild its inventories and modernize its weapon systems.

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Other Soviet economic demarches to the Gulf area include:

- Soviet trade officials meeting with Bahraini businessmen in Kuwait to discuss the import of Soviet commercial vehicles into Bahrain.

- Although Syria is not likely to persuade Moscow to bankroll its almost phobic goal of reaching military parity with Israel, the Syrians probably can count on Moscow to furnish the roughly \$1 billion per year in arms necessary to maintain their current level of military proficiency. The level of purchases could go even higher if Syria is able to come up with the hard currency probably required to get Moscow to provide advanced equipment not currently in Syria's inventory.
- The clout of Algeria's military leadership and the country's overwhelming reliance on Soviet weapons—some 95 percent of Algeria's war materiel is of Soviet origin—should continue to provide Moscow with a market worth some \$400-600 million annually, despite attempts by Algiers to diversify its arms suppliers.

The traditional arms customers will probably continue to look to Moscow for large-scale project assistance, mostly because of the favorable financing arrangements, but also because of Soviet flexibility to satisfy their concerns. For example, the Soviets are more willing to consider "hybrid" projects that utilize Soviet planning and technical services competitive in quality with the West but also allow for inputs of Western machinery and equipment of better quality.



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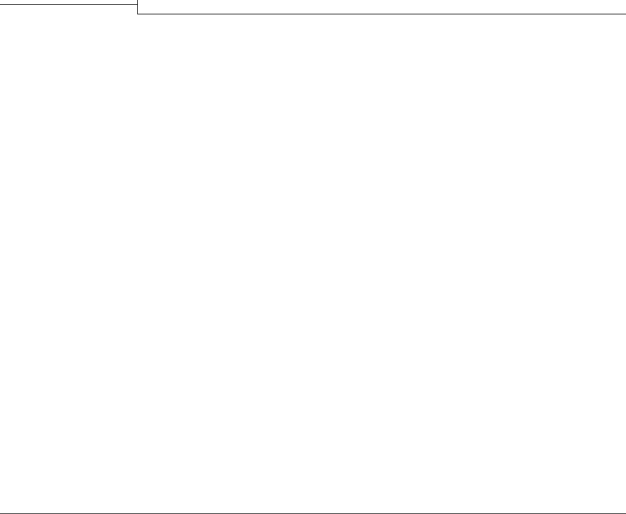
Limited Inroads With the Moderates

For the most part, Moscow's greatest economic links are being forged with Egypt, where severe economic problems and Mubarak's desire to balance Egyptian foreign relations provide a fortuitous opportunity for the Soviets.

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The published economic development plans for these countries also indicate a continued demand for sales of traditional Soviet machinery and equipment and technical assistance:

- Moscow reportedly will continue to play a large role in the development of both Syria's and Iraq's oil and gas extraction industries, irrigation projects, and electrical power generation and transmission facilities.
- Soviet assistance in the areas of agriculture, irrigation, construction and modernization of iron and steel projects, geological prospecting, civil engineering, and in training specialists are envisaged in Algeria's second five-year plan.
- South Yemen's budding oil industry is being developed almost entirely by the USSR and should provide a long-term market for Soviet technical services and equipment. Aden's newfound oil wealth may also provide Moscow with some additional opportunities in other areas of the South Yemen economy.



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Most moderate Arab leaders, however, remain worried that an expanded Soviet economic presence could lead to increased political meddling. Other major political obstacles include Moscow's stance on the Iran-Iraq war, Soviet treatment of the USSR's Muslim minority, and opposition from increasingly active domestic Islamic fundamentalist groups opposed to close relations with atheistic, Communist states. Moscow's decision to withdraw from Afghanistan is helping to deflate one contentious issue, but most states will remain concerned until the withdrawal is complete and Moscow's postwar role becomes clearer.

[Redacted]

But even in an atmosphere of reduced political animosities Moscow is likely to face an uphill battle in securing more than a marginal increase in economic ties to the moderate Gulf states. The depressed state of the region's economy brought about by the severe drop in oil revenues has already reduced demand for total imports from OECD countries by one-third in recent years. For other purchases, the region continues looking to the West for a host of reasons, including familiarity with capitalist marketing and financing procedures, a preference for Western goods and technology, and the availability of aftersales service and spare parts. Indeed, the last point remains a major headache for Soviet traders. For example, US Embassy reporting from Riyadh indicates that the quality of imported Soviet tractors and well-drilling equipment was satisfactory, but that servicing problems eventually spelled the end to continued customer loyalty.

