

APPRECIATION OF THE ECONOMIC POSITION OF NATO
AND WARSAW PACT COUNTRIES FOR THE PERIOD
THROUGH 1980

INTRODUCTION

The first economic appreciation(1) prepared in 1972-73 covering the period up to 1980, while still valid as regards the evaluation of the main economic factors influencing defence, was based on the assumption that no radical changes would take place in world political and economic relationships. Following the strong worldwide inflationary development and the serious deterioration of the balance of payments of most NATO countries as a consequence of the energy crisis, the economic outlook for the period up to 1982 has worsened drastically. The same seems true for most East European countries. However, for the USSR the economic developments in the West have, if anything, made the outlook slightly more favourable than that described in the previous appreciation.

2. The longer term effects of the fundamental economic changes which have taken place since 1973 are very difficult to foresee at this early stage, particularly for the NATO member countries, and only tentative forecasts could be made. The first part of the appreciation, which covers economic developments in NATO countries and the economic basis for defence in these countries, have been based on certain assumptions. It has been assumed that the current inflationary problem is brought under control, that the recycling of the oil exporting countries' incomes in the international monetary system is successfully arranged and that the restructuring and readjustment processes develop smoothly in Western economies.

3. The second part of the report covers the economic development in Warsaw Pact countries and the development of the ability of these economies to support the defence effort. The evaluation of the prospects for the Warsaw Pact countries in the 1972-73 appreciation remains broadly valid. The impact of external developments on their economies should be fairly limited, on the whole beneficial to the Soviet Union, detrimental to the East European countries

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SUMMARY APPRAISAL

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4. The year 1973 was a turning point for the economic development of member countries. Up to that year it seemed that the growth performance of the 1960s might be repeated in the 1970s and that the strength of the economies of NATO countries would increase substantially over the period under review, thus permitting a greatly improved resource base on which to draw for defence purposes. The strong inflationary developments from 1972-73 and the foreseeable balance of payments problems of NATO countries created by the steeply rising energy prices during the last quarter of 1973 have completely altered the growth outlook for the 1970s. These factors and increasingly difficult political and social problems have made the immediate outlook very uncertain and led to more fragile economic inter-relationships that make long-term economic projections hazardous. In such circumstances the possibility of recession taking a grip cannot be ruled out and decisions taken by any country could have considerable repercussions on the others.

5. Even supposing that NATO governments can cope with the many difficult economic problems mentioned above, in the present far from clear situation, the outlook points to reduced growth rates with inflation only slowly being brought under control. Under the best conditions it will take time for corrective measures to take effect and therefore over the period to 1978 average growth rates of the order of 2% to 3% per annum appear a reasonable planning assumption. Growth rates may differ from country to country depending on developments relating to inflation, energy supplies, the balance of payments, the level of employment and the corrective policies applied. If these policies are successful a gradual improvement in the annual rate of growth to 3.5% to 4.5% could be expected after 1978.

6. The events that have hit NATO countries are likely to have an overall positive effect on the Soviet Union so far as it can take advantage of higher raw material prices in export markets, but possibly less favourable or even adverse effects on other Warsaw Pact countries. Nevertheless, even the latter will be less affected than the Allied countries. Economic growth could average some 5% per year in the Soviet Union and increase the economic strength of the Warsaw Pact.

7. The concentration on armaments production in the USSR and the very considerable R & D effort made over the last decade place the USSR in a relatively very favourable position to make optimal use of resources for military purposes over the coming years. The rate of increase of military expenditures of the Soviet Union is expected to accelerate to 3 to 5% annually for the next year or two as conventional weapons are replaced or modernised and a new generation of strategic arms are brought into service. This reflects a cyclical development that is expected to leave the longer-term trend in military spending in the Soviet Union at a rate of the order of 3% yearly in real terms.

