National Intelligence Council

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Some Policy Implications of the Changing Global Economic Environment

National Intelligence Council Memorandum

Confidential

NIC M 82-10003
March 1982

Copy 164

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Approved For Release 2007/04/30 : CIA-RDP85T00176R001300090001-3

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Information available as of 4 March 1982 was used in the preparation of this Memorandum.

This Memorandum was coordinated within the National Intelligence Council and discussed with the Directorate of Intelligence. Comments are welcome and should be addressed to its author [redacted] of the Analytic Group of the National Intelligence Council [redacted]

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Some Policy Implications of the Changing Global Economic Environment

Scope Note

This paper presents selected propositions concerning circumstances that could either (1) make US policy choices more difficult, (2) increase frictions with other countries, or (3) enhance the ability of US officials to achieve policy objectives. The paper concentrates on the next few years, with a glimpse at some longer term concerns.

Key Propositions

Some major changes under way in global economic conditions may have important implications for the United States. Specifically:

- The timing and pace of the global economic recovery expected this year depend more heavily on the economic performance of the United States than has been the case for any economic recovery during the past 10 years.

- The competitiveness of US manufactures will suffer in 1982 just at the time the US domestic economy will be near a cyclical low point and trade frictions with Japan at a high point.

- Tokyo could miscalculate the seriousness of US and European trade concerns, and so contribute to a significant increase in trade barriers against Japan and a global upsurge in protectionism.

- Oil prices are falling this year and may continue to fall for several years, at least in real terms; consequently, the United States and other countries will have to deal with a new set of energy-related issues.

- The increase in foreign direct investment in the United States provides the US Government with an increased opportunity to press for the reduction of foreign government controls on US firms.

- Western Europe's current economic malaise will increasingly aggravate normal Atlantic Alliance frictions.

- The deteriorating hard currency position of the Soviet Union provides the United States and its allies with an enhanced source of subtle leverage against Moscow.

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Some Policy Implications of the Changing Global Economic Environment

The timing and pace of the global economic recovery expected this year depend more heavily on the economic performance of the United States than has been the case for any economic recovery during the past 10 years.

By mid-to-late 1982 the pace of global activity is expected by most observers to move out of the doldrums that characterized 1980 and 1981. How strong and durable that upturn will be depends to a large extent on what happens in the United States. The United States has in place the only major program to stimulate economic outputs through fiscal and other means—the midyear tax cut plus earlier investment incentives. In addition, inflationary pressures seem to be declining faster in the United States than elsewhere. For their part, the West Europeans and the Japanese are unwilling or unable to provide the engine of growth they did during the upswings in the 1970s. Both feel that they can no longer apply massive doses of fiscal stimulation because of their extraordinarily large budget deficits. The Europeans also seem to have lost, at least temporarily, their economic vitality and self-confidence.

Meanwhile, OPEC, the newly industrializing countries (NICs), and the Communist countries are no longer in a position to provide the growth markets they did in the 1970s. OPEC and the NICs were especially important because their import markets expanded at triple and double the pace of the developed-country markets. These latter two groups face significant foreign financial stringencies and some countries within these areas are coping with political turmoil.

From a psychological point of view, the industrial world and many LDCs have increasingly, explicitly or implicitly, turned to the United States for global economic leadership. Given their mood, the Europeans are much less inclined to be leaders than they were just a few years ago. Ingrained Japanese attitudes continue to prevent them from playing a role in global economic affairs that even begins to come close to their economic prowess. As a consequence, considerable attention abroad can be expected to be focused on the outcome of the present US administration's domestic economic policies.

The competitiveness of US manufactures will suffer in 1982 just at the time the US domestic economy will be near a cyclical low point and trade frictions with Japan at a high point.

