

CONSEIL DE L'ATLANTIQUE NORD  
NORTH ATLANTIC COUNCIL

EXEMPLAIRE  
COPY

N° 166

N A T O   C O N F I D E N T I A L

ORIGINAL: FRENCH/ENGLISH  
14th March, 1977

DOCUMENT  
AC/127-D/545

APPRECIATION OF THE ECONOMIC POSITION OF NATO AND  
WARSAW PACT COUNTRIES FOR THE PERIOD THROUGH 1984

Note by the Chairman of the Economic Committee

The attached appreciation of the economic position of the NATO and Warsaw Pact countries for the period through 1984 has been prepared by the Economic Directorate and reviewed by the Economic Committee in accordance with the agreed procedures for the NATO Defence Planning Review(1). It describes the economic prospects of both the Alliance and Warsaw Pact countries for the period through 1984 and includes possible trends in defence expenditures.

2. It consists of:
- a general introduction
  - Part I: A. The Economic Outlook in NATO Countries 1977-84  
B. The Implications for NATO Defence 1977-84
  - Part II: A. The Economic Outlook in Warsaw Pact Countries 1977-84  
B. Economics and Defence in the Warsaw Pact Countries 1977-84
  - Statistical Annex(2).

(Signed) J. BILLY

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- (1) See DPC/D(71)10, 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.
- (2) Circulated separately

N A T O   C O N F I D E N T I A L

APPRECIATION OF THE ECONOMIC POSITION OF NATO AND  
WARSAW PACT MEMBER COUNTRIES FOR THE PERIOD THROUGH 1984

GENERAL INTRODUCTION

1. This review has been carried out pursuant to the instructions in DPC/D(71)10 which call for an assessment by the Economic Directorate of the likely economic situation in the NATO and in the Warsaw Pact countries for the period covered by the military assessment, together with comments on possible trends in defence expenditures.

2. The present paper is the third in the series. It has been prepared in economic circumstances as complex and as difficult as those prevailing in the Autumn of 1974 the time at which the previous appreciation was drawn up. In the West, the medium/long-term expansion which constituted the distinguishing features of the 60s and the early 70s has been interrupted for over two years and has given way to a less buoyant, more uncertain, situation. The signs of recovery which appeared in 1976 in the developed and market economy countries were not as strong or as firm as had been hoped and international economic and financial transactions are being conducted in a climate of relative instability. In the Warsaw Pact countries, there has also been a slackening of growth and more moderate forecasts have been made for the period 1976-1980. Simultaneously the indebtedness of these countries vis-à-vis the convertible currency countries has been rising steeply and may force them to restrict certain vital imports, which could in turn constitute a further constraint on growth and possibly, in certain countries giving rise to social tensions.

3. To reduce some of the difficulties inherent in projections as lengthy - going up to 1984 - and as tentative as these - given the short-term uncertainties which overshadow future economic policy - it seemed advisable to distinguish between two major sets of factors influencing development: on the one hand, the relatively stable factors constituted by production potential and trade patterns and, on the other, those which hinge on economic policies involving levels of employment, costs, inflation, public expenditures and international trade and payments. Certain prospects for international relations have also been considered.

4. As regards basic factors, four types of resources have been taken into account: manpower, both quantitative and qualitative, additional investment capacity, the probable rate of technical progress capable of increasing productivity, the availability of basic commodities assuming a satisfactory international trade development. These factors determine the potential economic growth of each of the two blocs.

AC/127-D/545

-3-

5. Real growth over the period under review will depend not only on these factors but also on preserving or achieving a balance in certain fundamental areas: labour, the allocation of resources as between consumption and investment, prices - implying the control of inflation - public expenditure and the balance of payments. The difficulty of striking these balances will be proportionate to the tensions generated by the difficulty of investing on a large-scale, of spreading the new technologies, of balancing foreign trade and payments and reaching agreement between social groups on economic objectives. However, while some problems are shared by the countries belonging to both Alliances, others are generally less acute in the East, as for example employment, inflation or social pressures created by increasing consumer demand; others, on the contrary, create more serious problems such as the choice of investment or the stimulation of productivity.

6. Moreover, in a changing world, each of the two groupings will meet with varying success in its attempts to build up trusting and smooth economic relations with the rest of the world, a sine qua non for the security of supply in the case of Western Europe and essential in any case to the preservation of a stable international order without which regular growth, even on a limited scale, would be in jeopardy.

7. Within each grouping, too, the nature of economic and monetary relations between member countries will have an effect, either favourable or unfavourable, on the cohesion of the unit.

8. These four categories of variables: fundamental growth factors, economic policy assumptions, economic development and cohesion within each bloc, and relationships with the rest of the world, is examined in turn within the context of the two groupings before any attempt is made to assess possible trends in defence expenditure. In this respect attention is drawn to the assessment made in Part II of this report of the situation in the Warsaw Pact through 1984 as the economic and military potential of the latter has a strong bearing on the defence trends of the NATO member countries.

9. The refinement of forecasts raises the problem of methods. While it was possible to make growth forecasts for the period 1976 to 1980-81 by using on the one hand the Five-Year Plans and on the other hand OECD studies, in other words two types of relatively similar forecasts incorporating certain general economic policy options (more precise in the East than in the West), only tentative OECD indicators are available to underpin 1980 to 1984 projections. A careful distinction has therefore been made between the two sub-periods.

PART I

A. ECONOMIC OUTLOOK IN THE NATO COUNTRIES

10. Strong potential growth factors will be a continuing feature of the NATO countries during the period 1977-1984 in the shape of human resources, capital resources and new technological breakthroughs. The growth process will however continue to be heavily dependent on supplies of raw materials and particularly energy, which are both costly and relatively vulnerable. Furthermore fears of aggravating balance of payments problems and inflation will impede the NATO countries realization of their full growth potential.

I. Fundamental Growth Factors

Human resources

11. The population of the NATO countries, 554 million in 1975 including 318 million in the NATO European countries will continue to increase at an average yearly rate of about 1% topping 610 million and even coming close to 620 million in 1985. These figures compare favourably with the figures for the Warsaw Pact where the total population is much smaller (360 million in 1975) and will continue to grow at roughly the same rate as in the NATO area to some 394 million in 1985.

12. In Europe, the rate of population increase will be greatest in Turkey (2.5% per annum). In most other countries in the area there will be only a small rate of demographic growth and even a negative rate in Portugal and possibly in the Federal Republic of Germany.

13. The working population which is a more vital component of potential growth than the total population, will increase from around 350 million to some 392 million in the NATO countries, making an average rate of increase for the NATO area as a whole of 1.2% per annum which is about the same as in the Warsaw Pact countries (about 1%) with slight differences from one country to the next, except Canada and Turkey where the average yearly increase will probably be about 2.5% or more.

14. Additional manpower resources will have less of a bearing than hitherto on the process of expansion at least during the next few years while unemployment is being reduced. Furthermore, in the advanced industrialised member countries the need will be for more skilled labour which is likely to remain

AC/127-D/545

-5-

relatively scarce. Unskilled labour will be harder to absorb than in the 1960s and structural problems may become more serious with possible adverse repercussions on the present pattern of emigration from less developed countries.

15. Mobility of labour either in the form of migration or in the form of transfers to other jobs will therefore not play as important a part in the growth process as in the 1960s. Labour productivity will play a more important rôle and efforts to increase it will have to be matched by the adaptation and training of the labour force to meet new market requirements.

16. Despite the foreseeable difficulties of adapting the work force in the NATO countries, and more particularly in Europe, to the new demands of growth during the period under review, there can be no question about the qualitative superiority of this labour force over the working population of the Warsaw Pact countries. As explained further on, the problems of regional migration and of the adaptation of the labour force to new forms of industrial development is keenly felt in the East and act as a break on both productivity and growth.

Additional investment capacity

17. Overall demand should, in all likelihood, remain relatively high in the NATO countries given the volume, the diversity and a certain transformation of requirements. These will remain extremely varied, some of a social nature, others stemming from urban development, others still arising from the development of new resources and the protection of the environment or else from the need to increase research/development and innovation or to cover the higher cost of energy and commodity imports by greater exports.

18. The growth of the labour force will slow down in the United States from 2% to some 1.2% per annum by the early 1980s and in NATO Europe will rise from some 0.4% to 0.9% per annum. Taking into account the current high level of unemployment, new investment will be a decisive factor in increasing employment opportunities and ensuring sustained growth.

19. In 1976, productive capital in the NATO zone was well above the level obtained in the Warsaw Pact area. This quantitative advantage should persist though on a somewhat reduced scale. In fact, the rate of growth of this stock of capital has dropped markedly in recent years and, in any case, more steeply than in the East, for a number of reasons which include the reduced profitability of industrial investment.

