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C-112-1C

1 6 SEP 1988

MEMORANDUM FOR: Director of Central Intelligence

FROM: Richard J. Kerr
Deputy Director for Intelligence

SUBJECT: Untied Loans to the Soviet Bloc

REFERENCE: Question from DCI to DDI, dtd 25 Aug. 88, same subject

1. Action: None, for your information only. [redacted]

2. Background: The 5 August Jamestown Foundation letter compiles analyses that essentially assert that Moscow (a) is able to obtain Western credits at overly attractive terms and (b) has taken advantage of Western financial markets to finance its overseas empire. These lines of analysis are commonly used by those advocating a hard line with respect to Western economic dealings with the USSR and are cited by Congressional proponents of bills to restrict lending to the Soviet Union. [redacted]

[redacted] We have addressed the specific allegations raised by the referenced analyses on several occasions [redacted]

[redacted]

SUBJECT: Untied Loans to the Soviet Bloc

[redacted]

4. We are confident that all-source data reporting provide us with an accurate and fairly comprehensive picture of Soviet financial activity and in our assessment that (a) the USSR has not utilized untied credits to underwrite foreign policy initiatives in any substantial way and (b) that Eastern Europe is not acting as a credit conduit for the USSR. Moreover, we conclude that the elimination of "untied" loans would not--in any event--make a difference in Moscow's ability to use Western credits for such purposes: untied loans account for less than 10 percent of Soviet hard currency inflows and it would be relatively easy for the USSR to boost its use of "tied lending" by this amount, leaving the aggregrate inflow of hard currency unchanged. [redacted]

[redacted]

[redacted]

Richard J. Kerr

Attachments:

A. Memos to Director Casey
B. Memo to Assistant Secretary of Defense Richard Armitage
[redacted]
D. IEEW article of 9 September 1988

[redacted]

SUBJECT: Untied Loans to the Soviet Bloc

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[redacted]

[redacted]

27 February 1986

MEMORANDUM FOR: Director of Central Intelligence

VIA: Chairman, National Intelligence Council

FROM: Douglas J. MacEachin
Director of Soviet Analysis

SUBJECT: Analysis of Soviet Cash Flows

REFERENCE: Memo from DCI to C/NIC, dtd 20 Feb 86,
Same Subject

1. With regard to your memorandum of 20 February 1986, we agree with Mr. Robinson that, in the aggregate, Soviet foreign activities are possible only with foreign borrowing. However, by our calculations of USSR's balance of payments position, financial inflows, including borrowing, exceed known expenditures by an average of $3 billion over the last several years. [redacted]

2. While our estimates do not capture all of Soviet financial flows and, by implication, expenditures, we believe that unrecorded net inflows--including interbank deposits discussed by Mr. Robinson--are small. Because the Soviets conduct their financial transactions through Western financial institutions that are required to routinely report their

[redacted]

[redacted] [redacted]

SUBJECT: Analysis of Soviet Cash Flows

activities to government authorities, most of Moscow's financial flows are captured in reported Western statistics. These conditions hold true for Soviet-owned banks in the West. Like all Western financial institutions, Soviet-owned banks want to attract deposits from other Western entities, including interbank funds. [redacted] These funds cannot indiscriminately be transferred to Moscow but must be lent in accordance with government regulations--which limit the share of overall loans a bank can make to any borrower--and reported to the appropriate authorities. We estimate that outstanding Soviet loans from Soviet-owned banks in the West were under $3 billion at the end of 1985, about 10 percent of total Soviet debt to the West.

[redacted]

Douglas J. MacEachin

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~~SECRET~~ [redacted]

Central Intelligence Agency

Washington, D.C. 20505

O/DDI Registry
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21 JUL 1988

MEMORANDUM FOR: The Honorable Richard L. Armitage
Assistant Secretary of Defense for
International Security Affairs

SUBJECT: Soviet Financial Balance Sheet

REFERENCE: Your Memo to DDCI, dtd 2 July 88, Same Subject

1. Gorbachev's difficulties in revitalizing his domestic economy--as you clearly point out--have potentially significant ramifications for Soviet foreign policy with both the developed West and its surrogates in the Third World. It remains to be seen, however, whether Moscow is willing to turn to the West for assistance. [redacted] it is our view that:

--The leadership has heretofore sought an indigenous solution to its economic problems but may well decide to turn to the West for the technology, equipment, and consumer goods needed to get its modernization program on track. [redacted]

[redacted]

~~SECRET~~ [redacted]

