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THE DIRECTOR OF CENTRAL INTELLIGENCE

WASHINGTON, D. C. 20505

National Intelligence Officers

DDI/NIC #5729-82
13 July 1982

MEMORANDUM FOR: Director of Central Intelligence
Deputy Director of Central Intelligence

THROUGH : Chairman, National Intelligence Council

FROM : [redacted] 25X1
National Intelligence Officer at Large

: [redacted] 25X1
NIC Analytic Group

SUBJECT : Commerce Department Critique of our NICM on "The US in the World Economy: Elements of Strength"

1. We are disappointed, though not greatly surprised, at the tone and content of the Commerce Department critique of our study. The points they make are neither persuasive nor helpful. Our responses to the more important issues they raise are attached at Tab A.

2. We have drafted your reply to Lionel Olmer in a positive mode, in the hope of elevating the exchange to a more fruitful level. Our discussion with individuals on Olmer's staff gives us some hope that a more balanced appraisal of the difficult issues involved can be undertaken. In this regard, we suggested to Commerce that they sponsor an exchange of views among US high-technology companies, drawing in those who have been successful in competing with the Japanese, as well as those with a poor track record. As Hal Malmgren may have told you last week, he is undertaking such a study, drawing exclusively on corporate financial support. A suggested reply to Lionel Olmer, for your signature, is attached at Tab B.

[redacted] 25X1

Not referred to DOC. Waiver applies.

Attachments:
Tab A: Responses
Tab B: Memo for DCI Signature

[redacted] 25X1

All paragraphs are classified
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DDI/NIC #5729-82
13 July 1982

MEMORANDUM FOR: DCI
DDCI

THROUGH : C/NIC

FROM : [redacted] NIO-at-Large 25X1
[redacted] NIC/AG 25X1

SUBJECT : Commerce Department Critique of our NICM on "The US in the World Economy: Elements of Strength"

Distribution:
1 - DCI
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NIO-at-L[redacted]/NIC/AG/[redacted]sbl[redacted] 25X1
(13 JULY 1982)

25X1

UNITED STATES DEPARTMENT OF COMMERCE
The Under Secretary for International Trade
Washington, D.C. 20230

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17 JUL 1982

MEMORANDUM FOR THE DIRECTOR OF CENTRAL INTELLIGENCE

From: Lionel H. Olmer

Subject: National Intelligence Council Memorandum 82-10006 of May 1982: <u>The United States in the World Economy: Elements of Strength</u>

Because the subject report's conclusions struck me as totally unwarranted based on my own assessment of the competitive position of the United States in the world economy, I asked my staff to provide a detailed critique. This critique, which I attach for your review, suggests strongly that the NIC memo is seriously flawed, both from the point of view of economic analysis and, perhaps more importantly, because of the misimpressions it may create as to the true (and worrisome) character of our declining competitiveness in world markets, especially when compared with Japan.

The preface to the NIC memo identifies three assertions which it states will be "challenged" in the paper:

1. that the "United States is steadily losing its competitive edge in worldwide and key export markets"

2. that the "downward trend in US productivity growth is a firmly embedded phenomenon"

3. that "Japan's recent dramatic high-technology accomplishments foreshadow the end of US technological preeminence."

These assertions are indeed proper issues for analysis. Unfortunately, in the NIC memo, the points are either not treated in any substantive sense or, as is the case with item 1, the arguments presented are invalid due to errors or omissions of a technical character.

With respect to U.S. competitiveness in high technology industries, the Cabinet Council for Commerce and Trade (CCCT) has commissioned a working group composed of representatives from many executive agencies to examine this topic in detail. The working group, which I chair (and which incidentally has

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SOURCE: CIA NICM 82-10006
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benefited enormously from CIA's support), is now in process of expanding and refining a draft report which has recently been reviewed by the CCCT. I have shared the preliminary findings of the CCCT report (which pinpoint a serious erosion of U.S. competitiveness) with eight corporate leaders who have international reputations for expertise in different fields of technology. All have agreed with the basic thrust of the CCCT study and I think you will find the attached written comments from one respondent revealing.