US trade performance since the early 1970s has been highly cyclical as a result of exchange rate movements. During this period, major changes in the value of the dollar significantly influenced US trade trends after about six to 18 months. This lag partially reflects the time it takes before new contracts reach the shipment stage. For example, the relatively low value of the dollar between 1976 and 1978 was largely responsible for the United States' good performance in exports of manufactures between 1978 and 1980. In fact, the US share of OECD exports to the world was little different in 1980 from what it had been in the early 1970s.

The situation is changing, however. US price competitiveness is slipping as a result of a strong dollar. By far the most serious problem is the strength of the dollar vis-a-vis the yen since mid-1979. The appreciation of the dollar against the mark and some other European currencies since late 1980 has also reduced US competitiveness. As a result, the US share of OECD exports of manufactures began to slip around mid-1981, and there is every expectation that the decline in market shares will persist well into 1982. Expected slow growth of foreign markets will further add to US export woes. The poorer export performance will have a much greater adverse impact on the US economy than it had just 10 years ago. During that time, exports as a percentage of total goods produced have doubled.

The slipping US trade performance, once it is widely recognized, will exacerbate the already strong belief at home that US manufactures are no longer competitive and increase calls for actions to support US industries against foreign competition and to do more to open foreign markets.

The comparatively poor US trade performance eventually should cause the dollar to depreciate against the yen and the mark. What is uncertain is the degree and speed of the currency change. High US interest rates and political uncertainty in Eastern and Western Europe would help sustain the dollar's value, even though trade trends call for a depreciating dollar. The longer these two factors encourage dollar investments in the United States, the longer it will be before the United States can recoup its competitive pricing position in international trade. Meanwhile, the fundamental factors influencing price competitiveness will tend to favor the Japanese and the Germans. Their inflation rates are expected to run below those in the United States (as they have for several years), and these two countries are likely to continue to enjoy faster growth in productivity in the manufacturing sector and smaller increases in the labor costs of each unit of output than the United States. As a result, the longer the dollar maintains its strength, the larger will be the cut needed in the dollar's value to restore the price competitiveness of US goods.

Tokyo could miscalculate the seriousness of US and European trade concerns, and so contribute to a significant increase in trade barriers against Japan and a global upsurge in protectionism.

For the third time in the last 10 years, substantial pressure is building on Japan to hold down exports and open its domestic market to more foreign goods. Since 1980 Japan's exports have been climbing rapidly and its imports have been languishing . This trend is expected to last well into 1982. As a result, the country's current account, which fell deeply into deficit because of the 1979-80 jump in oil prices, moved back in surplus in mid-1981. This year Japan's current account, its overall trade balance, and its bilateral trade balances with the United States and the EC will all reach surpluses of record proportions. Other industrial countries understandably believe that these trends mean Japan is exporting its economic troubles. Japan has been able to maintain economic growth in the range of 4 to 5 percent and to avoid significant unemployment problems even though domestic demand has stagnated.

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Given these major roadblocks, there is a high risk that the Japanese will not make concessions significant enough to disarm the rising trade antagonism against them, thereby unleashing the industrial world's current pent-up protectionist sentiment. Some countries could decide to restrict Japanese exports in a major way, while others would have to follow suit to prevent a massive diversion of Japanese goods to their markets. In the end, the highly effective international trade arrangements, painstakingly put together in the post–World War II era, would be severely undermined. The newly imposed trade restrictions would be hard to remove, and, in the future, countries would be more inclined to take similar restrictive moves to right trade grievances they have with others.

The opportunity will also be present to make Tokyo take meaningful steps to reduce its trade barriers. Public outcries against Japan in both the United States and the EC will be particularly strong as a consequence of the high rate of unemployment and the huge Japanese trade surplus. The Japanese body politic takes foreign criticism rather seriously, and Tokyo would feel obliged to try to disarm it. Finally, a newly established high-level multilateral trade forum can be used to deal with the problem. The window of opportunity, however, will be temporary because the likely appreciation of the yen this year will cut deeply into Japanese competitiveness and trade surpluses by 1983 or 1984. 25

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Oil prices are falling this year and may continue to fall for several years, at least in real terms; consequently, the United States and other countries will have to deal with a new set of energy-related issues.