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20. The propensity to invest could well remain slight if the present trend towards lower profits continues. In addition, construction investment, and more particularly residential construction, is not expected to grow very rapidly over the coming few years. Lower birth rates and the consequent decline in family size can be expected progressively to moderate the growth of new housing demand. Also other factors such as the slow down in the process of urbanisation and improvements of the existing housing stock will tend to restrict residential construction. On the other hand there will remain a need to substantially increase industrial investment. This increase will be all the more necessary in view of the fact that heavy investment on the protection of the environment and on the development of energy resources will be required throughout the period under review.

21. However, the existence of idle capacity at the start of the period in most member countries should make economic expansion possible during the next few years without the development of serious bottlenecks. It must be noted nevertheless that such unused capacity can be due to structural demand changes and limits imposed by economic policy measures designed to restore a better overall economic balance.

22. This overall view must however be adjusted in the light of the disparities between the different countries as regards the volume and effectiveness of available per capita productive capital. These disparities which influence the productivity of national industries may well grow in as much as such financial capital as there is may be attracted towards economies and industries which are competitive because of the advantages which they derive from economies of scale, technological advances, innovative capacities and the capability to invest extensively in research and development.

Probable rate of technical progress

23. The NATO countries have an undeniable lead over the Warsaw Pact countries in the field of civilian technology. This is borne out by the large surplus on trade in capital goods with the rest of the world and more particularly with the Warsaw Pact countries (which in 1975 accounted for \$4.5 milliard worth of exports of this type).

24. This superiority seems unlikely to be challenged since the efforts put into research/development and innovation in recent years have a number of potential spin-offs for bio-chemistry, communications and management methods over the period under review.

AC/127-D/545

-7-

25. In addition, the direct or indirect productivity gains to which it will give rise and the prospects of harnessing new resources which it may open up, mean that this technological progress represents a growth factor which must in no case be overlooked.

Energy and raw material resources

26. The steep and repeated increases in oil prices applied by the OPEC countries, initially after the Yom Kippur War and then in response to the rise in world prices of exports of capital goods, increases which were matched by rises in a large number of raw materials, have had a strong impact on the terms of trade to the detriment of the West and, ipso facto, of the NATO countries. Moreover, within the context of the present international situation in the Near and Middle East and in Africa, the Alliance countries, particularly its European members, remain vulnerable to a renewed oil embargo.

27. There is no likelihood of any change in the situation in the medium-term. For the present and in the foreseeable short-term future, the distinguishing features comprise: (1) a cartel sellers' market with the vendors seeking, in the great majority of cases, to maximise their receipts; (2) increasing energy requirements, particularly for oil, engendered by economic growth of industrialised countries and the industrialisation of the non-oil developing countries; (3) the relative scarcity of oil which prompts producers to present a common front on prices and quantities; (4) the relative inertia of the West which partly because of the high marginal costs of prospection and exploitation are hesitant to embark on a quest for alternative sources of energy.

28. The oil situation in Norway and in the United Kingdom, is beginning to look up following the gradual harnessing of domestic resources. On the other hand, countries like Italy and France and, generally speaking, the countries of Southern Europe which have no oil of their own and which are continuing to build their industrial growth on this form of energy are at a serious disadvantage which could increase if international competition were to be more acute.

29. As concerns raw materials other than oil, that are essential for industrial development and for the continued expansion of the Western economies, there are none that combine such conditions of supply and demand as to give rise to a critical situation such as exists for oil supplies. On the other hand, the West is heavily dependent on external sources for

some raw materials, especially metals, but the possibility of their imminent exhaustion is considered unlikely by the OECD in its study for the period up to 1980. Price developments of raw materials might however negatively influence the efforts of member countries to attain a balanced economic growth, and too rapid increases in demand for raw materials might give rise to the same type of chain reaction that led to the 1973/74 jump in food and other commodity prices. Furthermore, the increasing dependence of Allied countries on external sources for raw materials, necessitates increased co-operation between NATO and producing countries with a view to ensuring stability of supply.

Estimate of potential growth

30. The growth factors in NATO countries are considerable, but unevenly spread. By comparison with the years of buoyant economic expansion (1960-1973), the situation and outlook are less favourable, both as regards the working population whose skills are not always in line with requirements and as regards access to sources of energy and to the basic products which have become more vulnerable and more costly since they must be paid for by higher exports which make corresponding inroads on availabilities. On the other hand, the NATO countries can rely on a considerable fund of potential new technology and on substantial idle capacity in terms of both manpower and capital.

31. To conclude this review of growth factors it would seem that the NATO countries and in general the whole group of countries that are OECD members, have a high potential that can be put at some 6% per year up to the end of the decade. For the period 1981-1984 the number of unknowns is greater, vis: the volume of available capacity in 1980, the drain on resources constituted by the redistribution of resources in implementation of social policies, the cost of protecting the environment, the volume of investment abroad, investment propensities, and the terms of trade. It would seem wiser therefore to envisage for this period a slightly smaller potential average growth rate. But these can only be theoretical projections the realisation of which are hardly likely given the difficulties created by bringing into use simultaneously and throughout the West all the factors of production in a manner compatible with policies aiming to re-establish a fundamental equilibrium on a durable basis.

AC/127-D/545

-9-

II. Economic Policy Assumptions

32. Following this evaluation of potential growth, three major questions must be answered. The first relates to the conditions in which this rate of growth can be achieved, in other words, what are the chances of the NATO countries reconciling fairly substantial growth with the preservation of a fundamental balance as concerns prices, public expenditures and external payments? The second is whether growth on this scale would solve the employment problem in the Alliance countries, a problem which, were it to continue, could undermine their political and social structures. The third question relates to the possibility of stimulating growth throughout the Alliance with the major industrial powers acting as the motive force. The latter question is essential to the continuing cohesion of the Alliance; and would play a positive rôle in the improvement of the employment situation.

33. There is even a fourth question; namely, whether the relations between the Alliance and the rest of the world, particularly the less developed countries, will be such that international trade can expand peaceably, if not buoyantly, and will not cause political tensions which could have a grave effect on the NATO countries' security of supply.

Inflation and rising prices

34. The inflation which was a feature of the early seventies has continued to weaken the economies of most Alliance countries where it is fuelled by rising costs and the inflationary methods used to finance the large public sector deficits. While it is true that the rate of price increases dropped between 1975 and 1976 from 11.3 to 7.5% OECD-wide, this rate is still twice as high as it was during the sixties. The OECD scenario to 1980 is based on average price increases falling to 5% in that year. This rate had already been achieved and even bettered in Germany and in Switzerland. The efforts made in most of the other OECD countries to draw closer to this figure could delay the solution of the unemployment problem, but would contribute towards the establishment of more stable exchange rates and the avoidance of future monetary upheavals.

35. Certain inflationary pressures could die down during the period under review such as, for example, increases in labour costs (which are normally held in check during periods of unemployment but which could resume their upward course in the event of a sudden recovery) and, in the case of some

countries, excessive domestic demand. On the other hand, the recent and foreseeable increases in the price of oil and other basic products will push up costs and because the producers enjoy additional revenue this will contribute to an increase in demand (external demand which will help NATO country exports).

36. The outlook therefore is one of continuing inflation which will however slow down by comparison with recent years without perhaps settling down at an average of about 5% before 1980. There will be strong deviations from this average, particularly between the industrialised and the Southern European countries and there will be some in an intermediate position.

37. A return to more stable, though adjustable, exchange rates would be a factor favouring more even international monetary relations and foster a greater degree of internal monetary stability. This solution, however, could only be reached through international co-operation in the field of economic and trade policies.

#### Public finance

38. The recession has led not only to a slower rate of increase in fiscal receipts but also to a large increase of transfer payments of a social or economic character in order to provide a guaranteed income for the unemployed and in some cases assistance for firms in difficulty. As a result, there were large public sector deficits in most Alliance countries in 1976 which have created severe budgetary constraints.

#### Balance of Payments

39. The steep rise in the price of oil and other commodities at the end of 1973 sparked off a big and widespread deterioration in the terms of trade of the Alliance countries which was only partly offset by the subsequent increases in their export prices. Since the beginning of 1974, the OECD countries as a whole have run a cumulative current deficit of some \$60 billion. But a group of them which, though numerous, accounts for only about 30% of the area's GNP has accumulated a deficit of no less than \$75 billion. This disparate performance between countries has been sharply reflected in exchange rate movements due not only to the need for readjustments of a structural nature created by the energy crisis, but also to the divergence between national inflation rates. Action to reduce the balance of payments deficits requires

AC/127-D/545

-11-

stabilization policies particularly by the hardest hit countries. This might entail severe domestic demand restraints until cost increases are reduced and export led growth is established. A major shift in resource allocation from the domestic to the foreign sector is required in many countries and according to the OECD(1), this shift in overall terms is manageable, taking into account the expected growth in world trade and the declining import propensities for oil within the OECD area.