[redacted]

SUBJECT: Soviet Financial Balance Sheet

--Moscow has the ability to increase substantially its hard currency indebtedness <u>without</u> threatening its fundamentally strong balance of payments position or otherwise leveraging itself to the West. [redacted]

3. The Soviets have clearly taken a harder line with their Third-World clients on the terms for Soviet economic and, in some cases, military assistance. Only a portion of these flows, however, involve hard currency [redacted]

4. We are confident, moreover, that the annual overall hard currency cost of Soviet foreign involvements is less than $3 billion as opposed to the $15-20 billion cited by Rand:

--The Rand estimate of $15 billion--last made in 1983--includes nearly $12 billion in "trade subsidies" based on the below market fuel prices charged to Soviet clients and the premium prices Moscow paid for imports such as Cuban sugar. Although the hard currency opportunity costs are relevant, this subsidy "cost" is fundamentally different from the cash outlays cited above. Moreover, this "subsidy" has turned into a "tax" because the price Moscow now charges its clients for oil is above rather than below world market prices.

--The balance of Rand's $15 billion "burden" estimate is comprised of Soviet arms deliveries which do not require payment in hard currency. We do not agree that such deliveries equate to a hard currency "burden" as there is no evidence that Moscow has lost out on hard currency arms sales by virtue of its sales and gifts of arms to soft currency clients. Our own analysis shows Moscow taking a tougher line with some of its clients over payments for arms deliveries but, at the same time, increasing the grant element in some of its contracts and offering easier credit terms in order to boost sales.

SUBJECT: Soviet Financial Balance Sheet

[redacted] we are comfortable in the judgment that actual Soviet hard currency outlays are in the $3 billion range. [redacted]

5. This evidence leads us to conclude that hard currency "shortages" have yet to affect substantially Soviet behavior. Soviet intransigence on the Northern Territories, for example, demonstrates that non-economic issues continue to play a key role in foreign policy decisions. A desire to achieve a more benign world environment and otherwise improve the atmosphere for expanded trade and technology flows clearly plays an important part in Gorbachev's foreign policy strategy. At the same time, one should not overlook the more general impact of perestroyka on Soviet foreign policy thinking and decisionmaking. Only time will allow us to sort out the economic variables in this equation. [redacted]

/s/

Robert M. Gates
Deputy Director of Central Intelligence

[redacted]

USSR: Holding the Line on Foreign Credits

Despite growing concern in the Soviet hierarchy over the slow progress of both the modernization drive and of consumer goods production, Moscow does not yet appear ready to run up its hard currency debt to finance sizable purchases from the West. Should Moscow seek to substantially increase imports, it would have no difficulty securing needed financing at attractive rates because the Soviets have managed to maintain a sound credit rating in the face of lower export earnings. Indeed, most of the estimated $19 billion increase during the past three years in the value of gross debt—while large by Soviet standards—has been the result of exchange-rate movements, not new borrowing. To the extent Moscow is borrowing, it is showing renewed interest in government-backed loans tied to imports and testing financial waters with previously unused instruments such as bonds. Nevertheless, the Soviets are only likely to turn heavily to world financial markets as a last resort.

Rising But Manageable Debt

A decline in oil revenues, coupled with growing credit extensions to traditionally hard currency paying LDCs to finance arms transactions, have increased Soviet activity in world credit markets in recent years. Although preliminary estimates indicate that Moscow's gross debt climbed to a record $41 billion in 1987, Western bankers remain unconcerned about Moscow's creditworthiness. The Soviets have maintained a strong financial standing in large part because the bulk of the debt buildup has resulted from exchange rate movements, not new borrowing. We estimate that more than three-fourths of the nearly $19 billion increase in gross debt during 1985-87 is due solely to exchange rate movements. Last year, for example, new borrowing actually declined, but the large exchange rate effect pushed up gross debt by more than $4 billion. With more than one-half of Moscow's debt estimated to be held in nondollar currencies, the dollar value of total debt has climbed markedly with the appreciation of nondollar currencies.

Other factors have also sustained Moscow's creditworthiness:

- Soviet hard currency deposits in Western banks have climbed almost $3 billion in the last three years, thus holding down the growth of net debt.
- Moscow's estimated gold reserves—more than 70 million troy ounces—are worth more than $30 billion at current market prices.
- The Soviets' debt servicing of a respectable 25 percent of total hard currency earnings is at roughly the same level as recorded during the last period of debt buildup in the late 1970s.

