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**HOW THE CHANGING INTERNATIONAL  
ENVIRONMENT AFFECTS OUR ECONOMY**

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MR. ALLAN D. AFFLECK: It is my pleasure to introduce our keynote speaker. James Schlesinger currently divides his time between the Center for Strategic and International Studies in Washington, where he is a member of the board of trustees, and the investment banking firm of Shearson Lehman Hutton, where he serves as Senior Advisor. He is a frequent commentator on energy, defense and world political issues. Mr. Schlesinger received a Bachelor of Arts degree *summa cum laude* from Harvard College and then a Master of Arts degree and a Ph.D. from Harvard. He has a broad background including work with the Rand Corporation as a consultant to the Federal Reserve System and to the U.S. Bureau of the Budget. President Nixon invited him in 1971 to become chairman of the Atomic Energy Commission, and in 1973 he became Secretary of Defense. In 1976, he became assistant to President Carter and the following year became the nation's first Secretary of Energy. Mr. Schlesinger is the author of two books and numerous articles. He has been awarded six honorary doctorates, as well as many prizes and medals. We are honored to have James Schlesinger with us. The subject of his address is, How the Changing International Environment Affects Our Economy.

MR. JAMES R. SCHLESINGER: I'm delighted to be here at the Society of Actuaries meeting. I figured out why you were meeting in Orlando. It was to do a study of the morbidity effects of St. Louis encephalitis in view of the mosquito outbreak.

I knew that I had arrived here last night when I got into the elevator, and one of the arrows was pointing up, and the other arrow was pointing down. There was a conversation in the elevator, which way will it go? And there was a response, we'll strike an average. I said, you must be actuaries. It was confirmed.

I cannot forebear mentioning the story of the actuary who died and went to heaven, and there, somewhat to his surprise, was this mass reception at the pearly gates with St. Peter out in front with a large brass band. He looked around and said, "why have I received this extraordinary welcome?" And the response was that he had broken the record. He was the oldest man ever to enter heaven, even older than Methuselah. "Why," he responded, "there must be some mistake. I'm only 60." And the mournful response was that he must have been judged from his time charges.

I'm supposed to talk about the changing effects of the international environment on our economy. So, I point out to you at the outset that an economist is someone who, when he finds that something works in practice, is determined to discover whether it works in theory as well.

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Let me start with the impact of a changing international environment and how it affects our economy. We have lived through the most extraordinary transformation of the world scene for 50 years and perhaps in this century itself. The changes that we have witnessed in just this last year have been just simply stunning. Indeed, given what is going on in the Middle East, it is important for us not to allow those events to overshadow the even larger developments that have occurred, particularly in Eastern Europe, during the course of the last year.

I ran into one of my favorite Sovietologists last March, and I said to him, "Why didn't you tell me what was going to happen in Eastern Europe?" And he responded somewhat modestly, "If I had been able to foresee these developments, and if I'd been rash enough to predict them publicly, I would immediately have been committed." Eastern Europe, as you all know, has been transformed, and for those political philosophers amongst you, that transformation has proved that Karl Marx was, indeed, right, at least in one respect. The final stage of communism is the withering away of the state. Eastern Europe exited the communist system in a mood of euphoria. I think that it is important for us to bear in mind that mood of euphoria because as the winter goes by, as the economies of these countries continue to creep along, there is bound to set in disenchantment and some of the difficulties that will flow from that disenchantment: the revival of national rivalries, a return, in a sense, to the kind of Eastern Europe that we saw before World War II. We already see these disintegrative tendencies. Yugoslavia, which is not strictly part of the Soviet empire, or was not strictly part of the Soviet empire, is in the process of disintegration. The Slovians and the Croats want to leave the country of the south Slavs. Slovakia in Czechoslovakia is preparing for its exit, and the rivalry between Hungary and Rumania with regard to the future of Transylvania has broken out anew. So, we must bear in mind that the end of the totalitarian threat and the bipolarity between East and West does not immediately alter all problems.

