March 10, 1982

IS THE SOVIET GAS PIPELINE A STEEL NOOSE?

INTRODUCTION

In one of Lenin's more familiar quotes, he boasted that capitalists would sell him the rope with which to hang themselves. Although the Yamal pipeline is not made of hemp, it may symbolically fulfill that prediction. Billed as the largest East/West commercial transaction ever undertaken, it will run 3,600 miles from the frozen wastes of Soviet Siberia to West Germany; from there it will branch out to ten Western European nations. When the line begins operation in 1985, it will carry $10.7 billion worth of gas each year, raising the share of Europe's needs met by the Soviet Union from 11 percent to more than one third. Since five of the nations to be served are NATO members, the potential for energy blackmail raises fears in Washington that Western Europe is about to put its neck in a Soviet natural resources noose. These fears are certain to be high on the agenda when Ronald Reagan meets French President Francois Mitterrand this week in Washington.

While the pipeline's most obvious danger lies in the ability of the Soviets to stop, or threaten to stop, the flow of gas, more subtle pitfalls loom as well. By its existence, for example, the pipeline makes Western Europe more amenable to Moscow's whims. In most instances it would be unnecessary for the Kremlin to make an overt threat. The pipeline itself would stand in silent testimony to Moscow's ability to act if provoked. As West Germany's Franz Josef Strauss noted in a recent Reader's Digest article, "the West was providing the pipeline, but the Soviets were providing the spigot." The West, moreover, is not only providing the pipeline, it is also providing the means to pay for it.

Led by West Germany's Ruhrgas, a consortium of European firms is assembling a package of low-interest loans to enable the

Soviets to purchase from them some $15 billion worth of equipment, materials, and technology. Without the low-cost financing, the pipeline could not be built. The West German banking community is heavily involved in the deal, with $1.8 billion in loans to date -- loans guaranteed by Hermes, the West German government's official insurance agency.

France also is taking an active role in financing the project, recently agreeing to lend the Soviets an additional $140 million with which to finance the purchase of French pipeline equipment. This latest move comes on the heels of a French agreement to purchase 280 billion cubic feet of Soviet gas per year for the next twenty-five years. In spite of the agreement, however, French Trade Minister Michel Jobert recently stated that France "is not happy" about having to rely on Siberian gas.

The heavy involvement of the West European banking community at a time when loans to other East bloc nations are heading toward default poses yet another vulnerability. The loans to the Soviets are to be repaid through gas purchases by the participating firms. This means that, in the event of an interruption, not only would the industries dependent on the gas be disrupted but the financial institutions expecting repayment would be jolted as well. This would leave a significant portion of the West European banking community hostage to the maintenance of cordial trade relations with the USSR; since the loans are largely government-guaranteed, it also places the governments involved in much the same position.

Of greater concern, though, is the fact that both the financing package and the gas purchases themselves free Soviet capital for military spending. Gas sales in Western Europe are expected to generate between $11 and $22 billion for the Soviets, easily offsetting the decline in oil revenues expected over the next decade. Were it not for these sales, Soviet domestic capital would have to be diverted from military outlays within the USSR to the manufacture of other goods. Were the financing not being provided by Western Europe, moreover, large amounts of Soviet domestic capital would have to go to its construction.

What most disturbs many U.S. observers is the "business as usual" attitude regarding the pipeline deal at a time when Moscow has invaded Afghanistan, strangled Poland's budding democracy, and is actively supporting its Cuban proxies in Africa and Latin America. In fact, concern has become so great that Senator Ted Stevens (R-Alaska) suggests that it may be advisable to withdraw U.S. troops from Europe, as the commitment of our NATO allies to blocking Soviet expansion is becoming questionable. His sentiments are echoed by key Members in the House. Regrettably, some strong voices in the U.S. business community are behaving just as Lenin predicted. It is especially mystifying that the U.S. Chamber of Commerce, a leading spokesman for U.S. business, endorses the Yamal pipeline, and has severely criticized the Reagan Administration's efforts to block its construction. In fact, Chamber

Chairman Donald Kendall, Chief Executive Officer of Pepsico (a firm enjoying substantial sales in the Soviet Union) has likened the Reagan moves to "economic warfare" against the USSR. In making this claim, he is eerily parrotting the line taken by Moscow. Even worse is the implicit message of the Kendall and Chamber statement that it somehow is wrong for the U.S. to consider economic retaliation against the many acts of Soviet intervention in other nations.