There may be a slight crack in the door, however, given that the Gulf states are unhappy with what they perceive to be growing trade protectionism in the developed West for their exports.

[Redacted]

Indeed, continued large purchases of Saudi grain—the Soviets purchased one-third of Riyadh's

grain exports in the first quarter of 1988—might facilitate the opening of a mission. Increased contacts elsewhere are likely. For example, US Embassy reporting from Abu Dhabi indicates that the UAE would not put its own security at risk by ignoring the Soviets as long as there was a shadow of doubt about US and Allied steadfastness in the Gulf. Along the same lines, the Bahraini Foreign Minister remarked to US officials in March 1988 that to ignore the Soviet Union was unrealistic. OPEC is also likely to continue its contacts with Moscow, but we believe it will avoid any formal link to the USSR (see inset).

[Redacted]

Trade gains elsewhere are likely to be slim in the near term, but Moscow's prospects for increased financial ties and other forms of economic cooperation look more promising.

[Redacted]

Some countries are also taking more than a passive role in the Soviets' search for joint ventures. The Kuwaiti oil minister made a proposal to the Soviets to hold a seminar for the Gulf states to present the laws governing joint ventures and the areas of investment interest in the USSR, pointing out that the objective of this was to enable government and private companies to familiarize themselves with Soviet activity in this arena. Another Kuwaiti official told the US Ambassador that Kuwait was interested in supplying capital for Soviet petroleum exploration, but a stumblingblock to a joint venture was its concern about profit repatriation. Kuwait has also shown a willingness to discuss cooperation in a joint project designed to transport water from Iraq to Kuwait.

[Redacted]

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The USSR and OPEC: Mostly Talk

The USSR's recent contacts with OPEC enhance Moscow's standing with members of the oil cartel and provide a forum for Moscow's efforts to better relations with the moderate Gulf oil producers. Under the auspices of consultation with OPEC, Moscow has been able to gain access to moderate Arab officials, such as the Saudi Arabian oil minister. Moscow occasionally has even espoused cooperation with OPEC to encourage cartel policies to strengthen prices; the Soviets are the world's largest oil exporter and share an interest in higher oil prices with OPEC countries. Aside from verbal support for OPEC, however, Soviet cooperation has been nonexistent. Past Soviet pledges to OPEC members Iran and Saudi Arabia to reduce oil exports by small amounts were largely symbolic because monthly fluctuations in Soviet oil exports and the lack of data made verification impossible. [redacted]

In the present oil-surplus situation, we believe that OPEC members probably favor further contacts with the USSR. But we also believe that only in the most dire circumstances would OPEC push hard for a more formal arrangement with the USSR. On the Soviet side, short-term needs to maximize hard currency earnings will probably prevent Moscow from entering into any deal to curtail the quantity of Soviet oil exports to the West. [redacted]

Overall, we believe that Moscow's total exports—military and civilian—to the Middle East over the next few years will be \$6.5-7.0 billion annually; some \$1.5 billion better than the average for 1985-86 but considerably less than the \$8.2 billion registered in 1983:

- Arms sales to the region over the next few years are likely to be slightly above the 1987 level of \$5.1 billion, primarily because of the increase expected in exports to Libya and Kuwait, and the sale of more costly weapons to Iraq, Syria, and Algeria. The profitability of the arms program will depend largely on the future oil revenues of Moscow's traditional

arms clients. In particular, Iraq's and Libya's inability to pay cash for their purchases could keep total arms earnings from the region below \$3 billion annually over the near term.

- The Soviets' nonmilitary forays will also have little payoff over the next few years; civilian exports are projected to average roughly \$1.3 billion annually. Indeed, much of what Moscow is likely to try will be directed toward maintaining existing economic links to traditional trading partners in the region and cutting the losses it has suffered in recent years.
- Despite a \$300 million increase in 1987 over the 1986 level of \$1 billion, nonmilitary sales are still some 20 percent less than they were in the early 1980s. Some stepped-up trade with more moderate regimes is likely, but real progress will come slowly for the numerous reasons already mentioned. [redacted]

The end of the Iran-Iraq war could provide Moscow with some additional nonmilitary sales to these countries as well as the return of some technical and economic specialists. [redacted] a number of economic projects in both countries for which the Soviets were to provide assistance have been on hold because of the war. Should Moscow be able to regain its prewar share of economic assistance to both these countries, nonmilitary exports to the region over the next few years could be almost 20 percent higher than we are currently estimating. [redacted]