Looking at Eastern Europe from the standpoint of economics, there had been established by the Soviet Union a simple -- one might even call it a semi-effective -- economic mechanism, and that consisted of the exchange of goods amongst the East European satellites. Each one of them produced inferior goods, and they exchanged it with their sisters in protected markets. So, no matter how weak the production, how inferior the good, there was always a market to be obtained behind the Iron Curtain with their sister socialist states. All of that is ending now, and the states of Eastern Europe are being thrust back upon the international market with all of the risks that that entails, and that thrusting back is reinforced by a decision of the Soviet Union. After January 1, 1991, all payments for oil must be made in hard currencies. Oil from the Soviet Union tended to be the lubricant that kept trade flowing in Eastern Europe and, if I may mix my metaphor, the cement that held the economic system together. That will end this January 1. Throughout Eastern Europe we had an economic system that barely managed to make it. We had a working force that said about their system, "We pretend to work, and they pretend to pay us." No doubt as this system breaks down and is replaced by little that is effective in bringing immediate increases in the standard of living, there will be a spread of disenchantment. Indeed, you see that spread of disenchantment today in Poland in which Lech Walesa is challenging the very government that he put into authority.

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Let me move on to the Soviet Union. Mikhail Gorbachev is something of an idealist. He was a communist idealist. I do not believe him to be that any longer. But he, from his standpoint in Stavropol, watched the corruption and decay of the final Brezhnev years and said to himself, "This is not communism. This is not what it ought to be. If ever I get up there to Moscow, I will straighten out this system." In some ways he was akin to Jimmy Carter, looking at Washington in the aftermath of Watergate and the CIA scandals and all of the other deficiencies that he saw there. And so, just like Jimmy Carter, he went to the nation's capitol and began to reform, but he did not understand the powers of resistance of the existing system any better than did Jimmy Carter. The nomenclatura, the senior communist bureaucrats, were determined to block Gorbachev at every effort for change, and they were successful to a large point. His goal was to achieve decentralization of decision-making within the Soviet Union and in this way unleash the forces of innovation. He could not do that, in part because of the hammerlock that the bureaucracy in Moscow had over critical aspects of decisionmaking. The net effect has been that his hope for change, which would unleash the pent-up energies of the Soviet public, has never been able to take hold and the command economy which he inherited from Brezhnev has begun to break down. I, myself, always predicted that perestroika would be a failure -- could not suddenly generate innovation out there throughout the factories and towns of the Soviet Union when everybody out there had been prepared to listen to the commands from Moscow and had been perilously afraid of disobeying them for fear of punishment. That is not a firm foundation to release the forces of innovation.

As I say, I did not expect perestroika to be a success, but I did not expect to see the abysmal performance that we now see of the Soviet economy, almost a total breakdown followed by the disintegration of the political system. Various people have asked me whether or not under these circumstances Gorbachev can hold on. So, I repeat that wonderful story from the 1970s of an American college president who was called in an emergency to take over this college because his predecessor had been driven out by the students and faculty in disgrace -- probably because he was attempting to enforce the rules or some other capital offense. His predecessor handed him three envelopes, and told him when he first got into trouble to open the first envelope, and it would carry him through quite easily. Then there would likely be more trouble, and then he would open the second envelope and so forth. So, he goes along smoothly and after about a year the faculty find that he has too oppressive a hand, and the students say that he's interfering with their freedom of choice, and he opens the first envelope, and it reads, "blame your predecessor." Now, he follows that advice with good effect, and the troubles die down, but then 18 months later the same set of difficulties arises, and he is driven to opening the second envelope which reads, "blame the system." He thinks that's a very good idea, and he proceeds to blame the system, and once again it has a calming effect on the campus, but that lasts only so long, and after awhile student unrest and faculty unrest drive him to open the third envelope which reads, "take three envelopes and three pieces of paper. . . ."

Well, quite clearly, Gorbachev has been through two of his envelopes. He started out blaming his predecessor. He then proceeded, and he had not intended to do this, to blame the system. He had intended to reform communism. Clean up the difficulties, and the system will work. And he had intended in Eastern Europe merely to replace the

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existing corrupt or old-guard communists with a new breed of reform communists. But he had opened up Pandora's Box, and he had unleashed forces that he, himself, could not control.