Despite concern within the U.S., it appears that Europe is determined to forge ahead with the pipeline project. European leaders, such as Mitterrand, see it as more than an opportunity to diversify their energy sources; they see it as the opening of a new market and an extension of detente. By and large, they dismiss the contention that the Soviets could use energy as a weapon, arguing that Russia has been a far more reliable supplier than the Middle East. They also argue that Europe has as much to gain from the project as do the Soviets and that closer trade relations will ultimately result in a more stable political climate as well. The question is: What if they are wrong?

OIL AND GAS IN THE SOVIET ECONOMY

Since 1955, oil and natural gas have accounted for 85 percent of Soviet energy growth. More important, however, crude oil sales have become the major source of Moscow's hard currency earnings. In 1980, oil sales brought in two out of every three foreign exchange dollars earned, even though the one million barrels a day exported to the West were hardly a major factor in the international oil market. Yet it constituted 70 percent of all Soviet trade outside the East bloc.

While the Soviet Union is currently the world's largest oil producer, pumping some 11.4 million barrels per day (mbd), its output is expected to peak in the middle eighties and then begin a decline. Until recently, CIA analysts had predicted a rapid drop in the USSR's production but have since revised their estimates to indicate a relatively stable output of between 12.4 and 12.9 mbd through at least the end of this decade. Still, the Soviets recognized that some other source of hard currency earnings had to be developed and ambitiously began developing their natural gas fields on the Yamal Peninsula near the Arctic Circle. The eleventh Five-Year Plan calls for a 100 percent increase in natural gas investments, increasing production from 435 BCM (billion cubic meters) to between 600 BCM to 640 BCM by 1985. Initial efforts will concentrate on the Urengoi field, which currently produces around 50 BCM, and is scheduled to increase to 240 BCM. The Yamburg field, which was originally to provide the gas for the pipeline to Western Europe, will be developed later.

EXPORTS TO EUROPE

New gas exports eventually will total 16 BCM per year. As a result, Italy is expected to rely on the USSR for about 30 percent of its gas, France for 35 percent and West Germany for 38 percent. Some areas within each nation, however, rely on the Soviets for far more gas than the national averages indicate. Bavaria now relies on Siberia for 80 to 90 percent of its gas. Since gas is delivered through a pipeline, users cannot readily switch to another source.

It has been argued by some pipeline supporters that in case of a cut-off Europeans could switch easily to gas from Norway. In fact, Norwegian gas requires special processing that the Siberian gas does not need. The facilities for this are relatively complicated and would take time -- at least a half-year -- to build. Since a substantial amount of the gas is used for home heating and cooking, it is unlikely that the affected countries in the emergency that would be created by a stoppage of Siberian gas could wait for Norwegian suppliers to convert. And before there is a European market for such Norwegian gas, there is no economic incentive for Norwegian suppliers to convert.

IS A CUTOFF LIKELY?

One of the major arguments put forward by advocates of the Yamal pipeline is that the Soviet Union has been a more reliable supplier of energy than many other nations and that it is therefore highly unlikely that they would use the pipeline as a weapon. This is not based on fact. At least three times since World War II, the Soviet Union shut off the flow of oil to a customer: 1) in 1948 when Yugoslavia broke away from the Soviet orbit; 2) in 1961 when Albania allied itself with China; and 3) in 1962 against China itself.

There is a very important recent case in which the Soviets have used the energy weapon as intimidation. Moscow threatened to cut off oil to pressure Poland's government to crack down on the Solidarity trade unionists on several occasions, including just prior to December's declaration of martial law.

It is clear, therefore, that the potential for using the gas from the Yamal pipeline as a means of pressuring European customers is all too real. The Kremlin's history demonstrates the willingness to do so. The use of the pipeline as a cudgel, though, is not all that is at stake. Critical too is the pipeline's role in changing the economic relationship between the USSR and Western Europe -- a change that has been gestating for nearly a decade. Western Europe could become increasingly dependent on trade with the East.

Beginning in 1970, with the advent of detente, the prospect of increased trade between the EEC and the Soviet bloc loomed large. By the middle of the decade, however, the enthusiasm for greater commercial ties between Western Europe and the East had dampened, leading to a sharp decline. By 1980, sales to the Soviet bloc had declined from the 1970 level of 3.2 percent of total EEC trade to only 2.5 percent.