After declining nearly one-third since 1979, the demand for OPEC oil will probably begin a trend upward as global economic growth resumes. The increase, however, is likely to be slow because of the continuing conservation momentum and the increasing availability of non-OPEC sources of energy. As a result, excess OPEC production capacity will remain large for at least a year or two, even if the Iran-Iraq war continues, and if there are no major new supply disruptions. An end to the war would probably increase available OPEC capacity enough to keep the oil market soft at least through the mid-1980s. Under these circumstances, the nominal price of oil will probably slip somewhat through at least 1982 and could even fall sharply. In the next few years, the real price of oil is likely to continue to fall as overall prices continue to rise while oil prices tend to level off.

The oil market outlook beyond the mid-1980s is highly uncertain. Diametrically opposed views on longer term trends are emerging among analysts. Many expect the oil market to tighten considerably in the mid-to-late 1980s as economic growth proceeds and as the declining real price of oil adversely affects conservation efforts and the development of new energy sources. These analysts thus see the margin of available excess capacity squeezed to the point that fairly small supply disruptions could threaten once again to set off a sharp price runup. Others predict little or no increase in OPEC oil demand through 1990 on the basis of more optimistic estimates of demand and supply responses to earlier price jumps. Whatever the outcome, the public mood for the next few years at least will be most impressed by the declining price trends, and any policy intitiatives in the energy field will be strongly influenced by this change in expectations.

Impact on Efforts To Protect Against Supply Vulnerabilities. The increasing long-term oil market uncertainties are increasing the difficulties policymakers face in deciding how much they should now spend on reducing the risk of an oil price explosion in the mid-1980s and beyond. If the first view above is correct, it is easy to justify building strategic reserves to offset any major supply disruptions. On the other hand, if a long period of large-scale excess capacity is expected, the advantages of this policy become less clear, and its cost becomes more burdensome. These costs would include the initial outlays to build and stock the facility and the ongoing spending on maintaining the effort, especially the interest paid to finance the inventories.

Impact on Oil-Importing Countries. As real oil prices decline, some energy production facilities in oil-importing countries will become unprofitable. As the number of profit-strapped producers increases and awareness of the new problems grows, the mood of the body politic could quickly shift from worrying about shortages to concern about surpluses and protecting domestic producers. In many industrial countries, producers would turn to their governments for protection against "cheap" foreign energy through price supports and/or budget subsidies.

In these circumstances, a set of national security arguments similar to those of the 1950s and 1960s could be injected once again into policy deliberations. Security issues would be the stalking-horse for economic interests of particular groups. Domestic producers and others would argue that a tariff on oil imports is needed to maintain output levels and conservation efforts in order to prevent a return to a highly dangerous level of dependency on imported oil. Consumers (both household and industrial) would argue that it makes more sense to import low-cost energy now and save domestic resources for future needs.

Protection of high-cost domestic energy would damage the US competitive position in some energy-intensive products and would make the oil input cost of a broad range of goods and services relatively high. Because jobs as well as profits would be at stake, trade frictions among countries could intensify. There would be growing demands for establishing rules of the game for energy-related trade protection—no small task, given the considerable differences among countries in their energy mix and reliance on domestic energy sources.

Impact on Relations With Oil-Exporting Countries. A decline in oil prices would erode both the revenues and the economic power of the oil-exporting countries. Most would have to scale down their ambitious development efforts, some would have to cut ongoing programs. The poorer and more populous oil-exporting countries—Nigeria, Indonesia, Mexico, Iran, Algeria, Venezuela, etc.—would be most seriously hurt by a soft oil market. Unable to diversify their exports quickly enough to fill the gap in oil revenues, these countries would face slower economic growth, and the expectations of politically powerful groups for a rapidly rising standard of living would be severely disappointed.

