LUNCH WITH SECRETARY OF TREASURY NICHOLAS BRADY

Friday, 18 November 1988, 12:15 p.m.

Treasury Building

DCI
EXEC
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The Director of Central Intelligence
Washington, D.C. 20505

National Intelligence Council

NIC 03323-88
17 November 1988

MEMORANDUM FOR: Director of Central Intelligence

FROM: [redacted] 25X1
Assistant National Intelligence Officer for Economics

SUBJECT: Panama Sanctions

1. Action: None; this is background information on the status and the impact of economic sanctions against Panama. [redacted] 25X1

2. Economic sanctions continue to strain the regime's finances -- we estimate they will cost the government some $250 million by year end. Noriega is managing the situation skillfully.

-- The government is spending little more than what it takes to meet payrolls. It has limited this amount by shortening work hours, forcing employees to take unpaid vacations, and cutting salaries. Noriega continues to cover military salaries in full.

-- Payments to foreign creditors remain suspended, as do many to domestic suppliers.

-- The regime refuses to cash some of the government checks it issues in varying denominations to pay for goods and services. These checks continue to circulate as a quasi-currency. [redacted] 25X1

3. Noriega also has relied on foreign assistance to cope with the sanctions. Libya disbursed a $20 million loan, and Cuba and Nicaragua have provided medicine and fertilizer. More recently, Libya reportedly provided $14 million in investment funds and [redacted] says the Soviets last week told a senior Panamanian Communist official in Moscow that they are willing to provide $160 million worth of aid in Soviet goods. [redacted] 25X1 25X1

4. The continuing gradual economic decline will erode popular support for the regime, but we do not believe that economic factors alone will prompt the General's departure in the next year. Beyond then, however, the government's coping mechanisms incur increasingly heavy costs and could ultimately prove unsustainable. [redacted] 25X1

[redacted] 25X1

Attachment:
The Extent of the Sanctions

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THE EXTENT OF THE SANCTIONS

The International Emergency Economic Powers Act (IEEPA), signed on 8 April 1988, blocked access to all assets and property of the Government of Panama in the United States and generally prohibited any payments to the Solis Palma/Noriega regime by the US Government, US citizens or firms, or Panamanian entities owned or controlled by US citizens and located in Panama. This action superceded and expanded upon other restrictions that already were depriving the regime of some $20 million per month in Canal payments and pipeline fees and that froze government assets of $50.5 million in US bank accounts.

Since the imposition of these sanctions, amendments have been made to permit payment of social security taxes, import taxes, travel-related expenses, postal and telecommunications costs, payments for utilities and similar municipal services, and indirect taxes including sales and excise taxes. IEEPA sanctions still prohibit the payment of corporate and individual income taxes, direct excise taxes to the Government of Panama, rental fees, and Canal and pipeline payments. Nevertheless, we believe some firms are paying the regime under the table in an effort to avoid harassment.

LATIN AMERICAN DEBT

The economies of Latin American debtors have been plagued by a number of similar problems:

- -- **High inflation and slow growth.**
- -- **Large budget deficits, the result of excessive spending, large state-owned enterprise sectors, and tax evasion.**
- -- **Structural problems such as low investment levels, restrictive trade policies, and excessive government intervention and regulation of the economy.**
- -- **Large net resource outflows, the result of capital flight and high debt payments.**

Although **Argentina** currently is the most troubled debtor, **Mexico causes the greatest concern because it appears ready to take tough action on debt to achieve domestic economic goals.**

- -- **Brazil**, although facing serious domestic economic problems, is of less concern because it has **recently received new loans and renegotiated its repayment terms.**

- -- Argentina, Brazil, and Venezuela become more troublesome over the next year, however, as **populist presidential candidates are voted into office.**

MEXICO

President-elect Salinas has made the fight against **inflation his priority.** Under his behind-the-scenes guidance Mexico has experienced a **dramatic drop** in inflation through a program which **froze wages, prices, and the exchange rate.** This success has been costly, however:

- -- At home, **living standards** have fallen sharply--this year real wages have fallen 30 percent.

- -- Freezing the peso has caused it to become **overvalued,** combined with **political uncertainty,** this has fueled **capital flight** and depleted **foreign exchange reserves** at an alarming rate.

- -- Sharply **higher imports**--the result of an overvalued currency and a lowering of import restrictions--have combined with a **large fall in oil revenues** to produce a **current account swing of $6.5 billion**--from a surplus of nearly $4 billion last year to a deficit of $2.6 this year.

To stem the loss in foreign exchange reserves and compensate for falling oil prices while maintaining the anti-inflation program, Mexico City in early October obtained **$3.5 billion bridge loan** from the US Treasury.

-- At the time, reserves had fallen by $6 billion in five months. We believe they have now begun to **stabilize.**

-- Overestimating oil prices in 1989 budgetary assumptions will produce an unexpected shortfall of $2 to $2.5 billion.

-- These lost revenues add to a **budget deficit** whose size already **threatened to dash any permanent gains against inflation** once prices and wages are unfrozen.

-- In conjuction with US Treasury financing, Mexico City announced that it would cut spending by $260 million, accelerate privatization of state-owned enterprises, and borrow more from banks.

The large **budget and trade deficits** we expect in Mexico next year will keep the **pressure on to devalue** the peso.

-- Salinas could halt the run on the peso and boost nonoil export revenues by devaluing, but such action **risks a return to high inflation.**

-- A devaluation would prompt producers to raise their prices to compensate for higher import costs, while workers will demand higher wages to meet the price hikes.

-- These actions will combine with pent-up price pressures and budgetary overruns to send inflation soaring once again.

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Although the Treasury bridge loan and World Bank money are short-term palliatives, **Mexico believes it needs substantial resources**--either in the form of cuts in debt payments or new loans--to keep inflation down and achieve moderate (3 percent) growth.

If the economy doesn't grow sufficiently next year, which is likely, Salinas will take a **hard line** to secure the financing he believes Mexico needs. He will be pragmatic in his approach, however, and deal through US Government channels. **We do not believe Salinas has settled on a firm debt strategy.**

-- Preliminary position papers suggest a strategy to **tie debt payments directly to growth.**

-- Reliable sources say his father is pressuring him to **limit debt payments to a fixed percentage of export earnings.**

-- We think Salinas will strive to **avoid the complete moratorium** that some of his more radical advisors have advocated.

Mexico City will continue to act based its conviction that it enjoys a special relationship in Washington which gives it a competitive edge in negotiations with US policymakers.

ARGENTINA

Argentina is the most **troubled debtor**, in terms of the **new money** it is seeking, the money it already **owes**, and **domestic economic problems**. In the last few days, Argentine officials have promised they will take the macroeconomic steps that creditors and the IMF deem necessary, but there is little optimism that these measures will go far enough.

-- The country has managed to keep one step ahead of being declared in default by making **token interest payments.**

-- It is now enjoying a **financial respite** as a result of **higher grain prices** brought on by the drought, and **bankers want a piece of the windfall** in the form of past due interest payments.

-- Argentine wants **$3.5 billion in new money** for 1988 and 1989, as well as **interest rate concessions.**

Carlos Menem, the Peronist presidential candidate, has a **lock on the election** in May. His **widespread popularity** has allowed him to be **vague** on the issues, although most expect a return to **large social programs.** Banks **do not welcome his election**--Menem has advocated a **five year "negotiated moratorium"** on debt payments.

-- The country has made very little progress in making the structural economic reforms called for in the Baker Plan, and with Menem coming to office, most think **we have seen as much reform as we are likely to see for some time.**

-- Optimists hope that regardless of his philosophy, the depth of Argentina's economic problems will **force him to face up** to them. They are encouraged by the quality of his economic advisors.

BRAZIL

With a new money package in hand and a record trade surplus this year, **Brazil's is unlikely to have debt problems** for at least the next year. The government has turned its attention to its worsening domestic economic problems, especially **inflation** which is expected to rise to 900 percent this year.

-- The new loan packaged contains $5.2 billion and rescheduling. $4 billion already has been disbursed, and most has been used to clear interest payments that piled up during the moratorium.

-- The remaining $1.2 billion in loans is tied to IMF economic performance targets. The country will miss these targets by a large margin, but everyone expects the Fund to issue waivers.