Prudent Borrowing Strategy

Moscow's ability to hold on to its sound credit standing stems from its willingness to forgo substantial borrowing during the current decline in hard currency earnings, occasioned by falling oil earnings and the depreciation of the dollar. As a result, hard currency imports of just $23 billion in 1987 were down 17 percent in nominal terms from peak imports recorded in 1983 and an estimated 30 percent in real terms. The fall would probably have been more severe, but Moscow boosted gold sales to an estimated $4 billion in 1986 and $3.5 billion in 1987, well above sales that averaged only a little over $1 billion during 1982-85.

To the extent that Moscow has sought foreign loans in recent years, it has maintained its posture as a tough bargainer, insisting on highly favorable terms and concessions from both lenders and exporters. The

USSR: Estimated Hard Currency Debt to the West [a], 1975, 1980-87

Billion US $

	1975	1980	1981	1982	1983	1984	1985	1986	1987 [b]
Gross debt	12.5	20.5	22.5	21.8	22.0	22.2	29.0	36.0	40.8
Commercial debt [c]	8.2	11.0	14.4	12.8	12.6	13.1	19.5	25.9	30.2
Government and government-backed debt [c]	4.3	9.5	8.1	9.0	9.4	9.1	9.5	10.1	10.6
Assets in Western banks	3.8	10.0	9.8	11.9	12.2	11.5	13.3	14.9	14.4
Net debt	8.7	10.5	12.7	9.9	9.8	10.7	15.7	21.1	26.4

[a] This series is based on a recently completed revision of the methodology for computing Soviet debt and, therefore, the data may not correspond to previously published series.
[b] Preliminary estimates.
[c] Estimates of government-backed and commercial debt are measured in current dollars and reflect fluctuations in exchange rates. Commercial debt also includes estimates for promissory notes held outside banks.

This table is

Soviets usually negotiate at length with several competing foreign financial institutions and firms, with financing often the critical factor in awarding contracts for large projects. The Soviets have also sought and received good terms for syndicated loans, a reflection of its excellent repayment record and strong credit rating vis-a-vis other prospective borrowers. The USSR has been particularly sensitive to interest rates, not only to hold down its debt service obligations but also because the interest rates it is accorded are a signal of its overall creditworthiness.

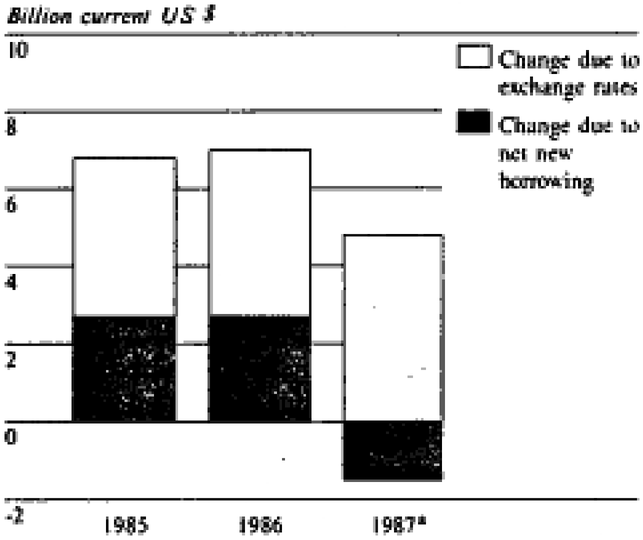
The pursuit of the best possible terms has resulted in Moscow shifting its borrowing between government-guaranteed credits linked to imports and largely untied loans from commercial banks. In the mid-1980s, interest rates on long-term syndicated credits fell below the minimum interest rate for official credits to the USSR as prescribed by the OECD Consensus.[1] Moscow responded by turning to commercial markets for a larger share of its borrowing.

During the past two years, however, official foreign credit agencies—in pursuit of Soviet business—have found ways to offer competitive terms to the USSR without violating the Consensus agreement. One tactic for lending countries with high interest rates is to offer loans in foreign currencies that carry lower interest rates. This strategy has shown some success, with the Soviets showing more interest in official lines of credit the past 18 months. On the downside of this quest for cheap loans, various reporting indicates that Moscow—to get low interest rates for government-guaranteed credits without subsidization—has, at times, paid higher fees or invoice prices (with the exporter rebating interest to the lending bank).

