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PART I

ECONOMIC COMMITTEE

APPRECIATION OF THE ECONOMIC POSITION OF NATO AND
WARSAW PACT COUNTRIES FOR THE PERIOD THROUGH 1988

Note by the Chairman

The attached appreciation of the economic position of the NATO and Warsaw Pact countries for the period through 1988 has been prepared by the Economic Directorate in accordance with the agreed procedures for the NATO defence planning review. It describes the economic situation and prospects of both the Alliance and Warsaw Pact countries and includes an evaluation of the implication of economic development on Allied defence and Warsaw Pact military efforts.

The report submitted to the Economic Committee for review(1) consists of three parts:

- Part I - comprising "Main Findings" and an evaluation of the current economic situation and outlook for the 1980s in NATO and the Warsaw Pact.
- Part II - review of selected economic factors having a major influence on the development of NATO economies and their implications for defence.
- Part III - review of selected economic factors having a major influence on the development of the Warsaw Pact economies.

Part II and Part III of the Appreciation will be circulated separately.

(Signed) J-N. GIBAUT

NATO,
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(1) See DPC/D(71)10 dated 19th May, 1971. For this purpose the Economic Committee is considered to be composed of the same participating countries as those represented in the Defence Planning Committee.

N A T O U N C L A S S I F I E D

APPRECIATION OF THE ECONOMIC POSITION OF NATO AND
WARSAW PACT COUNTRIES FOR THE PERIOD THROUGH 1988

PART I

- A. THE CURRENT SITUATION AND OUTLOOK FOR THE 1980s IN:
- NATO
 - WARSAW PACT
- B. MAIN FINDINGS

A. THE CURRENT SITUATION AND OUTLOOK FOR THE 1980sNATO- Introduction

The forecast horizon of the OECD for its on-going analysis of the economic situation and outlook for member countries is currently eighteen months and in their latest report(1) their analysis extends to the middle of 1982. This authoritative report covering the OECD area, including all the Alliance member countries, is presented by the OECD as one judgement out of a range of possible developments. For the remaining years of the decade of the 1980s there is no information available that taken together can offer a sufficient degree of reliability for projecting economic developments. The approach adopted in this report has been to draw on available authoritative economic studies and reports concerning the medium and long-term with particular attention given to the main elements that are likely to influence the formation of the future economic environment that will serve as the basis for NATO countries defence efforts over the period under review.

- The economic situation in the short-term

2. The increase in world oil prices of 150% over the eighteen months to mid-1980, jeopardised the success that many industrialised countries were beginning to achieve in counteracting the inflationary effects of the first oil price shock, and imposed a real income loss upon the area equivalent to more than 2% of GDP similar in magnitude to the effects of the 1973/74 oil price rise. It was not until 1978, five years after the first oil price rise that most countries were growing satisfactorily again, albeit more slowly than in the 1960s. In 1978 the economic growth rate in OECD member countries averaged 3.9% followed by 3.3% in 1979. However, in 1980 the rate was down to 1% with declining GDP recorded in many member countries in the second half of the year. The current recessionary trend prevalent throughout the OECD area that has led to rising unemployment, and huge current account imbalances coupled with high inflation rates has reduced the scope for an increase in consumption not only for private households, but also for public authorities.

3. According to the OECD, the prospects over the short-term are for a weak recovery starting in the first half of 1982. This recovery is expected to be extremely attenuated. The projected year on year growth of the area GDP for 1981 at 1% is no higher than that of 1980. GDP in 1981 will probably be 6½%, some \$550 billion, lower than it might have been without the latest bout of oil price increases.

(1) Economic Outlook No: 28, December 1980

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The tempo of growth may increase throughout, so that in the first half of 1982 it may be running at some 3% annual rate, below the average for the 1973-1978 period, and would entail in many countries widening margins of excess capacity in plant and labour force. The OECD growth forecast is based on certain assumptions, the most important of which is no increase in real oil prices. Should such increases take place the growth prospects would deteriorate.