President Sarney has his **hands full with economic problems** while his **hands are tied by the country's new Constitution.**

-- Workers have responded to **sharp losses** in living standards with **violent strikes.**

-- The recently announced **"Social Pact"**, similar to Mexico's, is **not likely to work:** business and labor will not sign on, and the government has not even done its part by cutting spending. Even **if Sarney agrees to make politically sensitive cuts, Congress may veto them.**

Preliminary analysis of municipal elections in Brazil suggest **presidential candidate Brizola will widen his lead.**

-- Brizola would likely take **radical action on debt** and has advocated nationalizing the banking system, cutting foreign investment, and restricting imports.

VENEZUELA

Venezuela has been the only major debtor to continue **paying both interest and principal. Low oil prices** now has the country in need of financial relief, however, and Venezuelan negotiators will seek a **grace period on principal payments** (standard for most other debtors) and some **$2.5 billion in new money.**

Similar to Argentina and Brazil, there is concern that Venezuela's next president, **Carlos Andres Perez** (CAP), will implement **populist policies** that will deepen the country's economic problems and jeopardize future debt payments.

-- As President from 1974 to 1979, CAP implemented **large social programs** which then were financable with oil dollars.

-- An ally of the Venezuelan worker, CAP has indicated he will **pursue similar policies, even though he will lack the oil dollars to finance them.**

Peru, Ecuador still not paying. Will they go to IMF? Columbia wants $1.85 billion, banks willing to lend $1.5. Will send signal because Columbia best credit risk. Chile doing ok, buying back debt, but how will political situation affect things?

State wants the US Government to sit down with the Group of 7 to discuss debt. Treasury is concerned about this, about being placed in a corner. They think the proper time will be later in the year. Treasury concerned about who will go to Salinas's inauguration, worried G-7 will raise debt issue.

REAL INTEREST RATES PAID BY SELECTED MAJOR DEBTORS, 1982–85[a]
(percent per year)

	1982	*1983*	*1984*	*1985*[b]	*Average*
Argentina	26.3	23.8	9.2	22.2	20.4
Brazil	22.2	19.6	8.9	17.1	16.9
Chile	33.8	8.9	15.8	13.9	18.1
Mexico	27.4	16.9	9.5	12.6	16.6
Nigeria	25.9	25.4	8.2	17.1	19.1
South Korea	14.0	12.5	5.3	12.1	10.9
Average	24.9	17.8	9.5	15.8[c]	17.0

SOURCE: World Bank and IMF Data Fund.

a. Real rates are nominal (money) rates adjusted by the country's export price index.

b. Estimate.

c. For all debtor countries, the World Bank estimates the 1985 real rates at 10 percent (oil-importing countries) and 12.5 percent (oil exporters), respectively.

EXTERNAL FINANCIAL FLOWS IN LATIN AMERICA
(billion dollars)

Year	*Net capital inflow (1)*	*Net payment of profits and interest (2)*	*Net financial transfer (3) = (1) − (2)*
1975	14.3	5.6	8.7
1976	17.9	6.8	11.1
1977	17.2	8.2	9.0
1978	26.2	10.2	16.0
1979	29.1	13.6	15.5
1980	29.4	17.9	11.5
1981	37.5	27.1	10.4
1982	20.0	38.7	−18.7
1983	3.2	34.3	−31.2
1984	9.2[b]	36.2	−27.0
1985	2.4[b]	35.3	−32.9
1986[a]	8.6[b]	30.7	−22.1

SOURCE: UN Economic Commission for Latin America and the Caribbean, *Preliminary Overview of the Latin American Economy 1986*, Santiago, 31 December 1986, table 14.

a. Preliminary estimates.

b. Includes both "voluntary" and "involuntary" lending.

 AND
ANALYTICAL SUPPORT

From the Desk of
the Director

14 November 1988

NOTE FOR: DCI

Judge Webster,

This morning Colin Powell asked the briefer to provide copies of the two attached memorandums which you had given to him, to Secretaries Shultz and Carlucci and the Vice President. The briefer will take them down tomorrow morning.

General Powell was told that a copy of the Transition Book would be delivered to him today.

Powell and the briefer discussed the article in the *Washington Times*, which I have attached for you. The briefer recalled that what the Vice President was quoted as having said was taken from a *Reader's Digest* item, and he told Powell that was the source for the quotation.

No other comments or questions came up this morning.

[redacted] STAT

Attachments:
As stated

Directorate of Intelligence

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7 November 1988

MEMORANDUM FOR THE RECORD

SUBJECT: New Credit Lines to the Soviet Union

1. In recent months Western banks have offered the USSR credit lines worth nearly $9 billion (see attached table). The bulk of the lines are to be tied to Soviet purchases of machinery and equipment for the production of consumer goods--not the direct import of consumer goods. Terms for the credits are sketchy at best since negotiations have not been completed--or even begun in earnest--for many of the lines. To date, only the West German and Italian lines have been signed. With the credits linked to projects, the payback periods reportedly will be lengthy--up to 8 1/2 years for purchases of plants. Interest rates will be determined at the time contracts are finalized. 25X1

2. Responding to recent demarches from the USG, the governments of those banks involved in negotiations offered assurances that there would be no subsidization of the credits and that OECD consensus guidelines would be followed. Government backing reportedly will be provided for the British and Italian lines, and possibly for others as the deals progress. This backing or "pure cover" is an agreement by the governments to insure domestic suppliers against the political and economic risks of exporting to the Soviet Union and does not involve direct credits, refinancing, or interest subsidies. 25X1

3. Despite the flurry of activity, there is little evidence to suggest that the USSR will make rapid use of these credit lines. Moscow would have little trouble repaying loans of this magnitude because of its healthy reserves of gold and liquid assets as well as potential export earnings, but the Soviet leadership continues to profess its aversion to a debt run-up to finance imports. Even a modest drawdown of these new credits would have a beneficial impact on the quantity and quality of Soviet consumer goods, albeit probably not for at least several years because of the time needed to bring the imported equipment on line. Moscow currently imports annually about $280 million per year of Western equipment for its food processing and light industries. A tripling of such purchases--consistent with the size of the credit lines--would increase total machinery investment in these industries by about 10 percent. The imports would afford the Soviet capabilities that their domestic industry cannot effectively provide--sophisticated leather tanning, textile finishing, and wool

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[redacted]

SUBJECT: New Credit Lines to the Soviet Union

processing equipment for production of clothing and shoes and equipment for processing and packaging fresh and frozen foods. [redacted] 25X1

4. The impact of the credits on other Soviet economic sectors is harder to gauge. Increased imports of western machinery would reduce at least slightly pressure for the Soviets to reallocate domestically produced machinery toward expanding production capacity for food and consumer goods. Soviet defense industry likely would be one of the beneficiaries, inasmuch as it is now being pressured to use its own resources to increase production of such machinery. The impact on defense, nonetheless, likely would be small.

-- On the one hand, the credits are not large enough to enable defense industry or any other sector to escape its obligations to the consumer program. Between now and 1995 the Soviets probably will invest the equivalent of about $80 billion in consumer and light industries. The credits will help, but most of the machinery will come from domestic resources and imports from Eastern Europe.

-- On the other hand, in the absence of the credits it is unlikely that defense would be tasked to make up the entire difference. The Soviets might not modernize the light and food industries on such a scale in the absence of the credits, and non-defense sectors--singled out for wasting investment--likely would share the increased burden. In the extreme, defense industry might be forced to use its own resources to increase annual investment in light and food industries by the equivalent of about $500 million per year, a very small share of total defense industrial output.

Finally, some of the domestic investment resources saved through using the credits would have to be devoted to ensuring that the Soviets would have the wherewithal to repay the credits. The Soviets are likely to continue to have to rely on exports of fuels--particularly oil--for the bulk of their hard currency earnings. Just maintaining current oil export capability will cost the Soviets the equivalent of tens of billions of dollars between now and 1995. The costs of increasing this capability to service new debt probably will continue to make the Soviets take a cautious approach in drawing down the new credit lines. [redacted] 25X1

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USSR: MAJOR NEW WESTERN CREDIT LINE OFFERINGS, 1988

COUNTRY/BANKS	VALUE/TERMS	PURPOSE
West Germany (Consortium led by Deutsche Bank)	$1.7 Billion. Maturity on credits up to 8 1/2 years. No fixed interest rates. Signed.	Machinery and equipment for food, leather, textile, and clothing industries.
Italy (Consortium led by state-ownded Mediocredito Centrale)	$775 Million. Maturity on credits up to 8 1/2 years. No fixed interest rates. Signed.	Machinery for light and food industries and related services.
United Kingdom (Consortium of banks including, Midlands, Lloyds, and Barclays)	$1.7 Billion. Multi-currency credit. Under Negotiation.	Machinery and equipment for modernizing hotels, airports, timber and food processing industries.
France (Consortium led by state-owned Credit Lyonnais)	$1.9 Billion. Under Negotiation.	Machinery and equipment consumer industries.
Japan	$2 Billion. Under Negotiation.	No details.
Canada	$500 Million. Under Negotiation.	Projects in energy and agricultural sectors.