Under these circumstances, some oil-exporting countries would be susceptible to greater political upheavals or radical subversion than is the case at present. While the interest of industrial countries in the exporters' energy resources would wane, there would still be a strong security interest (depending on Soviet behavior and intentions) and a considerable interest in these countries' markets. Thus, industrial countries would find themselves having to balance these concerns with the objectives of minimizing long-term vulnerability to oil supply interruption and the protectionist demands of domestic energy interests.

The increase in foreign direct investment in the United States provides the US Government with an increased opportunity to press for the reduction of foreign government controls on US firms.
Foreign direct investment in the United States has risen dramatically in recent years. In the 1960s less than 3 percent of foreign direct investment by OECD countries was placed in the United States; in the late 1970s that share had climbed to more than a quarter. In fact, the United States has now become the number-one choice for foreign investors. At the same time, the supremacy of US multinational corporations at home and abroad is being seriously challenged by foreign firms. Many of these large foreign firms are state owned. As such, they often receive from their governments capital at less than market rates, outright subsidies, and other benefits that give these foreign firms a competitive advantage relative to privately owned establishments.

Many industrial countries have extensive controls on foreign investment, even though they agreed under the 1976 OECD Declaration of Members that they will treat foreign firms in the same manner in which they treat their domestic firms (with exceptions such as defense-related companies). Ottawa has gone further, requiring US firms and other foreign firms to adhere to certain performance requirements as a condition of entry. For example, one US firm was required to purchase a specific percentage of its input requirements from Canadian suppliers. In Japan, US direct investments have been greatly restricted, and those few firms allowed in have been constrained by the same social-cultural barriers discussed earlier. A tougher US stand on foreign barriers that adversely affect US market entry would be possible in light of the significant stake foreign direct investors now have in the United States. The major problem in so pressuring foreign governments on this issue would be that they believe the United States would find it difficult to use its retaliatory power in any substantial way. Foreign government officials and business leaders realize that their US counterparts are highly reluctant to take such action because foreign investments most often boost US economic activity.

Western Europe's current economic malaise will increasingly aggravate normal Atlantic Alliance frictions.
Although certain of Western Europe's fundamental political-economic troubles have been building for a decade, they began to surface as serious issues only in the past year or so. Until recently, the region's leaders and public seemed to believe that they were making the adjustment to the 1973-74 energy shock reasonably well, especially when compared with the United States. In fact, in the late 1970s when the dollar was eroding badly, many Europeans believed they had to take a much greater leadership role in developing new initiatives in the international arena. Now there exists a crisis of confidence, especially in northern Europe—West Germany, Belgium, the Netherlands, and the Scandinavian countries. Leaders in these countries feel a striking loss in their ability to manage political and economic affairs.

Underlying this mood of despair are worsening economic problems. Unemployment has reached new heights, with little relief expected until the mid-1980s, when there will be a sharp reduction of new entrants into the labor force. (Such a demographic trend already is under way in the United States.) West European industry has been slower than the United

States to adapt to new technologies. Employment costs have been excessively high because of mushrooming fringe benefits and a guaranteed continuity of employment. Enormous outlays for social welfare benefits have pushed government outlays as a share of GNP far higher than a decade ago and well above those in either the United States or Japan. These problems differ considerably among countries, but to some degree infect all of them.

The West European malaise probably will turn out to be only a passing phase. Eventually, public awareness of the difficulties and public debate on causes and solutions may generate powerful new forces for change. The next few years, however, will be difficult. Economic activity will increase, but probably at a somewhat slower clip than in the United States. Dissatisfaction with economic leadership will take divergent political forms. Consequently, the West Europeans will be especially difficult to deal with.

