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Economic Dimensions of US-Iranian Relationship

by

Fereidun Fesharaki

Economic Dimensions of US-Saudi Relationship

by

J. Philip Hinson

26 November 1982

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Composition of this memorandum was accomplished by Mrs. Deloris A. Hutchinson.

FOREWORD

This memorandum evolved from the Military Policy Symposium, "Iran and Saudi Arabia: Problems and Possibilities for the United States in the Mid-Range," sponsored by the Strategic Studies Institute in April 1982. During the Symposium, academic and government experts discussed a number of issues concerning this area which will have a continuing impact on US strategy. This memorandum, which includes two of the papers presented, considers the economic dimensions of US relations with Iran and Saudi Arabia.

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This memorandum was prepared as a contribution to the field of national security research and study. As such, it does not reflect the official view of the College, the Department of the Army, or the Department of Defense.

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ECONOMIC DIMENSIONS OF US-IRANIAN RELATIONSHIP

The Iranian Revolution of February 1979, the hostage crisis, and the anti-American fervor of the clerical leadership in Iran have led to a situation where both Iran and the United States—after over a quarter of a century of close relations—seem to have parted ways. For the American Government and the public, the mess in Iran is something they wish to forget, fearing any public statements would worsen the already poor or nonexistent state of relations. On the Iranian side, the United States remains the scapegoat for all failures of the clerical regime: everything from the war with Iraq to urban guerrillas and electrical shortages. The following brief analysis is intended to show whether there are, in fact, any prospects and possibilities for mutuality of economic interests between Iran and the Western World in the mid-range.

THE IRANIAN ECONOMY

The story of economic problems in Iran is well known. Though accurate official statistics are collected rarely (even within the government), what is available, whether through official announcements or through unofficial estimates, shows a bleak picture indeed. Unemployment is around 4 million out of an active labor force of 12-13 million; the inflation rate is 35 percent according to official data (and close to 100 percent according to unofficial estimates). Industrial capacity use is less than 50 percent and 1.8 million are war refugees. The sources of government revenue—oil income and domestic taxes—have declined markedly. Oil income has fallen drastically due to the oil market upheavals of the post-1979-80 price shock as well as the erratic behavior of Iran toward prices and customers. Domestic taxes have declined because of decreases in business activity and increases in unemployment.

The real gross domestic product in Iran rose from $33.4 billion in 1970 to $62.7 billion in 1977 and began to decline to around $48 billion in the 1980-81 period (see Table 1). Not only did the oil income fall, but also the nonoil sector suffered badly. The nonoil sector grew at a real rate of around 11 percent during the 1970-77 period, but began to decline after 1977.

Iran's oil revenues, which had traditionally provided 97 percent of Iran's foreign exchange, fell drastically. In 1980, Iran's oil revenues were $11.8 billion, in 1981 the oil income declined to $10.5 billion and, for 1982, it is expected to rise only slightly to $12.9 billion in real prices (see Table 2). At the same time, foreign reserve holdings of $14-15 billion, just after the revolution, were depleted totally by February 1982 (excluding the $1 billion in escrow for outstanding settlements). In 1980, Iran's official statistics estimated imports of $12 billion. Given that only around $5 billion of the frozen assets in the United States were paid for the settlement of past debts (some of these debts were low interest long-term debts paid off at the time of soaring interest rates), actual imports during this period must have been in the range of $15-16 billion a year. Sources within the plan and budget organization indicate that, in 1981, $2 billion of foreign exchange were turned over to the Revolutionary Guards (through authorization of the Majlis Speaker) to make clandestine arms purchases. Planners in Iran estimate that at least $15 billion of nonmilitary imports are necessary for 1982-85 (in 1981 prices) to continue bare minimums. An absolute minimum level of $12 billion of nonmilitary imports is considered to be necessary to survive with all the current rationing and its associated problems. Since an economy the size of Iran needs at least $5 billion or so as a minimum foreign exchange reserve and needs to purchase arms in the black market, Iran would

Year	Nominal Prices	Constant 1975 Prices
1970	11.4	33.4
1971	14.3	37.6
1972	17.8	45.1
1973	28.0	50.3
1974	47.7	53.0
1975	54.5	54.5
1976	71.5	61.3
1977	80.8	62.7
1978	82.5	58.7
1979	88.3	55.0
1980	101.5	48.2
1985	-	74.6
1990	-	95.9
Annual Growth Rates (%)		
1970-75	37	10
1970-80	24	4
1980-85	-	8
1980-90	-	6
1977-85	-	2
1977-90	-	3
1985-90	-	5

Source: 1970-77, International Financial Statistics and Bank Markazi Iran. Post-1977 figures are based on estimate of the OPEC Downstream Project, East-West Resource Systems Institute.