Perhaps the subject of the U.S. position in the world economy is deserving of a careful and thorough "competitive assessment".

Attachments

Tab A: Analysis of the United States in the World Economy: Elements of Strength

Tab B: Letter from Horace G. McDonnell, Jr.

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Tab A

Analysis of

The United States in the World Economy:
Elements of Strength
(NICM 82-10006)

The National Intelligence Council has released this paper representing a startlingly different view of America's competitive position in global markets. In its preface, the NICM reports it has found an "overall picture that ... is considerably more encouraging than the gloomy perceptions now gaining wide currency even among well-informed observers." The following is the result of an analysis conducted by the International Trade Administration.

Summary of the NICM

According to the NICM, America's international economic performance in the 1970's was relatively robust. The outlook for a U.S. resurgence in the 1980's is, in the NICM's view, encouraging. The widely-held views of declining U.S. competitiveness, secular declines in productivity, and a prospective loss of technological pre-eminence are, in the NICM's view of the world, excessively pessimistic and are not supported by its analysis.

The NICM's conclusions regarding America's performance in the 1970's rest on four assertions:

- U.S. real economic growth matched or exceeded that of most other industrial nations;
- U.S. productivity losses did not reflect economic weakness so much as the fact that America experienced rapid labor force growth and emphasized job creation (over capital accumulation);
- America's current account registered a cumulative $64 billion surplus from 1970 to 1981, the largest of any major country; and
- America increased its share in world markets in the 1970's, when viewed in terms of the volume of trade.

The paper's optimistic view of the future is based (a) on the conclusion that the past decade or so has not been as bad as most observers have thought and (b) that the following five characteristics of the 1980's will bestow even greater strength on the U.S. in world markets:

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- We have great energy resources, and our high per capita energy consumption means we can benefit further from energy conservation;
- Uncertainties regarding future demand have repressed capital spending which will "surge" once current high interest rates decline;
- Foreign capital will continue to flow into the U.S.;
- Declining labor supply growth will place the U.S. in a relatively better position to reduce unemployment and induce American companies to emphasize productivity gains; and
- U.S. performance in technology frontiers will continue to be highly credible -- the challenge from Japan and other countries will not be as overwhelming as has generally come to be feared and, indeed, will serve to stimulate even greater U.S. efforts to meet foreign competitition.

Discussion

The assertions concerning America's relative decline in world markets, which the NICM sets out to challenge, are closer to the truth. The NICM incorrectly assesses past economic trends, asserts the likelihood of future developments without taking fully into account readily available demographic and economic forecasts, overlooks key factors which will affect U.S. and world economic and trade prospects, and uses data that are variously incorrect, or misleading in their portrayal of the U.S. condition in world markets.

Balance of Payments

The overall conclusion of the NICM relies heavily on points dealing with the U.S. current account position. However, both the data and the interpretation thereof are in error.

The NICM states that the overall U.S. trade performance was highly credible during the 1970's since our cumulative current account surplus was more than $64 billion (pp. 4 and 27). In fact, the cumulative U.S. surplus, 1970-81, was only $10.6 billion (1982 Economic Report of the President, p. 346; March 1982 Survey of Current Business, p. 48).

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This is no minor error. A cumulative surplus of $10.6 billion places America near the bottom of the countries listed in the NICM -- not the top. Thus, one of the paper's major reasons for concluding we did rather well is based on incorrect data. (The error seems to come from using the balance on goods and services, rather than the current account -- leaving out official transfers.)*

Even ignoring this error, the unqualified reliance on the balance of goods and services as an indicator of the strength of the U.S. international economic position is unwarranted. Much later in the report (p. 102), it is noted that the improvement in our goods and services balance has been due to advances on the services side of the ledger. A positive and growing balance on services trade is not an unequivocal indicator of a robust American economic position.

