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THE DIRECTOR OF CENTRAL INTELLIGENCE

WASHINGTON, D. C. 20505

DDI #555-82
22 January 1982

National Intelligence Officers

MEMORANDUM FOR: Director of Central Intelligence

FROM:
National Intelligence Officer for Economics

25X1

SUBJECT: Global Economic Paper

1. As per your request, attached is an expanded draft version of the Global Economic paper. I have written three wholly new sections:

- o The analysis of long-term industrial trends to which I referred during our talk;
- o A brief section on the Soviet Bloc; and
- o One on implications for national power, leverage and influence.

2. The section on short-term trends has been greatly shortened. The one on vulnerabilities and risks is largely taken from the earlier draft but the part on oil markets has been substantially revised.

3. The Key Judgments remain to be drafted, and we are still working on supporting statistical charts and tables. None of the material has been coordinated or reviewed.



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Attachment,
As stated

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DHS Review Completed

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SUBJECT: Global Economic Paper

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DCI/NIC/NIO [redacted] (22 Jan 82) [redacted]

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GLOBAL ECONOMIC FORCES

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GLOBAL ECONOMIC FORCES

Preface:

The US is more and more open to global economic forces. Indeed, it is scarcely an exaggeration to say that many of our present economic difficulties stem from a general national failure to appreciate how profoundly our country is affected by commercial, industrial, and agricultural events and trends beyond our own borders.

This failure of insight no longer obtains. We now recognize that in coming years and decades our ability to chart a successful national course will depend, at least in part, on our grasp of key global economic forces-- on our grasp of their status, their direction, and of their impact on the US and also on our chief adversary, the Soviet Union.

This paper will outline the key global economic forces at work today, project their respective directions through the near-term future, and articulate the opportunities these trends will offer--along with the vulnerabilities they will create--for both the US and the Soviet Union.

We are concerned not with predictions or projections of economic events or with a comprehensive survey of economic trends, but rather with identifying particular forces and conditions which may generate new or more intense economic problems for policymakers.

Following a brief evaluation of the world economy in 1982, we examine the main external trends which will affect the structure of industrial production and trade in the 1980s. Then we consider the vulnerability of the world economy to various shocks: interruptions in the supply of oil

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and other commodities; systemic financial crises; and a surge in beggar-thy-neighbor trade policies. Communist economies, and their linkages with the world economy are treated briefly. Finally, we assess the implications of those economic trends and vulnerabilities for the power, leverage and influence of the US, the USSR, and other major countries.

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1. The World Economy in 1982

1982 is a pivotal year for the global economy. By midyear, the pace of Free World economic activity should begin to move out of the doldrums that characterized 1980 and 1981 but the vitality and durability of the upturn remains a major uncertainty. US economic performance is unusually important to the world economy this year as most other countries can do little to expand their purchases. West European governments are very much in need of a rapid pickup just to prevent further increases in unemployment and large budget deficits are thwarting any major use of fiscal stimulation. Most LDC and Communist countries face weak commodity markets for their primary exports and a rising debt service burden. Many oil exporting countries may be forced to slow the growth of their imports because of the decline in demand for oil and falling real oil prices. Only Japan is likely to be less dependent on a pickup in US economic performance as it further increases its trade surplus.

The range of plausible recovery patterns for the United States and Western Europe foreseen by economic forecasters for 1982 is rather broad--ranging from a rapid, sustained upturn to continued economic stagnation into 1983. The bulk of forecasters anticipate a "saucer-shaped" recovery pattern with an initially vigorous recovery being checked by rising interest rates.

This consensus view is based mainly on the belief that financial markets will remain very sensitive to the long-term risk of renewed inflationary pressures and could trigger another upturn in interest rates in the US which would dampen the recovery. This, they argue, would be the

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case even though US inflation rates will probably continue to ease by late 1982, with less pronounced declines in Western Europe. With a "saucer-shaped" recovery, unemployment in both areas would remain near their cyclical high.

A more rapid pickup of economic activity in the US and Western Europe after midyear given the cut in US taxes and pent-up demand in the US and Western Europe could occur. During such an upturn, inflationary pressures should be held down by the large productivity gains that normally occur in the early phase of an economic upturn. Unemployment, however, even in this most optimistic case would remain high well into the recovery cycle.

The possibility also exists that the 1982 upturn could be choked off by high interest rates and self-reinforcing stagnation tendencies would evolve that could last well into 1983. In this case, inflation probably would fall dramatically but unemployment rates in both the United States and Western Europe could rise to politically disturbing proportions.