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Implications for the West

Despite some successes, Moscow's increased economic overtures to the Middle East are unlikely to impinge on Western economic interests in the near term. Some moderate regimes may turn to Moscow for weapon systems not available from the United States, but deals are likely to be on an "ad hoc" basis and thus only marginally cut into Western sales. Moscow also will probably not be able to take advantage of the conservative Gulf states' concerns over growing trade

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protectionism in the West for their petrochemicals. Low Soviet demand for the type of petrochemicals the Gulf states have for sale—mostly moderately refined bulk products—combined with likely demands for cash-on-the-barrel would deter any appreciable increase in Soviet purchases. Indications of the areas where Moscow may be able to broaden its economic links to the moderate Arab states may become more apparent over the next year should JEC meetings take place as planned. [redacted]

Moscow's traditional arms customers will probably continue to exhibit little enthusiasm for Soviet goods in general. Despite substantial purchases of Soviet weapons, their commercial trade is predominantly with the West. In 1986 these countries as a group imported \$16 billion in nonmilitary goods from OECD countries compared with nonmilitary imports from the USSR that year of just \$500 million. Preliminary data for 1987 suggest a similar trade orientation. [redacted]

In fact, near-term concerns for the West should be less economic than political. While actual business agreements are likely to progress slowly, Soviet

contacts and visits with Middle Eastern officials and businessmen will continue to pick up. We estimate there were 54 Soviet trade and aid officials posted to the moderate Arab states in 1986, the first year such estimates were made.⁶ As business ties increase—even at a slow pace—Moscow is likely to expand this nonofficial presence and seek to boost its official business representation. In particular, an increased Soviet presence in the region is likely in conjunction with new or expanded JEC meetings, increased financial dealings, and even more direct enterprise-to-enterprise discussions as a result of ongoing Soviet foreign trade reforms. Such an expanded role for the Soviets will provide them with new opportunities for building political influence, obtaining COCOM-controlled technology, and gathering intelligence. [redacted]

⁶ Trade and aid officials are those Soviets not on the diplomatic list but associated with trade missions, trading companies, joint ventures, commercial companies, and economic assistance programs. This category does not include technicians and professionals in the field. [redacted]

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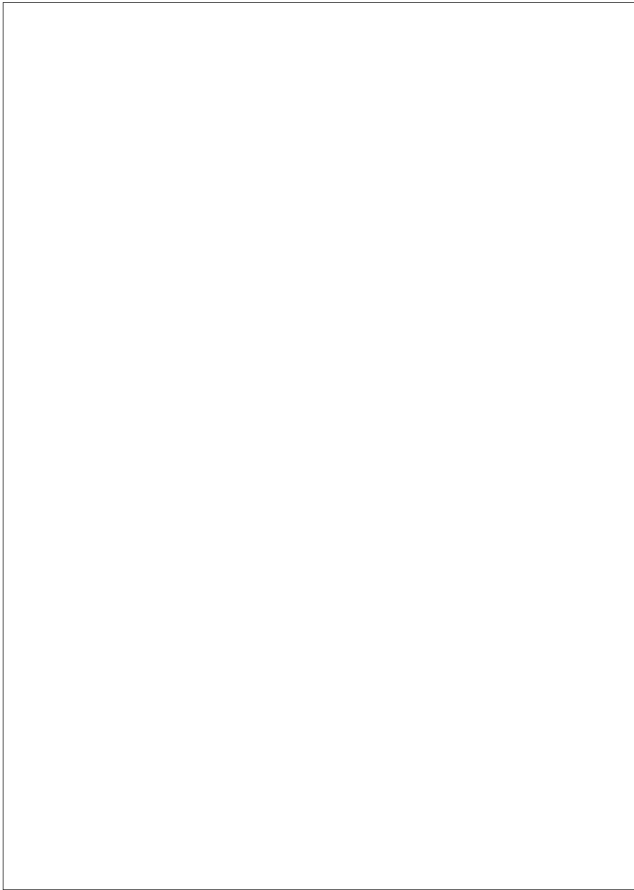
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Appendix A

Estimating Soviet Military and Commercial Exports to the Middle East

Official Soviet trade statistics and CIA estimates of Soviet military deliveries form the starting point for estimating the USSR's exports—less discounts and grants—of both military and civilian goods to the Middle East. Although these estimates represent a “first crack” at a difficult problem, we believe they provide a more realistic accounting than was previously available of Moscow's economic fortunes in the Middle East. [redacted]