4. Under the given assumptions inflation seems likely to slow down, although even by mid-1982 the rate in many countries is unlikely to have fallen back to the level prevailing in 1978 prior to the latest oil price rise. Lower rates of inflation are a primary condition for securing sustained real growth and top priority is being given to reducing exceptionally high rates now currently prevailing. In the second half of 1980 the rise in the aggregate GDP deflator in the OECD area was some 11% and the rate in 1982 is expected to be around 9%.

5. The weak economic growth foreseen through 1982 will result in higher unemployment rates. The number of unemployed in industrialised Western countries who are members of the OECD could approach 26 million in 1982, nearly 12% more than at the end of 1980. The rate for the OECD area is expected to rise to the historically high level of 7.5% in 1982. This figure compares with an average rate of unemployment of less than 3% of the labour force in the 1960s. The effect of this massive increase of unemployment falls unevenly on the labour force. Much of the brunt has been, and will probably continue to be borne by young people, whose unemployment rate is typically double or treble that of adults.

6. The deficit on the current account of the balance of payments of OECD countries increased from US \$35 billion in 1979 to US \$73 billion in 1980. It will possibly decline in 1981 to some US \$40 billion. The deficit will diminish in larger countries with the United States moving into significant surplus. The outlook for the smaller countries is less favourable and for the countries as a group very little improvement is foreseen. The distribution of the deficits in these countries may become more uneven and for the smaller countries whose external positions have been difficult for many years the deficits may continue to widen. In particular, the less developed NATO member countries will continue to face serious balance of payment problems that can only be solved through close co-operation with the richer member countries of the Alliance and assistance from international economic organizations.

7. Following the first energy crisis the policy response differed considerably between countries. After 1980 the reaction, a tight stance of both monetary and fiscal policy has been quite uniform and the OECD are of the opinion that such policies may prove more successful in containing the second-round inflationary consequences of the oil price rise, particularly in the major countries, and for the time being at least the OECD area's current deficit is distributed in a way that has not raised particularly difficult financing problems.

8. In the course of 1981 a number of countries may be in the position of having improved somewhat the inflationary situation. However, in the OECD view the scope for individual action to lift the curb on domestic demand growth may be limited by external constraints (e.g. balance of payments, and imported inflation) which at present bear heavily on the conduct of economic policy in all countries. An additional constraint on a more rapid resumption of economic growth is of a more general nature and bears upon aggregate activity in the OECD area as a whole, and on the ability to expand trade with the developing countries with whom there is a growing interdependence as concerns export markets and raw material supplies that is increasingly characterised by growing competition in the production of less sophisticated manufactured goods. Furthermore, any attempt at faster-than-forecast OECD area growth would almost certainly entail increased oil imports, the risk of sharply rising oil prices, an increased OPEC surplus and accelerating OECD inflation, leading to lower GDP in 1982 than currently seems likely.

- Possible medium-term developments

9. Although it is hoped that the economic strategy adopted by OECD members(1) will provide the basis for economic recovery and sustained growth there are many uncertainties, and any major setback to an economic improvement through to 1982 could have far-reaching consequences. The level of unemployment through 1982 will reach critical levels with adverse socio-economic repercussions. Resumed growth from 1982 will have to be adjusted to the production potential of different countries and on effective energy policies, if the transition is to be in any way a smooth one. Failure to adjust to the changes in the world economic environment during this early transition period, notably through inadequate new investment, is likely to have very damaging effects on the potential growth rates of member countries. This potential is already lower than it was in the 1960s and inadequate new investments could bring the potential below 3% for the rest of the 1980s for most countries. Productivity growth recently unusually low or even negative in a number of countries has to be stepped up if recovery over the longer term is to be sustained. Another danger is that recovery will also be unsustainable if it leads to a third energy crisis. In fact, the need to restore a viable balance in energy supply and the unavoidable time lag before dependence on oil can be significantly reduced, are key themes that recur in recent reports on the economic prospects through to 1985. At the Washington meeting of the IMF and World Bank in September last year the Managing Director of the IMF

(1) Adopted at Ministerial Meeting OECD, June 1980. It requires in the first phase that demand be restrained to reduce inflation. In the second phase resumption of economic growth is foreseen.