Table 1. Iran: Gross Domestic Product (Billions of US Dollars)

have to earn $20-25 billion of oil revenues to maintain a nongrowing but relatively stable economy. Instead, Iran is expected to earn less than $15 billion in 1982—of which a quarter are in barter deals with the Soviet bloc nations.

The question often asked is: "Everyone has been predicting a collapse of the Iranian economy for 3 years, but it has survived; how do we know they are not going to ride out 1982 again?" The answer is that all the talk about the economic collapse in the past was against some access to foreign exchange; this time the wolf is really here. After selling all or part of the estimated $1.3 billion of gold reserves and their historical antiques, there really is no one to whom the Iranians can turn, unless they receive massive financial

	1981	1982	1985	1990
Production	1.3[a]	1.8[b]	2.5[c]	3.5[c]
Domestic Demand	0.50	0.50	0.65	1.00
Exportable Oil[d]	0.80	1.30	1.85	2.50
Average Oil Price[e] (nominal)	36.0	30.0	37.6	60.6
Average Oil Price[f] (constant 1981 prices)	36.0	27.3	32.7	37.90
Oil Revenues (nominal)	10.5	14.2	25.4	55.3
Oil Revenues (constant 1981 prices)	10.5	12.9	22.1	34.6

Notes:

[a]Preliminary — author's estimate.
[b]Projected.
[c]Based on author's estimate of productive capacity and demand for Iranian oil.
[d]Actual for 1981 and expected 8 percent annual demand growth between 1983-90.
[e]Actual 1981 and 1982 prices. Assumes Iranian price will follow Arab light from 1983 onwards. Arab light prices expected to drop in real terms through 1983, stabilize during 1984, and then grow at 3 percent per annum.
[f]*Assuming 9 percent inflation in 1981 and 7 percent thereafter.*

Table 2. Iran's Oil Production, Exports, and Revenues in the 1980s (Millions of Barrels Per Day and Billions of US Dollars)

help from the Soviet Union. This is an unlikely prospect, indeed, given the Soviet Union's financial problems. Iran is also said to be canvassing international banks for loans, but no major prospects are seen there either. In short, the resilience of the Iranian economy, which has survived the turmoil of the past 3 years, cannot be explained by "faith" or by management techniques of the regime in Iran. The resilience owes much to the economic and bureaucratic infrastructure of the country, developed in the past two decades. The Iranian economy resembles a relatively well-built car, driven at high speed, which has run out of fuel. It does not stop immediately, but the slowdown and damages are visible. The eventual stop is inevitable.

The state of events, however, do not necessarily mean that the regime in Iran will collapse; rather something will have to give. Attitudes towards economic relations with the West must change, capable Iranians should be returned to the management of the economy, and erratic economic policies must stop if Iran is to survive as an independent nation.

TRADE RELATIONS WITH THE WEST

Iran's trade with the major industrial nations has declined radically since the revolution. Iran's import of goods and services (excluding military purchases) from the seven major industrial nations peaked at $13.3 billion in 1978 and declined to $4.6 billion in 1979. In 1980 and 1981, despite all the rhetoric and anti-Western fervor, imports continued at $5.3 billion in 1980 and $5.6 billion in 1981. The seven major industrial nations' imports from Iran

	USA	Japan	West Germany	France	UK	Italy	Canada	Total
Exports to Iran (fob)								
1979	1020	921	1285	425	493	414	19	4577
1980	23	1542	1506	721	914	575	27	5308
1981[a]	217	1049	1171	473[b]	112[c]	384[b]	17	5616[d]
Imports from Iran (cif)[e]								
1979	2978	4239	2320	1034	518	411	313	11813
1980	354	4119	1881	693	249	339	3	7638
1981[a]	51	1632	539	300[b]	4[c]	173[b]	2	3565[d]
Iran's Trade Balance								
1979	1958	3318	1035	609	25	-3	294	7236
1980	331	2577	375	-28	-665	-236	-24	2330
1981[a]	-166	583	-632	-173[b]	-108[c]	-211[b]	-15	-2051[d]

<u>Source</u>: International Monetary Fund; Directions of Trade.