8. While, due to the enhanced economic capability of the Soviet Union, the military potential of the Warsaw Pact is likely to increase relatively rapidly over the period under review, the resources available to defence in most NATO countries could increase only slowly. In both the Eastern and Western group of countries the impact of economic developments will vary considerably. For NATO member countries in particular, circumstances are likely to arise that would seriously weaken some economies, at least in the medium-term. For the hardest hit countries implementation of the defence effort has indicated in the 1975-1980 Force Goals might be difficult because of economic and political problems. This underlines the necessity of obtaining the maximum effective value from the resources that countries allocate to defence through rationalisation and co-operation in arms procurement on a NATO-wide basis.

PART I. ECONOMIC DEVELOPMENTS IN NATO COUNTRIES

(a) Main economic trends over the 1972-1973 period

9. In spite of the breakdown in the early 1970's of the international monetary system set up under Bretton Woods, an economic upsurge started early in 1971 in the United States and during the winter of 1971-1972 in Western Europe. For the Western world as a whole 1973 was a year of strong economic growth. In most countries growth tended to slow down somewhat by the end of the year, partly because of full capacity utilisation in several sectors of the economy, and partly because of measures taken by countries to dampen increasingly serious inflationary pressures. At the end of 1973 a slight slowing down in the economic growth was foreseen for 1974 (some 4% growth on average), but in the longer term the economic growth was expected to be similar to that achieved in the 1960's, some 5% yearly on average. However, the increase in the price of oil contributed towards accelerating an already unprecedented rate of world inflation and changed fundamentally the economic outlook of most member countries.

(b) The medium-term economic outlook, 1975-1978

10. The impact of the higher prices for oil, the effects of which have not yet been fully felt in price levels or the balance of payments, and the social and political difficulties experienced in curbing inflation will create increasingly difficult choices for policy makers.

11. Western governments will be faced with the problem of having to deal, at the same time, with inflation, growing unemployment and balance of payments problems. Assuming, however, that:

- (i) inflation is brought under control,
- (ii) the recycling of the oil exporting countries surplus funds in the international monetary system is successfully arranged, and the absorptive capacity of the OPEC countries' economies is increased,
- (iii) the restructuring and readjustment processes develop smoothly in Western economies,

member countries may witness a slow growth of their economies up to 1978. Failure to cope successfully with these problems could cause serious consequences for NATO member countries individually and for the Alliance as a whole.

- Inflation

12. Measures now being taken by most governments aim at reducing the current high rates of inflation. This will certainly produce an economic slowdown in most countries. Some of the external factors which accelerated inflation in 1973 and 1974 are, however, unlikely to give a new push to inflation in 1975. Oil prices are not likely to rise drastically and, during 1974, raw material prices other than energy and food have declined considerably. However, for 1974 lower import prices are unlikely to have time to greatly influence consumer prices. Furthermore, the anti-inflationary measures now being increasingly applied by governments are not likely to have a decisive influence on prices this year. By 1975 the combined effects of these factors should halt the acceleration and even begin to reduce the rate of increase of prices and costs(1). There is, nevertheless, a danger that governments squeeze their economies too long and too hard, causing reduced demand, higher unemployment and widespread social unrest. In summary, the outlook in the medium-term is for prices to rise less sharply than in 1974 but possibly considerably faster on average than the 3.0% increase realised in the 1960s.

- The problem of external payments imbalances

13. During 1974 huge external payments imbalances are building up as a consequence of the oil price rises. Surpluses of the oil exporting countries are by far the largest element of these imbalances.

(i) The size of the problem

14. High oil prices are gradually reducing the consumption of imported oil and will, in the longer-term, stimulate the development of internal fuel resources. The effect of such adjustment processes will, however, be only marginal in 1974 when the oil exporting countries are estimated to realise a \$60 billion increase in their receipts compared with 1973. The current balance of payments deficits of NATO countries will grow substantially over the next five years from \$25 billion in 1974 to \$50 billion in 1978(2). In these circumstances deficits aggregating between US \$200 and US \$300 billion will have to be financed by NATO countries to pay for their oil requirements over these years.

