NP, NSC, HS Files, ME Nexus, Box 1236 Iran Military 1/20/69-12/31/69

MEMORANDUM

Iran Military Mr. Saunders 331

THE WHITE HOUSE

WASHINGTON

4-29-69

ACTION

rec 5/1/69

SE[redacted]

MEMORANDUM FOR THE PRESIDENT

FROM: Henry A. Kissinger HK

SUBJECT: This Year's Military Sales Program for Iran

Attached is Secretary Rogers' recommendation (Tab B) that we now go ahead with the FY 1969 sale of military equipment to Iran under the Foreign Military Sales Act.

This is a yearly slice of a program that has been going on under a general memo of understanding at the rate of about $100 million a year since 1964. This year's package, which includes some F-4, F-5 and C-130 aircraft and tanks, is part of the Shah's broad military modernization program.

The general issue since this program began has been its effect on the Iranian economy. So far it has proved financially manageable, but Iran's future financial soundness is still fragile, depending as it still does on the continued flow of oil revenues at a high level. The Shah annually squeezes the American oil companies as hard as he can to maximize those revenues, and if he squeezes to the breaking point or overprograms his income, repayments on these military sales credits would become a serious burden. For this year, this problem still seems under control.

The specific issues in this proposal are fairly technical:

1. Defense proposes to maximize the use of private bank credit in order to stretch its own appropriated funds. This is a sensible direction in which to go and is consistent with your general desire to increase private involvement, but it creates a second issue--

2. Using private bank credit naturally raises the interest rate because of the current high price of money. If we need 100% U.S. Government credit, the interest rate would come out about 6.25%. Private rates are around 8%, and when we mix public and private credit the rate averages out between. In this case, the interest rate is an issue with the Shah because the Russians and others make attractive lower offers, and he does not see why his friends cannot do as well. Therefore, State recommends

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staying as close to 6.25% as possible. The Budget Bureau, however, recommends (Memo at Tab A) that we not make a special effort to keep the interest rate down because Iran can afford to pay and by the criteria in our legislation we must limit concessional lending mainly to those who need it for economic reasons. Of course, it is tempting to try to give the Shah what he wants, but there is an element of bargaining in his position too.

We cannot ask you to make a judgment on the precise division between private and Government credit or about the interest rates. However, it is probably desirable in relaying your decision on this memo to note these problems in order to stiffen the spines of our negotiators. A mere suggestion that you are aware of the budgetary implications will keep them as alert to our financial interests as they will be to Iran's.

Recommendation: That you approve Secretary Rogers' proposal and that we note in relaying your decision to State your recognition of the desirability of using private credit to the maximum extent possible and of minimizing the use of concessional credit.

Approve ______

Disapprove ______

~~Secretariat~~

THE SECRETARY OF STATE ~~S/S Pending~~

WASHINGTON

Approved 5/3/69 by memo from HA Kissinger. JPW

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April 18, 1969

Copies To:
NEA
J/PM
AID
L
H
RF

SE[redacted]ET

MEMORANDUM FOR THE PRESIDENT

Subject: FY 1969 Military Credit Sales Program for Iran

Recommendation:

With the concurrence of the Secretary of Defense, I recommend that you approve, subject to the satisfactory conclusion of Congressional consultations, the extension to the Government of Iran in FY 1969 of $100 million in credits under the Foreign Military Sales Act, to finance 32 F-4E aircraft and other items on terms to be negotiated.

DEF 12-5 IRAN

Approve: ________ Disapprove: ________

Discussion:

(1) Beginning in 1964 we have been shifting our military assistance to Iran from a grant to a credit basis. FY 1969 is the last fiscal year in which we will supply military materiel to Iran on a grant basis, although we will continue to provide military training and support for our Military Assistance Advisory Group under the grant program. Since 1964 we have extended $400 million in direct and guaranteed military credits to assist the modernization of Iran's military forces. The principal equipment items financed under this program have been 32 F-4D aircraft, now being delivered, 26 F-5 aircraft, 460 M-60 tanks, 22 C-130 aircraft and 16 Sheridan tanks.

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NEA/IRN: WM McClelland

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After approval by President Johnson and satisfactory Congressional consultations we informed the Shah in May, 1968 that the Executive Branch would undertake annually for the next five years to seek Congressional authority and appropriations for such credit sales as both governments would agree were indicated to carry out a military modernization program for Iran. The amount of credit to be extended each year, as well as the amount of sales to be made for cash, would be subject to an annual military and economic review with the Government of Iran. The Shah was informed that the actual amount and the terms of each annual credit would depend on the amount of credit authorization and appropriations approved by the Congress, on prevailing credit market factors and on other United States requirements worldwide. We subsequently agreed with the Government of Iran on a tentative figure, strictly for planning purposes, of $100 million in annual credits.

Our military credit sales program is the touchstone of our close relationship with Iran. This relationship provides us with ready means for influencing Iran on international matters, particularly the promotion of peace and stability in the Persian Gulf area, and for limiting pressures to divert Iran's resources unnecessarily to military purposes. Our relationship also provides us with other benefits, including overflight privileges and communications and intelligence facilities. The importance of our ties with Iran has increased as a result of the announced withdrawal of British forces from the Gulf in 1971, the growing Soviet threat to the Middle East, the continuing instability of the Arab world and recent events affecting the maintenance of our facilities in neighboring countries.