Japan's economic growth pace is likely to remain in the 4-5 percent a year range, but the expansion is expected to depend much more on domestic demand than on increases in exports. Japan is certain to run a massive trade and hard currency surplus in 1982. This will be so even though export growth slows substantially and domestic economic expansion continues at a fairly high rate based on rising domestic demand. The Japanese surplus will create severe political reactions in the US and especially Western Europe. Neither the politically feasible measures Japan may take in response to these pressures, nor the likely appreciation of the yen, will have much effect on the trade surplus for 1982, although they could in 1983.

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Non-oil LDC growth can be expected to remain below the average pace achieved since the early 1970s. It takes six months or more before the upturn in industrial country activity begins to significantly boost the LDC growth pace. Moreover, many important LDCs have already or soon will accept domestic austerity to relieve foreign payments problems. In Central America the disruptive impact of insurgencies and the depressive effect of weak commodity markets will continue or will worsen in 1982. In much of Africa, declines in earnings from primary exports, due partly to low prices, have uncovered a legacy of decades of economic mismanagement. A growing number of countries in both areas will have to reschedule their foreign debt obligations, but most countries will meet their obligations by cutting the imports which have supported the small but politically crucial urban populations. Among the large, newly industrializing LDCs, Brazil will have to keep the brakes on the economy to handle its enormous debt service burden, Mexico will have to greatly slow its economic growth to adapt to lower real oil prices and pay for past policy errors, and South Korea will have difficulty sustaining its renewed dynamism in the face of weak foreign markets and protectionism.

Most oil-exporting countries will increasingly have to deal with problems caused by oil revenues falling behind development spending. Only in the case of rapid growth would there be some chance of a modest oil price rise near the end of 1982 that could help relieve this financial and political bind.

2. Long Term Industrial Trends

Growing Competitive Pressures

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The mature industrial economies--the United States and Western Europe--are being subjected to three-pronged external competitive pressures from:

- o LDCs with low-wage costs in traditional labor-intensive industries, such as textiles.
- o Newly industrializing countries (NICs) and some oil-rich LDCs, in basic industries, such as steel, non-ferrous metals, and petrochemicals, and in the simpler types of machinery and equipment.
- o Japan in very high technology industries, such as robotics and microelectronics.

Basically, international competition is a healthy reflection of the economic development process and the growing integration of the world economy. But competitive pressures are far more severe than ever before because they are appearing on so many fronts at the same time, and the industrial economies are far more open to foreign trade. In the US, for example, the ratio of imports to domestic consumption of goods has doubled in the past ten years.

Foreign competition is by no means the sole, nor even the dominant pressure for change. The adjustment to high energy costs, for example, will have a major impact on the demand for and the mix of products such as steel, chemicals, and machinery regardless of foreign competition. Environmental concerns also will impose heavy costs, particularly on basic industries, as well as generate demand for new products. Domestic policies, not foreign competition, will have the dominant effect on savings, investment, consumer behavior and entrepreneurship. Nevertheless, international forces are playing a far greater role in the pressures for

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change, at a time when the mature industrial economies have placed increasing barriers in the way of dynamic enterprise and efficient adjustment.

A Worsening Economic Environment

These enhanced competitive pressures are being felt during a period when economic growth has been slow, with deeper and more frequent recessions. Slower growth has been due in part to demand management policies designed to bring down inflation, which had been ratcheted upward by the jumps in oil prices, as well as by excessive monetary growth over many years. Slower economic growth is also due to a slowdown in investment in plant and equipment; to the allocation of a substantial part of investment to energy conservation and substitution and to environmental control rather than to the creation of new productive capacity; and to government tax and regulatory policies which have discouraged risk-taking and hard work. Under circumstances of slow growth, changes in the structure of demand and costs have been more difficult to cope with. With overall demand growing rapidly as in the 1950s and -60s, there were few industries in which production was actually falling; shifts of labor and capital from these to more dynamic industries could occur without major trauma. But during the 1970s, demand for the products of a number of industries has fallen, sometimes sharply, for at least several years. This has meant large-scale structural unemployment and major social and political problems in various localities. A similar process can be expected in the 1980s.

Underlying Causes

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The intensification and broadening of international competitive pressures reflects complex technological, institutional and economic factors. Since World War II, the world economy has become more and more integrated thanks to reduced restrictions on movements of goods, capital, labor, and knowledge. At the same time, more and more countries have climbed the development ladder, but major differences in traditions and institutions have made their integration in the world economy difficult.

Among all the forces for change, the following appear to be of particular relevance for the 1980s:

- o Technological changes permitting automatic control of production processes and efficient, relatively small-scale production rates. Both of these technological trends make it possible for LDCs to develop certain basic industries rapidly and often to produce at low cost. The greatest disadvantage of newly industrializing compared with established industrial countries is in the shortage of skilled, experienced workers. For example, it takes experience and skill to know exactly when the iron is ready to pour or the mix of chemicals is right, and this needed experience is available only in established industrial countries. But in the past decade or so, automated computerized controls have been developed which permit a few highly trained experts to operate the entire production process. This is the case, for example, with the continuous casting process used in many modern steel mills. The need for skilled labor is greatly reduced, so that new industries can be run mainly with relatively unskilled labor and a few, largely imported, engineers and technicians.