The surplus in the services account is more than accounted for by the surplus in direct investment income and interest income from abroad. Although these returns can serve as an indicator of American overseas-based wealth, they should not be equated with a favorable current U.S. competitive position in the international economy.

Returns on those investments are a credit to the international mobility of funds, the acumen of American investors, and the relatively adverse aspects of the U.S. competitive position. They certainly should not be viewed as indications of a lastingly robust American economy.

Finally, if a measure of trade share (rather than trade balances) is the preferred basis for demonstrating a strong U.S. global economic position as the NICM implies through usage, why is this not also true for our performance in services? The NICM discusses services only in terms of balances perhaps to avoid having to consider claims such as those set forth in a recent issue of Industry Week that America's share of world services income fell from 25 percent in 1968 to 15 percent today. The selective employment in the NICM of different methods to evaluate the two components of the balance on goods and services further distorts the analysis and misleads the reader.

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* Even had the data been correctly stated, their simple declaration would have been misleading. The small U.S. current account surplus is due largely to the fact that we changed our statistical definitions a few years ago to include as a credit the reinvested earnings of U.S. companies overseas -- even though such earnings do not directly flow back to our shores. For example, the 1981 current account showed a $6.6 billion surplus.
That included $19.1 billion in repatriated earnings and $11.5 billion in reinvested earnings. Excluding the "flow" of reinvested earnings (they contribute to an increase in America's overseas wealth and thus eventually to expanded repatriated earnings, but not in 1981), our current account in 1981 would have registered a deficit of nearly $5 billion.

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Volume vs. Value

The NICM characterization of a robust U.S. performance also relies heavily on the improvement in the "volume" share of U.S. exports in the 1970's, that is to say, after adjusting for price and currency changes, America's share of total and manufactures trade actually increased slightly during the decade.* The NICM cites this as further evidence that our global competitive position actually improved.

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* Correctly pointing out that dramatic changes in currency exchange rates and oil prices have caused a "blurred image" of the U.S. export performance, the NICM proceeds to analyze events based on estimates of "volume" shares. However, these "volume" shares are not pure measures, but rather proxies. Derivation of such share data relies on a combination of two separate techniques:

  o deflation of export values based on export prices in a given period to produce export "values" in real terms (it should be noted here that all of the NICM data and tables fail to indicate the base years from which "volume" share performances are calculated); and

  o a calculation of shares on the assumption of constant exchange rates (again no indication of base year is given).

  Both techniques require a further assumption to be made: namely constancy in the composition of product and currency prices in the base year are maintained throughout the period being analyzed. However, the use of constant composition base period assumptions necessarily confronts the same type of problem which the use of "volume" shares seeks to avoid -- shifts in composition during the decade due to rising oil prices and the shift to floating exchange rates. The constant composition and related assumptions imbedded in this technique blur the image as much as market shares based on current values and exchange rates. Use of either form of share analysis requires analytical qualification that is not given in the NICM.

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Even granting that such "volume" share measures reveal a more dynamic U.S. economic performance than most observers would credit, a basic question remains: at what price?* If export value shares rise proportionately with volume shares, an improved competitive position is obvious. The reverse is not as clear. If volume share rises but value share remains the same or declines, as is the U.S. case, then a serious deterioration in the terms of trade is implied. Such a development hardly should be described as an indication of a robust U.S. performance.

As our share of world trade in value terms has been falling since 1970 even though it has been rising in volume terms, it is clear we are selling more now and getting less for our sales than we used to -- certainly a classic case of loss of competitive advantage. loss of terms of trade

Put another way, we have suffered a severe loss in our terms of trade. IMF data show that during 1970-81 U.S. import prices rose 44 percent more than export prices, meaning we must now export 1.44 units to earn the money to buy what one unit enabled us to purchase in 1970. There is no cheer to be found in these data. everybody's rose (oil price)

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* Of course, we do not grant the argument since it is clear that competitiveness is not judged by the physical quantity of goods shipped, but rather on the ability to obtain a good price for what one sells. It is the value of trade that counts, not merely volume. As an extreme example, the best way to maximize one's "volume" share of any market is to give one's goods away for free.