40. By 1980, it is considered in the OECD study referred to above, that the area will have returned to a small current account surplus with the rest of the world. This is to be set against a deficit for 1976 of some \$22 billion, itself sharply reduced from the \$33 billion deficit of 1974. These general prospects do conceal wide variations in the position of individual countries. With the development of North Sea oil the balance of payments of the United Kingdom and Norway will become strong and for some other countries could remain basically sound. For certain others, however, that are heavily dependent on external energy supplies, balance of payments constraints could adversely effect the rate of expansion.

#### The problem of employment

41. At the end of last year, there were 14 million unemployed in the OECD countries which represented 5% of the working population, and there is little likelihood of any significant reduction in these levels in the short-term. The growth scenario issued by the OECD in the summer of 1976, which stressed the vital necessity of decelerating the inflation rate if the employment position was to be improved, indicated that around 1980 an inflation rate of 5% and a "potential" unemployment rate of 4% appeared feasible. For individual countries the unemployment level would lie around the average figure of 4%. However, for the less developed economies and those less able to stand up to international competition, the level of unemployment could remain considerably higher than the average with adverse repercussions both in the economic and social fields. In particular, this could well imply a continuation, at least, into the early 1980s of the difficult budgetary position in a number of member countries.

### III. Economic Development and Cohesion of the Alliance

42. This review of economic policy problems shows that the ability to cope with them successfully varies considerably from one country to another. The United States and Canada will

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(1) "Growth Scenario to 1980" (page 143) July 1976 OECD Economic Outlook No. 19

undoubtedly continue to be faced with inflationary pressures and with balance of payment deficits but these are unlikely to lead to a serious economic crisis given their economic wealth and the strong financial position enjoyed by the United States.

43. In Europe, the outlook is less promising although the situation will differ from one country to another, with Germany and Norway in the strongest positions. In most of the other European countries, the growth of foreign trade supplemented, where appropriate, by different forms of co-operation and in certain cases by aid, appears essential if the momentum of expansion is to be sustained. This applies in particular to those European countries which will still have to cope with serious disequilibria both as concerns external trade and payments and internally as concerns unemployment, inflation and budgetary constraints.

44. The OECD economic scenario to 1980 highlights the sustained level of world trade necessary for the scenario to prove correct and the important rôle the United States will continue to play in this respect.

OUTLOOK FOR WORLD TRADE 1975-1980 IN SOME  
NATO COUNTRIES(a)

	<u>Growth of Imports(b)</u>		<u>Growth of Exports(b)</u>	
	<u>Early 1970s</u>	<u>1975 -1980</u>	<u>Early 1970s</u>	<u>1975 -1980</u>
Canada	10.3	8½	4.3	9
United States	5.4	9	9.8	8
France	11.4	11½	11.3	9½
Germany	10.8	9	11.0	8
Italy	7.9	7¾	8.4	9
United Kingdom	7.4	4½	6.8	7
Belgium	10.0	10	9.8	9
Denmark	6.7	6½	7.1	6¾
Netherlands	5.1	8	8.3	7½
Norway	7.0	4½	5.1	11
Total OECD	<u>9.0</u>	<u>8</u>	<u>9.5</u>	<u>8½</u>

(a) Sources: "Growth Scenario to 1980" (page 134) July 1976  
OECD Economic Outlook No. 19

(b) Goods and services according to national accounts

AC/127-D/545

-13-

As for the prospects of growth and price increases in the OECD area up to 1980, these also differ widely and the position for ten of the NATO countries by 1980 would be as follows:

ECONOMIC GROWTH AND PRICES(a)  
1970-1980

	<u>Economic Growth Rates</u> (GDP, in volume)			<u>Price increases</u> (GPD defiators)		
	<u>Early</u> <u>1970s</u>	<u>1976(b)</u>	<u>1975</u> <u>to 1980</u>	<u>Early</u> <u>1970s</u>	<u>1976(b)</u>	<u>1980(b)</u>
Canada	5.4	4.8	6.0	7.6	9.8	5.5
United States	3.0	6.3	5.8	6.0	5.0	4.5
France	5.3	5.0	6.0	7.4	9.8	6.0
Germany	4.3	5.5	5.0	6.2	3.5	4.0
Italy	4.5	4.5	4.5	11.4	16.0	7.0
United Kingdom	2.7	1.0	3.5	9.2	14.5	6.0
Belgium	5.0	3.0	5.0	7.9	10.0	5.5
Denmark	3.8	4.5	4.0	7.2	8.5	6.0
Netherlands	3.8	3.5	4.5	8.6	9.0	5.0
Norway	4.3	5.0	7.5(c)	8.2	7.5	5.5
Total OECD	<u>3.9</u>	<u>5.0</u>	<u>4.3</u>	<u>8.1</u>	<u>7.5</u>	<u>5.0</u>

45. Since the formulation of the OECD scenario, prospects have deteriorated somewhat. The 1977 growth rate for the OECD member countries as a whole is now put at only 3.8% in relation to 1976. With the average rate at this level, certain of the Alliance countries face the risk that, should such a low rate of growth persist, this could lead to social and economic difficulties which could be damaging to the cohesion of the Alliance.

IV. The Alliance and the Rest of the World

46. A necessary condition for the prosperity of the Alliance countries during the period 1977-1984 will be the development of favourable international relations, particularly

- (a) "Growth Scenario to 1980" OECD July 1976 pages 133 and 135 Economic Outlook No. 19 and Economic Outlook, December 1976 No. 20
- (b) Increase from previous year
- (c) 4½% excluding the oil sector

between the industrialised countries and the Third World. It is a reasonable assumption that the latter countries will continue to develop their economies helped largely by technological and capital assistance from the West. One consequence of this will be additional world demand for energy and basic products, which will have to be taken into account in the efforts being made to restore stable prices and market conditions.

47. The West, in particular the European countries, that largely depend on external sources of energy and raw materials have a major interest in ensuring stability of supply. Success in this endeavour will be commensurate with the increase in trade with the less developed countries and with the contribution made to their economic development. This means that there must be no deterioration in the terms of trade of the poorer countries which are already handicapped by a high level of indebtedness and have been deprived of the ability to make external payments following the increases in the price of energy and certain raw materials.

48. The efforts and financial sacrifices which will have to be made by the West will be easier to bear if they are spread between the different countries in relation to their resources and capabilities. Effective co-operation in the West and particularly between the NATO countries is thus another prerequisite for a satisfactory economic and social relationship with the Third World.

Conclusions with regard to the NATO countries

49. The realization of a theoretically possible rate of growth of the order of 6% for the years 1976-1980 cannot be retained for it would create, for member countries as a whole, excessive economic disequilibria and tensions. On the other hand a growth rate of 4% or so would seem compatible with a policy aiming at monetary stabilization, the control of inflation and with balance of payments and budgetary deficits held within acceptable limits. Such a rate would bring unemployment down to acceptable levels. To achieve such an objective, which is a desirable minimum, policies guided by the need for growth, firm in seeking a return to fundamental equilibria and innovative in certain fields, will have to be followed.

50. Within NATO, and particularly in the major industrial countries which act as pacemakers, there will be a need to stimulate, by fiscal and other measures, innovation and capital formation, and to improve the allocation of the factors

AC/127-D/545

-15-

of production in such a way as to meet demands of all kinds (protection of the environment, harnessing of new basic resources, social transfers, etc.). This policy will have to be combined with measures to boost employment and keep up a high rate of domestic demand while avoiding pitfalls of renewed inflation.

51. On the international scene, the sine qua non for such growth will be increased co-operation particularly within the OECD group of countries, so that the beneficial effects of growth and an improved employment situation in the economically and technically more advanced, particularly the United States, spread to those countries which do not share the same economic potential.

B. IMPLICATIONS FOR DEFENCE OF ECONOMIC DEVELOPMENTS  
1977-84

General

52. Compared with the situation at the time the last Economic Appreciation was drawn up two years ago(1) when it was considered that an economic growth rate of only 2 to 3% yearly represented a reasonable assumption for use in defence planning, the prospects through to the 1980s are now somewhat more favourable. Many uncertainties persist as to future economic developments, but a growth rate for Alliance members as a whole averaging some 4% or so yearly for the period 1977 to 1980(2) appears a reasonable basic assumption taking into account the growth projections contained in the latest reviews made by the OECD and the Common Market. In considering the implications of such a growth rate for defence the conclusions drawn in 1974 might be recalled. At that time the low (2 to 3%) growth rate envisaged was considered as providing "the necessary economic foundation for the maintenance or a slight increase of the defence effort of member countries as a whole, particularly during the period after 1978". At the same time it was noted that the economic situation in some countries was likely to become more difficult and that conditions could be created that might affect unfavourably their economic and political stability. Reviewing the situation today it is evident that some member countries are still experiencing serious economic difficulties and that considerable further progress is needed to achieve a satisfactory economic equilibrium in the West. Moreover, the prudent although optimistic projections of

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(1) AC/127-D/500, December 1974

(2) This implies lower growth rates for the full period 1974-80 than those projected in the OECD Scenario

growth now generally adopted as policy objectives by member countries and the problems of inflation and unemployment that in many countries have still to be resolved imply, that the constraints on the use made of resources will remain severe at least in the short-term.