[a] Jan 1981-Sept 1981.
[b] Jan 1981-Aug 1981.
[c] Jan 1981-Feb 1981.
[d] Projected total for 1981 based on available data.
[e] 97 percent of Iran's export earnings is from oil.

Table 3. Major Industrial Nations' Trade with Iran (billions of US dollars)

(around 97 percent oil), fell from a peak of $13.9 billion in 1978, to $11.8 billion in 1979, and to $3.5 billion in 1981. As a result, Iran's trade surplus of around $0.5 billion in 1978 rose to a surplus of $1.2 billion in 1979 and to $2.3 billion in 1980. However, the surplus turned into a deficit of over $2 billion in 1981. Table 3, which summarizes Iran's trade relations with the major industrial economies, indicates some interesting results. First, in 1980, the year of the hostage crisis and boycotts, exports to Iran, in fact, increased by 16 percent over 1979. Second, in 1981, when the hostage situation was resolved, the trade did not change significantly. In fact, in 1980—except for the United States—all other industrial nations increased their trade with Iran, indicating that the boycott of Iran was more rhetorical than real. Third, US trade with Iran was a little different than generally assumed. In 1980, the United States exported only $23 million to Iran, but imported $354 million from Iran, indicating that despite the oil embargo of Spring 1980, some oil (perhaps on the high seas at the time of the announcement of the embargo) continued to flow into the United States. In the first 9 months of 1981, US exports to Iran jumped to $217 million, while imports from Iran plunged to $51 million. The figures discussed here exclude massive trade through entrepots. For instance, Iran's imports from Dubai have increased tenfold during 1980-81. Clearly, most—if not all—such imports originated in the industrial nations.

Tables 4 and 5 show the major industrial nations' dependence on Iran's oil and the destination of Iran's exports of crude petroleum in 1980. Despite lower oil production and poor political relations with the West, the industrial world has continued to be the major customer for the Iranian oil.

FUTURE ECONOMIC RELATIONS: THE MID-RANGE

Fundamentally and structurally, the Iranian economy is linked to the West and particularly to the four nations of West Germany, Japan, the United Kingdom, and the United States. It takes more than a revolution and passage of a decade to sever this structural bond. Iran's oil will have to be bought mainly by the industrial world and Iran's dependence on imports will have to be based on Western goods—unless Iran ceases to continue as a sovereign state.

	% of Total Oil Import	% of Iran's Exports	Iran's Rank in Oil Imports
USA	.35	2.52	16th
Japan	6.56	35.09	6th
Canada	.16	.10	12th
Western Europe	3.50	44.45	8th
West Germany	4.27	12.08	6th
France	2.08	5.57	7th
U.K.	1.64	2.00	8th
Italy	1.07	2.41	11th
Netherlands	1.47	2.41	8th
Spain	5.94	6.62	8th
Other Western Europe	3.36	13.34	5th
TOTAL	2.85	82.17	9th

Source: International Energy Statistical Review, January 26, 1982 and OPEC Statistical Bulletin 1980.

Table 4. Major Industrial Countries' Dependence on Iranian Oil, 1980

	1978	% Change	1979	% Change	1980
USA	554	-46.4	297	-97.64	7
Japan	805	-41.86	468	-38.5	288
Canada	103	-56.31	45	-97.8	1
West Germany	346	-33.24	231	-49.8	115
France	209	-41.15	123	-80.5	24
U.K.	184	-65.22	64	-73.4	17
Italy	290	-84.83	44	-56.8	19
TOTAL	2491	-49	1272	-63	471

Source: As in Table 4.

Table 5. Iran's Crude Petroleum Exports to the Major Industrial Countries (Thousands of Barrels per Day)

Despite the damage inflicted by the current regime, the medium to long-term prospects of the Iranian economy can be rated as moderate to good. Iran's potential for oil exports and massive gas reserves (second only to the Soviet Union), as well as her large population and relatively diversified economy, show prospects for continued growth with "reasonable" management of the economy. The gross domestic product (GDP) in Iran is expected to begin to grow as soon as some degree of stability returns. By 1990, Iran's GDP is likely to be around $96 billion. The dismal performance of oil exports also is likely to reverse itself with moderate stability in the oil market, and revenues are estimated to rise to over $22 billion in 1985 and $34.6 billion in 1990 in real terms.