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Central Intelligence Agency

Washington, D. C. 20505

DIRECTORATE OF INTELLIGENCE

NOVEMBER 1988

SOVIET DEPENDENCE ON IMPORTS FROM THE WEST: WHY THE NUMBERS BELIE THE RHETORIC

Moscow's much publicized concern over the need to rapidly modernize the economy and, more recently, to address consumer discontent has led many Western observers to assume that Gorbachev will have to turn to the West in a major way for economic and financial assistance. The recent spate of credit lines linked to imports of consumer goods have served to reinforce this theory. In reality, however, the Soviet Union has reduced its imports of Western capital and consumer goods and reduced the growth of real borrowing since Gorbachev came to power. Soviet preference for an indigenous solution to its problems and longstanding concern over becoming vulnerable to Western economic and financial sanctions, in fact, argues for a much more measured turn to the West.

This memorandum was prepared by the Economic Performance Division, Office of Soviet Analysis. Comments and questions are welcome and can be directed to Chief, Economic Performance Division, 25X1

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Perceptions and Reality

There has been substantial discussion both inside and outside the Soviet Union regarding Moscow's need for substantial imports of Western equipment, technology, and consumer products. Debates initially focused on the role of Western technology and equipment in Gorbachev's economic modernization program. They have subsequently broadened to include those consumer goods and services necessary to legitimatize Gorbachev's regime--and his program of *perestroyka*--among rank-and-file Soviets.

In Western circles, such discussions are often a critical element in the larger debate over the appropriateness of "helping" Gorbachev solve his domestic economic problems. Although there may be wide disagreement over what the West should or should not do in this regard, there seems to be a consensus within political and media circles that (a) Moscow will rely heavily on the West and that (b) the Alliance should take steps to ensure that it does not inadvertently provide Moscow with substantial economic and military dividends by competing for Soviet business.

Gorbachev and his economic brain trust have not discouraged Western perceptions of a Soviet need for massive inflows of Western equipment, technology, and consumer products. Economic imperatives aside, it serves Moscow's broader national security objectives to have Western governments "vested" in a positive outcome of the regime's economic and political reform efforts. Discussions of major "joint-venture" arrangements with Western firms contain elements of such vesting. This tactic seems most evident, however, in Moscow's recent successes in landing the official blessings of West European governments for the extension of large credit lines to underwrite Soviet purchases of equipment in support of domestic efforts to improve consumer welfare.

Western expectations of increased Soviet economic dependence, however, contrast sharply with actual Soviet behavior: trade and financial data demonstrate that, if anything, Moscow has become more autarchic under Gorbachev:

- -Once one discounts for exchange rate movements, net indebtedness has risen by only 16 percent since 1985; net real borrowing actually fell by $1.5 billion last year.

- -Soviet imports of Western capital goods have fallen in real terms since Gorbachev came to power; although attention has recently been given to establishing credit lines to underwrite future imports, there are no signs of a substantial upswing in actual orders. The 1989 Soviet Economic Plan, for its part, calls for a slight fall in total trade turnover.

- -The leadership cut back substantially on imports of consumer goods in response to falling export earnings, and imports have yet to return to pre-1985 levels despite the increased saliency of improved consumer welfare to the success of *perestroyka*. Austrian companies, for example, complain that sales of shoes and clothes to the Soviet Union--more than $100 million in 1984--have almost evaporated.

Understanding Soviet Behavior: Past Lessons...

Moscow's reluctance to turn to the West for help is better understood when one considers the nature of economic problems facing the Soviet leadership and the broader implications of economic integration for Soviet national security objectives.

The leadership has undoubtedly drawn a number of sharp lessons from Brezhnev's experience in the mid-to-late 1970s:

-The emphasis on Western technology and equipment as a means of stimulating and leading economic modernization did not live up to its advance billing. While certain sectors--petrochemicals, automobiles--benefited from Western assistance, the overall record reveals a pattern of equipment and technology purchases which were either inappropriate to begin with, never properly installed or--even in the best of circumstances--utilized effectively.

-Expanded trade with the West paid political dividends by engendering potentially divisive competition within the Alliance for Soviet business, both in terms of heavily subsidized credits and pressures to relax COCOM guidelines. At the same time, the subsequent application of economic sanctions to modify Soviet domestic and foreign policy initiatives made the cost of economic dependency abundantly clear to Brezhnev and his successors.

The leadership has paid close attention to the economic and political problems faced by those East European countries that were unable to make good on the gamble of using Western equipment and technology to jack up economic performance to a higher plane:

-While some improvements occurred, the East European experience demonstrated that the sought-after technological and economic gains simply could not be achieved within an economic environment characterized by central plans and administrative economic decisionmaking.

-The price for this failure --economic austerity at home and a pronounced dependency on the goodwill of Western lenders--is still being paid. In some cases, it is at the heart of political dissatisfaction within Eastern Europe.

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-Soviet concern with avoiding similar mistakes is captured in a recent interview by the Soviet minister of Light Industry, who stated that Moscow had decided "categorically" against instant gratification. *"That path has no future in it...and the Soviet Union will never be able to get out of [such a] dependence on buying."*

... and Current Realities

Gorbachev's economic advisers also recognize the potential gains from increased use of Western technology and equipment, but they lack the confidence in the ability of the economy--as currently configured--to effectively absorb and ultimately diffuse imported technology on a large scale. They are specifically sensitive to the incongruence between the present set of administrative rules and incentives currently governing enterprise performance and the competitive economic environment--price flexibility, decentralized decisionmaking, competition for sales--needed if the USSR is to effectively draw on Western technology and equipment:

-Firms currently lack the ability to bid for domestic resources or otherwise elicit timely domestic machine builder response to their particular requirements. As a result, enterprises have a distinct bias toward imported equipment --which can be tailored to individual specifications and delivered on a timely basis--even when the same or similar equipment is produced domestically.

-Firms currently are not held fully accountable for the effectiveness of their import decisions. In the absence of an incentive structure to reward proper choices and effective absorption or, conversely, to penalize those who pay little attention to what is purchased and how and when it is installed, there is little guarantee that scarce foreign exchange will be well spent.

Steps have been taken to facilitate direct contacts between Soviet enterprises and Western equipment suppliers and to properly reward effective decisionmaking. *At present, however, Soviet enterprise managers are faced with the worst of all worlds: the old rules governing the selection and purchase of imported equipment have been remanded for many enterprises and ministries, but Moscow has yet to fully develop the sets of procedures to take their place.* This confusion, combined with the uncertainties regarding the implications of imported equipment for self-financing, product pricing, and the generation of hard currency export earnings, may well have resulted in an aggregate decline in enterprise demand for imported equipment. While some of this decline is entirely appropriate for the reasons cited above, enterprise confusion has probably resulted in a suboptimal level of equipment imports over the near term.

Import demand is also constrained by Soviet financial conservatism. This leadership, like those before it, is sensitive to the national security implications of becoming financially overextended. A number of leading Soviets have been particularly explicit on the need to avoid any semblance of dependence on Western financial markets to meet domestic economic imperatives. Any Soviets who doubt the rationale behind this line of argument need only look at the experience of Eastern Europe, the past imposition of economic sanctions, and the persistence of those who seek to monitor and condition credit flows. *This conservatism--manifest in a low level of indebtedness, a substantial "strategic reserve" of gold, and a high level of liquid asset holdings in Western banks--argues against a rapid rise in borrowing unless the ability to repay this debt is fully guaranteed.*

In this regard, the situation facing Moscow in 1988 is far different from the USSR's position in the early-to-mid 1970s, when the Soviets allowed their debt to the West to increase substantially:

-Brezhnev's economic advisers were confident of the Soviet ability to repay a significantly higher level of debt with higher priced oil and other natural resources. In 1988, in contrast, Moscow must contend with stable or declining oil prices and uncertainties over the quantity of oil which will be available for export. The leadership is painfully aware, moreover, that substantial hard currency sales of manufactured goods are not in the cards for the foreseeable future.