(ii) Possible solutions through foreign trade policies

15. If all countries tried to solve their balance of payments problems by increasing exports and decreasing imports a destructive trade war might develop. To avoid this, the OECD member countries, on 30th May, 1974, pledged to avoid new restrictions on international trade for a period of at least one year.

(1) See Annex table 2 for movement of prices of raw materials

(2) Based on estimates made by the OECD and the World Bank

(iii) The recycling of international liquidity

16. Because of the oil price increases, NATO member countries as a whole are not expected to attain current account equilibrium for some years. During this period, financing of import needs will be one of the major economic problems.

(a) Borrowing through banks

17. It now seems likely that the major part of the oil consumers deficits in 1974 will be met, at least in the case of NATO countries, from bank-arranged borrowing through the Euro-dollar and other capital markets. Oil producers have, in recent years, invested the bulk of their reserves in Eurodollars. It is, however, impossible to know whether these markets can made arrangements for their surpluses on the present scale, and the future of the financial markets in industrial countries is very uncertain.

(b) Investments by oil producing countries

18. Surplus oil funds will find their way back to the oil consuming nations either in the form of oil producer investments, loans or grants. The direction of investment flows will in part depend upon the attractiveness and security of investment markets in individual member countries. The bulk of the oil producers funds seems likely to be invested in the major financial centres. The oil producers have also turned to multilateral channels such as the IMF oil facility and to bilateral assistance. So far this has not been sufficient and the economic situation of the developing countries might take a serious turn for the worse during the next few years. On the assumption that the borrowing needs of member countries can be satisfied, they will gain the time needed to adjust and restructure their economies to the new situation.

- Structural changes necessitated by high energy prices

19. To reach a higher degree of selfsufficiency in energy is a longer-term task requiring considerable capital resources. For some countries, sufficient amounts of capital might not become available for this purpose.

(i) Medium-term measures

20. Energy conservation is the most important area for remedy of problems associated with increased oil expenditures, until new technology for energy production can be developed and in the absence of new sources of fossil fuels. As a consequence of measures taken the growth of consumption of energy in EEC countries is expected to drop considerably from the 6% level achieved between 1968 and 1973. In terms of balance of payments the energy deficit which will grow substantially up to 1978, might stop rising after that year and start to fall considerably by the end of the period (1982). In the

longer run, during the next four or five years, efforts must be directed to increases in domestic production among the oil-importing nations, to the development and implementation of new technology for energy production, and to the establishment of machinery to permit continuing discussion with oil exporters, dissemination of information about production and pricing of fossil fuels, and the establishment of emergency facilities including stockpile and pooling arrangements.

- Implications for the standard of living

21. All deficit countries will be facing a difficult choice as to the rate at which domestic demand should be controlled in order to make way for a shift of resources for the benefit of the oil producing countries and the pressing restructuring programmes to ease the balance of payment pressures. As there seems to be no escape from a certain contraction of the growth of internal demand if the problems are to be solved, the standard of living increases experienced during the last 20 years might well not be repeated in the medium-term.

- The growth prospects up to 1978

22. With regard to the period up to 1978, there remain three major areas of uncertainty:

- the success of the anti-inflationary measures which are now being taken by all governments. If the squeeze is too hard a worldwide deflation might result;
- the behaviour of world trade under present conditions whereby many countries may be trying to expand exports and cut down on imports to ease their balance of payments difficulties;
- the international shortage of credit that will develop as a consequence of the financing of oil imports during this period will necessitate increased domestic savings to finance vital restructuring and adjustment programmes. Such savings will tend to reduce further internal demand and thus economic growth.