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summed up the importance of energy developments with the words "no anti-inflationary efforts, no sustained policy of growth, no plan to organise the world's monetary system could succeed if the present energy situation were to persist. The problem of energy has become all pervasive, measures to deal with it must embrace the whole process of formulating the conducting policies at both national and international levels." The IMF has also warned against any easing of policy. At the meeting in September three main scenarios for the future of the world economy through to 1985 were considered. Firstly, with policy remaining tight, recession will continue through 1981, 1982 and then only a limited degree of up-turn for several years after that and, hopefully, by 1985 a break in inflationary expectations, that would permit the resumption of steady growth. Secondly, should there be an easing of policy there could be a sharp recovery in 1981/82 quickly followed by a new surge of inflation which would require a new clamp down on demand with an even grimmer outlook for the period through to the mid-1980s. The third scenario, considered a boost to demand now with no tightening up when inflation reappears, could be expected to lead eventually to a huge crash in the period 1985-86.

10. A report made by the World Bank on the economic outlook concludes that the most probable outcome for at least the next five years will be significantly lower growth rates with both developed and developing countries facing difficult adjustment problems.

- Economic prospects over the longer term

11. The phenomena described in the foregoing paragraphs have origins that can be traced to the early 1970s and often to the late 1960s in some member countries. They have created circumstances in which it is extremely difficult to deploy conventional economic strategies. The oil crisis has compounded and aggravated the problems faced, but some features such as inflation, were already deeply rooted in the social systems of the West before the oil shock of 1973. Reliable projections of developments beyond 1982 cannot be made in present circumstances, but some of the views expressed in various reports(1) that have been made can provide a certain guidance concerning likely future developments.

12. While economic developments in the early years of the 1980s will be very much influenced by the responses made to current problems, the second half of the 1980s will be increasingly influenced by more fundamental changes that are taking place such as population trends, development of productivity, changes in technology, awareness of environmental limitations, etc.

(1) Notably: "Interifutures - Facing the Future", OECD 1979; "Technical Change and Economic Policy", OECD 1980; "The Global 2000 - Report to the President", US 1980; "The Report of the Independent Commission on Development Issues", Chairman W. Brandt 1980; Hudson Institute Studies, 1980.

13. Governments will be more obliged to formulate their policies with due allowance for the emergence of new values and new social demands that could slow down economic growth. Population increases from 4.3 billion today to 6.5 billion by the year 2000, that will be particularly strong in the Third World countries will raise serious problems necessitating considerable capital transfers from developed countries in the agricultural sector if famines are to be avoided. Primary stimulus to growth offered by technological change are hindered by constraints of a political and social nature, which may retard or even paralise the introduction of technical innovations. None the less, technical and structural changes offer the best hope for the developed countries to break out of the current economic impasse of slow growth and persistent high levels of unemployment.

14. The developed societies of the West are on the verge of a fundamental structural transformation. The distinction between private and public production sectors will become more blurred and the growth of public expenditure which has marked the last thirty years will probably slow down. The transition now being experienced will have major implications for the forms and methods in which resources are allocated. How the developed countries will respond to the pressures for adjustment is an open question. World economic conditions have been transformed by the fact that Europe and Japan have "caught up" with the United States, and by the industrialization of countries which, until recently, were under developed.

15. The pattern and development of world trade has also created an interdependence of entirely new dimensions between countries of very different backgrounds and stages of development. The emergence of an overwhelming dependence of advanced countries on external oil supplies is only one facet of the interdependence of countries through raw material supplies and export markets, that imply radical structural changes. The severity of the necessary structural adjustments varies from country to country and there is a real danger that unless much greater efforts are made through co-ordinated action, the responses made could lead to growing disparities and conflicts of interest that would greatly weaken the economic prospects for the West.