Now, I have been looking at the downside of the world, in a sense. Let me look at the upside of the world, Western Europe. Indeed, the movement now towards integration in Western Europe may be the most important movement that we see on the planet. Don't let the Middle East overshadow the other things going on in the world. It is important to know that the developments in Eastern Europe, the developments in the Persian Gulf, have tended to overshadow that movement towards European unity which may, indeed, be the most important thing going on at the present time. We are seeing the recrudescence of European power that in some sense was badly damaged by World War I and then was obliterated by World War II.

The movement towards the European community, sometimes resisted by Margaret Thatcher, has slowed down slightly by the refocus of German attention towards the absorption of East Germany into the new Germany. Those subsidiary obligations towards Eastern Europe have captured the attention of the Germans so that they are no longer the driving force that they once were behind European unity. Germany has not turned its back on European unity, but it spares it what time it can from what are more formidable activities. Now, the movement towards European unity is going to have a major effect on the American economy, what we produce, how our own corporations interact with their counterparts in Europe, the degree to which we can sustain our exports to this new Europe. That will be one of the major challenges for the United States. As the move towards European unity progresses it is important for us here in this country, indeed, important for us here in North America, in this North American free trade area, to recognize the magnitude of that challenge so that we do not come to be two competing trading blocks. Our tendency, the American tendency, if not the Canadian tendency, will be to skulk around the sidelines making captious remarks.

In that 45 years of American dominance of Western Europe because we provided military protection, if we were skulking around the sidelines making captious remarks, others still paid attention to us. It is not clear in this new world with the Soviet threat reduced that the European partners, our allies, will not just say, "The Americans are captious." We will either have to get in seriously to the new European economy as it becomes unified or stay out, and it's, I think, important for us to get in. But that is one of the transformations on the world scene, one of the more overshadowed ones in terms of news reports, that is so important to us.

I should mention Japan as well. Why? Because that is one leg of the tripod that holds up the new international economy, one of the three driving forces behind it. The Japanese have discovered a technique of unfair competition which they meticulously practice on us and the rest of the world, but particularly on us, because we have a more open society. That unfair technique is to produce quality goods. Oh, how unfair that is! There are some difficulties between the United States and Japan, between Canada and Japan, and it involves Japanese trading practices. As I defend Japan I want to make sure that all understand that the Japanese trading practices do tend to be predatory by the standards of trading practices here in North America, and we should not indulge in

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the general Japanese bashing that is so widespread in the American society today. We ought not to forget and we should continuously remind the Japanese that in their trading relationships with us there are certain rules of the game that they, too, should observe. For the last year the Japanese have done something that is really quite unethical. They have been purchasing properties here in North America. I say unethical because when Rockefeller Center goes it tells you something. I'm not clear exactly what it tells you. What I think it tells you is that the American people have not been saving enough and that each year we are obliged to import \$120-130 billion worth of foreign capital to sustain investment in the United States and to sustain some kind of balance in the overall balance of trade, and the Japanese have been enormously forthcoming about that. It is they who have held down interest rates, and they have helped to permit, given the spendthrift habits of the American society, the steady rate of investment growth in this country, but there are those who think that that represents a Japanese invasion. I don't think we ought to be dependent on foreign capital, not the richest nation in the world, but if we allow ourselves to become dependent, we ought not to chastise those who are satisfying our need to acquire that foreign capital.

Now, as you know there is a downturn in Japan. The stock market is off severely. That is enormously important. In recent months Japan has been liquidating investments in the United States and pulling the money back to Japan. In other words, we can no longer count on that foreign capital, Japanese capital, to sustain our own economy. I suspect that we are in for a new phase of Japanese bashing. Last year we criticized them for investing here and buying up various American assets. This year we're going to criticize them for doing the reverse, which is to sell out and go home. We need your capital. How could you practice this additional, aggressive trick?