23. In the current confused international economic situation it is very difficult to make even approximate forecasts of future economic growth. Recent EEC and OECD studies vary widely in their estimates even for the year 1975. For example, for the four major European countries the OECD, without exception, takes a considerably less optimistic view and indicates a growth rate for the countries taken together, of just over 1% compared with over 3% in the EEC estimate. Such differences, are due to the assumptions on which the projections are based. Even supposing that NATO governments can cope with the many difficult economic problems mentioned above, in the present far from clear situation, the outlook points to reduced growth rates with inflation only

slowly being brought under control. Under the best conditions it will take time for corrective measures to take effect and therefore over the period to 1978 average growth rates of the order of 2% to 3% per annum appear a reasonable planning assumption. Growth rates may differ from country to country depending on developments relating to inflation, energy supplies, the balance of payments, the level of employment and the corrective policies applied.

(c) The longer-term economic outlook,
1978-1982

24. A general improvement in the economic conditions of member countries might be expected in the years 1978 to 1982. National efforts to save energy and to increase domestic production must be expected to have made important progress by 1978. During the five year period through 1982 further considerable improvements might be expected. Such a development would progressively allow countries to direct economic resources from restructuring purposes to other sectors of the economy, thus making higher rates of economic growth possible during the last years of the period. If successful, members of the Alliance could expect a gradual improvement in the annual growth rate to 3.5 to 4.5% after 1978.

25. The accumulation of a debt burden during the years up to 1980 of perhaps US \$300 billion or more would impose limitations on the rate of increase of standard of living improvements. Interest payments alone on this debt might for NATO countries amount to US \$30 billion per year in 1980.

26. Even if the situation on the whole is likely to improve on the given conditions, the development and the severity of the economic problems will vary between member countries. The basic energy position of North America is much stronger than that of most European member countries, and the ability of their economies to cope with the current problems consequently better. The longer-term balance of payments problem for the North American member countries should be less serious as relatively less resources will be needed to implement restructuring programmes than in Europe. For the whole period up to 1982 economic growth might, therefore, be higher than in Europe.

27. In Europe the earlier OECD projections of economic growth for the years 1975-1980 has been largely invalidated by the eruption of inflation and the balance of payments problems. Exceptions are the three oil and gas producing member countries, which should see their economic conditions improve considerably. For Europe as a whole economic growth might, however, pick up from some 2 to 3% on average between 1974 and 1978 to some 3 to 4% during the last years of the period.

(d) Economic Basis for Defence

General

28. The uncertainties which surround even the short-term economic outlook, severely reduces the reliability of assessments of resource availability for defence during the next few years. In view of this uncertainty a periodic reappraisal of the economic outlook is called for at more frequent intervals than in the past. For most countries economic resources might continue to grow slowly over the period under review if the main assumptions made above prove correct. This would create 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. Not only the economic growth but also the growth of the population is expected to slow down during the next eight years. This factor is not, however, likely to affect seriously recruitment of military manpower.

Key economic factors influencing resource allocation to defence

(i) Rising prices and costs

29. The very much higher rates of inflation that are now in prospect compared with past experience have very serious implications for defence. Anti-inflationary policies are likely to have a distorting effect on allocations within the defence budget unless provision is made for necessary adjustments.

30. In this respect the most marked effect of inflation over recent years has been on personnel costs. With much higher general rates of inflation now in prospect and the replacement in many countries of conscript service with regular recruitment, the outlook is for an even sharper escalation of personnel costs over the years ahead. Experience has shown that failure to accommodate at least that part of the increase due to higher pay could severely distort the allocation of expenditure within the defence budget. The system adopted by some member countries of supplementary appropriations for meeting the wage increases of all public employees, considerably alleviates the problems that arise. This system, if adopted by all member countries, would contribute to resolving the problem in this sector.

31. Inflationary price and cost increases for major equipment which will also be much higher than in recent years pose special problems. The setting of specific percentages of total defence expenditures for meeting military equipment needs provides a rough criteria that will take care of the inflation factor. However,

inflation coupled with the continuing sharp rise in costs due to sophistication of equipment, will make it essential for economies to be achieved through equipment standardisation, rationalisation measures and co-operative production/procurement on a scale that has not yet been achieved in NATO.