The main economic constraints influencing resource allocations to defence

53. Sharply rising prices and costs which were highlighted in the 1974 Appreciation as being likely to have a major adverse influence on defence financing, remain a major source of concern for most member countries. Furthermore, over the last two years a serious unemployment and balance of payments situation has developed and although there are signs of the position improving the compound effect of these factors is being strongly felt on the public sector, and indeed has had, in some countries, particularly negative effects on the efforts made to maintain or even increase (in real terms) the financial resources made available for defence.

54. The problem of unemployment, which as mentioned in the earlier part of this paper will take some time to resolve, has indirect effects on defence through its social and budgetary implications. In the 1980s it is expected that the employment situation will have improved taking into account that there will be a continuing or even slightly sharper rise in the population of working age in most member countries at that time.

55. A key element of the economic policies being implemented by member governments is the reduction, by the 1980s, of the rate of inflation to a level considerably lower than currently, for most countries to less than half. Such policies if successful should ease, but by no means eradicate, the serious problem most countries face, of having to make additional compensatory allocations to their budgets in order to maintain the real level of expenditure intended for defence purposes. Experience has shown that failure to accommodate at least that part of the increase in expenditure due to higher costs and notably pay severely distorts the allocation of expenditure within the defence budget. Indeed, inflationary price increases for major equipment coupled with the escalation of costs due to sophistication are posing problems that are difficult to solve for many countries. Looking into the future, the lowering of the inflation rate and improvement in the budgetary situation in most member countries will, at best, only alleviate somewhat this type of problem.

AC/127-D/545

-17-

56. The appearance of reinforced budgetary constraints is one of the more important immediate consequences of the deterioration in the economic situation over the last few years. The unprecedented growth of budget and public expenditures generally has not been matched by a similar growth of revenues and to cut back the resultant large budget deficits drastic measures have been taken in many countries to restrict and reallocate expenditure resulting in changes in priorities in government spending often to the detriment of defence. The present constraints on budget expenditures generally can be expected to persist over the next few years but as the economic situation improves the position might ease. For the less industrialised member countries, however, their particular economic situation will confront them with special problems as regards their capacity to implement their defence effort; in this respect they will need the support of their Allies.

57. The balance of payments considerations will pose a special problem over the period under review since many countries have moved to lasting serious deficit positions which indirectly are having adverse effects on their defence efforts. For some countries the ability to pay for imported military equipment has been seriously weakened and measures taken in others to re-establish economic balance have added to the budgetary constraints mentioned above. However, the position should become easier by the 1980s if the OECD Scenario proves correct with many of the deficit countries returning to a surplus position. For some, particularly the less industrialised member countries the position is likely to remain serious with the need in the defence field for assistance in meeting requirements for major military re-equipment programmes.

General appreciation of the outlook for defence through 1984

58. The economic strength of the Alliance member countries as a whole is far superior at present to that of any other major grouping of countries and, given a reasonable degree of success in restoring an economic balance should substantially increase through to 1984. The economic potential which can be applied to defence purposes should thus remain high, but due to increasing dependence on external sources for raw materials and oil, may be conditioned by developments in international relations. In particular, the economic vulnerability of the Alliance to interruption of energy supplies will remain a serious consideration throughout the period under review.

Possible trends in defence expenditure

59. Beyond purely economic considerations, appraisal of the need for military preparedness by the national authorities and public opinion will continue to exercise an influence over the resources member countries devote to defence. Over recent years the results, in terms of intended levels of defence expenditure, have been for only modest real increases, at best. In many countries defence budgetary plans have been suspended or revised due to the economic difficulties experienced since 1974. One recent indication of possible future trends was given in the results of the May 1976 NATO Force Goals exercise covering the years 1977-1982. The International Staff estimates of defence expenditure increases over this period were summed up in the final report(1) and reproduced in the Statistical Annex(2) thereto. The increases in defence expenditure required to implement the force goals agreed last May vary considerably from country to country. For the NATO European members the yearly average increase ranges from little more than zero to around 4% in real terms and for North America the range is between just over 2% and just over 3%.

60. On the basis of the assessment of the NATO economic situation through 1982 made in May 1976, the defence burden implied by the implementation of the Force Goals in terms of the share of GDP would decline slowly in most member countries. For the European member countries as a whole, the defence share would fall from 3.9% in 1975 to some 3.5% by 1982 and a similar trend was also foreseen for the United States and Canada. Taking into account the more optimistic economic growth objectives now generally reported, the defence share of GDP by 1982 could be somewhat lower than those projected in the Force Goals report of May 1976(1).

61. Economically, with the return to more stable conditions and sustained growth the Alliance globally has the potential to support a significantly higher defence effort than currently foreseen. For the period 1977-84 as a whole, increases in defence expenditure, in real terms, up to the rate indicated for GDP would not jeopardize achievement of the objectives of economic policies mentioned above(3). However, budgetary constraints might limit the financial possibilities which could impose practical limits, but still allow a 3 to 4% yearly average increase. Moreover, economic disparities from country

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- (1) DPC/D(76)7-GENERAL REPORT, 26th May, 1976  
(2) Annex I to AC/127-WP/499, Table 14  
(3) See paragraph 49 above

AC/127-D/545

-19-

to country will remain an important factor influencing the Allied defence effort and concerted action will be needed to alleviate economic difficulties if these increases in defence expenditures are to be attained. In particular, to ensure that the most effective use is made of resources, a greater co-operative effort than hitherto between member countries in the sphere of armaments co-operation and production would seem to be called for.

PART II

A. ECONOMIC PROSPECTS IN WARSAW PACT COUNTRIES

62. The aim of this Part II is briefly to describe the projected economic evolution based on the 1976-1980 Plans for the Warsaw Pact outlining possible strengths and weaknesses. The development of the economies of the Soviet Union and the East European countries has not been similar over the 1971-1975 Plan period; the former experienced a slowdown in growth over the previous period while the latter generally witnessed a satisfactory increase in their NMP despite the fact that in 1975 their performance was disappointing. The current Plan period 1976-1980 is marked by greater caution and by a scaling down in the rate of growth for all these economies.

I. Main Growth Factors

Population and manpower

63. The population of the Warsaw Pact areas reached 360.3 million in 1975 and is projected to rise slowly to 393.7 million, or 0.9% a year, by 1985. This is a continuation of the slow growth trend registered which emerged in the mid-1960s. The population growth in the USSR will be slightly above this average or 1.0% a year and total Soviet population in 1985 will reach 280.4 million; East European growth will be somewhat lower at 0.69% per year and will reach 113.3 million(1).

64. This low rate, coupled with the desire to maintain very large armed forces and general propensity towards over-employment in agriculture, factories and services, will mean that there will be difficulties in obtaining sufficient additional labour, though the size of the problem will vary from country to country. Severe manpower shortages will continue in Hungary, Czechoslovakia and the GDR. The latter is likely to be more critically affected as it is more highly developed than elsewhere. Labour shortages will be less evident in Poland, Bulgaria, Romania, and the USSR in the present Five-Year Plan period, although there will continue to be a shortage of workers with technical skills and in the agricultural sector. NMP growth will have to occur almost solely through increases in productivity and new technology. There will not be much inter-COMECON labour mobility. It is unlikely that the system of "Gastarbeiter", fairly common in the West, (although not without problems, e.g. Yugoslavian workers in Sweden), will be established due not only to the on-going national and cultural differences with East Europe, but also because of economic and ideological differences.

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(1) Figures based on US Department of Commerce, "Projections of Populations of Communist countries of Eastern Europe" (Washington, 1976), and Joint Economic Committee (ed), "Soviet Economy in a New Perspective" (Washington, 1976) using the medium-range.

AC/127-D/545

-21-

65. In the Soviet Union, for which projections of the labour force are available, the working population will increase at an average annual rate of 1.2% between 1975 and 1985. However, in the case of East European countries, projections are only available for the population of working age (15 to 64 years); although this concept does not correspond to that of labour force, the trend over a decade is more or less similar in both cases. For the six East European countries, the annual average growth rate will be of 0.7% (highest rate for Poland: 0.9%; lowest rate for Hungary: 0.15%).