16. All the above-mentioned factors will affect the economic growth prospects and although only a range of possible developments can be foreseen, the view generally held is that economic growth rates will be significantly lower in all member countries in the 1980s compared with the two preceding decades. For the advanced member countries a range of yearly GDP growth rates (annual average) of 1.5% to 3% is often used as a reference basis. The lower rate would almost certainly give rise to dangerous repercussions affecting the economic foundations of Alliance member countries and their cohesion within the period under review. The higher end of the growth rate will only be attainable with some radical adjustment policies for the advanced

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member countries, the full implications, social and economic, of which are hard to foresee, but would in any circumstances exert very strong pressures on government policy decisions and on the availability and use of government funds. For the newly industrialised members (Greece, Portugal and Turkey) the range of growth rates generally quoted could be somewhat higher if growth rates of close to 3% are attained in developed countries, but remain well below the growth objectives of these countries. Given their population growth and their stage of industrialisation, such developments could have far-reaching economic and social repercussions.

- Implications for Alliance defence of economic developments through 1990

17. An economic situation during the period under review, characterised by slow growth rates of member countries' economies, mounting unemployment, associated social unrest, inflation, balance of payments and serious structural problems, is a difficult environment in which to pursue policies aiming at strengthening the Alliance defence effort. Nevertheless, total NATO defence expenditures took only 4.4% of the total NATO Gross Domestic Product in 1980. This share of total available resources represents a considerably lesser burden than in the early 1950s when the defence share of GDP between 1949 and 1952 increased from 5.1% to 13%, at a time when member countries' economies were faced with severe difficulties of post-war reconstruction and living standards were considerably lower than today. Moreover, the defence share of total budget expenditures has been strongly reduced, in many cases to between one-third and one-half of the level twenty years earlier. The impact of defence on the economy is on the whole much lower today than it was in the early 1960s and 1970s, and the economic efforts or "sacrifices" for meeting security needs, even with prospects of low economic growth rates in the future, should be manageable. This was clearly illustrated in the 1980 Defence Review, country chapters. They showed that full implementation of the NATO 3% target for defence would require additional resources corresponding to some 0.1% of the Gross Domestic Product or 0.3% or less of total budget expenditures for most member countries. In the case of the Soviet Union the defence share of GDP in 1980 of 11 to 13% was three times higher than the NATO average and the yearly real increases over the last ten years averaging 4 to 5% probably exceeded the yearly real growth in NATO Europe's defence expenditure by more than ten times.

18. Total availability of real resources is overwhelming in relation to the defence needs of the Alliance. If necessary, a considerably higher defence effort could be supported without creating scarce real resource constraints following decisions to increase longer term military demand for manpower, metals, energy, industrial capacity, etc.. The amount of real economic resources taken by defence is, however, decided by the priorities given by the Authorities to the different sectors of the Central Budget.

Following very unfavourable world economic developments over several years, the freedom of movement of the Authorities as concerns budgetary policies has been severely restricted. For the period under review the foreseeable economic problems of member countries will tend to increase further the budgetary difficulties. In such a situation, political initiatives to protect the defence sector will be necessary if member countries wish to satisfy their security requirements. If not, constraints deriving from the difficult financial situation will result in underfulfilment of the 3% target for most member countries. Defence expenditures during the period under review may none the less exceed the economic growth rates of most countries. The consequence will be a slightly increasing share of resources taken by defence in the NATO area as a whole from the level of 4.4% attained in 1980(1).

(1) For a more complete review of the implications of economic developments on Alliance defence efforts see Part II of this report pages 40-47.

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WARSAW PACT

Introduction

19. The outlook for the Warsaw Pact economies in the 1980s is one of declining growth in the total output of goods and services and probably in output per man. Primary reasons for the slowdown are dwindling labour reserves and increasing difficulties in developing raw materials and energy supplies. For these reasons, barring radical changes in labour or management practices, or the successful widespread adoption of technological innovation, annual increases in total economic output will probably average no more than 2-3% in the 1980s. Such a rate of growth implies that the Warsaw Pact will probably continue annually to produce around two-fifths the volume of goods and services of the NATO member countries, and in per capita terms, half as much.

Sectoral Prospects

20. Industry. Although agricultural output and rapidly expanding service sectors will play an important part in determining the rate of economic growth in the Warsaw Pact countries, the main factor will continue to be industrial production. Besides manpower constraints and investment limitations development will be hindered by labour and management inefficiencies induced by central planning and control, and slowness in adopting new technologies. In addition to being affected by the degree of success in developing of energy and raw material supplies, growth in industrial production will also depend on improvements in transport, agricultural output, and stocks of consumer goods; the last two items are essential to promote worker motivation and productivity.