Well, enough of the discussion of Japan. Let me summarize this segment to say that here in the trading area, in the post-cold-war world, we find the greatest of international opportunities for the United States which is the theme of your meeting here in Florida. But international opportunities mean international challenges, and the challenges are, in some ways, more formidable than the opportunities. Trade, finance, the effective performance of national economies are more important than ever before, and there are some limits to our performance.

In this recent Gulf crisis for the first time, probably since 1914, the United States dollar has declined, and the United States of America is no longer regarded as a safe haven for foreign capital. That is one of the most novel developments that has come out of the Gulf crisis. Capital is pouring into Germany, the new Germany, into Switzerland, into the U.K. The U.S. dollar is sinking in relation to all of these other currencies. With an international crisis no longer raising the specter of a Soviet invasion of Western Europe, those economies look more sound than our own, and for the first time we have not gotten the stimulus that normally flows from the influx of foreign capital during a crisis. As I say, the dollar has been dropping. That's not a problem for Canada. In Canada the dollar has been rising, and that's quite a problem. But for the United States that drop in the dollar represents an opportunity. The decline in the dollar represents an opportunity for the United States because it permits U.S. industry to compete more effectively against some of the sources of international trade that in some sense have acquired better reputations than American products. It permits us to improve our balance of

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payments. It permits us to persuade Americans to buy American products when they might be inclined to go overseas. There is, of course, an equal downside to the decline of the U.S. dollar. We do not want our industry to become dependent upon low prices relative to foreign products as a way of bringing the revival of American manufacturing. We must find a way to improve the quality of the products, vis-à-vis the Germans and the Japanese. I do not mean sustain our quality relative to Poland and Czechoslovakia, but if we want to be number one, a quest of most Americans since World War II, we are going to have to shape up.

Now, I say that the United States is no longer regarded as a safe haven, that the dollar has dropped for the first time, and this was going on even before that budget debacle in Washington that captured your attention last week. That was spectacular. We here in the United States are used to this kind of confrontation between the Executive and the Legislature, but to much of the rest of the world it looks scandalous, and it looks as if the American government is breaking down. There is an important change that has come just in this last year. In the past, if the American government looked as if it could not operate, others became concerned about themselves because the Americans might not be able to provide protection against the Soviet threat and other threats. With the end of those fears we are no longer in the same position. That leads to a conclusion. In this last 45-year period of the cold war, the United States could behave as it pleased. It could be dilatory. It could take its own due time about making decisions that were necessary. And others had little opportunity but to wait for us to complete that process.

I'm about to turn to the subject of the Middle East and the possibilities of sabotage. We are no longer in that position in which others will wait for us. They will go ahead. Europe is going ahead. The American position has changed substantially, and I shall come back to that, but as I emphasize these questions of quality performance, we have got to learn to compete harder, and that starts with the way we train our kids. Scholastic aptitude test scores are still going down. They're going to have to change the standard pretty soon. In mathematics and science and even geography, Americans perform at a miserable level. Half the kids in the United States don't know that Canada is the country that lies to the north or that Mexico is the country that lies to the south. That may not be flattering for you Canadians, but it's disgraceful for us Americans.

Let me turn now to the Middle East which, as I say, I was warned not to allow to preoccupy my remarks. With the end of the cold war we are returning to something that existed before 1939 not only in Eastern Europe but in the Middle East, and that is a return to old-fashioned, power politics. Old-fashioned, power politics consists of national and ethnic rivalries. It consists of the desire for loot. And both of these things have been well-exemplified by Saddam Hussein. Saddam Hussein is a brute and a rascal. However, that has no news value. As a policy that we might be tempted into, just denouncing him carries no weight. He is something that we have to deal with. Now, I mentioned the Middle East at the outset because it is tempting to us. We are once again central as we were not a few months earlier. On the international scene only the United States can move 200,000 men to the Middle East in 90 days. Only the United States today has that kind of military establishment. Only the United States, therefore, can put together a coalition in the United Nations that has been able to impose an embargo and make it stick -- that's unique -- on Iraq, and so once again we are back in