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Technologies which permit low cost production on a relatively small scale also favor the LDCs. Economies of scale gave major advantages to established industrial economies in the past because the LDC markets were generally too small to support large-scale production. Now many mills using electric furnaces can produce crude steel and some steel products far more cheaply than most large-scale integrated mills. In the US mini-mills now account for about 20% of the domestic steel market and can undersell the Japanese for many steel products. But similar technologies are being used in LDCs such as Egypt, Mexico and Saudi Arabia.

o More and more businesses have developed integrated international operations, including specialization of production components on a global scale in order to take advantage of least cost opportunities.

In the global industries, for example, Ford has major assembly plants in 15 foreign countries and significant production facilities in 34 countries including a large number of LDCs. Obviously, this global approach to production by multinational corporations has been an important instrument for bringing not only capital and technology, but also modern management to newly industrializing countries.

o Japan has reached a new stage of development, expanding R&D in its already advanced production technology and beginning a major R&D effort to develop new products in leading edge industries, such as microelectronics and robotics. The Japanese are capitalizing on a labor force with the highest educational attainment in the world, coupled with a high degree of discipline and social cohesiveness. This

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means that the kinds of training and skills needed for R&D are cheap in Japan compared with the US or Western Europe, and that Japanese firms are able to pursue R&D objectives with consistency and purpose.

The Adjustment Process

The adjustment by the mature economies to growing international competition has taken various forms, with varying degrees of success. On the whole, adjustment has been smoother in the US than in Western Europe, because it began earlier and was less constrained by government controls and other institutional factors. The basic evolution in the mature industrial economies has been from labor-intensive and basic industries to knowledge-intensive industries and services. Recent US experience has shown that competitiveness can be maintained or regained in some components of most industrial branches, including such traditionally labor-intensive branches as textiles. Various combinations of modern equipment, better organization of production, product specialization, and marketing skills, can assure healthy US industries in some types of textiles, shoes, etc.

Unfortunately there are many barriers to the adjustment process, and some of these are of recent vintage. In the US, high marginal income tax rates and taxation of capital gains have discouraged new, risky investments, of the type that would often be required for quick adjustment to growing foreign competition. Moreover, high inflation and uncertainty about future inflation have raised the target rates of return on new investment to levels that were bound to exclude new ventures with relatively long payoff periods.

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In Western Europe the constraints to adjustment are greater than in the US. Extremely high tax rates (which are now near 50% of GNP, compared to about one-third ten years ago), very high levels of social security payments and unemployment compensation, coupled with wage indexing and labor union pressure, have greatly discouraged the hiring of labor by private business and hindered labor mobility. High agricultural price supports and various forms of protection of small, traditional retail business also have tended to raise the cost of labor. Investment has been focused on saving labor, not on adding to capacity. A host of tax laws and licensing regulations discourage the development of small-scale, modern enterprise, as in microelectronics and in modern service industries.

Future Industrial Problems

In the future the main adjustment problems will occur not so much in traditional labor-intensive industries as in basic industries, including traditional machinery and equipment, and in very high technology industries.

Increased competition from low wage LDCs in such areas as textiles and shoes began on a large scale in the 1960s in the US market and continued in the 1970s in both the US and Western Europe. The adjustment process has involved production specialization and various degrees of protection, as through the International Textile Agreement. Japan, too, is being subjected to this kind of competition. Although competitive pressures will continue, the adjustment process is already far along and should not involve any major shocks. Inevitably, employment in these industries will decline in the US, Western Europe and Japan.

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The crisis in basic industries will continue and probably worsen in the 1980s. The US steel industry is on the way to being reconstituted, based on mini-mills and a reduced number of large-scale plants. The European steel industry is undergoing a traumatic adjustment, with many plants being closed down. With high energy costs, less steel, a highly energy intensive product, will be used per dollar of final output. Thus the demand for steel will continue to be weak and will shift in favor of thin sheets and special steels. New capacity will be built exclusively in the LDCs, and these new industries will be highly competitive in producing steel bars, sections and other relatively simple shapes.

Environmental problems will continue to push non-ferrous refining upstream, from the industrial countries to the LDCs. This shift should accelerate. In the case of petrochemicals, large new capacity is being built in Persian Gulf countries and a few other LDCs, using highly automated plants which require little skilled labor. Many of these plants should be competitive on world markets, with resulting pressure on the Western industries. The European and Japanese industries will be more vulnerable to this competition than the US industry, which has access to cheaper energy.