(ii) Public expenditure trends

32. The immediate implications of the economic situation and outlook for budgetary policies are that the rapid increases in public expenditures of recent years will need to be slowed down. Between 1968-1973 the budgets of member countries increased considerably faster than the simultaneous growth of GNP(1). Defence budgets rose less rapidly and their share in the budget total has, with few exceptions, declined. The drastic reallocation of resources that has taken place increases the need for a close scrutiny of the priorities in national budgets. This has been made more urgent by the additional claims on resources that are required for meeting investment and other expenditures for economic restructuring and readjustment programmes.

Possible trends in defence expenditures

33. Projections of defence spending provided for the NATO force goals exercise covering the 1975-1980 period, give one indication of possible future trends. The International Staff estimates of defence expenditure increases over this period as summarised in the final report are reproduced in the attached statistical Annex (Part I, table 3(b)). As can be seen from the table, the increases in defence expenditure required to implement the force goals agreed in May this year varies considerably from country to country. For the NATO European member countries taken as a whole the yearly average increase is of the order of 3.5 to 4% in real terms and just under 3% in North America. For NATO Europe and Canada the projected rise is substantially higher than the rate of increase actually implemented over the years 1965-1973.

34. Assuming economic growth rates of only 2 to 3%, the implementation of the Force Goals would imply an increase of the share of GNP taken by defence. Such a development would be no more than a continuation of the trend of the last few years of slowly rising defence share of GNP for this period and, a leveling off after 1978 when economic growth rates are assumed to be higher. The economic situation in some member countries is likely to become difficult over the next few years with serious inflationary and balance of payments problems developing. In such countries conditions could be created that might affect unfavourably their economic and political stability. For the hardest hit countries the implementation of a defence expenditure growth as recommended in the Force Goals 1975-79 might raise difficult economic and political problems.

PART II ECONOMIC DEVELOPMENTS IN THE WARSAW PACT COUNTRIES

(a) Current Trends (Performance in 1972/73 and prospects for 1974)

35. Over the years 1972/73 economic growth in the Warsaw Pact countries was a little less than in the NATO countries. Progress in the East European countries was steady, GNP rising 5-6% per year. In the Soviet Union on the other hand performance was uneven. Growth in 1972, owing largely to a bad harvest, was the lowest in the post-war period. In 1973, the harvest reached record levels, and GNP rose by more than 6%.

36. There was an unprecedented rise in East-West trade in 1973, the Soviet turnover in particular, rising by more than 40%. Trade was fostered by easier access to Western credits, the result of détente, but the USSR, and to a lesser extent Poland and Romania, benefitted by the rise in world prices of energy and raw materials. As the result of higher prices obtained for gold and oil, there was a big jump in the convertible currency earnings of the USSR in 1973, of the order of at least US \$1 billion dollars. The Arab countries, moreover, were able to pay cash for arms supplied by the Soviet Union.

37. In the USSR prospects for growth in the year 1974 are mixed. Industrial production is rising more rapidly than in 1973. The harvest will reportedly be smaller than in 1973 though still be the second largest on record. Agriculturally this may be quite satisfactory, but it does mean that overall economic growth will probably be less than in 1973. External factors are favourable; owing to the rise in commodity prices the Soviet trade balance with the convertible currency area may well be in surplus for the first time in many years, this despite commitments to buy Western equipment well in excess of \$2 billion both in 1972 and 1973. As foreign trade only amounts to 6% of Soviet GDP, such developments will not have any significant immediate effect on growth but they may increase Soviet leverage in foreign relations.