66. More serious for the Soviet Union, both economically and militarily, is the steep drop in new manpower availability after 1980 and the projection that the increase in the able-bodied ages will mainly originate in the less technologically-oriented Central Asia and Kazakhstan. In addition, there are the factors of the incessant urbanization, perennial housing shortage and soaring divorce rates which provide little scope for the population's growth rate to improve. Given the increased labour demand for the development of Siberian resources, the USSR also faces the need to solve the problem of persuading workers to remain in Siberia and not to return to the relative comforts of European Russia. If this difficulty is not overcome, Siberian development may be seriously hampered.

#### Investment Patterns

67. Over the 1976-1980 period, a lower, more cautious economic growth is planned in COMECON countries with targets generally below 1971-1975 results. With growth prospects reduced, the average yearly COMECON investment increase will decline from 9.6% in the last Plan period to some 7% in 1976-1980, and the amount of new construction will drop quite fast. In the case of the USSR and Poland, targets are dramatically lower than those of 1971-1975. There are several reasons for these lower investment projections: the scarcity of capital as the Pact's fast growing interest in foreign loans shows; the necessity to complete the large number of unfinished projects rather than continuously embarking on massive new ones as had been the pattern of the past, and the increasing cost of raw materials, energy supplies and manpower which require much more judicious use of existing assets. Lastly is the realization by all countries that substantial investments do not always guarantee success but rather may encourage waste and inefficiency. The 1976-1980 Plans are determined to avoid following this pattern.

68. The non-productive aspects which benefit the Soviet consumer will continue to languish as productive investments in 1976-1980 will make up 78% of COMECON investment total of \$1,287.7 billion(1). The stress on investment for COMECON, will, however, vary according to the need for each member to remedy particular weaknesses. Both Poland and the USSR are allotting 30-34% of their productive investment to agriculture and the food industry in yet another effort to overcome the deficiencies; e.g. the share of capital inputs allotted to other sectors of the economy will be considerably lower than in the case of other COMECON countries, especially the GDR and Romania. Nevertheless, industry will still have first claim on investments and most countries have realized the need to increase investments in fuels and raw material supply, expansion of metal and engineering industries, as well as the chemical and electronic sectors, and continued purchase of Western technology.

Technology and productivity

69. The Warsaw Pact suffers in the civilian sector from technological backwardness in comparison with the West, in particular with regard to automated production technology. Obsolescent plants, lack of incentives to innovation, non-diffusion of available know how, poor market conditions, low educational standards in several countries, have all contributed to this in the past. It has become apparent that to compete and develop effectively, the Warsaw Pact has to rely on technological imports from the West. Weakness has been evident in those fields that require very sophisticated R&D programmes and a market economy in which to test the products; electronics (computers, micro-circuitry), automated machinery, wood and mineral processing equipment, fertilizers, chemicals and all aspects of advanced hydro-carbon extraction. Moreover, and this applies more to the Soviet Union than to Eastern Europe, the system of incentives based on quantity instead of quality growth in the economy trends to have a negative effect on technical standards, innovation and resources at hand. There also exists a very weak link between institutional R&D and commercial exploitation by state enterprises as well as a lack of well trained technical support personnel in both science and industry.

70. The principal aim of the planners apart from any covert military implications, is to incorporate the new technology into each country's industrial strategy, to improve efficiency and to raise labour and capital productivity. This

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(1) D. Lascelles, "COMECON to 1980" (London, 1976) p. 17

AC/127-D/545

-23-

is especially necessary for Plan fulfilment in the GDR, Czechoslovakia, Hungary, Poland and the USSR. In the latter country, factor productivity registered a minus growth of -0.3% and contributed significantly to the drop in the growth level(1) during the period 1971-1975.

71. Recent purchases in the West of entire plants (e.g. Kama truck factory) reflect both a failure in operation of domestic R&D and its commercial implementation, as well (though to a lesser degree) as a decision to forego expensive and time consuming development of similar R&D programmes. The foregoing indicates the need to supplement inadequate domestic R&D capabilities. Examples of considerable economic COMECON progress made possible with Western technology are especially noticeable in the Soviet oil/gas production in Siberia, using Western pipe, compressor stations and pumps. Hungarian agricultural output is increasingly dependent on specialised Western machinery. Another example is the projected increase in the Polish export trade based on new Western plants and equipment.

72. At the same time the Warsaw Pact shows a certain degree of economic co-operation within the context of various COMECON institutions such as Interatominstrument, Interetalonpribor and others. Technological consultation and harmonization of long-term plans help eliminate some duplication of costly R&D or investment programmes; this is evident in East European contributions to the development of Soviet energy sources.

### Energy and natural resources

#### (i) Energy

73. The availability of energy for the USSR is not considered a major domestic problem area in the period under review, unlike Eastern Europe which is dependent upon the USSR, and the OPEC countries for oil and an increasing amount of natural gas. Nevertheless, for the Warsaw Pact as a whole, the huge natural energy resources of the Soviet Union as well as the on-going Soviet efforts to integrate COMECON joint energy projects, has given the Pact a large degree of self-sufficiency in the major fuel materials. The USSR is the world's largest crude oil producer, with an output forecast to rise by 5% a year to

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(1) USA Delegation paper "Soviet economic plans for 1976-1980: A first look", March 1976, p. 46 as corrected by Errata sheet. See also figures in Joint Economic Committee (ed) "Soviet Economy in a New Perspective" (Washington 1976) p. 279 (Table 8). Productivity of capital in 1971-1975 was -3.8%.

640 million tons(1) in 1980. Natural gas production is scheduled to rise at an even faster rate with exports to reach over 60 billion cubic metres in 1980.

74. Soviet exports of oil to both East and West Europe will continue in 1976-1980. This trade is the USSR's largest earner of hard currency (\$3.2 billion in 1975, rising to at least \$3.8 billion in 1976). While on the one hand Soviet exports to Eastern Europe which, apart from Romania, represent 80-90% of the area's oil imports, give the Soviet Union a certain political "leverage", Eastern European countries, on the other hand, continue to benefit from rates which are below world market prices and they are able to pay in soft currency for most of the deliveries. These concessions obviously represent a cost to the USSR which could probably find more remunerative outlets in the West. Although the West seems willing to meet Soviet requests for oil and natural gas technology imports necessary to expand output, a major difficulty facing the USSR could be the industry's, especially the crude oil sector, inability to grow fast enough to meet the increases in domestic consumption and leave a substantial surplus for export to the hard currency countries and to the COMECON. This development would compel the Soviets to chose between maintaining exports at a high level and curbing domestic supplies or alternatively to decide whether to reduce sales to Eastern Europe or to the industrialised West. Either choice would have negative implications for the USSR.

75. In addition, there is some doubt about the country's ability to meet the Five-Year Plan targets for electricity, as on-going administrative delays and inefficiency in the supply of the necessary power plant have delayed construction of both conventional and nuclear stations.

76. The energy situation in Eastern Europe will continue causing concern. This area has set itself two main goals: achieving large savings in fuel and power and adapting the energy balance to the new (higher) price structure set by both the USSR and OPEC. Principally this means reducing the rise in their dependence on hydrocarbons. Most countries are therefore busy reversing or at least halting the decline in coal production and consumption, and building thermal power stations based on coal. This, however, is not an easy task

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(1) Such target is unlikely to be met without large imports of Western inputs. A more likely figure is the lower range of 620 m tons, and some recent estimates put the figure even lower, at 590 m tons.

AC/127-D/545

-25-

as coal (except for Poland), is generally poor in quality (Romania), hard to extract (Czechoslovakia) or of relatively limited supply (GDR). Consequently, East Europe is also going ahead with nuclear power projects using uranium from Czechoslovakia, and the USSR, with the GDR and Bulgaria presently taking the lead in construction of reactors.

77. The 1976-1980 period will also see a relative reduction in East Europe's dependence on the Soviet Union for oil because of Russia's unwillingness fully to meet the requirements of her Warsaw Pact partners. The East Europeans, however, will continue to invest in Soviet energy projects to ensure a primary flow of fuels in the coming decades and the Orenburg gas pipeline, due for completion in 1979, is an example of this type of co-operation. At this stage the USSR is encouraging East Europe to turn to OPEC for some of its oil needs. It is estimated that OPEC deliveries of oil to East Europe may be as much as 33 million tons a year by 1980.

(ii) Natural resources

78. The COMECON area contains many, though not all, of the most important raw material resources, but here again it is the Soviet Union and not East Europe that possesses the bulk of the wealth. The former has a large share of the world's most critical metallic raw materials including copper, tungsten, chromium and vanadium, although it is poorly endowed with bauxite and fluorspar, and her production of tin is not sufficient. Some East European countries are producers of certain materials such as bauxite (Hungary, Romania), lead (Bulgaria, Poland, Romania), copper (Poland), zinc (Bulgaria, Poland, Romania), but the GDR and Czechoslovakia depend almost entirely upon imports. Overall East European output however does not meet increasing demand and the region has been forced to import metals and minerals from the Soviet Union, the West and the LDC's in return for currency or commodities.