The 1980s will see a vast increase in the competitiveness of newly industrializing countries in medium technology machinery and equipment. Although Japan will continue to be a major factor in automobile markets, the main new long-term competitive threat in this area is from such countries as South Korea and Brazil which can easily master the modern technology, have access to a relatively well trained labor force, but pay

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only a fraction of US, or even Japanese wages. The NICs are already major producers of standard machine tools; in the future they will certainly enter a great many areas of machine building, as they climb the economic development ladder.

Japanese competition in very high technology industries presents a special challenge. Japan is unique in that, although its per capita GNP and average productivity is still well below the US and many countries in Western Europe, it has the best educated labor force in the world. Apart from lower wages, Japan's competitiveness in many industrial areas has been based heavily on an ability to develop much improved production processes. In recent years the Japanese have rapidly increased their R&D expenditures, in such areas as microelectronics and computers. Although they have not developed many really new products, they have found cheaper methods for producing products first developed in the US and elsewhere.

Over the next few years, the bulk of the Japanese competitive thrust in the US market will remain in the traditional industries--steel, autos and certain brands of consumer electronics. The Japanese will continue to apply robotics and other new technologies to reduce labor costs as they have already done at Nissan's Zama auto plant--the world's most automated. US firms also will start to feel the impact of Japanese efforts to expand sales in the computer and telecommunications industries in third-country markets. Japanese companies have already won orders for computers in Australia--a market long dominated by the United States--and will most certainly go after growing markets in the LDCs.

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In the longer term, Japanese firms can be expected to attack directly the US market for computers and telecommunications equipment once they have built the necessary production volume. Moreover, recently initiated massive R&D programs at the frontier of microelectronics, biotechnics and robotics may start to have a significant impact. The Japanese believe that the country's economic future depends on increasing the technology content of its exports. Most recently, the Japanese have demonstrated their ability to move in this direction in the semiconductor market. They now hold 70 percent of the market for 64K RAM computer chip and may be ahead of US manufactures in the development of a 256K RAM chip. Although the outcome is still in doubt, their resources, excellent organization, and singlemindedness enhance the chances of success.

3. Major Risks and Vulnerabilities

The economic troubles of this past decade have made the public and policymakers much more aware of the vulnerabilities of the global economy to:

- large scale commodity supply interruptions--oil, other raw materials, and grain.
- collapse of the international financial system.
- rampant protectionism.

Although the nature of the three risks are much different, they have some important characteristics in common.

- The chances that they will occur are low. Since World War II, only three situations can be considered to have had widespread and highly adverse political-economic consequences. In each case, the

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problem was inadequate supplies causing rapid price runups: (1) 1950, when demand soared at the beginning of the Korean conflict; (2) 1973-74, when a confluence of events sparked speculative fever for most commodities, and cuts in Arab oil production spurred energy prices; (3) 1979-80, when the collapse of the Shah's regime sharply reduced Iranian oil production.

- Their timing cannot be predicted, even though the risks are ever present and widely recognized. Events (political turmoil, strikes, bank failures, poor weather etc.) that could trigger these serious situations almost always turn out to be local disturbances and/or frictions that are a normal part of a dynamic global economy. The few crises that do occur most often evolve from a highly unusual coincidence of events and timing.
- The global economy is most prone to these risks at the top of the business cycle when speculative pressures are greater and at the bottom of the recession when business financial problems are most acute. The global economy is now at the bottom of the cycle, and the next peak may take place in the mid-1980s.
- Preventive measures do exist to reduce the risks. In the case of supply interruptions, stocks and/or set-aside production capacity are important; for the other two vulnerabilities, international institutions and informal linkages and codes of conducts among nations play a major role in risk reduction. These links have been helpful in building an awareness of potential problems and imbuing an understanding of the self-interest involved in supporting the

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international system and in avoiding actions that can hurt other countries or impair the international order.

Supply Interruptions

Oil The painful transition toward a global economy less profligate in the use of oil is clearly underway. Driven by two oil price shocks, a conservation momentum has taken hold, and the shift away from conventional oil to other sources is well along. The chances now seem low that some oil shortfall will trigger a devastating price runup this year and possibly through the mid-1980s. Although oil stocks have fallen from their record high levels of mid-1981, excess production capacity this year will likely remain rather large, even if the Iran-Iraq war continues. Even though demand for OPEC oil may slowly increase in subsequent years, the probable return of substantially larger Iranian and Iraqi exports, once the war ends, makes it likely that there will be sufficient OPEC oil to meet demand for several years. It would take a major and prolonged political upheaval in Saudi Arabia or a closure of the Strait of Hormuz to create an OPEC III. It is even possible, though unlikely, that the nominal price of oil will fall.