21. Energy. Soviet energy resources are so vast and diversified that the USSR can probably meet practically any energy contingency for itself, and partially at least for its Warsaw Pact Allies in the 1980s. It might have to do so, however, at great investment cost, and possibly with considerable reliance on imported Western technology and materials for oil and gas extraction and transport. In order to continue its current high annual level of oil production the USSR will rapidly have to supplant dwindling reserves in the Western part of the country with production from new wells in Siberia, whose reserves are large but unclearly known, and can be developed only at great cost and after lengthy lead time. Soviet natural gas, whose production is expanding rapidly, may to some extent become a substitute for oil supplies in the 1980s, and by the end of the decade, an ambitious programme for the construction of nuclear power plants should begin to have a perceptible effect on Warsaw Pact electricity supplies.

22. Raw materials. As a whole, the Warsaw Pact should also have adequate supplies of most industrial raw materials throughout the 1980s, the USSR being the most important source of supply. Because growth of domestic demand is beginning to outpace that of production for some of the minerals, however, the USSR will have to devote considerable investment funds to the exploitation of new deposits; alternatively, for some raw materials, notably bauxite, fluorspar, and super-phosphates, the USSR may rely increasingly on imports. Eastern Europe will, as in the past, look to imports to fulfil most of its industrial raw materials needs. Where these cannot be purchased from the USSR or other CMEA member-countries, preference will be given to obtaining them from the developing world under long term barter or project agreements, in order to avoid outlays of scarce convertible currency.

23. Agriculture. Subject to the vagaries of the weather and a short growing season, Soviet agricultural output has tended generally to expand over the past fifteen years, as a result of extensive mechanisation, additions and improvements to arable land and increased fertiliser use. Nonetheless, the growth has required huge investments, and the USSR still does not harvest enough grain to generate increased meat supplies. In the 1980s the USSR will attempt to improve its grain harvests in particular through continued high investment and more fertiliser use; in addition, it will give more material encouragement to private agricultural activity, which supplies more than one-fourth of the USSR's total farm output, including more than 30% of its livestock products. Nonetheless, agricultural output will undoubtedly continue to be hindered by management problems and unproductive use of capital, by limits to arable land expansion, and by a shrinking agricultural labour force. In Eastern Europe in the 1980s, Poland, Czechoslovakia, and East Germany will follow the Soviet example of using more machinery and fertiliser to improve grain production in particular; and Hungary, Romania, and Bulgaria will continue their efforts to promote exportable agricultural surpluses.

24. Transport. Throughout the 1980s transport deficiencies will adversely affect economic growth, particularly that of the Soviet Union where increasing demands on the rail system, still the principal means of long-haul goods transport, have outpaced improvements and modernisation: rail capacities have become choked and the average time required for a rail journey lengthens yearly. Increasingly large investments are to be devoted to solving these problems, but they must be shared with other forms of transport, notably oil and gas pipelines. Further, all the Warsaw Pact's transport systems continue to be hindered by widespread administrative, labour and management shortcomings, which cannot be quickly rectified.

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25. Consumer goods. In the absence of heightened international political tension, increasing attention will be devoted throughout the 1980s to satisfying consumer demand, partly in order to meet growing expectations, but also to promote labour productivity by providing additional goods and services for purchase with wage incentives. Although more frequently recurring strikes may become a potent expression of consumer discontent, in the decade, they may have a negative impact on welfare by giving rise to stronger instruments of political and economic repression. The Hungarian example of allowing price mechanisms to affect consumer goods production may become more widely adopted in the other Warsaw Pact economies.

26. Foreign trade. Finally, foreign trade considerations play an important role in the outlook for the Warsaw Pact economies in the 1980s, especially for those of Eastern Europe. Most probably, the USSR and Eastern Europe will import less capital equipment from the West than they did in the 1970s, but Eastern Europe will be faced with the need for continued energy and raw materials imports. As a consequence, the Soviet balance of payments should improve, but those of Eastern Europe will probably worsen, either with respect to the West or to the USSR, the latter, as the most likely supplier, may insist increasingly on payment in hard currency or potentially hard-currency generating merchandise.