-Much of the debt runup in the 1970s was formally tied to Western agreements to purchase Soviet raw materials, notably Siberian natural gas, coal, and wood products. In all cases, the flow of hard currency earnings far exceeded project-associated hard currency expenditures, guaranteeing the Soviets an increase in hard currency import capacity. Although similar deals cannot be ruled out in the 1990s, there are few indications that this option is being heavily pushed.

On the other side of the ledger, Western capital markets are far more developed and the Soviets more sophisticated in tapping them. Initiatives such as bond issues allow Moscow to expand its borrowing before running up against portfolio constraints and otherwise reducing access to additional funds and/or raising the cost of future borrowing. Soviet pragmatists would contend, however, that current conditions only serve to allow Moscow to get into bigger trouble faster.

Gorbachev's Current Initiatives

Soviet emphasis on concluding joint ventures with Western firms reflects these concerns and limitations. The deals, by forcing long-term Western involvement in enterprise decisionmaking and productive efficiency:

-Improve the likelihood for effective Soviet absorption of Western equipment and know-how.

-Increase the chances for increased manufactured goods exports to the Developed West.

-Minimize the drain on scarce hard currency by virtue of Western capital participation and agreements to repatriate profits in the form of products.

The saliency of joint ventures to the leadership's economic agenda is seen in the regime's willingness to bend or change the rules in order to attract Western investors to priority projects. Alternatively, their inability to resolve issues pertinent to the joint venture's access to raw materials and intermediate products and the ability to develop a pricing strategy, hire and fire employees, and repatriate profits in dollars highlights the economic barriers to economywide modernization using foreign investment.

Soviet interest in international organizations such as GATT and the IMF has strong political overtones in signaling Soviet intentions to become a full member of the international economic and financial community. From an economic perspective, links with these organizations would improve foreign trade and financing decisionmaking and otherwise provide the framework for expanded exports of manufactured goods over the long term:

-Moscow is probably most interested in becoming a party to GATT rules and negotiations. Moscow's cooperation agreement with the European Community also reflects the desire to develop a better understanding of potential export opportunities.

-Discussions with the IMF and the World Bank are far more exploratory in nature. More than likely, the USSR is interested in developing a detailed appreciation of the costs and benefits of membership before making any formal approaches: there is no financial need to link up with the IMF at this time.

Beyond joint ventures and a new interest in international trade and financial organizations, however, Moscow's turn to the West is more show than go. By all indications, there is no leadership consensus supporting a major turn to the West at this time. Emphasis continues to be placed on domestic solutions in the belief that substantial increases in the quality and quantity of civilian products--both producer durables and consumer goods--will evolve from the implementation of ongoing programs to:

-Draw on the expertise and productive base of the defense sector.

-Reduce the barriers to the effective development and application of Soviet-designed production and process technologies.

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-Decentralize enterprise decisionmaking and otherwise allow for increased enterprise control over the quality and quantity of inputs it receives.

-Alter the structure of incentives to better reward efficient enterprises and productive employees.

-Increase the supply of consumer goods and services by allowing for greater privatization of economic activity.

Its own reservations regarding the utility of relying more on imports notwithstanding, Moscow has not belittled the belief among Western governments that Western support for perestroyka *can be a profitable business.* In a move somewhat reminiscent of the mid-1970s, Soviet negotiators are concluding a number of major credit agreements with Western bank consortia, explicitly blessed by West European governments, to underwrite future Soviet purchases of Western technology and equipment for the USSR consumer goods sector.

Credit Lines Extended to the USSR

	Secured: April 1974-March 1976 $Millions	Currently Signed or Under Negotiation $Millions
Austria	$ 304	—
Canada	$ 487	$ 500
France	$ 3,095	$ 1,900
Italy	$ 1,917	$ 775
Japan	$ 1,648	$ 2,000
UK	$ 2,270	$ 1,700
FRG	$ 1,334	$ 1,700

While Moscow could well be lining up credit lines now to permit more flexibility in resource allocation decisions pertinent to the next five-year plan, the spate of activity, size of the lines, and their explicit and highly publicized link to improving consumer welfare indicate the presence of a political agenda as well:

-There is no indication that Moscow is prepared to move quickly to place equipment orders against these credit lines.

-Unlike the credit lines of the mid-1970s, when credit competition among Western governments led to substantial interest rate subsidies, the recently concluded lines do not offer preferential financing (outside of the slight interest rate savings from the presence of government political and economic risk guarantees) or otherwise materially broaden the potential base for Soviet borrowing.

The Soviet initiative comes at a time of Congressional and Executive Branch consideration of the propriety of restricting or monitoring credit flows to the USSR. Within this context, Moscow--in lining up large credit lines backed by Western political leaders--may have sought to steal a march on any attempt by the US to develop an Alliance-wide consensus on the credit issue. More broadly, Moscow undoubtedly sought to use the credit issue to promote official Western support to Gorbachev's program of economic and social revitalization to the betterment of its larger foreign policy and national security objectives.

And the Road Not Taken

Gorbachev may ultimately be forced to turn to the West for help in transposing the Soviet economy and may buy time in the interim with substantial inflows of consumer goods. Such a decision would quickly become evident to Western analysts by virtue of the media attention to the signing of specific contracts and the like. This option, however, holds dangers that Gorbachev's predecessors did not have to face, making the choice much harder this time around. In many ways it would be a clear sign of leadership desperation:

-Unlike the situation in 1970s, there is no guarantee that Moscow will be able to repay a marked increase in hard currency indebtedness. Barring export increases, the USSR would have to continually increase the level of annual borrowings if it were to maintain a flow of imported goods while servicing an ever-growing debt. It would be only a matter of years before the Soviet leadership would find itself potentially vulnerable to Western economic and political leverage.

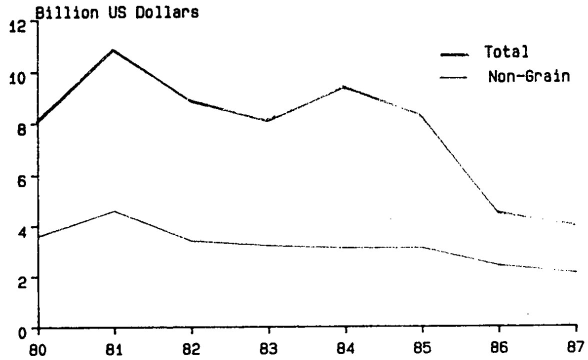
-Western firms will want a significantly greater managerial involvement and Western physical presence within the Soviet Union as part of any agreements which meet Gorbachev's demands for Western technology and managerial know-how.

-Unlike the 1970s--when the Soviet leadership viewed expanded trade as a means of complementing a basically sound economic structure--turning to the West this time around will be perceived as a sign that the regime is incapable of fixing its economic problems on its own.

SOVIET CONSERVATISM IS SEEN IN THE DECISIONS TO...

reduce imports, ...

Hard Currency Imports of Consumer Goods, 1980-87



Orders of Western Machinery and Equipment 1985-88

...rather than increase debt.

Estimated Change in Gross Debt

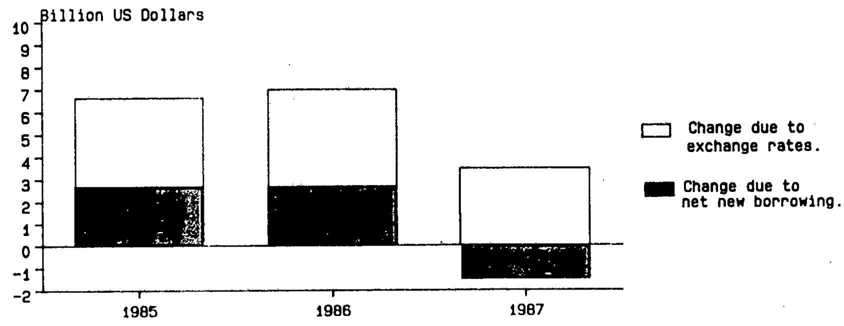


Photo by Stephen Crowley/The Washington Times

...ack Jamie Morris during first half action in RFK Stadium ...ense sent the Redskins down to defeat, 34-14. Story B1.