38. The outlook for the other Warsaw Pact countries is less favourable. Industrial output could be affected by a shortage of energy. Last year already the output of hydro-electric stations was reduced by drought, and, possibly in anticipation of future difficulties in the purchase of oil from the Soviet Union, general energy conservation measures were introduced. Industrial growth in Poland, Romania and Hungary in 1974 is in excess of plan but in East Germany and Bulgaria the reverse is the case. Agriculture prospects in the area are uncertain. As can be seen from the table below foreign trade is more important

in the economies of these countries than in the Soviet Union. The bulk of their trade is within COMECON but trade with the West is expanding rapidly. For the present, at least, these countries seem ready to accumulate deficits with the West.

TRADE IN RELATION TO GNP 1972

	GNP(1) \$bill.	Trade as share of GNP % (2)			
		Total	CMEA	West	Developing world
Bulgaria	14.3	36.0	28.1	5.0	2.2
CSSR	37.9	25.3	17.0	5.5	1.8
DDR	46.5	26.1	17.7	6.7	0.8
Hungary	18.2	35.4	23.0	9.3	2.0
Poland	56.2	18.2	10.8	5.9	1.0
Romania	31.4	16.6	7.7	6.2	1.4
USSR	548.7	5.7	3.4	1.3	0.7

(b) The longer term outlook 1975-82

39. Whereas, as the result of recent developments, the economic outlook in the NATO countries is uncertain, economic growth in the Warsaw Pact area seems likely to continue over the period envisaged at between 4% and 5% a year on the average. External factors, notably the rise in the price of many raw materials, are likely to work somewhat in favour of the Soviets, though the effect of improved terms of trade will be limited and will be felt mainly towards the end of the period. The impact of the same factors on the East European countries, however, is likely to be greater, more sudden, and unfavourable. Their bargaining strength relative to the USSR will be reduced and the impact of Western inflation on their balance of payments may make them more dependent on trade with the USSR.

(i) Internal Developments

40. The economic model existing in these countries has certain structural weaknesses which have caused trouble in the past and might do so again. These are set out below. On the other hand massive investment and the development of a large engineering

(1) Estimates: Planetary Product in 1972, US Department of State in 1972 \$

(2) ECE Geneva and Comecon Yearbook 1973

industry in the past has promoted rapid growth and might well continue to do so, even though at a diminishing rate. Present efforts to computerise the economy to improve the educational level are likely to pay off too. If the enormous resources of Siberia were sold to the West, the equipment which could be bought with the proceeds would help to speed up growth. At present foreign trade contributes too little to the national income for this to be a very significant matter but conceivably the situation could have changed somewhat by the end of the period under review.

41. The leaders of these countries have long been faced with the problem of maintaining growth while gradually changing the character of the economy. The Stalin system had entailed a constant expansion of resources with priority for investment and defence at the expense of the consumer-related activities. As human and material resources became less abundant and less easy to mobilise, new policies became necessary. The various attempts at economic reform, the drive to improve technology, the preoccupation with living standards, the new attitude to agriculture and foreign trade, the idea that consumption might prove a factor of growth are all aspects of this trend.

- Resources

42. The problem of resources is less acute in the USSR than in other countries but in the longer term is equally applicable. Despite the slowdown in the growth of population in the Warsaw Pact area the labour force in most countries is still expanding. There is, nevertheless, a labour shortage which is due to the fact that the various means of bringing in labour from households and the countryside are practically exhausted. Everything now depends on natural growth which is insufficient to maintain economic expansion unless productivity rises considerably. Material resources, which are short in Eastern Europe, are plentiful in the Soviet Union. However, even there, the most easily accessible resources, located, like the bulk of the population and the industrial centres, in the European part of the country, are fairly fully exploited, while the massive resources beyond the Urals are costly to exploit.

