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East-West Trade and National Security

By Roger W. Robinson, Jr.

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EAST-WEST TRADE AND NATIONAL SECURITY

by

Roger W. Robinson, Jr.

I think it would surprise most people were they to step back and assess how many of the more publicized issues and challenges which the United States faces in the world today are directly or indirectly underpinned by the East-West economic and financial equation. I make this assertion because, like most endeavors in the human condition--whether it be at the individual, state, or national level--the proverbial "bottom-line" of the ability to get things done rests upon economics and particularly finance.

Having said that, I must confess that after a dozen years of active involvement in this policy area, I continue to be somewhat troubled by the lack of a more common understanding in the Western Alliance concerning the key elements of the strategic or security side of East-West economic and commercial relations. I have long referred to what I believe to be the three most important components of strategic trade with the East as the "Triad." They are: 1) the illegal acquisition by the Soviet bloc of militarily relevant Western technology; 2) Western energy security--specifically, the ongoing Soviet strategy to dominate Western Europe's natural gas markets; and 3) untied and non-transparent Western financial flows to the Warsaw Pact countries. These components of the Triad are, in my view, the principal avenues of the West's windfall contributions to Soviet military-related innovation, the USSR's hard currency earnings structure, and the Soviet Union's ability to maintain and expand its costly global commitments.

For example, has it not struck most Western policy makers as odd that the Soviet Union, which has a total annual hard currency income of only about $32 billion from all sources (including arms sales), can sustain a global empire which can directly rival the United States? More specifically, how does the USSR support such a vast array of third country commitments--many of which must be hard currency financed--with annual earnings equivalent to only about one-third of Exxon's annual revenues for 1985? These are central questions which I believe call for more thorough examination. Although the brevity of

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my remarks today will not permit a detailed attempt to answer these questions, I might at least offer a framework to advance the search.

In the area of finance, I have often been curious why I have never come across a security-oriented cash flow analysis of the USSR, a page divided down the middle with "sources" of hard currency on the left side--for example, oil and gas exports and the sales of arms, gold, diamonds--and "uses" of hard currency on the right side--such as imports from the West, technology theft, underwriting Cuba and other client states, KGB/GRU operations, and other expenditures. My own guess is that a detailed security cash flow analysis of this kind would show a formidable annual hard currency shortfall that presumably has to be financed through Western borrowings. Declining Soviet oil production and plummeting prices for both oil and gas--composing approximately two-thirds of the USSR's total annual hard currency earnings structure--should result in an even more active Soviet presence on the world credit markets than the roughly $3 billion in new credits attracted in 1985. The fact is that the level of Soviet indebtedness remained largely unchanged during the period 1979-1984 despite the fact that the USSR's hard currency needs apparently grew significantly. I believe this discrepancy can be explained, at least in part, by substantial Soviet reliance on a rather hidden borrowing source in Western financial markets.

This less visible borrowing activity takes place in the vast and amorphous interbank market where the Soviet Union has been a major player for many years. The interbank market is global in scope and is formed by the established practice among the world's banks of depositing cash with one another to facilitate the efficient flow of funds and to earn income on excess cash. The London Interbank Offering Rate (LIBOR) serves as a benchmark rate at which these deposits are offered to prime potential borrowers, and usually floats at roughly 1 percent below the U.S. prime rate. Interbank transactions can either be arranged by a money broker or directly between banks. A typical transaction might have bid and offer rates of 7-7/8 percent and 8 percent respectively, with the higher rate representing the price at which a bank would offer, for example, a six-month time deposit to another bank. Prior to concluding an interbank transaction, the bank offering the funds will check the credit limit for the particular bank taking the funds as well as the "country exposure limit" for the country in which the bank is domiciled. It is not necessarily standard practice to check the "country exposure limit" for the country which owns the "taking" bank.

The six Soviet-owned banks located in the West, along with their branches, have been major beneficiaries of this global flow of interbank funds. The largest Soviet-owned banks in the West include Banque Commerciale pour l'Europe du Nord or Eurobank in Paris, Moscow Norodney Bank, London (which often serves as the coordinating point for other Soviet banking institutions in the West), and Ost-West

Handlesbank in Frankfurt. Other 100 percent Soviet-owned banking institutions are located in Luxembourg, Zurich, Vienna, and Singapore. The latter is a branch of Moscow Narodney. The Soviets go to some lengths to obscure their complete ownership of these institutions. For example, these banks are incorporated under the laws of the countries in which they are domiciled, have foreign nationals in management positions, have what appears to be a diverse group of shareholders, and even maintain representative offices in Moscow similar to those of Western banks.