With the initiation of the Yamal pipeline project, the prospect of burgeoning commercial activity with the Communist bloc is once again on the horizon. And with the increased commercial ties expected to follow in the wake of the line's completion there is the likelihood that the resolve of EEC members to resist Soviet expansionism in other quarters of the globe will be weakened as economic considerations take precedence.

The French and West German loans to the Soviets are an early indication of this trend, as are the eager moves by these countries and others to contract with Moscow for the sale of technology, materials and equipment. In many ways, the current situation resembles that which existed just prior to World War II when U.S. firms did business with Japan and Germany virtually up to the outbreak of hostilities. Since the question is one of trade, however, there is a solution: offering an equivalent deal with the U.S.

A U.S. ALTERNATIVE

The West German and French Trade Ministers state quite openly that one reason for going ahead with the Soviet gas pipeline project is that there seems no U.S. alternative. This is not the case; the U.S. can offer an alternative to the Yamal pipeline project and could include the elements in the Soviet package: 1) the sale of fuel; 2) the opportunity for participation in the financing; and 3) the opportunity to sell technology and materials.

One potential U.S. alternative comprises all these elements -- coal. American coal provides an attractive and secure alternative to the Yamal pipeline. The U.S. boasts a quarter of the world's coal reserves and nearly half of the free world's reserves. U.S. coal already enjoys a growing market in Europe and its customers have found it a reliable supplier. To greatly increase U.S. coal production would require the expansion of port, rail, and loading facilities. This expansion would afford Europe the opportunity to participate in both financing and selling technology.

Although there have been several measures introduced in the House and Senate over the last few years to provide for expansion of port facilities and an upgrading of rail service to handle increased volumes of coal, progress to date has been slight. Now, with the emphasis on reduced spending in the President's economic recovery program, funds for these activities will be even more restricted. The Reagan Administration, however, offers a number of proposals allowing ports to finance their own expansion through charging user fees. These would encourage private financing and speed development. Since the capital requirements would be large, overseas investors could participate -- indeed, should be encouraged.

The opportunities offered by such a project would be enormous. Shipyards would be put to work building coal colliers. Railroad cars would have to be manufactured. Cranes, hoists, and other types of heavy equipment would be required, expanding the market for steel, machine tools and the like. West Europeans would be able to help supply this equipment.

Most important, however, is the fact that this would constitute merely a natural expansion of the coal trade already developing between the United States and Europe. While the U.S. had always exported metallurgic coal to Europe, only in recent years has it begun to sell steam coal there. With some 150 million tons of excess annual coal production capacity, the U.S certainly could furnish the 90 million tons that would be the thermal equivalent of the Soviet gas. All that remains is for Europe to ask for the coal. Says National Coal Association President Carl Bagge: "We can deliver."

In the short run, there are a number of options that would serve to fill the gap in European energy needs until U.S. ports and coal handling facilities are completed. Among these are expanded imports of natural gas from Mexico and West Africa. At present, large quantities of Mexican gas still are being flared for want of a market. Given the currency requirements of Mexico and the rate at which they are likely to grow, it would seem that Europe could be persuaded to consider the Mexican stop-gap option. In the case of West Africa, major oil and gas finds are anticipated and this would be an opportunity for Western Europe to get in on the ground floor.

CONCLUSION

Of all the concerns arising from the Yamal pipeline project, perhaps the most disturbing is that it could go forward in the face of recent Soviet activities around the world. It is this issue that Ronald Reagan above all else must pose directly to Mitterrand. For the past several years, the Soviets and their surrogates have been waging a silent war with the West. There have been no staged battles, no glorious campaigns, no declarations marking the onset of hostilities. Still, it has been as real and tangible as any war in history.

It is taking place in El Salvador, the Horn of Africa, Cambodia, Afghanistan, Nicaragua, and Poland. To some, it recalls the closing days of 1938. There are those in that troubled time as well who argued for appeasement; who said that a few concessions, a little more understanding, better trade ties were all that were needed. They were wrong then. Do we dare take a chance that they are not wrong now?

Lenin counted on the capitalists' greed to obscure the threat his revolution held for them. The Soviets are counting on the same greed to obscure the pipeline's threat to Western Europe. Sadly, it appears that Moscow may have judged them correctly. They do not realize that even though the pipeline is made of steel, it still constitutes a noose -- a noose with which Moscow one day may strangle them.

Milton R. Copulos
Policy Analyst