As the Iranian economy grows, the need for revitalization of the economy and more foreign exchange availability will push Iran further towards her natural trade partners in the industrial democracies. To some extent, the natural growth of Iran's economic relations is likely to become independent of who rules the country. Depending on whether the clerics remain in power or a secular government takes over, this process may slow down or accelerate, but the underlying relationship is not likely to disappear.

Despite the radical attitude in international oil policy, Iran has learned an important lesson in the past 3 years: you cannot fight the market without understanding the force of supply and demand and expect to win. When Iran priced her light oil at $37 per barrel in 1980, at a time of declining demand, and vowed to stick to the unreasonable priced levels, she priced herself out of the market. That Iran could not sell her oil in 1980-81 was far less due to the hostage crisis than to market reactions. Iran lost revenue, market share, influence in OPEC, and antagonized the oil companies as well. As financial pressure mounted in the last quarter of 1981, Iran reduced her price to the level of Saudi light. In the first quarter of 1982, Iran reduced her price three times to a level $4 below Saudi light and $7 below her own price a year before. By betraying OPEC through official price discounting, Iran lost prestige, but gained little extra revenues. The large drop in price resulted in only 200,000 b/d rise in exports, some of which went to barter deals in Eastern Europe. In effect, on the oil front, Iran is likely to have learned a lesson in respecting the norms of international trading.

The current intolerable financial pinch referred to earlier in this paper will result in two possible events. Either the regime will experience massive shortages, civil disturbances to a much larger degree than experienced before, and fall, or the regime will have to extrapolate the lessons learned through costly mistakes in her oil policy to her general economic policy. If the latter prevails, one could expect a gradual, but definite trend toward improving trade relations with the West.

Finally, a number of sources of economic relations with the West will remain intact in the medium term, even if other sources of relations do not increase at the expected rate. The most important of these sources is oil field maintenance and secondary recovery programs. Iran is reported to have suffered an irreversible loss of between 1-2 billion barrels of recoverable oil in the past 3 years because of declines in reservoir pressure. The loss is likely to accelerate and might have already reached a level of 1 billion barrels per annum. At least eight major gas injection programs have been suspended since 1979, and the equipment is rotting away. The primary source of technology and expertise for such activities is the United States, followed by the United Kingdom. Neither the Soviet Union nor her East European allies are much help, since they themselves rely on US and British technology and expertise for such matters. As the current oil production capacity of 2.5-3.0 million b/d continues to decline further, there is little any regime can do but to turn to the West.

Iran's need to turn to the West is inevitable, but it is the Western World's response to this need which will determine the pace of future relations with the Western democracies.

ECONOMIC DIMENSIONS OF US-SAUDI RELATIONSHIP

Perhaps the best way to approach assessment of the prospects for the US-Saudi bilateral economic relationship over the next decade is to identify the major components of that relationship and review the current state of each. From the economic perspective, there are four such components or linkages: energy, aid, trade and commerce, and finance. These components are considered independent of unforeseen political and military events in the region and observations about them are predicated on the absence of cataclysmic changes there during this decade.

With this in mind, let us turn first to the most obvious aspect of the US-Saudi relationship—energy production. In my opinion, US-Saudi relations on this issue will be basically symbiotic in the 1980's. The United States and the other oil-importing nations will need Saudi oil, and the Saudis will need to produce it at reasonably high levels.

Let us first consider the consuming side. The recent spate of press commentary on long-term oil gluts and the demise of OPEC are, I think—as Mark Twain said of reports of his death—highly premature. Projections of world oil markets are a hazardous business. But, based on what we now have learned about income and demand elasticities and conservation propensities after 9 years of turmoil in world oil markets, conservative analysis suggests that OPEC production of 23-25 mmbd will be needed in world markets by 1985; this will rise somewhat by 1990. This contrasts with a current collective OPEC output of about 17 mmbd. The necessary role of Saudi Arabia and other Arab Gulf producers will probably be larger than the growth of these figures suggests, because some of the other OPEC producers (Algeria, Ecuador, and Indonesia) will no longer be net oil exporters by that time. In sum, it will not be long before we need Saudi Arabia back at production levels near those of 1979 and 1980.