By the mid-1980s, however, the oil market may become more vulnerable to supply interruptions, even those of a moderate size. As demand for OPEC oil rises with global economic activity, and as the additional impact of past oil price increases on energy production and conservation diminishes, the margin of available excess capacity may be squeezed. As a result, a much smaller supply interruption than a Saudi production disruption could threaten to set off big price increases. Unlike past price spurts,

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however, it is highly unlikely that any large future oil price increase could be sustained for long. The conservation reaction after the 1979-80 price rise was far greater than had been the case after 1973, because oil prices have become a much larger component of consumer and business expenditures and have reached or surpassed the cost of many alternative energy sources. The forces for adjustment would be far stronger in the future, although there would still be massive economic costs.

In deciding how much should now be spent on reducing the risk of an oil price explosion in the mid-1980s and beyond, policymakers face tough decisions. The problem is that experts differ widely on oil market trends. Although many analysts, including ourselves, expect the oil market to tighten in the mid-to late 1980's, leading eventually to a rising real price trend, and, in any case to a greater vulnerability to shocks, others hold different views--that demand for OPEC oil will continue to decline and unused oil production capacity will remain large. If the first view is correct, it is easy to justify building strategic reserves and keeping domestic oil prices high to stimulate energy production and conservation.

On the other hand, if a long period of low prices and low risk is expected, the advantages of these policies become less clear, and their costs become more burdensome. These costs include not only a direct impact of added expenditures or taxes, but also the loss in cost competitiveness which would occur if the United States tries to support high prices for domestic energy while some of its competitors import energy from the cheapest source.

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Other Raw Materials. The potential problems associated with dependence on imported raw materials are far less severe than in the case of oil. As can be seen in table __, no other commodity even comes close to matching the value of oil trade. It would take a widespread commodity shortages, as in 1950-51 and 1973-74, to seriously disrupt global economic activity. And even in those cases, the surge in prices was soon reversed.

It is highly unlikely that LDCs exporters or Communist countries, individually or in groups, will create shortages by withholding production for political ends.

- For most key commodities, the sources of supply are well diversified with such developed countries as Canada, Australia, and South Africa providing the bulk of Western imports.
- Non-oil exporting LDCs lack the economic and financial wherewithal to withstand a prolonged denial of mineral products.
- LDC producers of commodities rarely have common political goals powerful enough to initiate large cuts in exports.

One remote possibility is an embargo by Black African nations against industrial countries for supporting South Africa. In this case, the United States would be deprived of the bulk of its cobalt supplies and about 40 percent of its manganese needs. In addition to these two metals, the Europeans and Japanese would be affected by more limited supplies of copper, bauxite, and iron ore.

A more serious and enduring potential danger is a prolonged period of racial strife in South Africa, which would disrupt supplies of platinum, chromium, some minor strategic metals, and gold. To have a serious global

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impact, such a supply interruption would have to exceed a few months and/or would have to coincide with a sharp increase in demand. This risk could be significantly lessened through strategic reserves or private inventories.

Platinum is the only strategic metal for which industrial countries depend heavily on the Soviets. Nearly half of Free World platinum consumption is supplied by the USSR, while similar percentages for other metals are 8 percent or less. Even in the case of platinum, users could obtain sufficient amounts to meet crucial needs (mainly in petroleum refining and chemical processing) for at least several years through increased output of other major producers (mainly South Africa), available stocks (both government and private), and the ability to substitute or to do without. The inflationary impact would be small because platinum adds little to the final selling price of most products in which it is used.

Grain. In the case of grain, the international market has become increasingly prone to price fluctuations stemming from unpredictable weather patterns. The US Government no longer holds huge grain stocks which can be used to smooth out prices. International grain sales have risen sharply in recent years, because oil-exporting countries and the USSR have greatly expanded their purchases, and many countries have increased their demand for livestock protein. The market, nonetheless, has remained remarkably resilient to substantial and prolonged jumps in prices. In recent years, for example, such a price run was averted despite three consecutive poor Soviet harvests, a major US corn belt drought (1980), and relatively low stocks. A major reason is that the significant increase in grain-fed herds worldwide has provided a new means of grain storage.

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During good harvest years when grain prices are comparably low, farmers build up their herds and feed them more grain; when crops are poor and prices soar, the livestock industry responds by cutting back herds and by reducing the grain fed each animal, thus providing the market with grain-fed meat while reducing the demand for grain. Such a phenomenon has been particularly noticeable in the United States, with the major retrenchment in hogs and grain-fed beef. Given this market adjustment potential and the likely quick production response of farmers to higher grain prices, it would take a highly unusual number of crop disasters throughout the world over a number of years to create serious global food shortages or a prolonged period of relatively high grain prices.