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the central position. It is dangerous for us only in this respect that we will, by returning to the pleasures of an absolutely central position, begin to forget these greater challenges in Europe, on the international trade scene, and that we will revert to our position of believing that political or political military power is the preeminent tool for the 21st century. It will not be. The way that we have decided to deal with Saddam Hussein is to impose an embargo, and the oddity is that we were operating very close to full capacity for the production of oil worldwide when the invasion of Kuwait came. This is the third oil crisis, but it is the first oil crisis that has been brought about by the actions of consumers. In the prior oil crises the oil-exporting nations refused to or could not export oil, and that brought around the crises in the importing countries. But in this case there is oil available, and organized by the Americans through the United Nations we refuse to import that oil, the first crisis, as I say, brought about by the actions of consumers. The President of the United States has three strategies that he can follow. One is to make the embargo work to bring Saddam Hussein to his knees. The second, some weeks down the line, is to initiate military hostilities against Saddam if he has not withdrawn from Kuwait. And the third is the pursuit of diplomatic negotiations. Each has its serious downsides, and none of them are particularly attractive, but I want to dwell for the moment on the one that we have chosen and we have persuaded other members of the United Nations to follow, as it may not yet have been decided whether to embrace violence as our option.

But there seem to be around here those who have already made that choice. In embracing the embargo what we did was create an oil famine around the world and particularly a famine of oil products because the damage to refinery capability worldwide is much greater than is the damage to the sheer capacity to produce crude oil. We have had a disruption of oil markets. We have had a larger run-up of oil prices than we experienced in 1979-80 in so brief a period. In 1979-80, oil prices took seven to eight months before they doubled. Here they doubled in less than two months. So, we have a problem, particularly against central banks that refuse to accommodate such an oil price run-up. Here in the United States we have Alan Greenspan who is not eager to accommodate that rise, but may to some extent. In Canada the Bank of Canada will never yield, and it will fight any price increase, and the effect of that is to drive down employment, drive up unemployment, reduce economic activity, slow down the rate of growth, and give us what we used to call stagflation, that combination of rising prices and stagnant economies. Probably the cost of imposing this strategy on Saddam Hussein over the course of the next two years will be something like half a trillion dollars worldwide in lost growth, \$200 billion of lost growth here in North America. I emphasize this because that is the strategy that we will probably continue to follow, and it has a major impact on the environment. If you listen to the discussion in the press, the Saudis have increased production and oil is flowing again. If you look at things globally, watch out when somebody says look at things globally, if you look at overall oil consumption and overall production, they are in balance. I go back to what I said about economists at the outset. An economist is somebody who, when he thinks something is solved in theory, doesn't really care much whether it is solved in practice. We have seen, despite this notion that the oil supplies are in balance, a run-up of prices from less than \$20 a barrel to \$40 a barrel. Now, it's an ill wind that blows nobody any good, and I was reading the other day that the Calgary Petroleum Club had just nominated Saddam Hussein as Oil Man of the Year.

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But aside from some local benefits, the overall impact is going to be stagnation, slow growth, particularly here in North America. That is not necessarily an opportunity. That is more of a challenge. All of this leads to the conclusion that the world has dramatically changed in the course of the last year, in ways which none of us would have predicted, some of us would have predicted could never take place. The collapse of the Soviet threat is the end, de facto, of the Warsaw Pact which has posed a threat to Western Europe. It is all that we had hoped for for 45 years, and this country, may I say with some pride, despite the disbelief of others, managed to stand the watch on the Elbe for 45 years until the collapse of the totalitarian threat. Were Winston Churchill alive today, he would say this was America's finest hour.