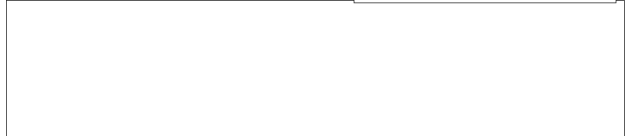


Estimating Nonmilitary Sales

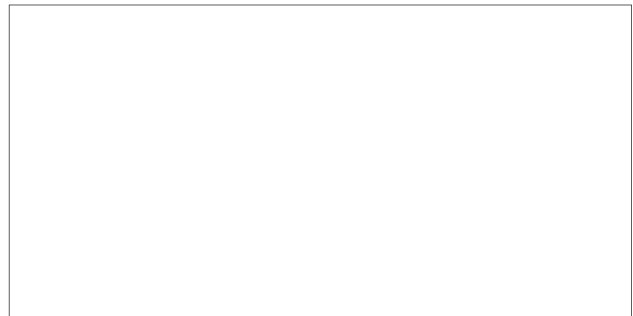
CIA and academic studies of Soviet foreign trade statistics indicate that Soviet data on trade with



Middle Eastern states—as with other arms customers—include some military sales, thereby rendering the data inadequate for determining Soviet nonmilitary exports to those countries.⁸ Moreover, the same studies show that the Soviets do not report all of their arms sales by country, but lump about 80 percent of total sales into “trade not specified by partner country,” causing Soviet-reported total exports to individual countries to understate actual sales. In an attempt to circumvent these problems, we have developed a methodology for estimating both the total and the civilian component of exports [redacted]



The value of nonmilitary sales to an individual country is calculated by taking the difference between the Soviet-reported export total to that country and the estimated arms portion of reported exports. Drawing from previous CIA research in this area, we found that the military component could be estimated reasonably well using a specified share of trucks, planes, and indeterminate goods in total Soviet exports to each country. [redacted]



⁸ For a discussion of estimating Soviet arms exports using Soviet trade statistics, see [redacted]

[redacted] *Developments in Soviet Arms Exports and Imports, 1980-83*, Wharton Econometric Forecasting Associates' Newsletter, Volume IV, Number 62 (August 1984). [redacted]

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Appendix B

USSR: Estimated Nonmilitary Trade
With the Middle East ^a

Million US \$

	1973	1975	1980	1983	1985	1986	1987
Total							
Exports	646	1,058	1,389	1,576	1,127	988	1,320
Imports	977	1,676	1,625	3,517	3,287	2,733	2,679
Balance	-331	-619	-237	-1,940	-2,159	-1,745	-1,359
Algeria							
Exports	80	109	84	126	95	27	72
Imports	70	187	96	16	327	340	179
Balance	10	-79	-12	110	-232	-313	-107
Iran							
Exports	165	338	310	667	239	82	174
Imports	188	317	116	509	173	26	78
Balance	-23	20	194	158	66	56	96
Iraq							
Exports	85	186	239	117	104	107	276
Imports	257	452	398	516	668	491	1,246
Balance	-172	-267	-159	-399	-564	-384	-970
Libya							
Exports	18	24	200	79	24	17	8
Imports	41	0	443	1,368	1,053	987	403
Balance	-23	24	-243	-1,290	-1,029	-971	-395
North Yemen							
Exports	4	4	51	8	9	5	10
Imports	0	1	0	0	0	0	0
Balance	3	3	51	8	9	5	10
South Yemen							
Exports	6	13	54	138	122	110	145
Imports	0	0	8	7	10	7	4
Balance	6	13	46	131	112	102	141
Syria							
Exports	60	73	93	110	198	244	235
Imports	63	96	236	405	231	252	301
Balance	-3	-22	-143	-295	-33	-8	-66
Egypt							
Exports	210	290	264	283	302	371	377
Imports	356	623	325	482	369	381	468
Balance	-146	-333	-61	-199	-67	-10	-91

Secret**USSR: Estimated Nonmilitary Trade
With the Middle East ^a (Continued)***Million US \$*

	1973	1975	1980	1983	1985	1986	1987
Jordan							
Exports	3	6	21	24	11	0	2
Imports	0	0	0	0	0	0	0
Balance	3	6	21	24	11	0	2
Kuwait							
Exports	11	5	23	7	4	0	0
Imports	0	0	2	1	0	0	0
Balance	11	5	21	6	4	0	0
Saudi Arabia							
Exports	4	8	47	17	18	26	20
Imports	0	0	0	211	455	249	0
Balance	4	8	47	-194	-436	-222	20
United Arab Emirates							
Exports	0	3	0	0	0	0	0
Imports	0	0	0	0	0	0	0
Balance	0	3	0	0	0	0	0

^a Export numbers are estimated using the methodology discussed in appendix A. Import numbers are reported in Soviet foreign trade statistics.



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