On the Saudi side of this relationshbip, it is relevant to capsulize their current economic situation. With a declining real price of oil and significantly reduced production levels, Saudi Arabia's current account surplus is declining very rapidly, probably registering in the $18 billion range during 1982, down from the $40-50 billion range during 1980-81. On the expenditure side, however, the Saudis are finding how difficult it is to cut back on spending levels once they have been incorporated into social expectations.

Saudi perceptions of necessary expenditure levels derive largely from their policies on development spending, military preparedness, and aid flows to other regional and Islamic nations. It is not likely th. . the pace of development spending will decrease significantly in the medium term. Saudi Arabia still has many unfulfilled aspirations in infrastructure, vocational education and technical training, desalination projects, and downstream petrochemical manufacturing capacity. Further, Western analysts consistently have underestimated the absorptive capacity of the Gulf nations over the last 10 years; there's a lesson to be learned in the adage that no matter how much you're making it's never enough. As for aid expenditures, it seems reasonable to assume that regional exigencies (e.g., Sudan, Pakistan, Turkey) will continue to occur, and that the Saudi government will feel compelled to respond. Thus, one would expect Saudi assistance expenditures to continue at about the current high level. On the military side, perceived threats from Iranian exported fundamentalism, Israeli expansionism, and Marxist initiatives in Ethiopia, South Yemen, and the like do not allow room for cutting back.

All told, the need for oil revenues in Saudi Arabia can be expected to continue to grow at a healthy pace in real terms. Further, the rapid dissemination of wealth among middle and lower classes (including expatriates) in Saudi Arabia has proven to be a remarkably effective emollient for latent political discontent. There is no denying that the stresses from rapid social change and modernization have been jarring in the Gulf; and one need only look to Iran to see the ultimate popular reaction these can elicit *if they are not defused* through wise and sensitive government policies. In fact, unlike Iran, the governments of the Arab Gulf states seem to have proven themselves rather adept in this area, and one of the pillars of their success has been the rapid downward distribution of government revenues. A central component of this effort is an elaborate and extensive system of subsidies and grants, involving everything from consumer goods, education, and medical care to massive allowances for housing and land, and subsidized venture capital. While these programs are expensive, the stabilizing effect of satisfying rising expectations has not been lost on the ruling house of Saud, and oil policies likely will continue to be made with a view toward avoiding any sudden slowdown in the proliferation of the domestic wealth.

For all of these reasons, I think that the Saudi government is, to an extent, locked into rising levels of expenditures in real terms over the years ahead. What does all of this mean for Saudi oil production levels?

I do not agree with the analysis of Feith, Kanovsky, and other op ed page sages who have written that Saudi Arabia must produce at or near its maximum sustainable capacity simply to survive. In fact, I find it somewhat indigenuous. On the other hand, the public assertions of oil Minister Sheikh Yamani and some other Saudi officials as to necessary production levels must be treated as suspect. Rather obvious analysis of Saudi budgetary requirements and, perhaps more importantly, foreign exchange needs suggest that, at the present official price of $34, Saudi Arabia will have to produce at an average level of 6.9 mmbd in 1982 to meet its needs. (Should the price drop to $32 per barrel, the figure would be 7.3 mmbd.) By 1983, however, production would need to rise to 7.7, and by 1984 to 8.6 mmbd, assuming 10 percent increases in real Saudi spending over this period. Of course, if the government is willing to draw down its considerable foreign assets, production temporarily can be reduced to well below these levels.

Additionally, Saudi Arabia is likely to pursue a strategy to retain leverage within OPEC over the collective decisions of that group. Over the roughly 2-year period from 1979 to 1981, Saudi production rose from 29 percent to 44 percent of the total output of the 13-nation group. This was achieved within a framework of observing OPEC agreements through a combination of moderate price policy and a policy of producing what the market was prepared to buy at its relatively low prices. This enlarged market share is even more notable, considering that it was achieved during the same time that the overall market for OPEC crude was shrinking dramatically—from about 31 mmbd to 21 mmbd. Saudi Arabia's enhanced clout within OPEC was demonstrated when other OPEC nations were unable to do anything about developing downward price pressures until the Saudis finally consented to consider the issue at an extraordinary OPEC meeting on March 19. Given the apparent genuine concerns that Yamani and other Saudis have over maintaining prices at levels sufficiently moderate to ensure their long-term markets, it seems likely that the Saudi Arabian Government's price and production policies will continue to be formulated with a view to maintaining Saudi power within OPEC. One cannot predict what this would lead the Saudis to do in all circumstances, but generally, it seems to me, it would move them in the direction of moderate pricing and reasonably high production levels.