- Policies and Structure

43. The radical alteration of policies which might seem appropriate to the new situation is not too easy to achieve. The leaders understand that increased emphasis on consumer satisfaction is necessary not only to ward off dissatisfaction which could be politically dangerous, but also to provide the motivation for increased productivity. A cut-back in investment as a whole and stress on consumer orientated investment

would seem to be necessary. One problem is that investment in the USSR is not as productive as it should be or rather investment outside the defence sector has not been very productive. The defence sector is relatively very efficient. It has at its disposal the best human and material factors and production is carefully watched by the customer, the Ministry of Defence, which gets extremely good value for its money. Western observers consider that the defence sector is almost distinct from the rest of the economy so that it is very difficult simply to switch resources without a fundamental reshuffle.

44. Agriculture is a good illustration of this problem. The crucial nature of agriculture's rôle is well realised by the Soviet leaders. They are very keen to improve the nation's diet and have invested considerable sums in the sector. Agriculture however remains inefficient.

45. The slowness of the non-defence sectors to absorb technical developments is another consequence of the traditional system. The defence establishment has all the motivation and facilities to study and apply the latest technology and is very successful in doing so. In the other sectors there is little or no end user influence on the enterprises which are concerned to carry out plans imposed by the centre.

46. The centralisation of decision making which is characteristic of the Warsaw Pact economies is efficient in mobilising resources or redirecting them radically in the light of clearly defined priorities. It is much less effective in advanced economies where resources are already committed and the problem is to effect marginal changes as the situation develops. This is no doubt why developed countries like Czechoslovakia and East Germany have suffered more from the system than relatively undeveloped countries like Bulgaria and Romania.

47. What structural changes are the Party leaders in the Warsaw Pact countries likely to accept? In the East European countries, it is in the economic sphere where the scope for independent, national decision is greatest, and since, in addition, economic problems are particularly acute in many of these countries it is understandable that various possibilities of economic reform have been toyed with. In most cases little has come of these ideas largely because they turned out to be unreconcilable with the political imperatives. In the Soviet Union the pressure for reform is evidently less. The leaders enjoy their political power and are against any measures which might threaten Party control or their freedom to dictate priorities. The leaders are ready to accept measures to improve the flow of economic information or to introduce certain economic criteria so long as the principle of central

planning and control is not called into question. As long as economic growth continues at a reasonable pace, it is unlikely that any major structural change will be undertaken.

(ii) External Influences

48. The import of Western equipment incorporating advanced technology is recognised as a good means of raising the efficiency of the non-defence sector. This implies, however, a need, sooner or later to sell competitively on Western markets a corresponding amount of home-produced products, which given the structure and economic policies of the Warsaw Pact countries limits the scope of this business. As far as the Soviet Union is concerned, the recent rise in the price of materials has greatly increased its earnings from the sale of materials and energy and therefore its capacity to import. Moreover, the rise in price of products in which Siberia is so rich would make more profitable the development of that area.

49. This turn in events is not likely, however, to favour the East European countries. Only Poland and Romania have raw materials which they can profitably sell at the present moment. The other countries of the area are short of raw materials and energy and are likely to become still more tied to the USSR.

50. The impact of Western inflation on the Eastern economies may be quite small. Though East-West trade is basically carried on in Western currencies at Western prices, these have little or no influence on domestic prices. True, the East has its own form of inflation, but the excess purchasing power is not allowed to affect prices or influence production or investment. Moreover, the prevalence of inflation and other disorders in the West will be used by the Party leaders as evidence of the superiority of their system and as an argument against those who urge radical change in the Eastern system.

51. A slowdown in the West however could affect the East in a number of ways. There might be a fall off in the Western demand for Eastern products, and the need to restructure Western economies might reduce the volume of capital available to finance Eastern purchases of equipment. Moreover although joint East-West production schemes might to some extent be due to political considerations, in some cases Western firms may also have been attracted by the prospect of lower cost manufacturing in the East at a time when full employment prevailed at home. If there was a period of recession and unemployment in the West, these schemes might well be criticised as "exporting jobs" and thereby lose some of the attractiveness to Western businessmen.