Financial Collapse

Although since the early 1970s the international financial system has remained remarkably resilient to shocks that could cause a panic, it also has become increasingly susceptible to such devastating events because:

- The dramatic changes that have taken place in the size, scope, and complexity of the system have created numerous new uncertainties.
 - Differences between domestic and international systems have been greatly clouded, thereby reducing the effectiveness of each country's ability to regulate financial transactions and creating many "grey" areas in regard to each government's responsibility in a crisis.
 - The much longer chain of financial institutions linking the ultimate saver and borrower has significantly enhanced the potential for a weak link to set off an uncontrollable chain reaction.

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- The switch from a fixed to a floating exchange rate regime has vastly increased the potential for bank failures resulting from losses on foreign exchange dealings.
- The rapid rise in Euro-dollar transactions has established a financial market that lacks government controls and seems to work in a mysterious fashion.
- Market participants have become less prudent in handling deposits and making loans. It is only natural that bankers should act with less caution. The international system has worked remarkably well despite two currency crises (1971 and 1973), several bank failures in 1974, and two bouts with absorbing and dispensing huge amounts of new petrodollars. In addition, for many banks international lending has produced fewer bad debts than domestic operations and has been very profitable. This sanguine mood, however, has meant that banks have become more prone to borrow short-term funds and lend them out on a long-term basis, and have taken less cognizance of the risks inherent in the system and those arising from lending to foreign governments where they have no legal recourse.

The probability of a full-fledged systemic crisis, nevertheless, remains low. The same forces that have created greater dangers for the system have also bolstered its survivability. The lack of government regulation over international transactions has provided the flexibility needed to cope with rapidly changing circumstances. The much greater involvement in international business by many financial institutions has

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diversified the risks. The constant publicity as to potential problems has made banks somewhat more cautious and has led to government and bank actions aimed at preventing and at better diagnosing potential problems. Probably most important, both lenders and borrowers have accepted informal norms of behavior because they believe it is in their best interests to ensure a continuing smooth operation of the system. Finally, a closely knit and rather small fraternity of Western financial leaders (both in government and in the private sector) has worked together effectively, even during emergencies.

If there is a system crisis, it will most likely result from a surprise event (or confluence of events) that leads to a loss of confidence in the system. Such an undercutting of the basic beliefs in the system's operation would occur if:

- Central banks and/or the financial community are unable or unwilling to act quickly and in unison to meet an emergency.
- The leader of some major debtor nation decides to repudiate its debt for whatever reason (political or economic), and this type of action becomes commonly accepted.
- The US government is incapable of controlling inflation and thus unable to prevent a significant erosion in the value of the dollar.

During the next few months the international system should be watched more carefully than usual. There is a high potential for widespread bankruptcies, country defaults, and bank failures because of adjustments to the sharp drop in economic activity. In addition, the political turmoil in Poland raises a specter of that country defaulting on its massive foreign

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debt. In itself, the problems caused by a Polish default (mainly for West German and Austrian banks) are unlikely to lead to a failure of the international financial system, especially since the potential difficulties are widely recognized. If other important borrowing countries default on their debt or if there are a significant number of major domestic bank or firm failures, then the risk of a crisis would be uncomfortably high.

Protectionism

The battle against protectionism in the industrial world has been remarkably successful in the past decade despite the considerable jump in unemployment, the severe strains caused by major shifts in industry, the numerous times protectionist sentiment reached a feverish point, and the imposition of some new import restrictions. By far the major reason for this favorable outcome has been the high priority government leaders have given to preventing a global trade war and the international institutional arrangements that have allowed for a give-and-take on trade issues. This process has provided enough pressure on the key countries to inhibit them at least from taking actions that could seriously hurt other nations. Attitudes could shift dramatically, however, if any one major country would decide it is in its best interest to break with established international norms. As such, protectionist tendencies must be constantly watched and countered.

In the next few years, the following possibilities are the most likely sources of-rampant protectionism:

- Japan -- The frustrations against the Japanese trade practices are growing once again in both the United States and Western Europe and

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will likely be exacerbated by the growing Japanese current account deficit which is expected to reach a record \$20 billion in 1982. Although once again Tokyo might be able to approach the other industrial countries with minor trade concessions, it is certainly conceivable that this time the frustrations against Japanese trade practices may be much greater than Tokyo realizes. The result could be that some countries decide to restrict in a major way Japanese exports. Other countries would have to follow suit to prevent a massive diversion of Japanese goods to their markets.

-- France -- If, as now seems likely, the newly introduced economic policies of the Mitterrand government fail to materially reduce unemployment, Paris might believe the only way to achieve this goal is by further closing the French market to foreign manufactures. Because France is a Common Market country, it would mean that the other nine nations would be forced into applying their own restrictions. Again, the potential for export diversion could cause other industrial countries to take similar actions as the French.

