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FROM: Harry Rowen, C/NIC			
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National Intelligence Council

27 Jan 82

NOTE FOR THE DCI

Here is the text of my supplemental
statement on economic prospects for Europe
and East Asia that you asked to see.

HSR

Henry S. Rowen
Chairman

Attachment

Economic Prospects in the West

Economic prospects in the West can be summarized as follows:

- growth prospects for the market economies with large socialized sectors are generally poor
- those for the more purely market economies are good on the whole, but even here there are some problems

In contrast:

- growth prospects for the centrally planned economies are dismal

Much of the Western industrial world has suffered from several ailments over the past decade including higher oil prices, high inflation, reduced investment in plant and equipment, and government tax and regulatory policies which have discouraged risk-taking and hard work. In addition, the United States and Western Europe have come under increasing foreign competitive pressures. Only Japan among the industrialized countries has managed to retain a high level of dynamism.

Growth prospects for Western Europe in general have been impeded by extremely high tax rates (now nearly one-half of GNP versus only one-third ten years ago), high levels of social security payments and unemployment compensation, trade union rigidities, agricultural

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Germany have dimmed along with the rest of Europe and unemployment has risen sharply, its record on the inflation and trade fronts remains the best among the industrialized world. Bonn nevertheless must face the longer term problem of revitalizing its manufacturing sector, especially in the face of increasing competition from the newly industrializing countries (NICs), if any progress is to be made in lowering its unemployment rate. The new Socialist government in France has undertaken the most reflationary program among the European states in hopes of curbing its unemployment rate -- the highest among the Big-Four. In the coming years, Mitterrand's economic policies are virtually certain to backfire, given accelerating inflation rates and various perverse disincentives. In Britain, the jury is still out on Mrs. Thatcher's policies. Although some encouraging signs have been seen, fundamental social attitudes may still prevent a long-term turnaround. It is unlikely that the Italian government will be able to fashion a coherent economic program any time in the foreseeable future and will continue to muddle along.

In Japan, in sharp contrast to Western Europe, there are no signs of the fading of Japan's dynamism although growing resistance in other industrial countries to its export-oriented economic behavior may increasingly constrain it in the 1980s. In the future, Japan may even be able to fall back on its domestic market more so than in the past in order to maintain its remarkable pace of economic growth.

Moreover, the increased integration of the non-Communist world economies poses new adjustment strains. The European, and also Japanese, steel industry is undergoing traumatic adjustment. Non-

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ferrous refining is moving upstream to the LDCs. A substantial amount of oil refining and petrochemical capacity is moving to the oil exporting countries. Competition in automobiles will be coming from South Korea and Brazil as well as Japan. And of course Japan is moving on to higher technology areas in electronics, telecommunications, and robotics among others.

The ability of the Europeans to cope with these external challenges and internal rigidities will strongly affect their ability and willingness to pay for defense in the 1980s, political cohesiveness in Europe and within the Atlantic community, and their attitude toward perceived economic opportunities in the Soviet Union and Eastern Europe.

Future trade relations with the Soviet Bloc will have little overall impact on the prospects for West European economic recovery. Although sales to the Bloc are relatively important for several industries, including steel, chemicals, and machinery, sales to the region account for only 5% of total exports. While the West Europeans do not consider the East a boom market -- its share of total West European exports was about the same in 1981 as in 1961 -- the market is too large to ignore. At this point there is only limited basis for optimism about the Europeans' ability to change.

The stellar performers in the 1980s, as in the 1970s, will be the newly industrializing countries, the NICs, especially those in East Asia, Hong Kong, Taiwan, South Korea, Singapore; in the '70s, they grew 7% annually compared with 3% in the OECD countries. Moreover, their technological sophistication is growing; for instance, they are becoming increasingly important in our imports of electronics. Their success is due to outward-looking growth policies and the avoidance of government

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measures which have stultified growth in so many of the industrialized countries.

In contrast, GNP growth of the LDCs, excluding the NICs, has remained low, less than 2.5% per year for the past four years and there is no near-term prospect of a significant improvement in their condition.

The trends I have described are going to continue to generate new challenges -- and opportunities -- to the US. As the Japanese, and Europeans, move progressively to the production of higher technology goods, the competitive US sectors will be increasingly challenged. And close on their heels will be the NICs moving in with competitive, only somewhat lower technology goods.

This outlook for the market economies could be upset by several developments. One is a major and extended oil interruption, which could happen given the high dependence of the non-Communist world on Persian Gulf oil and the proximity of Soviet military power to the Gulf. A second is a systemic crisis in the international financial system. This appears very unlikely but there has been a very large growth in foreign indebtedness and exposure which needs watching. A third is creeping protectionism in the West which could have damaging economic and political consequences.

With all of these current and potential problems there is little doubt that the prospects for the market economies are brighter for the centrally planned ones. Indeed, the future ability of the Soviet Union (and Eastern European) economies to grow and even to avoid decline may depend crucially on their ability to acquire more Western goods and technology. The Soviet Union's ability to acquire Western goods through

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its traditional method of exporting raw materials looks unpromising given the prospect of low raw material prices. Only if the Europeans and other Western nations are prepared to provide generous credit to the Soviet Union is it likely to be able to gain needed access to Western goods.