(iii) Growth in 1975-1982

52. Economic prospects for Warsaw Pact countries as a whole thus do not seem significantly changed from the outlook described in the 1972-73 Appreciation. The rate of growth projected therein (4.5%) is accordingly retained in the current projection (see Table below and Annex attached). Like the OECD projections, this is based on estimates of future variations in past rates of growth of labour force and productivity. The influence of agriculture on total economic growth is still considerable especially in the Soviet Union. In this country, judging by Brezhnev's plan for agricultural development, the leaders appear to be willing to devote considerable resources to this section.

53. Present trends seem to favour the Soviet Union, and to some extent Poland and Romania and these advantages might on balance outweigh the disadvantages affecting the other Warsaw Pact countries. By the end of the period development projects in Siberia may have provided adequate raw material resources for the whole area which would imply increased dependence on the Soviet Union. If owing to price rises on Western markets the East European countries have to reduce their trade with Western countries they might well achieve the same trade turnover by developing further intra-COMECON relations. However, the reduced import of Western equipment incorporating advanced technology will delay the development of these economies along more balanced lines.

54. Relative to the previous estimate it now seems logical to envisage a slightly higher growth rate for the Soviet Union and the Warsaw Pact area as a whole and a slightly lower rate in that of the East European countries.

WARSAW PACT COUNTRIES: ESTIMATED GROWTH OF GNP 1971-82

	average annual growth %	
	1971-80	1974-84
USSR	4.5	4.8
Eastern Europe	4.3	3.8
Warsaw Pact countries	4.5	4.5

SOURCE: See Annex, Table I, Part II

(c) The defence burden in the Warsaw Pact countries

55. Within the Warsaw Pact Alliance the Soviet Union weighs, defence-wise, considerably more than the United States within

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NATO. It is difficult, however, to make statistical comparisons. In the Soviet Union prices are officially fixed and reflect very imperfectly the relative scarcity of resources. Certainly defence prices do not adequately reflect the overriding priority given to the defence sector where the best management, research and scientific personnel are employed and the best equipment and materials concentrated. Financial comparisons with NATO countries can therefore be misleading. On the basis of official Soviet defence and science budgets, it can be calculated that outlay on defence in rubles since 1969 has risen on the average about 3% per year. Because of the priority for defence and the peculiar price system this increase has made possible a considerable military build up which, in a comparable NATO country, where prices normally reflect market forces, would have necessitated a much larger annual increase in outlay.

56. The other Warsaw Pact countries appear over the last few years to have increased their defence effort rather more than the Soviet Union. However the burden of defence in these countries is certainly less than in the USSR. in terms of GNP perhaps one-half.

- Outlook

57. There is reason to believe that in the near future the Soviet defence effort may increase at a faster pace than over the last five years. Between 1969 and 1974 the official defence vote remained just under 18 billion rubles, whereas the total allocation to science rose from 10 billion in 1969 to 16.4 billion in 1974, of which about one-half to two-thirds is believed to go on military Research and Development. This tends to confirm that in recent years the emphasis has been on developing qualitatively superior weapons and systems. It is known that a number of new strategic weapons and missiles have been developed and are going into production on a large scale, which would not preclude further efforts in the R & D field, but would imply a rise in hardware costs.

58. The Soviet authorities could probably maintain or slightly increase the pace of their defence effort without impinging too obviously on consumption though there would be fewer resources for other forms of investment. Moreover should serious recession or social unrest hit the West, the leaders might find it easier to resist pressure from the consumers.

- Conclusions

59. The Soviet Union has several options as regards defence spending. With GNP growing at say 5% a year and consumption at 4% it would be possible to maintain a rise in

defence spending of 3% or more per year, as in the past. If the Soviet leaders believe that they have achieved parity with the United States they can fairly easily adjust their spending to requirements. On the other hand it seems unlikely that the East European countries will continue to push up their defence spending at the same rate as over the last few years. A rise of 1-2% a year might be expected.

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