SPECIAL TO THE WASHINGTON TIMES

JERUSALEM — Prime Minister Yitzhak Shamir of the right-wing Likud bloc last night won the chance to form Israel's next government.

Two ultra-Orthodox parties, Shas and Agudat Israel, gave Mr. Shamir their support after he promised — in writing — to gain passage of a law that recognizes only Orthodox conversions to Judaism as the basis for Israeli citizenship. The law now accepts conversions performed by Reform or Conservative rabbis outside of Israel.

Shas and Agudat Israel told President Chaim Herzog yesterday that Mr. Shamir was their choice to form the ruling coalition. That gave Mr. Shamir the support of at least 63 members of the newly elected Knesset, Israel's parliament, against only 55 who support Shimon Peres of the Labor Party.

Under Israeli law, the president is obliged to empower the political leader who has the most support to try to form the government.

The decision by the ultra-Orthodox parties means that Mr. Shamir has first crack at forming the next government. But difficult coalition negotiations still remain — negotiations in which he will have to ...rties that would make up his government.

Reuters

Prime Minister Yitzhak Shamir will begin to form Israeli government.

Mr. Shamir will have 21 days to do that, with an extension of 21 days if he requests it.

If Mr. Shamir's coalition negotiations with the Orthodox parties should prove too difficult, he could still opt for such a coalition with Labor — a coalition that could lead to new elections within a year, under a new system.

The results of Israel's Nov. 1 election gave the four Orthodox parties 18 seats and, through them, the power to determine whether the Likud or Labor would form the next government.

All four demanded from the start that the next Knesset amend the Law of the Return, which grants automatic Israeli citizenship to any Jew who settles here.

That law now defines a Jew as one who is "born of a Jewish mother or who converts to Judaism."

A handful of immigrants to Israel have been converts who went

see SHAMIR, page A10

...dge ...viets

...port by a task force ...cience Board, which ...owers on both basic ...ch and the technol... ...ployed weapons sys...

... spending an esti... ...ion more than the ...lly on research and ...e gaining qualitative ...optical devices, di... ...chnology such as la... ...ear warheads, sur... ...les, tanks, anti-tank guided missiles and naval cruise missiles, the 85-page study said.

The science board, the Pentagon's internal think tank on technological issues, said that the U.S. lead is slipping in eight out of 15 basic-technology areas where it enjoys an edge, including radar sensors, submarine detection, high-tech materials and biotechnology.

In deployed hardware, the board found only one of 31 major weapon types — strategic cruise missiles — where the trend is toward U.S. superiority.

Among the weapons systems where the United States is losing its clear advantage to the Soviets are submarine-launched missiles, bombers, attack helicopters, jet fighters, attack submarines, surveil-

see EDGE, page A9

Bush, unlike Powell, frets over untied loans to Soviets

By David R. Sands
THE WASHINGTON TIMES

Vice President George Bush's remarks last week on Western lending to the Soviet Union suggest the president-elect may be leaning toward a stricter policy than the current administration.

Contradictory statements by Mr. Bush and National Security Adviser Colin Powell last week also underline the continuing internal debate on the issue among policy-makers in the outgoing administration.

On the day that a French newspaper was publishing an interview with Mr. Bush in which he said, "We don't want to see untied credits being given to the Soviets at this point in time," National Security Adviser Colin Powell told a group of investors meeting in Washington that, to date, such lending is not a security concern for the U.S. government.

Mr. Bush, in using the term "untied credits," was referring to loans not linked to any specific deal or venture.

Commenting upon a proposal that banks in the United States and other Western countries restrict general-purpose lending to the East bloc, Mr. Powell said, "Absent a national emergency, we believe such controls would be counterproductive and less likely to achieve intended results than direct controls on goods."

The confusion appears genuine, in that the Reagan administration is

see BUSH, page A9

PLO leaders

...agenda," Mr. Foley said yesterday, appearing on CNN's "Newsmaker Sunday."

Mr. Rollins said the incoming president's relationship with Congress also will be determined by what issues are at stake. In general, Mr. Bush is likely to enjoy much more leeway on foreign policy, including arms control talks with the ...

... Devine, another GOP consultant who was close to the Bush ...

... irony is, that if the moderates and conservatives among the Democrats prevail, it will be good for Bush in terms of his ability to lead the nation in the short run but bad for the Republican party in the long run.

"If the Sam Nunns and Chuck Robbs win the power struggle and ...

... difficult balancing act among a variety of members who are pretty ...

... Tony Coelho [the liberal congressman and majority whip from California] isn't going to change his philosophy just because the Democrats got beat five of the last six times for the presidency," he said.

Another unknown element in the relationship between Mr. Bush and the new Congress is who will be...

... if Mr. Bush and Congress can't find a way to pay off the ...

"There's no question revenues must be a part of it," Mr. Johnston said. "That's not a question of philosophy. That's a question of mathematics."

Mr. Foley said Congress will not initiate a tax increase without Mr. Bush's full agreement.

"I'm absolutely certain that you ...

Mr. Foley said he believes Mr. Bush will try to compromise on the ... deficit and other key issues because he is a "pragmatist, interested in solving problems."

Sen. Richard Lugar, Indiana Republican, agreed that Mr. Bush is not likely to engage in confrontational politics.

"George Bush in my judgment has always been a consensus figure," Mr. Lugar said on CNN. "I don't see a provocative bomb-thrower there."

...EFENSE

...echnology level

...rior	U.S./Soviets equal	Soviets superior
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BUSH

From page A1

internally divided over how to deal with the question of trade and lending to the Soviet Union and its allies.

"The administration has clearly been schizo on this one," said one congressional aide who monitors the issue.

In one corner are proponents of Western lending and trade with the East bloc, primarily in the State, Commerce and Treasury departments. Opposing them are those who fear the consequences of increased commerce with the Soviet Union, including many Defense Department officials supported by a number of members of Congress.

Mr. Bush, in an interview published Tuesday in the French newspaper Le Figaro, appeared to be taking a stand with those suspicious of increased general-purpose Western bank lending to the Soviet Union, which the Bank for International Settlements put at $8.4 billion (adjusted for exchange-rate fluctuations) from 1985 through 1987.

"We want to put Gorbachev in a position where he has to make hard choices and pull back from defense spending. That is supposed to be one of the hallmarks of perestroika. If we give him enough money, without stipulating how he is to spend it, we make it possible for him to avoid making this fundamental decision,"

WESTERN BANK LENDING PATTERNS 1983-88

Syndicated loans to the Soviet Union, in millions of dollars

	1983	1984	1985	1986	1987	May 1988
Total	2,381.0	263.1	801.4	1,763.7	1,587.3	814.2
Untied	222.6	708.8	1,443.3	1,596.7	1,235.4	150.0
Tied	40.5	92.6	320.4	615.9	351.9	664.2
			Percentage			
Total	100	100	100	100	100	100
Untied	85	88	82	72	70	18
Tied	15	12	18	28	30	82

Source: Report of the Special Interagency Task Force on Western Lending to the Soviet Bloc, Vietnam, Libya, Cuba and Nicaragua. Table figures do not include loans to Soviet-owned banks in the West.

Chart by Greg Groesch / The Washington Times

Mr. Bush was quoted as saying.

"So we don't want untied loans or credits," he added.

Mr. Bush or his spokesman could not be reached for comment, but opponents of current Western lending practices with the East bloc have moved quickly to pin the incoming administration down on the question of untied credits and loans.

Sen. Steve Symms, Idaho Republican, immediately hailed the Bush remarks printed in Le Figaro as "an important policy change from the previous Reagan administration position.

"I am delighted to see him take the leadership on this," the senator said.

Dennis Ross, a foreign-policy adviser on the Bush transition team, further indicated that policy may shift. Mr. Ross said Friday in the Wall Street Journal that untied credits "subsidize" the Soviet military establishment.

Adding to last week's controversy was the release of an interagency task force on Western lending practices drafted by the Treasury Department and containing input from the departments of State, Commerce and Defense and the Central Intelligence Agency.

While taking a generally benign view of Western lending to the Soviet bloc to date, the report supplies ammunition for both sides.

The report puts the growth of Soviet bloc gross debt to Western banks and other lenders at 14 percent from the end of 1981 to the end of 1986. Growth is calculated using constant exchange rates. Net debt — gross debt minus deposits — is shown to have fallen by $1 billion, or 1.4 percent.