It was fun, by the way. It was fun for a lot of us who have engaged in the calculation of nuclear deterrents, but a lot of that is now over the hill, and this country must move on and not get lost in the laurels of the past. While the Soviet threat existed there was no question that others had to follow our lead, and if they did not, they did not at their own peril. That's changed now, and we must face up to a loss of centrality for the United States. It was reflected in Houston at the Houston summit. The Germans came there. The Japanese came there. The others came there. All of them deferred to their American host, President Bush. They deferred to American leadership, and they did just exactly what they damn pleased. The Germans who were engaged in removing themselves from the threat of the Soviet Union continued despite American protest to offer new economic aid to the Soviet Union to get out of Eastern Europe. The Japanese, similarly, despite American protestations in the light of Tianenmen Square, said they had their own interests, and they proceeded to offer additional aid to the Chinese. They didn't want to make it blatant, mind you. They didn't hold placards out in Houston, but they were going to pursue their own interests. The effect of the collapse of the Warsaw Pact is that others no longer are so dependent on American protection, and so America's centrality has declined with the decline of the Soviet threat. Some months ago Chancellor Kohl went to visit Mikhail Gorbachev at his own hometown, Stavropol, and there they cut the deal that ended the Soviet threat to Western Europe, the removal of Soviet forces from Germany. East Germany has been the strategic center of the Soviet threat to Europe, and Helmut Kohl negotiated it away without any turning to the Americans for approbation. He just did it. Now, these are indicators of a change in the American position. As I say, it was fun for many of us, and there's likely to be some nostalgia about the cold war, indeed, some well-deserved nostalgia. One thing about the cold war is that it suppressed all of these national and ethnic rivalries that are reasserting themselves. They were suppressed below the heavy weight of the bipolar, ideological conflict. Once that conflict ends, those national rivalries reassert themselves.

I offer you only one conclusion. The world has radically changed in this last year. It creates great, new opportunities for us. It creates even greater challenges, and one of the greatest of those challenges is to acknowledge how much the world has changed, that is, the free world is no longer dominated by the United States, dominated by the quest for protection from the Soviet Union, and it is best for us, much as we may want to look back, to acknowledge that simple fact.

**MR. AFFLECK:** I think the applause indicates the interest and appreciation for your comments. We would entertain maybe one or two questions, and I'd just like to start



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that off. Do you have any comment on what your own recommendation on an energy policy for North America would be at this point, given what's going on in the Middle East?

MR. SCHLESINGER: Well, I'll make a little speech. Energy policy is inherently simple. The threat is dependency on foreign oil. The way you deal with it is through conservation and substituting other fuels. That's all it is. The trick, of course, is to have the will to do that. The tools you use, and here we begin to run into trouble, are taxation, such as taxing gasoline even here in the American Republic where the 11th Amendment to the Bill of Rights is Thou Shall Have Abundant and Cheap Gasoline. But raising taxes runs into the President's pledge about "read my lips." You subsidize domestic production or conservation, but that runs into that budget deficit. Or, horror of horrors, you interfere with the workings of the free market which is sacred here in the United States. So, if those are the three tools, we're not likely to be too successful in energy policy. If we're willing to use the tools, we can drop back to 30% dependency on foreign sources of oil if we wish to.

FROM THE FLOOR: What are your views for Asian and Latin American countries in the context of your presentation?

MR. SCHLESINGER: This is a prelude to your answer. One of the dangers of what's going on in the Middle East is that it's forcing us to devote all of our attention to Saddam Hussein, his works and his ways. We have forgotten the disastrous impact on Eastern Europe of the cutoff of oil and stagflation in the West. We have forgotten the impact on Latin American countries, other Third World countries, of the run-up in oil prices, and we ought to reflect back on that. The Latin American countries, or many of them, got into trouble with the last oil crisis when they had to borrow too much money. Now they're back in the same stand, as it were, and we're going to have to find a way to alleviate indebtedness. A second point is this: despite the protestations of the central bankers that the only goal to follow is to maintain the stability of the currency, I think that our international obligations are such that we should lean towards avoiding serious economic downturns which has a reinforced effect on those underdeveloped countries in Latin America and in Asia. When we talk about Asia, by the way, we talk about a mixed bag. We've got the oil-producing countries of Southwest Asia, Saudi Arabia and United Arab Emirates (UAE). They are undergoing no economic and financial troubles at the moment, except that there are too many claimants against their new revenues, and Korea, the five tigers are in good shape, but much of Asia, heavily populated Asia, falls under the category of underdeveloped economies.

FROM THE FLOOR: Do you think that it's in the interest of the United States to allow the Hussein regime to stay in power and work out a negotiated settlement where in two or three years he's going to have a nuclear capability?