- ***Trade.*** Protectionist forces will be particularly strong, especially in France. Trade and investment policies of the EC members are likely to become more nationalistic, and the European Monetary System (EMS) will be under a severe strain as France and West Germany pursue much different fiscal and monetary policies. The EC, thus, will be less inclined to strongly pursue new international free-trade arrangements although they probably will want to avoid any serious breakdown in the current trade practices. In this last regard, the desire to maintain the basic EC structure will be among the chief factors inhibiting rampant protectionism. Each member will be forced to moderate its trade actions to maintain the Common Market.

- ***Defense.*** Much higher defense spending is highly unlikely in the absence of some blatantly outrageous act by the Soviet Union directly affecting Western Europe. Budget deficits will not subside until European states begin to trim their social-welfare outlays, and there are few signs of a movement in that direction. Defense outlays that boost local economic activity—manpower, manpower support, and domestically produced arms will be given a higher priority than imported defense items—mainly US sophisticated equipment.

- ***East-West Trade.*** Western Europe's economic troubles probably will have little if any impact on this issue. Even if unemployment were much lower, West Europeans would continue to pursue trade with the Soviet Bloc because they strongly believe that it helps contain Soviet aggressive tendencies and because political pressure is constantly applied by the many local firms that are highly dependent on exports to the Soviet area. The higher unemployment nonetheless provides the Europeans with a stronger argument to continue to sell the Soviets whatever they can in goods other than those that could directly enhance Soviet military power.

The deteriorating hard currency position of the Soviet Union provides the United States and its allies with an enhanced source of subtle leverage against Moscow. The sharp erosion in the Soviet hard currency position which began last year probably will be long lasting. Unlike previous bouts with foreign financial stringencies, this time there is nothing on the horizon that is likely to bring relief. In 1974 and 1979-80 Moscow enjoyed large windfall gains from large oil price increases. Throughout the 1970s there was a boom in Soviet hard currency revenues from arms sales. And Moscow has benefited from soaring gold prices.

Now, however, oil prices have fallen and the Soviets are having difficulty sustaining the volume of oil exports; gold prices have plummeted since the 1979 peak, and arms sales have leveled off. Moreover, Western banks are extremely reluctant to extend new unguaranteed long-term credits because of the economic disaster in Poland, a general weakening of the East European economies, the severe worsening of East-West political relations, and the vanishing Soviet financial umbrella over Eastern Europe. The pressure on the banks to make new loans also has declined with the falling inflow of OPEC deposits. The only potential large new source of foreign exchange earnings is gas sold via the Yamal pipeline, but those sales will not be important until the late 1980s. By that time these gas sales might only be replacing faltering oil sales.

Moscow has been adjusting to its foreign exchange bind by drawing down its sizable assets in Western banks, borrowing short-term, and selling more gold. With export earnings probably declining this year, a cut in industrial imports or grains will be required in order to hold the balance-of-payments deficit within reasonable limits. In the longer term, and even with a firming of Western markets for Soviet exports, Moscow will be hard put to increase its import capacity. After considering the chronic need for large food imports and the heavy dependence on Western pipe for developing Soviet gas, there will be enough hard currency to pay for only the highest priority imports of machinery and equipment. Without massive new Western credits, feasible only in an easier political atmosphere, Moscow will not be able to use imports of Western equipment and technology as a major factor in improving productivity.

Although Moscow retains some financial flexibility, it is beginning to face politically tough decisions between and among domestic and foreign policy considerations as a result of the foreign exchange bind. Now the Soviets must think harder about the burden of defense and of empire. The tough choices they will have to make include:

- How they should divide the limited foreign exchange among urgent domestic needs—for example, grain versus microprocessors.

- How much hard currency earnings to forgo in providing subsidized commodities, especially oil, to client states.

- Whether to take on additional foreign commitments that may impose a burdensome financial drain.

Under these circumstances, a limitation on the flow of Western credits to the Soviet Union seems to provide a powerful means of applying leverage vis-a-vis Moscow.

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