79. Products the area does frequently lack are grain and fodder due to the fluctuating state of COMECON agriculture. Up until now, the West has been able to meet COMECON demands from its own large surpluses. It is possible, however, that a series of mediocre Western harvests, coupled with poor Communist crops, could be disastrous for the Warsaw Pact and lead to a period of severe belt-tightening and economic slow-down.

II. Economic Evolution and Relations  
with the Rest of the World

Potential Growth: 1976-1985

(i) 1976-1980

80. Over the 1976-1980 Five-Year Plan period an average NMP(1) growth rate of 5.4% a year (1971-1975: 6.4%) is forecast for the Warsaw Pact area. Romania, Bulgaria, Hungary and Poland targets are above this average, while the GDR and Czechoslovakia have rates somewhat below. The Soviet Union, still suffering from the crop failure of 1975, also forecasts reduced growth in NMP on the order of 5% a year in 1976-1980(2).

81. Caution also tends to permeate growth targets throughout the various sectors of the economy over the next five years: for example, industrial production in the Warsaw Pact area, except for Bulgaria, is expected to increase at a yearly average of some 1-1.5% less than in 1971-1975. Poland's industrial growth rate in particular is substantially less than the last period's achieved target. In all cases, stress will be on expanding the engineering and chemical industries which are to represent 41% of the total Warsaw Pact area share of Group A (heavy industry) production. Agricultural growth will not differ substantially in the East European countries from the 1971-1975 rates, except in the case of Romania and the GDR, both of which have set rather more ambitious targets. The Soviet Union has revised its estimates upwards due to the record 1976 crop, but this target can easily be untenable if poor weather and continued bad management are much in evidence.

(ii) 1981-1985

82. During the first half of the next decade it is likely that the rate of growth of the Soviet economy will be lower than that achieved during the present decade. Investment will remain a critical matter; the more so as the planners may be under some pressure to allocate a larger volume of resources to the light industry and to those industrial activities aimed at meeting consumer demand(3). Greater emphasis will be put on the development of the resources of Eastern Siberia and the Far East, the more so as the BAM railway line should be completed in 1982.

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- (1) NMP is estimated to be about 1-2 percentage points higher than the Western concept of "GNP".
- (2) In 1976, despite an excellent harvest, economic results have been mediocre. NMP rose 5% and fell short of the planned target of 5.4%.
- (3) Up to 1984 it seems likely that relatively more emphasis will be placed on the consumer than in recent years.

AC/127-D/545

-27-

83. This anticipated decline in growth is based on a number of developments. First the rate of growth of the labour force is estimated to drop to an annual rate of only 0.9% in 1981-1985 compared with 1.5% in 1976-1980. There will even be a decrease in the numbers of the populations of 18 and 19 years of age; this will create a problem of manpower allocation to the military and civilian sectors of the economy. The conditions of growth will not be met unless labour productivity rises above its present low level. Secondly, although agriculture should continue to receive investment priority, structural weakness, inevitable adverse weather conditions and the migration of young, skilled workers from the agricultural sector may well impede a regular and sufficient increase in production, the development of which may continue to be erratic. Thirdly, investment should result in smaller returns as the Authorities allocate it for capital expensive development in Siberia, environment protection, and infrastructure for the auto age. Fierce competition from other resource claimants will preclude allocating a larger share of GNP to investment in order to compensate for the lower returns.

84. US experts have made a baseline projection for average annual GNP(1) growth rates of 3.7% over the period 1981-1985(2). Soviet economic expansion can easily deviate from these projections if domestic and external conditions change markedly. The US experts have formulated a model of the economy based on four alternatives for the Five-Year period 1981-1985:

- (a) Easy conditions, both domestic and external - viz., good technological progress in all producing sectors including agriculture, favourable terms of trade, no undue political pressures. Result: average annual growth rate of 5.5%.
- (b) Hard conditions, both domestic and external - viz., negative technological progress, crop failure, poor labour productivity rates, sluggish foreign trade and adverse terms of trade. Result: average annual growth rate of 2.4%.
- (c) Easy domestic and hard external conditions - viz., high level of investment, good agricultural results, but unfavourable developments in foreign trade. Result: average annual growth rate of 5.4%.

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{1) Western concept - in constant prices  
{2) Joint Economic Committee, US Congress "Soviet Economy in a New Perspective" (Washington, 1976), p. 203 ff.

- (d) Hard domestic and easy external conditions - viz., lower aggregate consumption, and poor agricultural results; trade grows at predicted rate. Result: average annual growth rate of 2.6%.

85. One factor that will further influence these rates is the level of defence spending. It is clear that reductions in Soviet defence outlays release resources that facilitate the achievement of the main Soviet economic objectives - greater consumption and greater investment in industry and agriculture.

86. The overall assessment is that Soviet output expansion will slow down over the next 10 years and the economy will be that described as "sluggish stability". This could happen particularly if domestic conditions are less than "easy". Favourable foreign trade patterns will not be enough to overcome a major defence such as poor agricultural results, or slow rates of technological or productivity progress.

87. For Eastern Europe in the 1981-1985 period the growth rates are likely to vary considerably. Romania and Bulgaria, the less developed countries of the area, are likely to continue their high annual NMP growth rates of 8-11%. Poland, which registered a high growth rate in the 1971-1975 period has already announced a much reduced rate of 7.2% a year over 1976-1980 due to the on-going economic problems. The rate at which the Polish economy will grow between 1981-1985 will very much depend on the success or failure of the present Plan and of current policies to control the growth of foreign indebtedness, reduce the large delays in plant construction and to improve the lot of the consumer. It can be expected, however, that the Polish Authorities will try to maintain an even growth through the first half of the next decade and their objective could well be of the same order as that set for the present Plan. In the case of Czechoslovakia and the GDR, the expense of importing almost all their hydrocarbon fuel and raw materials as well as the tight manpower situation will continue to act as a brake on any high growth rates, and an NMP growth rate on the order of 4-5% is realistic for the 1981-1985 period. Hungarian growth could be 5-6% given an upswing in foreign trade and a lessening of worldwide inflation, both of which significantly influence her growth potential.

AC/127-D/545

-29-

Prices, inflation and the consumer

88. Living standards in the Warsaw Pact vary considerably from country to country but are overall much lower than in the industrialised NATO countries despite improvement in income and availability of goods in the 1971-1975 period(1). The general tendency of the population in the recent past has been not to show dissatisfaction (Poland being the conspicuous exception) due to various factors of threats, police action, job loss, etc., with prospects of immediate consumer relief and betterment lying mainly in parallel and, even black market activities. Nevertheless, the tensions and stresses within the social fabric are undeniable and there are reports of growing domestic criticism especially in Czechoslovakia and East Germany, and discontent in Poland over tighter consumer supplies. If the present Five-Year Plan targets are not achieved and the consumer is once again asked to sacrifice his expectations for the sake of foreign trade balance and investment and to put up with poor quality goods, there could be an acceleration of social unrest in some East European countries and even possibly disturbances in some Republics in the USSR.

89. For the most part, staple items such as rent, transportation and basic food products remain low in price thanks to state subsidies which can be huge; those for meat and milk in the USSR amounted to over 19 billion roubles in 1976. Even these prices can be increased as the January 1977 Soviet increases have shown, but many products considered routine and essential in the West (good apartments, cars, household goods, etc.), are scarce and carry prices far beyond the value of Western equivalents. Nevertheless, those price increases which would have the most significant impact on imports and domestic consumption are mainly in foodstuffs and the government has yet to get this through. Only Hungary has successfully sharply increased some prices, including those for food, in order to curb imports.

90. The so-called official lack of inflation in COMECON conceals a different reality. Repressed inflation has tended to distort certain sectors of the economy. Poland has increased some prices sharply in the last year because of the need either to pay for more expensive imports or curb domestic consumption. All countries also suffer from hidden inflation illustrated in the latter instance by the introduction of so-called "higher

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(1) If GNP per capita, (1975 US estimates), is taken as a standard of comparison we find: USSR \$2,175; Eastern Europe \$2,189; highest GDR \$3,250, lowest Romania \$925. NATO: US \$6,317; UK \$3,285. (Source: D. Lascelles, op. cit., p. 38).

quality" goods at higher prices which replace identical lower priced items. Moreover, the prices of goods in the parallel market, especially in the USSR, are usually higher than official levels, indicating a truer value for the goods.