Longer-term Trends

27. Demographic. The Soviet Union and most of its East European allies face during the 1980s the prospect of a growing labour shortage. In the Soviet Union, prospective additions to the able-bodied population throughout the 1980s will average only some 600 thousand a year, as compared to 2.4 million annually in the 1970s. Soviet industry, which employs 40% of the total workforce, will feel the effects of the trend most sharply, although it may continue to see the addition of some agricultural workers. To offset anticipated stagnation in labour force growth, the Warsaw Pact's principal options are to employ more pensioners and to increase labour productivity, primarily through additional capital investment. There is little prospect that the USSR will be able to move significant amounts of labour from its southern labour-surplus regions to the worker-short regions of the West and Siberia.

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28. Investment. Growth in total investment will doubtless continue to decline in the Warsaw Pact economies in the 1980s, along with a general slowdown in economic growth. The proportion of investment as a share of national income will probably continue to remain high, but it will most likely not be allowed to increase at the expense of national consumption, in view of rising materials costs and prevailing consumer attitudes. Hence investment will be directed increasingly to priority economic sectors and the modernisation of existing facilities and the completion of projects already begun. Because of these limitations, the possibilities of using investment to promote long term gains in labour productivity will be more restricted than they have been in the past. These limitations may be offset, however, by imports of technology from the West.

29. Labour productivity. Besides continuing to rely on capital investment, the leadership will also attempt to stimulate worker productivity by improving labour attitudes and management practices, primarily through wage incentives and bonuses; in Hungary, indicative planning and a freer market mechanism may also serve to promote labour productivity by giving greater play to individual initiative. To make incentives meaningful, the Warsaw Pact governments will have to offer more and better consumer goods, and in attempting to do so may come into conflict with other economic development priorities. Existing political conditions will probably prevent the extensive growth of free trade unions as instruments for promoting labour productivity by boosting morale, and the exigencies of central planning will probably continue to reward management's traditional over-manning of factories.

30. Industrial restructuring. To the extent that profitability might increasingly be used as a measure of a firm's performance in the 1980s, the Warsaw Pact economies may see some industrial restructuring in favour of industries which are competitive in foreign markets, or on domestic ones within the framework of current government pricing policy. Export-oriented industries will probably receive even greater priority than in the past in Eastern Europe, because of the area's persistent trade imbalance with hard-currency areas in particular.

31. Technology. In the 1980s the Warsaw Pact may import less technology from the West than it did in the previous decade, partly because of frequent lack of immediate visible gains in output as a result of such imports, and partly because of the deterioration of the East-West trade climate. Where the Warsaw Pact economies cannot rapidly develop their own

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technologies, however, they will doubtless continue importing from the West, as the less costly course for economic development. On balance, technological progress should not see any more rapid advance in the 1980s than it has in the past, and its potential for promoting economic growth may be offset increasingly by investment limitations.

32. Prospects for reform. Current reforming trends in the Warsaw Pact economies point to increasing reliance on incentives to promote labour productivity, and to gradual decentralisation of operational decision-making, but subject to continuing strong central control. In the future, efforts will doubtless be made to follow the Hungarian example of reducing plant workforces without corresponding declines in output, and the other Warsaw Pact members may attempt to give their pricing mechanisms the flexibility which has helped to make the Hungarian reforms successful. To encourage further industrial efficiency throughout the Warsaw Pact, computers will increasingly be used to strengthen central verification, administration, and control.

- Implications for the Warsaw Pact's military potential of economic developments through the 1980s

33. During the 1970s Soviet military spending grew at an average annual rate of 4-5% in real terms, according to Western estimates. The rate of economic growth was somewhat lower than this and consequently the burden on the Soviet economy as measured by the ratio of military expenditures to estimated GNP rose from 11-12% in 1970 to 12-13% in 1979. In certain sectors military spending absorbed an even greater percentage of available resources, the claims on scientific personnel being especially high.