Lines of credit extended by European and Japanese banks to the Soviet Union in the past few months have totaled between $5 billion and $6 billion, and 82 percent of the syndicated loans made to the Soviet Union in the first five months of 1988 were tied to specific projects and ventures, according to the report.

But the report also notes that the ratio of untied to tied loans in 1988 is very different from what it was the previous five years. Over the period 1983 to 1987, untied Western syndicated loans made up an average of 80 percent of all loans made.

Private critics of the interagency report say that the sudden reversal in the figures results from the fact that the U.S. government chooses to believe its European and Japanese trading partners when they claim that the new lines of credit are tied to specific projects.

"The fact is, established lending techniques which could ensure that these new loans are indeed tied to specific trade transactions are not being fully employed," said Roger W. Robinson, a former National Security Council senior director and president of a private international economic consulting firm in Washington.

MANILA

From page A1

sion that it was confirmed, but I could be wrong. Is it Oxford? Is it the ...

THE THRIFT CRISIS

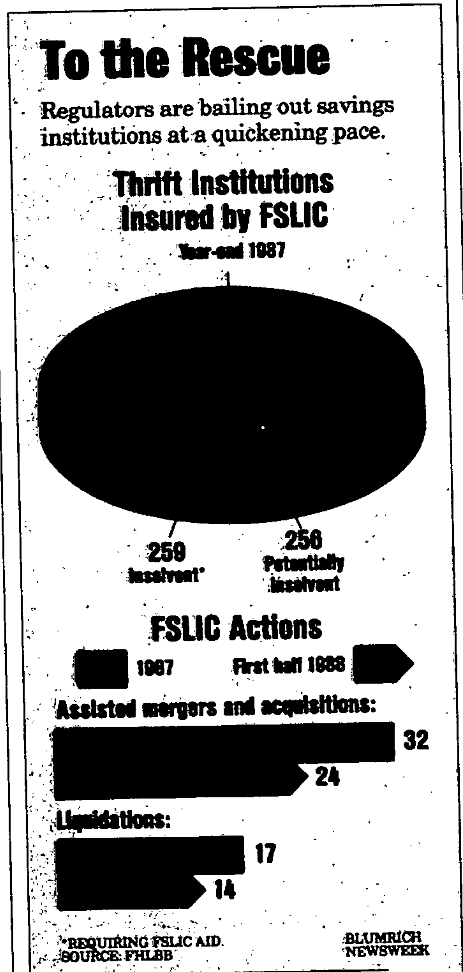
Going for Broke

How many more troubled S&L's can the Feds fix before they need a big bailout of their own?

This could be the stuff of financial panic. Every week or so, somewhere in the nation, another troubled savings and loan association is either liquidated or taken over by a stronger institution. Remarkably, American savers seem to be taking it all in stride. When federal regulators closed down American Diversified Savings Bank and North America Savings and Loan Association in southern California last week, depositors simply reclaimed $1.35 billion of their money—the largest cash payoff in U.S. banking history. Depositor Joan Steen, a Huntington Beach marketing consultant, got to her thrift 45 minutes before its 9 a.m. opening; by 9:45 she was on her way out with a check for $90,000 tucked in her purse. "I chuckled to myself about it," she says. "They were not only validating parking tickets, they were also serving coffee and doughnuts."

Savers can afford to be calm, since accounts of up to $100,000 are guaranteed by the federal government. The nervous flutters are felt at the thrifts themselves and at the Federal Home Loan Bank Board, which regulates them. About one in six of the country's more than 3,100 thrifts is technically insolvent and about one in three is losing money. The losses are huge: a total of $13.4 billion in red ink was spilled in 1987, more than double the $6.6 billion in earnings reported by the profitable S&L's.

Many of the losers have little hope of ever recovering their health—experts refer to them as the "walking dead." That's especially true in Texas, where a number of thrifts were run into the ground by inept or even crooked operators who got rich on questionable schemes (page 42). Nationwide, the plight of the S&L's will get still worse if forecasts of rising interest rates and then a recession in 1989 come true. The only solution for most of these shaky thrifts is a government takeover. But current bailout funds, provided by the Federal Savings and Loan Insurance Corp., may be far from adequate. And while they struggle to survive, the troubled thrifts continue to lose money. "The problems in the S&L industry haven't been this widespread since the 1930s," says Wall Street analyst Henry Peltz of Keefe, Bruyette & Woods.



Moneyman: FHLBB's Wall

ARTHUR GRACE—NEWSWEEK

In the case of the two California thrifts that failed last week, FSLIC is paying $1.1 billion to American Diversified's depositors and an additional $209 million to North America's. (Regulators hope to reduce their total losses to $931 million through the sale of the thrifts' assets.) The two institutions, which shared the same sleek office building in Costa Mesa, Calif., typify much of what has gone wrong in the savings business: inexperienced management, freewheeling investment policies and overblown interest rates.

American Diversified was run by Ranbir Sahni, a former pilot in the Indian Air Force. North America was owned by Duayne Christensen, a dentist. Both thrifts solicited deposits by telephone, offering interest rates of more than 8.5 percent as a lure. FSLIC took over American Diversified in 1986, accusing Sahni of mismanagement; he denied the charges and said the government didn't understand his strategy. Among Sahni's investments: wind farms and ethanol plants. At one point, the bank board declared 98 percent of North America's loans were bad; when regulators took over in 1987, Christensen was killed in a car crash the same day. FSLIC is now seeking a fraud judgment against his estate and a former associate (who denies the charges).

'Ponzi scheme': Blame for the crisis may lie partly with Congress. In 1982 it deregulated thrifts, letting them diversify beyond the home-mortgage business. The move seemed reasonable: the thrifts were in trouble then because the interest they paid to attract deposits exceeded what they were earning on their mortgages. In theory, income from other types of business would put them back in the black. The states deregulated, too, notably Texas and California, where most of the failures are concentrated. In Texas the situation was exacerbated by the plight of the oil industry: when the price of oil plummeted, taking real estate with it, many Texas S&L's were stuck hopelessly in the red.

Last year Congress tried again, authorizing FSLIC to sell $10.8 billion in new bonds to renew the rescue fund. It wasn't enough. Without adequate cash to liquidate losers or get them in shape for a sale or merger, FSLIC had no choice but to take over thrifts or leave them in the hands of the same managers who led them astray. And thanks to federal deposit insurance, even