4. The Soviet Bloc

The Communist countries, especially the Soviet Bloc, will suffer not from enhanced competition from outside industrial sources, but rather from the lack of competition inside. A stultifying bureaucratic economic system will continue to promote slow modernization, but with a massive waste of resources, and an inability to make quick, effective adjustments to changing circumstances.

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Economic growth in the Soviet Union and Eastern Europe will be slow-- probably 2% a year or less. Given the grossly inefficient use of investment and the large defense burden, this will mean stagnation in living standards which will be perceived by most as a decline in the quality of life. The hope of most Russians and East Europeans that they could achieve substantial improvements in living standards by working hard through the system has largely disappeared and popular attitudes are likely to be even more negative in the 1980s. These attitudes in turn will further dampen productivity unless drastic reforms of the economic system are introduced, and that is very unlikely.

Among the factors likely to cause slower economic growth are: a much reduced growth of the population of working age; much slower growth of energy production; greatly increased cost of extracting and transporting raw materials and energy from Siberia; and apparently growing difficulties with introducing and absorbing technological change. In addition, Soviet and East European growth will be hindered by a likely stagnation or decline in imports from the West. Stagnating exports coupled with a high hard currency debt for some countries will greatly constrain hard currency import capacity for the entire Eastern Bloc even if the West provides large new credits.

5. Implications for National Power, Leverage, and Influence

These economic trends and vulnerabilities taken together are not unfavorable to the position of the United States as a world power. Although there is a potential for serious weakening of the US economy under some circumstances, the US clearly has the potential dynamism, the resources and

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the institutional flexibility to prepare itself against some future economic problems, and to adjust effectively to other problems. Many other countries are not so fortunate.

The rapidly growing integration of the international economy is clearly an important force enhancing economic growth, efficiency and welfare throughout the world. At the same time closer international links constrain the freedom to pursue purely national goals.

For the US, a healthy economy provides a strong foundation for national defense and foreign policy, but may not meet all national security needs. Growing foreign competition, especially in high technology industries, may leave the Defense Department far more dependent than in the past on purchases from abroad to obtain key elements of US weapons systems. This dependence could grow to dangerous proportions. No projection can now be made, but the problem must be closely analyzed and watched.

Economic trends and vulnerabilities will affect the economic leverage and influence the US can bring against other nations as well as the pressures they can bring on the United States. The potential for leverage can rarely be specified unambiguously, however, because of the complexity of the linkages within the world economy and between economic and political relations with foreign countries. The closer and more complex these links, the greater the difficulty of defining and using economic leverage. For example, the complexity of US relations with Canada, Mexico, and Western Europe is such that use of leverage in one economic area tends to have unintended undesirable effects on other areas very quickly. Potential for

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leverage is easier to define in relations with countries like the Soviet Union, which are far less intricate and pervasive.

Western Europe

Western European countries are likely to be sufficiently preoccupied with their economic problems to bring a further erosion of their ability to take any strong new initiatives in defense and in foreign policy. The tendency for dissatisfaction with high unemployment and other economic ills to spawn strongly divergent political solutions both within and among countries in the area will probably continue. Political divisions over economic problems in turn will make it harder to achieve a national consensus on such issues as: increased defense spending within NATO; tighter controls over trade with and technology transfer to the Eastern Bloc; and solution of the Arab-Israeli dispute. Given political divisions, it is unlikely that a higher degree of regional policy coordination will be achieved through the Economic Community. Indeed, there is a growing risk that policy coordination among European countries will diminish, although the underlying, widely shared interest in continuation of the degree of economic union that has been achieved probably assures against major steps backward.

Japan

Economic trends in the 80s clearly will enhance Japan's national policy options. The rapid development of high technology industry will greatly strengthen the base for arms production. Even if military expenditures are held down, Japan will be able, should it so decide, to develop most modern military systems very rapidly. Major departures in

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Japan's foreign and military policies are unlikely, however, because of the country's pacifist and nuclear hangups and deepseated fears of losing its access to foreign sources of energy, raw material, and food.

US relations with Japan will continue to involve a strong US tactical leverage which is limited by longer term strategic considerations. In the short term--a few years--Japan has little choice but to negotiate the best terms it can for access to US and West European markets. It has nowhere else to go. This means that serious threats of imposing restrictions on Japanese goods may, if sustained, be effective in slowly opening up the Japanese market. But at some point of intensity, such pressures would begin to stimulate a change in Japanese internal politics, greater nationalism, and bilateralism, including broader dealings with Soviet Bloc countries.