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Japan

The NICM declares that U.S. manufactures trade export volume "climbed almost as rapidly" as Japan's (pp. 3 and 39). The validity of this statement rests on using 1971 as the base year. It fails to note that Japanese export volume boomed from 1970 to 1971 with an increase in that year alone of nearly 20 percent. By contrast, America's performance that year fell by one percent. The following data illustrate this point:

Index of Exports of Manufactures
(1967 = 100)

	U.S.	Japan
1970	125.3	167.5
1971	124.0	200.1
*	*	*
1980	252.5	432.8
Percent Change		
1970 to 1980	101.5	158.4
1971 to 1980	103.6	116.3

SOURCE: International Economic Indicators, March 1982, p. 30.

Thus, by adding only one year to the equation, we see that, rather doing nearly as well, we did considerably worse even using the NICM's preferred measure of "volume" share.

Even so, the NICM proceeds then to denigrate the significance of Japan's economic potential by observing that Japan's better performance was due to a concentration (52% of exports in only five categories: road motor vehicles, steel, consumer electronics, industrial machinery, and ships. Further, the NICM asserts, this concentration will limit the scope of Japan's success in the future.

These five categories are so broad and basic they can hardly be regarded as "concentrated". Also, it is not at all clear how the large share of Japan's exports accounted for by these categories will restrict, ipso facto, further export growth of those products, export of other products, or in any way restrict total production by the Japanese economy.

For instance, using categories at a comparable level of disaggregation, U.S. exports are even more concentrated than Japan's. Five categories account for 64 percent* of total U.S. exports compared with only 52 percent for the five Japanese categories. The five U.S. categories are industrial machinery, foods (including feeds and beverages), chemicals (excluding medicals), road motor vehicles, and civilian aircraft and parts. (These U.S. categories differ from those cited in the NICM.) Obviously, there is nothing unique in this "concentration" in Japan's total exports. The scope is typically broad and is growing. The notion of a relation between the scope of those Japanese product categories and a restraint on future Japanese competitiveness is specious.

Furthermore, the NICM misses the real point -- the growth potential of Japan's economy facilitated its ability to rapidly increase its share of foreign markets in the 1970's. Indeed, this is in part the source of concern -- Japan has demonstrated an ability to increase rapidly its share of a particular import market, whether it is a relatively small market such as video recorders or a very large and basic market such as automobiles. Japan's ability to mobilize industrial capacity is a very high profile issue, as Japan tends to focus on large markets with the greatest growth potential for its exports such as those in the United States.

This concern with the scope of Japan's competitive capability is even more vital as Japan is making rapid inroads into the U.S. competitive position -- both in foreign and U.S. markets for high technology products. As both the United States and Japan must increasingly rely on their output of high technology goods to pay for purchases of lower technology goods, this growth of Japan's exports in high technology goods should be a matter of increasing U.S. concern. This NICM completely fails to deal with the high tech issues and their relationship to the U.S. economic position now and throughout the 1980's.

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* Again, there appears to be a discrepancy in the NICM's data. The report asserts the comparable U.S. figure at less than 40 percent.

The notion that Japan is a copier and embellisher, not an innovator, in product technology is deservedly being relegated to the archives. The notion that Japan's 64K RAM chip success story "may have been dramatic as a single accomplishment, but it represents only a speck on the large canvas of the computer-based knowledge industry" (p. 10) is precisely the sort of view which, if it continues, will result in America's waking up to the realities of global competition only to find we are too late and that the world has passed us by.*

Productivity

The NICM states that declines in U.S. productivity growth in the 1970's were benign, being due to the fact that the labor force was increasing rapidly and expansion in output could be achieved more economically by adding labor than by increasing capital. The paper judges that when the growth in the labor force slows, productivity will improve.