Moscow has also sought to cut borrowing costs by diversifying its sources of funding, either by tapping new markets, such as recent loans from Kuwait and Abu Dhabi, or by turning to new or previously unused types of financial instruments. The initiative that has garnered the most attention has been the USSR's

[1] The OECD Consensus, originally signed in 1978, categorizes borrowers as rich, intermediate, or poor, and establishes minimum official lending rates for each. The USSR was designated a rich country in 1982. The agreement also allows for nonsubsidized loans on a commercial basis.

USSR: Estimated Change in Gross Debt, 1985-87



a Preliminary.

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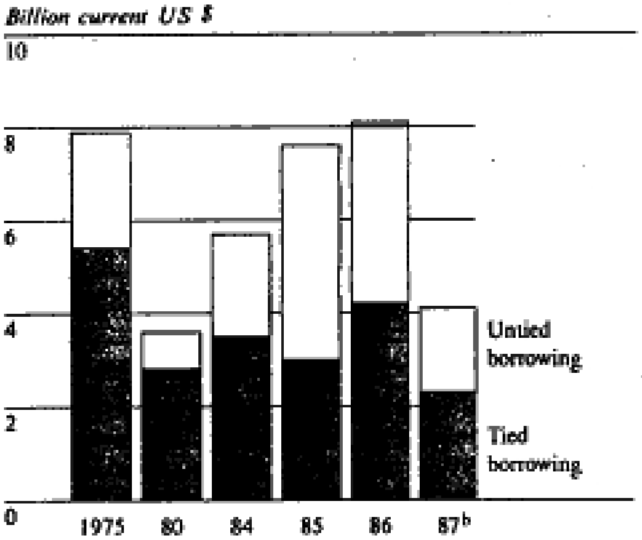
move to enter the international bond market for the first time in 70 years. Since the beginning of the year, the Soviets have issued bonds in Switzerland worth $77 million and in West Germany worth $270 million.

Another well-publicized effort has been Moscow's willingness to accept direct investment via joint ventures with Western firms. The Soviet leadership acknowledges such arrangements help it secure Western capital and management expertise with far lower hard currency costs than are required with outright purchases. Movement has been slow, however, with the actual flow of Western capital this year estimated in only the tens of millions of dollars. Nonetheless, the prospects for several sizable joint-venture deals have probably kept the Soviets from signing some traditional contracts with conventional financing.

To Borrow or Not To Borrow

The USSR remains in a strong position to step up borrowing. Such an option is receiving more attention lately, given the shortfalls in implementing Gorbachev's economic program. New and modernized industrial capacity has been slow to come on line, while new measures designed to change the way workers, factory managers, and central planners operate have disrupted industrial production. Moscow may decide that foreign resources—particularly those from the West, given Eastern Europe's weak contributions so far—could play a much larger role. Noted Soviet economist Nikolay Shmelev has repeatedly pushed in the Soviet press for the USSR to borrow additional billions of dollars. Borrowing to finance imports could

USSR: Estimates of Tied Versus United Borrowing [a]



ease current supply bottlenecks in industry and satisfy consumer restiveness by addressing some pent-up demands. Large imports of capital goods, however, will not have much of an impact on the overall modernization program until the 1990s.

The call for increased borrowing is still resisted by top Soviet officials. While Moscow is currently negotiating credit lines to help finance imports of capital goods from the West for the consumer goods industry, it does not appear to be actively stepping up borrowing across the board. The leadership seems fixated on not repeating the mistake of the 1970s when Moscow ran up its debt to finance imports, many of which were wasted because the internal mechanisms were not in place to effectively assimilate and diffuse Western equipment. Gorbachev himself has commented on the "import plague" that has left the USSR addicted to some imports and stymied Soviet internal development. On several occasions, one of Gorbachev's economic advisers, Abel Aganbegyan, has spoken out against rising indebtedness, arguing that Moscow's interest payments are already too high and that the USSR, unlike Poland and Hungary, has no one to bail it out should it run into debt problems.

Should Moscow seek substantially more imports, it would have no difficulty securing the needed financing at attractive rates. But the leadership is more likely to pursue other options, hoping that the combination of higher energy revenues and low world grain import prices would free up a good portion of the funds needed to buy Western capital and consumer goods. Moreover, it is likely to continue emphasizing joint ventures to reduce up-front hard currency outlays. In the financial arena, the Soviets would likely continue recent efforts to diversify their sources of funds and to utilize new financial instruments, not only to help cut borrowing costs but also to help hide the level of their indebtedness. Only as a last resort are the Soviets likely to turn heavily to world financial markets and allow their debt to run up substantially.