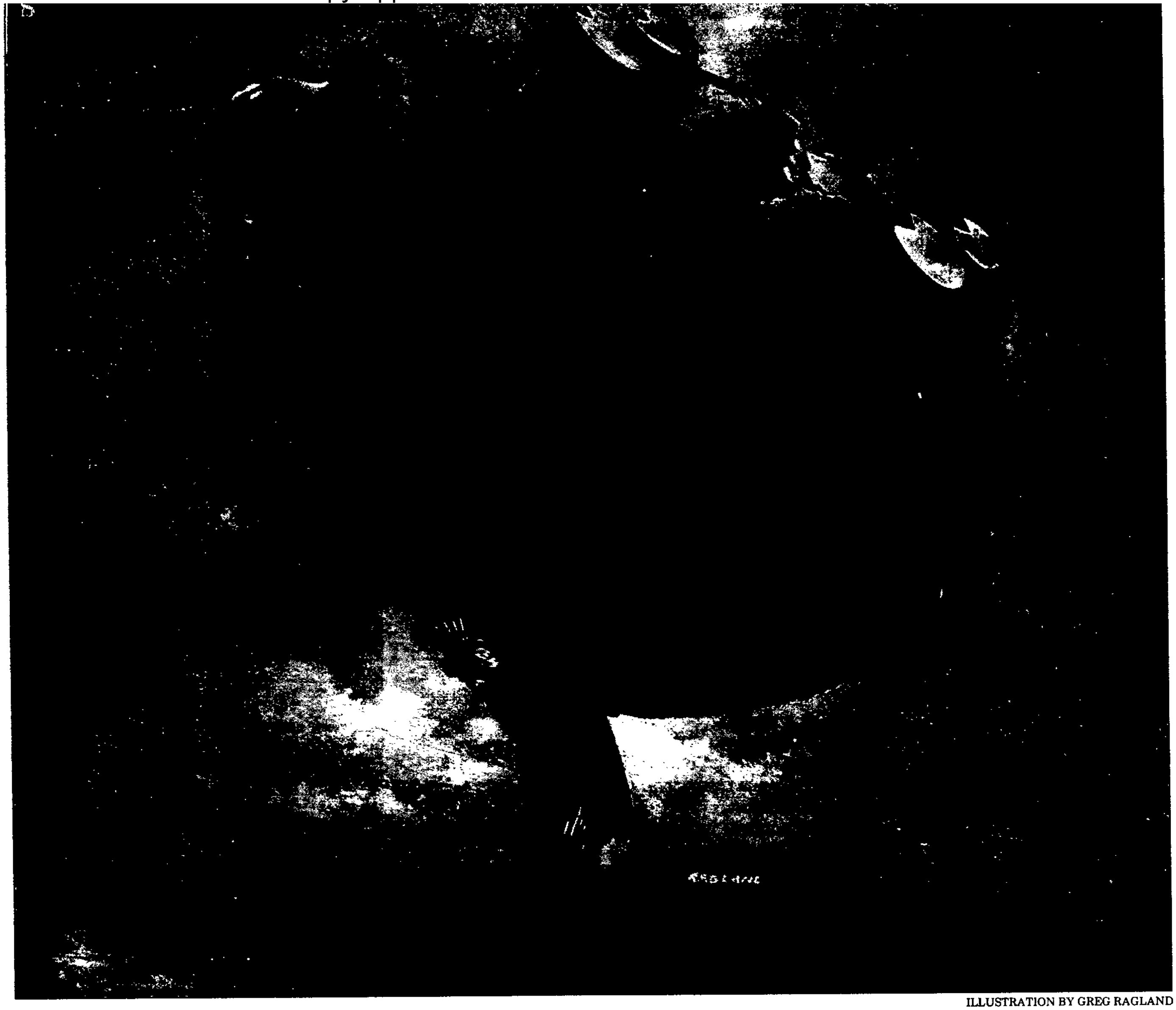


ILLUSTRATION BY GREG RAGLAND

the worst losers usually managed to stay afloat by offering higher interest rates than solvent thrifts did. Crafty savers knew the lofty rates reflected financial weakness, but they also knew that each account was guaranteed by the government. Analyst Bert Ely says some S&L's are running, in effect, "a government-sanctioned Ponzi scheme," soliciting new deposits to pay interest on existing ones.

Joan Steen was one of these "rate chasers." Her account at North America was earning about 1 percentage point more than average, but then she switched to American Diversified last month to get a still better rate. John Woolley, an Orange County Superior Court judge, was playing the same game on behalf of his 73-year-old mother. "She lives off the interest, so you try to get the most you can," he says. "Anybody would."

The regulators are helpless to stop thrift failures unless they can raise enough money. Unfortunately, nobody really knows how much is needed. FSLIC appears to have sufficient funds to dispose of the 259 "hopelessly insolvent" thrifts on its books, a job expected to cost $17.4 billion. But whether it can handle the other 256 thrifts likely to fall into its lap is another question. FSLIC says the second tier of cases can be settled for $5.3 billion (the thrifts in deepest trouble are being dealt with first, so the second phase will cost less). FHLBB chairman M. Danny Wall says "There is no question we have the resources" to deal with all the problem thrifts by the end of 1991.

Huge shortfall: The General Accounting Office, however, claims the second phase might cost as much as $19 billion. Among other things, GAO says the insurance agency overestimated its revenues, which are based in part on S&L deposits. FSLIC says deposits will rise at their historic rate of 7 percent a year, even though growth has missed that mark in each of the past three years. GAO also says that FSLIC underestimates the number of thrifts it will have to liquidate. Eugene Sherman, chief economist for the Federal Home Loan Bank Board of New York, says the shortfall could run anywhere from $10 billion to $25 billion.

Alarmed by that crushing load, some analysts suggest that FSLIC boost the rescue kitty by merging with the Federal Deposit Insurance Corp., which insures accounts at commercial banks. That strikes most experts as being basically unfair and unworkable, however. Banks, too, are now failing at a higher rate than at any time since the Depression, thanks to iffy Third World and commercial real-estate loans, and the FDIC may not have much money to spare. Who will pay for the S&L bailout? "It is ultimately going to have to come from the taxpayer," says Sherman. "There's no way around it." But Washington wants to cut federal spending, not increase it. Key congressional figures now admit more help is needed, but the problem is so sticky it probably will be passed on to the next administration and Congress. Meanwhile, the cost of saving the S&L's keeps rising—just like compound interest.

DAVID PAULY *with* MARK MILLER *in Washington,* CAROLYN FRIDAY *in New York,* HARRY HURT III *in Los Angeles and bureau reports*

ROBERT J. SAMUELSON

Bailing Out the Thrifts

The taxpayers may ultimately have to pick up the tab—and it could cost billions

Some years ago I interviewed a Dallas businessman named Ira Corn Jr. He was immense: he weighed 300 pounds, if he weighed an ounce. He smoked a huge cigar and, in general, was the picture of a tycoon. This was back when Texas was booming, and I asked: what made the Texas economy grow? After listing some obvious reasons—oil and gas, low taxes—Corn got to the point. Credit, he said. People were more relaxed than in the East. Banks loved to lend, businesses loved to borrow. Easy credit was great. "You go where you can borrow—where people [banks] lend on people not on assets," he said.

The story comes to mind now (Corn died in 1982) because the Texan passion for easy credit has reached its logical, if destructive, conclusion. A sizable part of the federally insured savings and loan industry is bankrupt, and the greatest concentration is in Texas. The thrift insolvencies could cost taxpayers billions of dollars. No depositor at an insured thrift will lose a penny up to $100,000. But that's the problem. Because deposits are insured, taxpayers may end up absorbing some of the industry's huge losses.

How huge? No one really knows. Bert Ely, a financial consultant, thinks they exceed $50 billion and are still growing. R. Dan Brumbaugh Jr., a former top economist of the Federal Home Loan Bank Board—which regulates thrifts—guesses about $45 billion. The Bank Board estimates its costs between $22 billion and $29 billion. The upper limit roughly equals the projected reserves of the Federal Savings and Loan Insurance Corp. (FSLIC) through 1990. If the costs top that, the board would need more money from Congress.

The scandal is that no one, aside from the experts and officials directly involved, is paying much attention. Let me make a small confession: back in 1985, Ely called me and we had lunch. He forecast a FSLIC crisis. Thrift losses were mounting, and FSLIC would exhaust its reserves. His predictions sounded alarmist. The economy was improving. Why shouldn't the thrifts' health improve? I dismissed his warnings. Boy, was that a mistake.

It's a mistake that others still make. The general attitude in Congress is: hear no evil, see no evil, do no evil. Congress has replenished FSLIC's reserves with "off budget" funds so that the official budget deficits won't grow. But action has been slow, and the amounts—compared with the problem—have been insufficient. Brumbaugh, Ely and other analysts think FSLIC now doesn't have enough manpower or money to close down all the bankrupt thrifts it should. So it tolerates ongoing losses that will inflate the final cost.

The problem isn't located exclusively in Texas, but without Texas it would be more manageable. Consider some numbers. At the end of 1987, the nation had 3,147 federally insured thrifts with assets of $1,252 billion. Of these, about 510, with $145 billion in assets, are insolvent under generally accepted accounting principles. Insolvent means that their assets (mainly loans) are worth less than their liabilities (mainly deposits). About 126 of these insolvent thrifts, with $48 billion in assets, are in Texas.

What happened? Well, the Texas economy collapsed. Many buildings planned on the basis of permanently high oil prices and rapid growth are simply unneeded. But the gluts of office towers, shopping centers and condominiums reflect more than naive optimism. Generous tax write-offs for real estate passed by Congress in 1981 (and since reduced) fed the speculative frenzy. So did deregulation of savings associations, which freed thrifts from investing most of their funds in residential housing.

What shrewd operators found in thrifts was an ultimate source of easy credit. Because federal insurance protected depositors from losses, a thrift could attract all the money it wanted by offering above-average interest rates on its accounts. The money could then be re-lent for speculative projects. If they went bust, the government would pick up the tab. Developers (often allied with thrift owners) would already have earned fees. Some stories are astonishing. At one insolvent Texas thrift, 96 percent of the loans were delinquent. Since 1982 the loans had grown by more than 1,000 percent, to $1.3 billion.