34. For the 1980s increases in the economic output of the Soviet Union are likely to remain relatively low: weaknesses in raising agricultural output; the slowing of population growth; rising consumer aspirations; the probable levelling off of oil output and limits to the availability of capital for investment purposes, will restrain economic growth. Such developments, however, are not expected to greatly influence commitments made concerning the military capabilities of the Soviet Union. On the contrary, the evidence on weapons production and testing, as well as on construction in defence industries, points to a commitment to continued growth in defence spending through at least the mid-1980s.

35. There are a number of factors which argue for a continuation of the upward trend in defence spending. These include the traditional high priority which the Soviet Union attaches to military strength, the Soviet leaders professed belief in a potential military threat from China and the West, which they use to justify a military posture

well in excess of defensive requirements; the repercussions of continued involvement in Afghanistan; the continuing Soviet concern to upgrade their forces, and to match or surpass technological developments of major weapon systems in the West; and the ability of a totalitarian régime to impose considerable economic and social sacrifices on the population as a whole.

36. Unlike the situation in the West, Warsaw Pact expenditures on military manpower remain relatively low, and the principal component of increases in defence expenditure arises from research and development and putting new weapons into production(1). In the USSR the machine-building sector, which implements such programmes, receives around one-quarter of all industrial investment and its output has grown at an average rate of over 10% yearly throughout the 1970s. The USSR is in a position to continue substantially increase the value of goods produced for defense even in a period of generally declining total economic growth.

37. With raw materials and energy supply prospects generally good, although requiring increasing expenditure for their development, the principal problem affecting Soviet military capabilities both directly and indirectly in the 1980s may be manpower requirements. Indirectly new military equipment production programmes might require additional personnel at production plants, but since such a programme would probably use machinery embodying labour saving technology, and since most Soviet factories have excessively large and under-employed labour forces, there is scope for considerable managerial improvement, which is being given close attention by the Soviet authorities. The decline in the growth of the labour force now being experienced, will have some repercussions on the manning levels in the forces. However, cutbacks in the numbers directly engaged in the armed forces which currently total some 5 million, would not help in solving the overall manpower problem, since even large reductions in the forces would add less than 1% to the total civilian labour force. There would, in fact, be a loss to the economy if the large numbers of troops involved in construction, agriculture or railway building were cut back; they provide a cheap form of labour more easily directed to work in unpopulated regions.

38. For the other Warsaw Pact countries, the repercussions of economic developments can be expected to have a greater influence on their military spending. On the other hand the level of such expenditure does not appear to weigh as heavily on their economies as it does in the case of the Soviet Union. Military expenditures by the non-Soviet Warsaw Pact countries as a whole have been estimated to be equivalent to some 10% of the Soviet Union's expenditure. Armaments account for about 15% of non-Soviet Warsaw Pact countries military expenditure, but the proportion of manufacturing capacity set aside for defence is probably limited in as much as military equipment is mostly bought from the Soviet Union.

(1) Procurement of weapons and equipment and construction of facilities takes about half of the Soviet military budget, as against some 20% of Allied member's defence budgets.

39. On the basis of the developments outlined above, Soviet military outlays are expected to grow, at least through 1985, at an annual rate of over 4% in real terms. In such circumstances the share of military expenditures in Soviet GNP would rise to about 15% by 1985 as the rate of economic growth slows down. This would put some further strain on civilian consumption and investment and in order to simultaneously maintain expanding military capabilities while mobilising the other investment required for economic growth, the critical factor will be the feasibility of holding back the desired increase in civilian consumption.