The overall conclusion here is that, over this decade, we will continue to need relatively high levels of Saudi oil production, and they will need to produce it for their own reasons. So, on energy grounds, a coincidence of interests between our nations is likely.

In the area of multilateral development and financial institutions, the Treasury Department, as the lead US Government agency on multilateral development institutions, has developed close and cooperative ties with the Saudis over recent years. Our two governments generally hold shared views on the proper role for such institutions as the World Bank, the International Monetary Fund, International Finance Corporation, and the International Development Association, as well as on specific issues such as conditionality terms for lending. We have supported and assisted

Saudi efforts to increase their quotas in these institutions, and relied on the Saudis to provide augmented capital subscriptions and lending to them which we were not in a position to provide.

Similarly, on bilateral aid issues, the Saudis have contributed materially in supplementing US assistance flows to countries of particular regional or strategic importance. I mentioned Pakistan, Turkey, and the Sudan in this context earlier, but there are certainly other examples.

Given the forthcoming period of domestic Saudi budgetary stringency noted above, the United States may not be able to count on the same degree of Saudi help in financing our global objectives that we have come to expect. Nonetheless, there is a general convergence of our views on military and economic assistance to the Third World, and this builds a bridge in US-Saudi relations which is likely to persist into the next decade.

Looking to the economic and commercial area, US-Saudi ties increasingly have become close. In spite of numerous irritants in the relationship, I believe the prospects are good that this trend will continue. The Saudis always have seemed to have a predilection for things American, our culture, our values, and our goods, and I am convinced that this preference will persist. The United States continues to capture the largest single share of Saudi Arabia's merchandise imports, and probably of its skilled service imports as well. The Kingdom has become our ninth largest foreign customer, and today accounts for something like 300,000 American jobs in high paying, skilled occupations.

This commercial relationship, reflecting the real underlying Saudi affinities, lies at the heart of our bilateral relationship and is also an area of particular Treasury interest, as economic and tax policies bear heavily on these ties. Some recent examples in which Treasury officials have played key roles in eliminating frictions in the economic relationship with Saudi Arabia include liberalization of US taxation of American expatriate workers, the according of interest earnings on advanced military payments to the Defense Department, and favorable clarification of the tax exempt status of the Saudi Arabian Monetary Agency (the Saudi central bank and investment authority).

But frictions remain. Letter of credit issues continue to pose problems for American firms. Treasury is charged with administering US antiboycott laws under the Ribicoff Amendment to the 1979 US tax law. (The Commerce Department administers a second and conflicting set of antiboycott regulations which arise from the Export Promotion Act.) The Foreign Corrupt Practices Act continues to befuddle and intimidate US business initiatives around the world, but Arabs suspect that the law was intended primarily to disrupt US business in the Middle East.

Looking ahead, when Saudi downstream petrochemicals begin to flow onto world markets in the mid-1980's, it is likely that the Saudis will encounter some jarring confrontations with the numerous and complex set of treaties and conventions which govern world trade. To the extent that Saudi exports of downstream products seek to gain entry to world markets through cost advantages based on subsidized feedstocks, they will quickly run afoul of the US countervailing duty law and similar laws in most other industrialized nations. Treasury's Trade Office, along with other agencies of the US Government, probably will have a role to play here, and perhaps will have an opportunity to ease or defuse problems which arise. These problems may be serious—Saudi plans for production and marketing of downstream products constitute the centerpiece of their development aspirations over the next decade. Some $25-30 billion have been committed to this effort. But they will be marching boldly into an industry that is already characterized by intense competition and serious overcapacity. It is, of course, incumbent upon the Saudis to learn the rules of the game now, and to form their market strategies within those guidelines.

In my opinion, prospects for the tenor of our bilateral economic and trade relationship over the next decade are mixed, as critical as these ties are. Sensitive and creative diplomacy is especially important in this area. It is encouraging that the State Department, Commerce Department, and Treasury Department liaison on these issues continues to be both forthcoming and productive.