More problems? It's hard to estimate the thrift industry's total losses for two reasons. First, no one knows the value of the buildings underlying many soured loans. The gluts in Texas are enormous. In Houston the office-vacancy rate is 32 percent. Are projects worth 70 cents on the dollar or 40 cents? Second, some thrifts—in Texas and elsewhere—that are reported solvent by normal accounting practices may not be. Loans haven't yet been written down to reflect their true value. Ely thinks 300 more thrifts may be insolvent.

This is a story of greed, stupidity, bungled regulation and, in some cases, criminality. (Yes, executives of some plundered thrifts are being investigated. The allegations involve kickbacks, phony land sales and false financial reporting.) It would be funny if the potential price tag for taxpayers weren't so steep. The tale would also be more satisfying if it could be fitted with a happy ending. Unfortunately, there isn't any quick solution. One suggestion is to bail out the FSLIC by merging it with the healthier Federal Deposit Insurance Corp., which insures commercial bank deposits. At most, this would be a stopgap because the FDIC faces its own mounting losses—many at Texas banks with their own bad real-estate loans.

Put simply, this mess is likely to be around for a while. The trick is to clean it up at the lowest possible cost. The Bank Board is moving more rapidly, but the pace is slow. A plan to reorganize the Texas thrifts has yet to produce any results. If Ely and Brumbaugh are correct, the delays will raise total costs. It may be necessary to spend more now—on Bank Board staff, on money to pay off depositors—to minimize costs later. But Congress prefers to put off the problem in hope that, somehow, it will go away.

The whole affair has an air of unreality. Suppose tomorrow someone proposed spending $10 billion or $15 billion more for schools or the war on drugs. Everyone might applaud the goals, while saying that the price tag was unrealistically high. By inaction, Congress may be making an equivalent commitment to cover the thrift industry's losses. This is not government by choice, but by abdication.

On a Wing And a Payoff

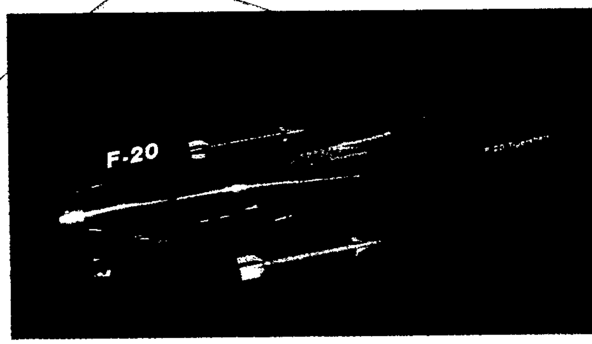
Northrop faces an F-20 probe

In 1984 Northrop, the Los Angeles–based defense contractor, turned over $6.25 million to a company that was not a usual supplier. The money, which was ostensibly intended to finance the construction of a hotel in Seoul, went into the Hong Kong bank account of a firm controlled by Park Chong Kyu, a former South Korean general and owner of a Seoul night spot called the Safari Club.

But the hotel was never built, and Congress and the Korean government are investigating another possibility: that the funds amounted to a payoff to Park, who had important political connections in Seoul. Northrop allegedly paid Park, who died of liver cancer in 1985, to arrange for the Korean government to buy the company's proposed F-20 fighter plane. Had Park succeeded, the *Wall Street Journal* reported last week, he stood to receive $55 million from Northrop. Congress is looking into whether there was a violation of the U.S. Foreign Corrupt Practices Act, which bars payoffs to foreign officials.

If promises were made to Park, they did no good. Northrop canceled its $1.2 billion F-20 program two years ago without having sold a single plane. The fighters, developed with Northrop's own cash instead of the usual Pentagon backing, lost their appeal after the combat-proven F-16s built by General Dynamics became popular with the Israeli air force and European governments. Then two F-20s crashed in 1984 and 1985, and the U.S. Air Force decided not to buy any of the planes, dooming the fighter's future.

Northrop admits paying $6.25 million to Park, who was known as "Pistol" Park because of his fondness for handguns. But the company contends the payment was a legal part of a so-called offset program, which many U.S. firms use to invest in countries that buy their goods. Northrop, claiming it was defrauded, is suing a group of Koreans allegedly involved with Park in the scandal. "We made the investment in good faith," a spokesman says.



INTERNATIONAL DEFENSE IMAGES

The fighter was canceled before a single plane was sold

Investigators for the House Energy and Commerce Committee are not so sure. In most offset programs, the company making the investment does so in installments, as funds are needed, rather than in the kind of lump sum that Northrop sent. In addition, the committee wonders why Northrop sent the money to a Hong Kong account instead of directly to Seoul.

The latest F-20 revelations come at a bad time for Northrop. The company, long a target of Government probes into bribery charges, is under pressure from the Pentagon to improve the workmanship on its $46 billion Stealth-bomber project and to speed up the delivery of guidance devices for its MX missile. Now Northrop must answer a round of new questions about one of its old mistakes. ■

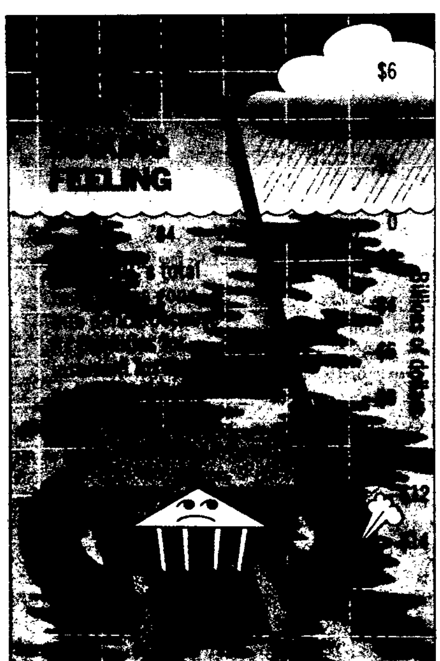
Too Far Gone To Bring Back

Liquidating two big S and Ls

Even in an era of perilously go-go thrifts, the two California savings and loan associations seemed to be looking for trouble. One of them loaned money for energy schemes ranging from windmill farms to cow-manure incineration, while the other served as a whimsical and allegedly fraudulent investment machine for its owner, a former dentist. Last week federal regulators said they would liquidate the two ailing S and Ls, a drastic step for institutions so large. The Federal Savings and Loan Insurance Corp., which guarantees thrift deposits, will spend a record $1.35 billion in cash to pay off insured depositors (up to $100,000 for each account) of Costa Mesa's North America Savings and Loan Association and the American Diversified Savings Bank. The payout, which temporarily slashes the federal insurance fund's cash balance by 40%, to $1.9 billion, is likely to heighten the debate over the adequacy of the FSLIC's resources to deal with the troubled thrift industry.

The Federal Home Loan Bank Board, which regulates savings and loans, tries to avoid cash bailouts, preferring to merge insolvent institutions with healthier ones. But the two California thrifts were poor prospects for such a rescue because they lacked loyal, small depositors. Instead, the two institutions attracted funds from money managers who demand higher-than-average interest rates.

Under the ownership of Ranhir Sahni, a former airline pilot, American Diversified squandered the assets of the S and L on ventures ranging from synthetic-fuel schemes to a national paging system. North America Savings was founded in 1983 by a dentist, Duayne Christensen, who made real-estate investments on behalf of relatives and his girlfriend. Christensen was killed in January 1987 when the car he was driving slammed into a bridge abutment a few hours before the regulators seized his S and L.



The assets that the thrift operators gambled away on risky loans are mostly long gone, leaving the FSLIC to pick up the tab. The Government is suing the managers of both thrifts for more than $100 million, charging them with fraud and negligence. But most of the $1.35 billion payout will come from the FSLIC's reserve fund, which is largely composed of premiums collected from S and Ls.

Federal regulators said last week that liquidations will remain a last resort in resolving the industry's widespread insolvencies. Of 3,100 federally insured thrifts, some 200 are considered hopelessly insolvent. The FSLIC's liability for these S and Ls now significantly exceeds its assets on hand, so that the fund posted a deficit of $13.7 billion at the end of 1987, contrasted with $6.3 billion the previous year. But the FSLIC aims to narrow that gap over the next few years, relying on income from premiums and other sources. The FSLIC estimates that it will have $20 billion available for bailing out thrifts over the next three years, an amount it deems adequate for the task provided there is no economic downturn. Yet some experts, including Bert Ely, a Virginia-based financial consultant, believe the cost could exceed $50 billion. They fear that the FSLIC will need a multibillion-dollar infusion from taxpayers to restore the thrift industry to health. ■