The LDCs

Economic trends in the 1980s will bring an increasingly sharp bifurcation among the LDCs between the successful ones and those that remain undeveloped. Neither group of LDCs, however, will be able to exercise much political power. As the successful countries--the NICs and some of the big oil exporters--climb up the development ladder, they will have less and less in common with the rest of the "South." Although they will want to increase their international influence, they will try to do this by increasingly participating in the institutions which govern the present international trade and monetary system. As their economic links to the industrial West expand, the practical possibilities to adopt narrow, inward-looking, policies will shrink. There will be little scope, there-

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fore, for cooperation between these countries and those that remain poor and undeveloped. The latter group will continue to agitate wherever it can for more aid and higher prices, but will have little muscle behind their demands.

The political power of OPEC producers and other oil exporters will probably be smaller in the 1980s than it was in the 1970s. A soft oil market at least for the next few years will reduce their purchasing power. Growing domestic expenditures also will cut into any surpluses; indeed, most OPEC countries may well be running a deficit within a year or two and could continue to do so for some time. Those oil exporters who will succeed in diversifying their economic base will thereby acquire new economic linkages with the West and consequently additional reasons not to want to rock the boat. Finally, domestic economic development will divert more and more of oil production to domestic consumption and reduce the surplus for export. Consequently, although the West will remain highly vulnerable to a prolonged oil supply interruption, the flexibility of the oil exporters to use their oil assets for political purposes will be reduced. This situation could change drastically, however, if only temporarily, if a major oil supply interruption or strong growth in oil demand caused new shortages.

Among the oil exporters, however, Saudi Arabia will have considerable economic power for years because of its enormous oil earnings and excess productive capacity. The Saudis will continue to play a key role in OPEC, will have a major influence on Middle Eastern politics, and will be courted by the West. Their political links with other Arab countries, their

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growing economic links with Western countries, and their dependence on the US to help protect their security all work against Saudi use of the oil weapon in other than a subtle way. Iraq too may become a Middle East power to be reckoned with if it can extricate itself from the war with Iran and can avoid major political upheavals, which is by no means certain. Even with a far larger population and economic base than the Saudis, the Iraqis should be able to export enough oil to fund foreign aid programs and other external initiatives.

Among the other countries, South Africa is probably the only one with large implicit economic leverage by virtue of its vast mineral resources. A desire not to disrupt supplies of South African minerals is likely to be as much of an inhibition on Western willingness to impose severe sanctions on South Africa in the 1980s as it was in the 1970s. Other African mineral producers need money too badly to use their minerals for political purposes. LDC based commodity cartels are likely to be no more successful than in the past, and where there has been some success, as in the case of tin, economic, not political, objectives are governing.

The Soviet Bloc

Economic problems in the '80s will make the further expansion of Soviet military power and political influence increasingly difficult and painful. Moscow will try to continue to increase its military expenditures rapidly, sustain its empire, and finance influence in the Third World in spite of slow economic growth, by forcing the long-suffering Soviet people to accept a lower standard of living. But expenditures on foreign adventures and to support Eastern Europe, always unpopular in the past,

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will obviously become even more so in the future and are likely to generate substantial internal political opposition. And it is possible that popular pressures for improved living standards and reform will build up to such a point that the Soviet leadership would have to consider changing its priorities.

Moscow will be in a weak bargaining position in its economic dealings with the West during the 1980s. The Soviets badly need Western grain, technology, and steel. Moreover, Moscow cannot increase, and may have to curtail, its hard currency imports if it cannot obtain a great deal of new Western credit and/or Western help in developing new energy and raw material exports. To exploit this dependence, however, will take concerted Western actions. Because Moscow can obtain almost everything it needs--whether grain, industrial products, or credit--from other non-Communist countries, the US has little unilateral leverage on the Soviet Union. Coordinated Western policies regulating credits to the Soviet Union and Eastern Europe could have a subtle influence on Soviet foreign policies. The possibility of achieving a common position among major Western lenders may be greater in this area than any other. It will be far more difficult to achieve a common position on investments in Soviet energy and raw materials development, but Japan and, to an increasing extent Western Europe, should be able to extract favorable economic terms and possibly some modest bilateral political concessions.

The Soviet Union's economic leverage on Western countries is small and diminishing. Soviet Bloc markets will constitute a diminishing share of Western country exports. Apart from Soviet natural gas, the availability

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of which can lower the price of gas in Western Europe, and platinum, there are ample and cheap sources outside the Soviet Bloc for what this area exports. Only an exceedingly unlikely set of circumstances could lead to Soviet control of enough of world supply of any critical material to allow Moscow to gouge the West or disrupt markets on a significant scale. In the case of LDCs, Soviet economic aid is useful primarily to help maintain governments that have already swung toward the Bloc; it is unlikely to be a significant attraction.

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