These Soviet banks engage in other banking activities outside the interbank market and even place some of their own deposits with major Western banks. This does not, however, offset the enormous advantage to the Soviets of having access to a large amount of hard currency at an interest rate which is below the U.S. prime rate and which can be used at their sole discretion. Similar to an individual who would use his or her cash reserve bank line to bridge shortages of cash in a regular checking account, interbank deposits provide the Soviets with needed liquidity on the margin to meet their pressing cash requirements. Access to these Western deposits also permits the Soviets to avoid more expensive and visible forms of Western financing. After all, why should the USSR step up its modest use of bankers acceptances or go more often to the syndicated loan market when they can tap a largely invisible pool of Western deposits at interest rates below U.S. prime?

It is very difficult to estimate the precise amount of such Western funds on deposit with the Soviet Bank for Foreign Trade, the COMECON banks, the State Bank of the USSR, and Soviet-owned banks in the West. Nevertheless, as the Soviets maintain correspondent banking relations with virtually every sizeable banking institution in the world, a ballpark estimate of the aggregate amount of Western deposits with Soviet-owned banks in West would be roughly $5 billion. I would estimate that several billion dollars more in Western deposits have been attracted directly by the Soviet Bank for Foreign Trade and the State Bank of the USSR. Individual East European banks also enjoy the same favorable access to this untied, low-cost financing source. Although these deposits must eventually be repaid, similar to loans, they still represent a major reservoir of cheap money. I think that it would be very illuminating for the Administration and Congress to get a better handle on the role of interbank deposits in the funding of the Soviet Union's global activities.

Returning for a moment to the first leg of the strategic trade Triad--the Soviet acquisition of militarily sensitive technology--we can take satisfaction in knowing that this problem is far better understood today than ever before. The President instructed the bureaucracy early in his first term to redouble its efforts to stem the flow of strategic technology to the Warsaw Pact countries. This past fall the Department of Defense, in coordination with the CIA, released an unclassified White Paper which made a valiant effort to quantify, where possible, the magnitude of our technology losses. The paper sought to identify the estimated savings achieved by the Soviet military research and development establishment as well as the direct costs incurred by U.S. taxpayers to defend against these Western-sponsored advances in Soviet military strength. Whether or not one accepts the estimates in the Department of Defense White Paper, most informed observers would have to concede that U.S. taxpayers are penalized to the tune of billions of dollars annually.

Concerning the second leg of the Triad--Western energy security, and specifically the carefully crafted Soviet game plan to dominate the natural gas markets of Western Europe--again, the President demonstrated what will be judged by history to be impressive vision and courage when he urged his allied counterparts, at the Ottawa Summit in July 1981, to limit their level of dependency on Soviet gas supplies. Subsequent to the Ottawa meetings, he dispatched two high-level U.S. delegations to Europe (the first one in the fall of 1981 and the second in early 1982) to persuade the allies to identify and develop secure, indigenous natural gas reserves (particularly the Troll gas field in Norway) and to halt the expansion of subsidized credits to the Soviet bloc for energy development and other purposes. The declaration of martial law in Poland in December 1981 added urgency to these undertakings, since the Alliance needed to send a unified signal that continued repression in Poland would not be cost-free.

The President immediately decided to implement economic sanctions against the USSR by embargoing U.S. origin oil and gas equipment destined for the Soviet energy industry. In June 1982, with no movement toward reconciliation in Poland and insufficient allied unity on a response to this situation, the President extended these sanctions to include U.S. subsidiaries and licensees located abroad. This decision temporarily crippled progress in the construction of the USSR's major gas export pipeline. Intensive allied consultations were then undertaken at the ministerial level with a view toward achieving the President's goal of forging a durable allied consensus on the security dimensions of East-West trade.

The positive outcome of these ministerial deliberations led the President to decide in November 1982 to lift the oil and gas equipment sanctions, but only after the allies had agreed to undertake urgent work programs in the key strategic trade areas, including enhanced Western energy security, which were to be completed by the Williamsburg Summit in May 1983. Progress was swift in coming. The practice of offering subsidized credits was eliminated by an understanding achieved within the OECD. An agreement signed by some 25 nations in the International Energy Agency in May 1983 also represented a major accomplishment for the Administration. The language of that agreement effectively deprives the USSR of major European participation in construction of the anticipated second strand of the Siberian gas pipeline which is currently underway or will be imminently. If abided by, this agreement will not only block Soviet domination of Western Europe's gas markets but will also deny the USSR between $5 to $10 billion in annual projected hard currency earnings from the second strand in the mid- to late 1990s and beyond.

I think it is important to emphasize that the mission of the Poland-related sanctions was not, as was so often reported in the world press, to block the first strand of the Siberian gas pipeline project. The Administration was aware that the first pipeline was a fait accompli. The Administration's extension of the Poland-related sanctions represented a last-resort, tactical decision by the President to penalize Soviet repression in Poland and to forge a new consensus within the Alliance on the security aspects of East-West economic relations. All of the security-minded objectives which the President outlined to his counterparts in Ottawa in 1981 were achieved.

POLICY PRESCRIPTIONS

I would like to use the remainder of this talk to offer some specific policy recommendations which address each of the three legs of the strategic trade Triad.