The Shah's military modernization program is based in large part on his belief that threats to Iran are most likely to materialize in ways which would not justify direct United States involvement on Iran's side. He is particularly interested in protecting Iran's vital Persian Gulf lifeline after the British depart. While having demonstrated a desire to cooperate with the other Gulf powers and to work for solutions of outstanding problems between them, the Shah wishes to have the military power to defend, if necessary, Iran's lifeline against radical Arab, possibly Soviet-inspired, penetration of the Gulf and to deter sneak attacks on Iran's oil installations in the Gulf area. His program attaches highest priority to the Iranian Air Force.

Following British withdrawal from the Gulf Iran will be the dominant military power there. This could create concern among Iran's neighbors in the Gulf. However, for our part, we find Iran's present policy in the Gulf essentially reassuring and our ability to encourage constructive Iranian policies there enhanced by our close military relationship.

Iran's economy is booming, with its real GNP having increased at an average annual rate of about 10% over the last four years. Some of the strains which such a growth rate can be expected to cause have become evident, particularly in declining foreign exchange reserves and a growing debt service ratio. Overall military expenditures, in large part related to our credit sales program, have been rising rapidly. These factors will be kept under review in connection with possible future military credits to Iran. A key question is whether Iran's oil income will keep pace with the Shah's demands and Iran's expenditures. A breakdown in the relationship between the oil Consortium and Iran would endanger Iran's economic development and military programs. In this light, the current negotiation between Iran and the Consortium is a matter for concern.

We believe that the proposed FY 1969 program would not cause a significant slowing in Iran's rate of economic growth and that Iran's debt servicing burden would continue to be manageable. Section 35(a) of the Foreign Military Sales Act prohibits sales to any economically less developed country when the President finds that such country "is diverting its resources to unnecessary military expenditures to a degree which materially interferes with its development." It is our opinion that Iran is not in violation of Section 35(a) at the present time.

In sum, we believe that our proposed program for FY 1969 will assist the maintenance of our close ties with Iran, promote our important interests in the area and meet the Shah's desires.

The Proposed FY 1969 Program

The proposed program, as approved by the NSC Interdepartmental Group for the Near East and South Asia, contains the following elements:

1. Extension of $100 million in credits, at least $20 million of which would be USG guaranteed private bank credit, if arrangements can be worked out with the banks, with the remainder (or the entire $100 million in the event arrangements for private credit cannot be worked out with the banks) being direct USG credit. Funds for direct USG credit and for the USG guarantee of private credits have been authorized and appropriated by the Congress and are available for this program.

2. At least $80 million of the credit would be used to finance two squadrons of 16 aircraft each of F-4E aircraft. The total cost of these aircraft is estimated at $130 million, and the Government of Iran would sign a dependable undertaking to finance the remaining cost estimated at about $50 million. If we decide to provide additional military credits to Iran in FY 1970, such credits could be used to finance this remaining cost. This "split financing" is desirable in order to permit ordering of all 32 aircraft prior to June 1, when substantial price increases are anticipated, and to permit financing this year of up to $20 million of other items, while at the same time keeping within our $100 million annual planning ceiling.

3. Up to $20 million of the $100 million in credits would cover the cost of other equipment to be agreed. Iran has indicated a desire to purchase additional electronic equipment for its Persian Gulf defense, logistics ships for its navy and additional Sheridan tanks to add mobility to its ground forces.

4. We would seek Iran's acceptance of an interest rate of no less than 6.25 percent (cost of money to the Treasury) for the direct USG credit and of the current market rate (not to exceed 8 percent) for the USG-guaranteed private credit. It is likely, however, that the Iranian negotiators will strongly object to these terms and will insist on a lower interest rate. In order not to dilute the political benefits we hope to obtain from this program, our negotiators would be authorized, if necessary to complete the negotiation, to agree to reducing the interest rate for direct USG credit to a level needed to bring the overall average rate for the total $100 million credit down to no less than 6.25 percent. This could involve a total loss of interest receipts to the Treasury of up to $3 million during the course of the credit. This procedure is consonant with State-Defense-Treasury guidelines on financial standards and criteria for foreign military sales. (The Treasury Department has indicated that it would prefer the interest differential, if any, to be subsidized by an addition to military grant aid rather than by a concessionary interest rate on the direct credit, but this does not appear feasible, at least in this fiscal year.)

5. The provision for the possible inclusion of guaranteed private credits in the $100 million credit package has been made in an effort to save USG budgeted funds, because we have to set aside only 25 percent of such credits in a guarantee reserve, and these are not expended unless there is a default. However, arrangements to this end have not yet been worked out with the banks.

6. In presenting the program to the Shah, our Ambassador would be instructed to note that it is a token

of our confidence in the Shah and in Iran's desire to contribute to the stability of the area and to urge that Iran's economic progress not be adversely affected by her military expenditures. He would make clear that we cannot guarantee the availability of future credits in advance of Congressional authorization and appropriations or of our annual economic review and that to the extent we cannot extend such credits, Iran will have to finance the remaining cost of the F-4's being partially financed under this program or cancel the contract.

William P. Rogers
William P. Rogers

S/S
A True Copy

Concurrences:
NEA - Mr. Rockwell
NEA/RA - Mr. Sober (draft)
J/PM - Mr. Farley (draft)
L - Mr. Belman (draft)
H - Miss Folger (draft)
OASD/ISA - Mr. Schwartz(draft
AID/NESA-Mr.Williams(draft)
Treasury - Mr.Hausman(draft)
NEA/ARP-Mr. Gatch (draft, paras 1 & 2, p. 3)

NEA/IRN:WMMcClelland:TLEliot,Jr.:psw
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