Finally, we will consider the financial aspect of the US-Saudi relationship. Of note here is that Saudi crude production beyond levels required for near-term, domestic financial needs results in a transformation of their national patrimony from oil in the ground to foreign financial assets. Their willingness to produce at such levels necessarily rests heavily upon their perception that they can invest their national wealth safely and profitably in developed nations. One critical aspect of this investment involves their conviction that such assets are safe from expropriation or freezes.

Discussions with Saudi government and financial officials yield an appreciation of how deeply shaken they and their Gulf neighbors were by the 1979 US action to freeze Iranian assets in this country. The incident remains in their minds, despite repeated US assurances that this unprecedented action was brought about by extraordinary circumstances. The nervousness remains: if we could do it to the Iranians, we could do it to them; and the Saudis are vulnerable. About 70 percent of their official foreign assets continue to be placed in dollar-denominated instruments.

However, the share of these assets placed in US-owned institutions could easily decline. Foreign nations would only have to transfer their offshore dollar bank balances from US banks and redeposit them into Euro-currency institutions of other ownership. There is a lesson to be learned, or relearned, here about the fragility of capital markets, and the old saying that "capital is a coward" comes once again to mind.

Other facets of the financial relationship are also important. Oil exporters must be reasonably certain that the real value of their investments abroad will not be eroded by inflation. Over much of the 1975-80 period, real rates of return on their financial assets in the United States were negative, and Gulf officials seriously questioned their high oil production levels which were generating investable financial surpluses.

Additionally, government officials in these countries are most anxious that the US Government continues its policy of confidentiality regarding their investments here. This may be a way of testing American steadfastness in the relationship. In any case, confidentiality is provided for under US law, as well as by the repeated assurances of four successive Secretaries of the Treasury. Repeated attempts by Congressman Rosenthal and some private groups to force the Treasury Department to divulge these numbers are not helpful in preserving this relationship, and cause Arab investors to doubt the wisdom of deploying their wealth in the United States. Such attempts, combined with periodic press "exposes" and editorial efforts, further their suspicions that Arab investments are less than welcome in the United States.

As some observers seem to be gnawed increasingly by self-doubts about diminishing American economic vitality, it behooves us to consider the contributions these investments make to our economic strength. Such foreign portfolio investments augment our domestic savings, reduce the tax burden of financing our national debt, contribute to the preeminence of US institutions in international banking and, in a very real sense, lead the foreign investor to identify his own interests with our national fortunes. It seems to me that under any foreseeable outlook, both of our nations have a need to preserve the cooperative relationship that exists on issues of finance and investment.

How does one summarize the prospects for the economic relationship over the next decade? In all four of the areas discussed, there appears to be a mutuality of interests which militates in favor of a convergent relationship. This does not mean it will be free of tensions, however. It is unrealistic to hope that US foreign policy, broadly construed in the Middle East, will not, at times, continue to frustrate Saudi Arabia and other Gulf Arab states almost to the limits of their endurance. Even within the narrow economic and commercial framework, there will be serious tensions, particularly on the Saudi side. The 1980's will be their coming of age—their first real prolonged immersion into the numbing world of arcane, rule-bound negotiations where earnestness and guileless negotiation cannot always provide solutions. Perhaps because of a lack of self-confidence, or a lack of adequate bureaucratic expertise, the Saudis have tended so far to avoid the necessary confrontations with issues such as the General Agreement on Tariffs and Trade, bilateral tax and investment treaties, reciprocity, and national treatment. But this will come over the next decade, and it will constitute the final step in Saudi integration into the complex global economic society that exists among developed nations

The United States can help in the process, for our economic and commercial policies impact directly on the way Saudi Arabia views its relationship with the West, and with the United States in particular. So long as the Saudis perceive their own security and economic welfare linked with the West, they will continue to be sensitive to the economic health of Western governments and institutions.

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This memorandum evolved from the Military Policy Symposium, "Iran and Saudi Arabia: Problems and Possibilities for the United States in the Mid-Range," sponsored by the Strategic Studies Institute in April 1982. During the Symposium, academic and government experts discussed a number of issues concerning this area which will have a continuing impact on US strategy. This memorandum, which includes two of the papers presented, considers the economic dimensions of US relations with Iran and Saudi Arabia.

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