First, on technology transfer, I recommend the continuation of the effort to quantify the impact on the West of what these losses mean to our long-term security, to our taxpayers, and our intensive efforts to reduce the U.S. budget deficit. The potential Gramm-Rudman trigger mandating reductions in our own defense expenditures adds urgency to this task. The infrastructure of COCOM, the multilateral organization which controls strategic technologies, must be substantially bolstered from its woefully inadequate present status. In addition, an expanded array of incentives and disincentives should be bought to the table by the U.S. in negotiations with the allies and neutral countries in an effort to finally subordinate commercial benefit to our common security. The U.S. should also continuously develop new methods designed to assist the tracking and identification of stolen technology so that would-be diverters will operate in an uncertain environment.

In the area of Western energy security, the Administration should send an early signal to the allies that despite the fall in demand for Soviet gas, we will insist that the May 1983 International Energy Agency agreement be strictly observed, particularly when the Soviets begin to contact Ruhrgas, Gaz de France, and others for below-market second strand gas deliveries during a future period of increased demand. In addition, the positive direction of the current negotiations for the accelerated development of the Norwegian Troll gas field, as a substitute for Soviet gas, should be politically reinforced at the highest levels. The Administration should also do whatever it can to defuse the dangers inherent in West Berlin becoming 100 percent dependent on Soviet gas stemming from an agreement signed in 1982 and the likelihood that Turkey will become approximately 95 percent dependent on Soviet gas if current negotiations with the USSR come to fruition. Also, allied willingness to provide the West's most sophisticated oil and gas equipment and technology to the USSR and actively assist in the extraction, processing, and transmission of Soviet energy resources should be, in some way, factored into allied efforts to increase emigration from the USSR and achieve equal and verifiable reductions in nuclear weapons. The other elements of the Triad should likewise be considered in this context.

Finally, the Administration can play an important role by examining the practice of untied or so-called balance of payments lending to potential adversaries and scrutinizing the extent to which the Soviets rely on interbank deposits. Certain principles or guidelines should also be considered for voluntary adoption by the Western banking community, if they have not already been instituted. Specifically, each loan to a potential adversary should have an identified and verifiable purpose--be it an equipment purchase, a specific project (with loan drawdowns calibrated to project expenditures) or a short-term commodity transaction such as grain. Every loan should have a maturity that is strictly matched against the duration of the underlying transaction. For example, a grain transaction should be financed with a maximum loan maturity of 180 days rather than 3 years which would otherwise de facto provide the Soviets with 2 1/2 years of cash for their discretionary use. Finally, U.S. banks should aggregate their interbank deposit exposure to all Soviet-owned entities and periodically report these aggregate exposures to U.S. ban regulators, if they are not already doing so. The same practices should be applied to East European entities. In this connection, I am not arguing for the discontinuation of interbank activity with the USSR--only that specific information be developed on the amounts and the proper use and maturity of such deposits.

These proposed principles to govern financial flows to potential adversaries are prudent from a commercial as well as security perspective, and therefore, it is hoped, will not present major problems for the Western banking community. The Administration should urge our allies, through the OECD, to monitor the implementation of similar guidelines. In the event that the Administration and Congress are disappointed by the lack of allied cooperation in adopting these commercially prudent lending principles, more information should be gathered to determine the respective levels of allied involvement in untied, non-transparent financial flows to potential adversaries and what, if anything, should be done about it. To illustrate why we need a coordinated allied approach to this issue, we should ask the allies whether they view it as appropriate to make available even $10 million in untied Western cash to Colonel Qadhafi for his sole discretionary use. This particular issue brings to mind the sound advice offered by

John Le Carre in his novel The Honorable Schoolboy, which is embodied in three simple words--"Follow the money."

In conclusion, there do not have to be any "losers" in the West as a result of these policy recommendations. Legitimate, non-strategic trade can go forward and expand; the U.S. can continue to streamline and expedite its export licensing procedures and trim the COCOM list of controlled technologies, where indicated, to ensure enhanced U.S. export competitiveness; Western loans can continue to support specific trade transactions and projects; and incentives for greater Soviet geopolitical cooperation can be created through expanded East-West economic and commercial relations. Nevertheless, we simply cannot avert our eyes from those economic and financial practices which are deleterious to our long-term security interests; nor can we side-step the need to develop a more comprehensive picture of how the Soviet Union funds itself and its global activities.

I would hope that the U.S. security community, The Heritage Foundation, and other like-minded organizations will dedicate more resources and talented people to undertake further analyses of these issues. I would also recommend that consideration be given to the establishment, through legislation, of an Assistant Secretary of Defense for International Economic Security specifically to deal with the critical security aspects of trade and energy relations, and global finance. If properly structured, such a new position need not interfere or overlap with existing positions or functions which are, for example, responsible for the complex issue of technology transfer.

Finally, it is imperative that we successfully come to terms with the enormous Western contribution to the economic and financial vitality of the Soviet Union and its client states, particularly at a time of budget-related austerity at home.

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