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CENTRAL INTELLIGENCE AGENCY
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INTELLIGENCE MEMORANDUM*

US-Iranian Relations

1. US-Iranian relations may reach a critical point this month over the issues of Iranian military purchases and the Iranian drive to increase oil revenues. An annual joint survey of the Iranian economy is under way now, and the report of the US Military Survey Team to Iran (Peterson Report) has been completed and was submitted to the Shah on 4 May. Analysis of these two reports in Washington will determine the extent to which large Iranian military expenditures in the US are economically feasible. In addition, the Oil Consortium will determine this month how much to increase its oil offtake (exports) from Iran. The Shah considers a large increase essential to finance his military and economic programs.

2. The Shah is determined to make major military purchases in the near future to bolster defenses in oil-rich southern Iran and in the Persian Gulf, which he believes are endangered by the ambitions of Egyptian President Nasir. The Iranian parliament in November approved additional military expenditures of up to \$200 million. The Shah would prefer to make these purchases in the US, but has made it clear that he will turn elsewhere if this proves too difficult.

3. The US takes the position that these purchases can be approved only in the context of an annual joint review of the Iranian economy. The annual review grows out of a US-Iranian Memo of



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Understanding in 1964. In essence, the review provides economic information which Washington will analyze to determine whether Iran can afford increased military expenditures and still maintain rapid economic development. The Shah finds such limitations irritating and insulting, particularly in the light of his new "independent" foreign policy.

4. The arms issue is complicated by the completion of the Peterson Report. This report appears to be more in line with the Shah's thinking--it acknowledges the Arab threat to Iranian security and recommends stronger defenses in the southern provinces and the Persian Gulf. The additional recommended armaments would require a credit of \$328 million over the \$200 million credit extended under the 1964 agreement.

5. However, the State Department has tentatively determined (pending completion of the annual review) that the new credit must not exceed \$184 million, thus requiring that the Shah postpone a substantial portion of the arms purchases until after 1971. In addition, the US Embassy in Teheran has expressed its concern over the magnitude of the prices listed in the Peterson Report, and fears that the Shah will be disturbed also. Thus, although all the Shah's wished-for purchases except a prestigious destroyer apparently will be approved in principle, the Shah may well find the delay on some items, and the prices, unacceptable. Completion of the annual review probably will not substantially alter the US position. It is quite conceivable that the Shah will use the Peterson Report to counter State Department arguments against immediate heavy expenditures.

6. The oil issue is locked in closely with the foregoing. Members of the Oil Consortium may reach a decision this month on the rate at which they will increase oil offtake. As of late April, the member companies were thinking in terms of a 10.5-percent, or at most 12-percent, increase over 1965 production. The Shah insists, however, that the rate must be at least 17 percent if Iran is to carry out its economic and military programs without "reorienting" its trade pattern. Both the US and British companies in the

-2-

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consortium argue that they are producing as fast as possible, and each group accuses the other of holding back production. A final meeting was scheduled for 10 May, but apparently has been temporarily postponed because the Shah has invited some company heads to Teheran for discussions later in May. The US fears the consequences of a major confrontation between Iran and the consortium, and has been encouraging US companies to raise their production as much as possible.

7. The Shah, bolstered by his rapprochement with the Soviets and by political stability and economic growth at home, has exhibited an increasingly independent spirit in the past year. He is determined to obtain new military equipment soon, and there is little doubt that he will turn elsewhere if the US does not sell quickly and on favorable terms. He has felt for some time that the US takes Iranian friendship for granted, and he regards the arms question as a crucial test of US support and sincerity. He is equally determined to increase oil revenues, and may well be serious in his threat to shift at least part of Iran's trade to the East, where export prices are lower and terms are easier. This could, in turn, put a brake on the growing US private investment in Iran, as well as affect our general politico-military relationship with the country.

-3-

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