MR. SCHLESINGER: Do I think that it's in the interest of the United States to allow Saddam Hussein to remain in power? The trick there is in the verbs. I would consign Saddam Hussein straight away to hell if it was within my power to do it easily. Am I prepared to go to war in order to remove him? I would be very cautious about that. You put your finger on what may be the greatest motivation for our going to war, which

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is to neutralize the forthcoming nuclear capability of Iraq, which is a couple of years down the road, which will increase even the great instability that exists in the Persian Gulf region. I think that there may be possibilities for the United States and others to press for a close monitoring of those facilities, and if we could do that, I would be prepared to have a negotiated settlement. Beyond the nuclear capability, Saddam Hussein, after all, leads a nation of 17 million people, four million of whom want nothing better than to get out. The remaining 13 million people are quite an irritant to the Gulf now that we have helped them neutralize Iran. As long as that is the case we can quite effectively deter Saddam Hussein from any military aggression if that is our desire, and we can continue to do so at a lower price probably than war. By the way, you remember the Iranian moderates of a few years ago, they're back. We have managed over these last 45 years to deter the Soviet Union from its advanced positions in Eastern Europe and a set of satellite nations, most of which were larger than Iraq itself, from actually posing more than a threat to Western Europe. If we can deter the Soviet Union, formidable as it is, we can deter Iraq. So, I do not see the necessity of our going in and cleaning him out. However, under some circumstances that may be the least bad of the several options that we have before us.

**FROM THE FLOOR:** Given the Soviet Union's need for hard currency and their proven oil reserves, what role do you see the Soviet Union having in ameliorating the current Middle East crisis?

**MR. SCHLESINGER:** The Soviet Union is still a superpower. It is still the only nation on earth that can destroy the United States in the next 45 minutes, should it be led by a madman and decide to do so, and that should generate eternal vigilance, if not a constant wariness. Its fingers are deeply involved in the Middle East. Its air defense capabilities undergird the air defense system of Iraq. There are 5,000 Soviet technicians in Iraq who are providing considerable and abiding assistance to the Iraqis, including on their air defense system. The effect of the choice that we have all made as the initial way of bringing pressure to bear on Saddam Hussein, which is to cut off oil sales from Iraq and Kuwait and part of the neutral zone, has boosted prices roughly to the \$40 mark, and that's not bad from a Soviet perspective. The Soviet Union probably will earn \$10 billion more this year in hard currency than it did in the last year. As you may recall in 1973, during the Middle Eastern war, the Soviet Union encouraged the Arab oil producers to stop producing oil. I don't think that was strictly geopolitical because it added to the income of the Soviet Union at the time, and I've sometimes suspected that the Soviet Union was prepared to support vigorously whichever power was prepared to cut off the flow of oil. In this case it happens to be the United States, and, therefore, we have considerable Soviet support. That may seem a little on the cynical side to you.

Gorbachev's decision is that he has become dependent on the West, and even though it causes great concern amongst the Soviet military to see the Americans out there 200,000 strong establishing bases that they fear will be permanent, Gorbachev has been prepared to support the Americans. Until that settlement comes, oil production will be low, oil prices will be high, and that will be some consolation to the Soviet Union as we go through the next year. Nothing is without effect, however. Eastern Europe may turn more ugly which may, incidentally, be to the advantage of the Soviet Union. Disenchantment in Eastern Europe will make the past seem better. Western Europe will become

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more preoccupied with itself. North America will be more stagnant, and that, in itself, will force us to be less helpful to the Soviet Union during this extended period of transition than Gorbachev would want. The fact that there are thousands of Soviet contract employees in Iraq and, included amongst them, Soviet offices helping the Iraqis with their defense systems and defense purchases, shows that Gorbachev probably does not control what the Ministry of Defense in the Soviet Union does. The Ministry is a power to itself and it is keeping those people there despite Shevardnadze's and Gorbachev's requests. That is not altogether reassuring from our standpoint. It points to the fact that the Soviet Union continues to have immense potential influence, and its role on the international scene is too complex to be dealt with by any simple formula.