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B. MAIN FINDINGS

40. From the overall review contained in this report(1) of the economic situation and outlook in NATO and Warsaw Pact countries for the 1980s attention is drawn to the following main findings:

- (i) The need for structural change both in Alliance and Warsaw Pact countries will become of prime importance in the 1980s. In NATO delays to structural change through growing protectionism will hinder the shift of labour out of non competitive traditional industries into those where labour productivity is high, implying slow economic growth and persistently high unemployment and inflation rates. It will also adversely affect the growth prospects of developing countries. There is a real danger that unless considerable efforts are made through co-ordinated international action, the responses of individual countries could lead to growing disparities and conflicts of interest that would further weaken the economic prospect for the West and with it the defence potential of the Alliance. In the Warsaw Pact countries the rigidities of the central planning system are the main handicap to higher productivity in industries not directly geared to military production.
- (ii) If present energy problems are not resolved no anti-inflationary efforts, no sustained policy of growth, and no effective stabilization of the world monetary system can be expected to succeed. In particular, among the wide ranging implications, the foreign policy and defence options open to the Alliance will be severely handicapped. In the case of the Warsaw Pact, the Eastern European members are vulnerable while the Soviet Union is in a position to open up new gas reserves that can compensate the decline in growth of indigenous oil output.
- (iii) Interdependence with the Third World countries has taken on a entirely new dimension. The consequences of overwhelming dependence of advanced countries on external oil supplies is only one facet of growing interdependence of countries through raw material supplies and export markets. Political initiatives on the part of Alliance members to foster beneficial relationships with these countries will be of increasing importance for Alliance security and will have a

(1) More detailed information is contained in Parts II and III, which are circulated separately.

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considerable influence on the future development of Western economies. For the Warsaw Pact countries the relationship with the Third World is more of a political/military character but with a growing degree of economic interdependence.

- (iv) Serious balance of payments problems can be expected to persist notably in those countries already experiencing difficulties arising from external indebtedness. Member countries still in process of industrialization will be particularly vulnerable and support and co-operation will be vital for maintaining the cohesion and defence capabilities of the Alliance. The Eastern European members of the Warsaw Pact will also be severely affected by the difficulties of obtaining sufficient inflows of hard currencies to meet import needs and rising debt servicing and repayments.
- (v) Inflation is likely to remain at historically high levels through the 1980s, it erodes savings and by limiting productive investment destroys the prospects of sustained economic growth. It is at the root of severe constraints in the defence sector and only an effective compensation can make a defence planning system based on agreed real increases workable. In the Warsaw Pact countries inflation is increasingly a matter of concern, but under central planning systems has less impact.
- (vi) The freedom of movement of the Authorities as concerns budgetary policies which has been severely restricted in recent years will worsen given the prospects of low growth. Increasing social discontent as a consequence of economic developments pose a serious challenge to the ability of member countries to give the necessary political priority to defence. Initiatives are called for to inform public opinion in NATO countries on the realities of the dangerous weakening of the defence and the deterrent capabilities of the Alliance.
- (vii) The prospects of a fairly sharp decline in growth of the labour force in the Warsaw Pact will adversely affect their economic capabilities in the 1980s. It will have some repercussions on the manning levels of the armed forces that can, however, be corrected by priority measures such as increasing the length of military service. In NATO countries rising personnel costs for the armed forces and the need for skilled personnel for sophisticated equipment are the main problems to which more attention will have to be given.

- (viii) The stark contrast in the allocation and use of resources in NATO and Warsaw Pact countries will continue to account for significant differences in future developments of economic and defence capabilities. The total available resources in NATO is over-whelming in relation to defence needs. NATO's total production is about three times higher than the Warsaw Pact countries, whereas the defence share of total resources is only one-third that of the Soviet Union. During the period under review the relative strength of the two sides will not change significantly and the potential of NATO to match the Warsaw Pact military effort cannot be questioned. However, the priority given to equipment procurement and R & D in the Soviet Union in the military sector, which accounts for some 60% of total military expenditures against 20 to 30% in NATO countries is expected to continue to have a major impact on equipment procurement capabilities compared with NATO.

41. In conclusion this report, which provides a summary review of likely developments for the 1980s clearly indicates the fundamental nature of changes in the economic and political climate that began to emerge in the early 1970s. The economic developments have been such that behind the political decisions now having to be taken, economic/social considerations have become of major importance compared with earlier years. Such changes pose a serious challenge to the effectiveness of the decisions taken in the Alliance and as defence related economic studies are not covered by other international organizations means by which Alliance consultations could be effectively reinforced should be given serious attention.

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