91. The present imbalance between real earnings and desirable consumer goods has led to massive savings in all countries which represents a form of repressed purchasing power. Based on available evidence it is clear that the consumer in Warsaw Pact countries is either expected to wait still longer for greater consumer satisfaction or, as in the case of Poland and Hungary, is now required to pay a most unwelcome price for goods provided by the state sector. For example, the worst inflation year for Hungary was 1976 when the rate was 5%. In Poland, 1974 was particularly bad with a 6.2% inflation

Balance of Trade

92. The overall Warsaw Pact trade deficit, which stood at \$2.16 billion in 1974, widened considerably in 1975 reaching \$9 billion. The trade deficit with the developed market economies grew from \$3.0 billion in 1973 to \$10.7 billion in 1975(1) but is likely to have fallen back to about \$6 billion(2) in 1976 as the Pact managed, for the first time since 1971, to reduce its deficit. The total publicized accumulated hard currency debt (export credits, Eurodollar loans, etc.) for the Warsaw Pact stood at about \$38-40 billion (net) at the end of 1976 and may go higher in the next year or two.

93. The phenomenal rate of growth of East-West trade since 1970 has been possible only through very large hard currency credits to Eastern Europe and the USSR. In order to reduce their hard currency indebtedness and secure continued access to credits, these countries eventually will have to run a surplus in trade with the West. It appears unlikely, however, that this result can be achieved before 1980, and perhaps not thereafter, especially given the sluggish pace of Western economic recovery and continued increases in the prices of raw materials.

94. All the Warsaw Pact 1976-80 Plans were supposed to have special sections on integration, but little has been concretely stated due to the difficulties over the reformed pricing system of 1975 which is the heart of inter-COMECON trade. Under the new pricing system for energy and raw material, prices are adjusted annually on the basis of a five-year moving average of world market prices. As the Soviet Union is the Pact's largest exporter of energy and raw materials, terms of

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(1) Based on national statistics (Source: GATT)

(2) See AC/127-WP/497 and "The Financial Times", 23rd February, 1977 (based on OECD trade figures). Full trade data are not yet available from all Pact countries.

AC/127-D/545

-31-

intra-COMECON trade have moved in its favour; for the others, particularly Hungary, the terms of trade have worsened and contribute to the growing balance of trade difficulties. These are likely to persist until the 1980s.

Warsaw Pact economic self-sufficiency

95. The Warsaw Pact appears to be both reasonably unified and self-sufficient in economic materials. It has ample energy reserves, vast basic products resources, and a fairly broad industrial base. Although the transportation systems have lagged behind, they are in the process of improvement and should not represent a drag on a quick military mobilization. It is very likely that stocks are maintained for the few raw materials that it does not produce or that it lacks in quantity (mainly lead, tin, natural rubber, bauxite), as well as for essential grain supplies.

96. The USSR, the dominant Warsaw Pact power, meets most of the Eastern European (excluding Romanian) demands for imported fuel. It is also an important supplier to the area of raw materials and manufactured goods. It provides equipment for nuclear power projects and promotes, in the COMECON context, numerous joint ventures which tie East Europe into a compensation arrangement with the USSR (e.g. the Orenburg gas pipeline) and at the same time allows for a pooling of resources.

The Warsaw Pact and the rest of the world

97. Several trends have emerged from the Warsaw Pact trading activity over the last five years which will extend into the 1980s. First and foremost is the fact that the Warsaw Pact countries, like those in the Alliance, rely on a recovery of world trade and export activity to finance a part of their future projects for modernization and economic growth. Any sluggish recovery, or even downturn, in Western Europe may have repercussions in those countries, notably in Poland, that rely on heavy export increases. Secondly, the 1976-80 projected trade figures indicate that in spite of the growing Pact trade with the developed West(1), intra-COMECON trade will continue to retain a major share of total trade flows of the area. Trade between the Pact and the less developed countries is also expected to rise, though at a slow rate. There has recently been a number of reports discussing the proposals of the Soviet Union to set up a transferable rouble, to be used in trade with the West. It is, however, unlikely that this system will be established in the foreseeable future until the Soviets answer a number of questions as to the full extent Western firms might be able to use the rouble.

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(1) All Warsaw Pact countries are endeavouring to raise the share of manufactured goods in their exports to the West

98. In assessing the Warsaw Pact one should consider the global aspect of its strength: over the past five years the Pact countries have progressed in their economic penetration in certain areas of the Third World. The inevitable concomitant is the strengthening of their political influence in key areas that straddle important shipping routes for the West: Angola, Mozambique, Somalia, in Africa, Syria and, possibly, Libya in the Mediterranean. Soviet and East European merchant and fishing fleets, together with the Soviet navy, constitute a significant part of the Pact economic activities and contribute to its military potential. As pointed out in a recent article by Admiral Kidd, the Pact now has "the ability to interdict or pressure international trade at points well outside the NATO area", and interfere with the supplies of energy and raw materials needed by the West and with the flow of trade(1).

III. Conclusions with Regard to  
the Warsaw Pact Countries

99. During the current Plan period, and probably well into the 1980s, each country's economy will still be affected by inescapable constraints - higher import prices, expensive energy, scarcity of skilled labour, and a philosophy that demands centralized decision making in planning and investment, that has in the past led to great waste and inefficiency.

100. In the period under review the changes of extensive deployment of production factors - especially manpower already critical in several countries - will become more limited, so that economic growth will depend increasingly on gains in labour and capital productivity. Consequently, growth will become more uncertain than in the past, when spare capacity was still available in the economies of many of the Warsaw Pact countries. These elements cannot but have an impact on economic trends in 1976-1984 which include the sensitive areas of private consumption and personal incomes. These internal and external restrictions suggest that caution and restraint in Warsaw Pact countries' economic development are to be the watchwords. Poland in particular faces an austere period with the threat of greater Russian "management" hanging over it until exports pick up and her massive hard currency debt is reduced.

101. The per capita national product of the Soviet Union is already lower than that obtaining in most East European countries. The gap may become greater between 1977 and 1984 and reveal a growing degree of divergence between the standards of living of the Soviet and East European populations. This

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(1) Admiral Isaac Kidd, Jr, "NATO Strategy and the New Dimension at Sea", NATO Review, December 1976, p. 7

AC/127-D/545

-33-

phenomenon could have a non-negligible impact on the cohesion of COMECON and on the economic policies of the countries belonging to it.

102. To strengthen their economies and to give a real impetus to consumption the Soviet leaders, as well as the East European ones, should carry out in depth reforms of the economic system. These would aim at restoring the rôle of prices as a yardstick for measuring value and introduce more flexibility and competition in production. But such reforms would, ultimately, remove the bureaucratic and ideological constraints and have repercussions which might be difficult to control. Therefore the Soviets and their allies are not likely to allow any substantive change in the working of their economic systems.

B. ECONOMICS AND DEFENCE IN THE  
WARSAW PACT COUNTRIES  
(Period 1977-1984)

I. Introduction

103. It is no easy matter to assess the impact of economic developments on the defence potential of the Warsaw Pact countries. The production and utilization of resources in those countries are governed by central planning which, particularly in the USSR, gives priority to the achievement of political aims and accordingly to the defence effort.

Soviet Union

104. In the Soviet Union, the defence effort continues to weigh very heavily on the economy. For some years now it has accounted for between 11% and 13% of the national product and, more specifically, for one-fifth of industrial output and about one-third of the output of the engineering industries. One-third of budgetary receipts goes on military expenditures. During the past six years, these have increased on average by 4% to 5% per annum in real terms which is about the same as the rate of growth of the economy. This average covers a number of fluctuations which are the consequence of the successive armaments programmes. In the past two years, expenditure has increased by 5% to 6% reflecting both the scale of a new cycle of armaments production and the growth in the cost of these armaments. This is particularly true of the new strategic arms systems which have been extensively deployed since 1975 and of the air force the modernization of which, in recent years, has generated an increase of about 10% per annum in the financial resources allocated to it(1), a reflection of the high cost of the new type of equipment issued.

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(1) See C-M(77)11, paragraph 16

105. The rise in costs is due not only to the sophistication of the weaponry and to the growing outlay on the research which the latter entails, but also, to the increased cost of factors of production particularly since, in certain cases, different technologies are used for one and the same type of production. In addition to this armaments effort and to the upkeep of a very considerable military establishment, the Soviet Union has quite clearly put in hand a passive defence programme the cost of which cannot as yet be estimated but which requires considerable material and manpower resources. The overall effort can be estimated, in United States prices, at \$144 milliard in 1975 as compared with \$107 milliard in 1965 (in 1977 dollars).

106. A special feature of the Soviet defence effort is that despite the growing resources which it is absorbing, it appears to have been largely unaffected by the vicissitudes of economic development such as, for example, the failure to meet the Five-Year Plan targets or the episodic signs of stress in the allocation of resources. Enjoying as it does a high, politically motivated, priority, the defence effort absorbs a constant share of the budget as well as of the volume of available resources. The Soviet military-industrial establishment occupies a privileged position and is sufficiently powerful to influence government decisions relating to the military programmes which are regarded as necessary, and even to force the government's hand.

107. The repercussions of the defence effort on the economy are both quantitative and qualitative. The allocation of large resources to uses which in most cases are unproductive hampers rapid growth. The Soviet forces and paramilitary organizations keep about five million men (i.e. roughly 4% of the total working population and nearly 8% of the male working population) out of productive employment at any given moment, and this at a time when the number of young people coming on to the labour market is tending to drop. In addition, the armament industries swallow up a large proportion of the best technicians and the best qualified manual workers although labour productivity in the economy as a whole is relatively very low. Likewise, the priorities assigned to the armaments programmes mean that in practice a high proportion of research capacity and of the most advanced technology is used for their benefit.

108. The negative impact of these factors on the rate of growth is however difficult to assess. The separation between the military and civil sectors, particularly with respect to research, is detrimental to the modernization of production.

AC/127-D/545

-35-

The transfer to the civilian economy of a large proportion of military production capacity would inevitably be a slow process. On the other hand, a reduction in the number of serving personnel would benefit civilian production proportionately.

East European Countries

109. The defence effort of the other Warsaw Pact countries, although considerable, does not weigh so heavily on their economies as in the USSR. According to Western estimates based on the official budget statistics, military expenditure in most East European countries appears to have risen sharply in the years up to 1974. However, there are considerable variations in the available estimates. It has also been found that military expenditures and GNP as calculated are not fully comparable due to the use of different types of dollar conversion rates for the two variables. Consequently, until further studies have been completed, comparison, particularly with estimated GNP can be misleading.

110. In the East European countries over recent years, significant progress has been made with the modernization of military equipment. However, a major part of the defence equipment is purchased in the Soviet Union and part is manufactured under licence by those countries with sufficient industrial capacity, both for their own use, and for their Warsaw Pact allies. Expenditure arising from the maintenance of Soviet occupation forces is partly offset by deliveries of military equipment.

II. Outlook for the period 1977-1980

111. There is no evidence of any kind of Soviet budgetary data or in the information available on the targets and resource allocation in the 1976-1980 Five-Year Plan that there will be any reduction in the resources committed to defence. The official budget figures on military expenditure are in any case only of political significance and the slight downward trend in the defence budgets since 1974 obviously does not tally with the Soviet Union's visible build-up in the number and quality of its armaments which inevitably lead to an increase in budget commitments. This very high level of expenditure should continue until the end of the decade since the current military programmes presuppose long and increasingly costly manufacturing cycles.

112. This effort seems feasible and unlikely to create any special stress in the allocation of resources up to the year 1980. The number of young people of call-up age will remain sufficiently high to permit continuation of the present manning levels and implementation of the Tenth Plan without any likely change in the system of channelling the best engineers and technicians into the military and space sectors. In addition there seems no prospect of any bottleneck in the provision of basic resources for the defence industries. It should also be noted that the construction of the planned pipeline network towards Eastern Europe, particularly starting from the Friendship pipeline, should go ahead in accordance with the Plan. This network, which is of undeniable strategic importance, will make it considerably easier, in the event of tension, to ensure supplies for mechanised equipment and for forward air forces. There is likewise a strategic content in the announced intention to expand road building and to improve under the Plan the Warsaw Pact countries' road network. This is equally true of the continuing construction, under the Tenth Plan, of the BAM railway line which should be finished by 1981 and which will partly duplicate the present Trans-Siberian, thus providing new transport facilities for troops on the Sino-Soviet frontier. The increase in the civilian air fleet will provide a potentially large capability for troop transports, although not for transport of outsize military equipment. Many Aeroflot units are currently being used for the twice yearly relief of military personnel stationed in Eastern Europe.

113. The channelling of an even greater share of production than under previous Plans into Group A civilian manufactures which can be used for strategic or military purposes, either directly or subject to quick and easy adaptation, further increases Soviet potential in the field of conventional warfare. Perhaps more important still, however, is the extension and modernization of its air transport capability and of pipeline throughput which will increase the flexibility and capacity of the logistic system and the speed with which it can respond to military requirements, particularly in the West. The stockpiling of food, which cannot unfortunately be assessed with any degree of accuracy, strengthens the impression of an increasing shift in civilian production towards areas which would be essential in times of crisis.

114. By comparison with Soviet military might, the strength of the East European forces is, as already stated, fairly limited. In addition the economic difficulties stemming from a lack of basic resources, a certain shortage of

AC/127-D/545

-37-

qualified manpower and balance of payments difficulties which these countries now face and will probably continue to face until at least the end of the decade, would seem to indicate that resources allocated to defence will not increase as fast as in earlier years. Nonetheless, since the overall military strength of those countries is disproportionate to the strength of the Soviet forces, this possible, and even probable, downward trend in the growth of military expenditure will have little effect on the balance of forces between the NATO and the Warsaw Pact countries.

115. On the other hand, the extension in Eastern Europe of natural gas and oil pipelines from the Soviet Union will increase the effectiveness of Soviet logistics. Current co-operation, which should increase, between East European and Soviet technicians in connection with certain industrial development programmes, in most cases on Soviet territory, may also make it possible in the medium-term to switch between various equipments in certain COMECON country industries, a development which would give a logistic advantage in the event of a political or military crisis.

116. This brief assessment of the economic aspects of the Soviet defence effort up to the end of the decade shows not only that military expenditure could continue to rise at an average yearly rate of 4-5% without jeopardizing the implementation of the relatively moderate Tenth Plan targets, but also that the expected growth of the civilian economy will improve the ability, if need be, to build up quickly and effectively the capabilities of the military machine, particularly in the field of logistics.

### III. Post-1980 Uncertainty

117. The current Soviet and East European Five-Year Plans will be completed in 1980; in the case of the Soviet Union it is known that the results of the Ninth Plan (1971-1975) were below target, with the possible exception of agricultural investments. The current planning targets are less ambitious, with an economic growth rate in the region of 4.7% a year. For 1976 a growth rate of 5% was, in fact, achieved but it was below the 5.4% projected for that year. The trend is therefore towards a slackening of growth, which can be attributed both to the fact that the planners are aware that the economy has reached a higher degree of maturity and to the factor productivity difficulties encountered both in agriculture and in industry.

118. This downward trend in economic growth can be expected to extend beyond 1980; at the same time, the increase in defence planning may, at least initially, be more rapid than that of the national product and complicate resource allocation. There are other factors, too, which may aggravate these strains. On the labour front, the population growth since 1960 points to a drop in the number of young people arriving on the labour market and an increase in the proportion of non-Russians in the working population. Where resource allocation is concerned, the volume of resources devoted to exports may increase if only to obtain a better foreign trade balance. It is also possible that if the economic situation in some of the Warsaw Pact member countries continues to deteriorate the Russians may be obliged to step up their aid.

119. According to the long-term projections made by some Western experts, in order to maintain the national product and private consumption growth rate at the comparatively modest level - if there is no increase in public demand - of 4% a year in real terms for the period up to 1984, defence expenditure must not rise by more than 2% to 3% a year in real terms. This estimate would be upset only if labour and capital productivity were to go up after 1980. But for this to happen a number of conditions would have to be satisfied, such as growing inputs of Western technology and their extensive dissemination throughout the economy, a high degree of innovation, better agricultural performance and certain reforms. Economic considerations are not, however, the only or main criteria governing the assessment of the volume of resources to be directed towards defence; other factors must also be taken into consideration, for example the leadership's conception of the external threat or the political rôle of military power. It may be assumed that the future growth of national product will be sufficient to allow defence spending to continue to rise, although more slowly than at present, and at the same time leave enough resources available for a progressive improvement in living standards.

120. In most of the other Warsaw Pact countries, it is likely that if the present economic difficulties are not overcome during the next few years, probably with some Soviet aid, the modernization of the armed forces which, since the beginning of this decade, has entailed an average increase in defence spending of almost 10% a year, will not be able to proceed as rapidly as at present. Much will depend on the Soviet Union, which will contribute to a varying degree to the modernization of the forces of the Eastern European countries. Be that as it may, the growth rate of expenditure will probably remain high, certainly higher than the present level in the NATO countries.

AC/127-D/545

-39-

121. It follows, therefore, that if the present trend continues the volume of armaments produced by the Warsaw Pact countries as a whole, which is already greater than that of the NATO countries, will increase at a much higher annual rate than the volume produced by the Alliance. On the other hand, under the expenditure assumptions considered, the strength levels of the Warsaw Pact forces will remain stable, with perhaps a drop after 1980; their ratio to the levels of the NATO armed forces will therefore not vary much.