This judgment is incorrect. For example, the paper correctly notes that the United States created 19 million more jobs in the 1970's -- but fails to note that only 900,000 of these were in manufacturing. Despite the marginal increase in manufacturing employment, U.S. manufacturing productivity declined from a 3.1 percent annual rate in 1960-73 to a 1.4 percent annual rate in 1973-79 and to less than a 0.6 percent annual rate in 1977-80.

Productivity declines are due to insufficient investment in new equipment. From 1949 to 1974 capital per worker grew 3.3 percent annually in the United States, but since 1974 it has grown only 0.2 percent annually. Our capital-labor ratio, for example, was eight times Japan's about 1960. But by 1975 Japan's capital-labor ratio had almost caught up to ours.

The NICM's analysis is further voided by the fact that it made its judgments only in terms of labor productivity. What is more troubling is that overall factor productivity (units of output per units of total input) has been on a secular decline in the United States. Dennison, Kenderick, and other economists have documented this decline, but have been unable to agree on the basic cause, much less a cure.

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* An article in a recent issue of The Economist (June 19, 1982) does an especially good job of revealing how and why "the betting must be that Japan will overtake" us even in high tech matters. The authors of the NICM would be well-advised to read it carefully.

Relative Economic Growth

An additional basis for the NICM's claim to cheer in the 1970's is that the United States did relatively better in its real GNP growth compared to the other industrial nations than in earlier decades.

This, however, is only because other nations did more poorly than before. While U.S. growth slowed in the 1970's, real growth in the other industrial nations slowed even more. Thus, in relative terms, we improved.

But this is cause for gloom -- not cheer. We want other nations to grow more rapidly, so they will pose better export markets for U.S. companies and so they will be less tempted to pursue begger-thy-neighbor policies.

Moreover, the relatively favorable U.S. economic growth was achieved only at the expense of enormous federal budget deficits. In macro economic terms, these deficits supplied the demand stimulation necessary to offset the depressing effect of the huge U.S. trade deficits. Such budget deficits, however, are obviously unsustainable -- and in retrospect few would applaud as sound U.S. economic policies in the second half of the 1970's.

Manufactures Trade

The NICM dismisses manufactures trade as being relatively unimportant for the United States. Yet two-thirds of our exports are manufactures and half our imports are manufactures. Furthermore, manufactures have proven to be our principal import problem -- not oil. U.S. oil imports grew $72 billion from 1970 to 1980. But during that same time, U.S. imports of manufactures grew $100 billion. The NICM barely addressed the causes of that huge import burden and the loss of competitiveness that is implied by it.

Exchange Rates

The NICM probably correctly points out that the U.S. dollar has recently been at a high point in its series of cyclical swings, and that in the next year or so the dollar will likely decline. That decline will help improve the competitiveness of U.S. exports and make imports more expensive. To what extent this will improve the underlying trend in the U.S. trade balance remains to be seen. In any case, the NICM asserts that the current extent of non-competitiveness is more due to the current cyclical position of the U.S. exchange rates than other factors. Nevertheless, the NICM chart (P. 63) comparing the U.S. trade balance to cyclical shifts in exchange rates suggests no underlying appreciation in the value of the dollar, but instead a possible long-term deterioration in the dollar's value. The NICM fails to take account of this trend in addition to the cyclical swings.

Factors for the Future

The NICM based its optimism not only on its view of the 1970's but also on some factors for the 1980's. These, however, are mere assertions, not supported by facts, forecasts, or analyses. This is difficult to understand in view of the fact that there has been considerable public and private research into many of the factors which will affect growth and competitiveness in the 1980's. Most of this research provides little ground for optimism. Almost all of it shows that government and business must work harder to assure a good future for the United States.

Technology -- As noted earlier, the NICM indicates that Japan will have difficulty moving to original technologies and will most probably continue simply to improve on U.S. technologies and stay confined to certain limited areas. The paper implies that the United States will have little difficulty in staying on top of the technology heap.

The facts indicate the contrary -- including almost all of the research that has been conducted by the CIA, and specifically those elements of CIA which have analyzed Japan's technology future.

Japan each year graduates twice the number of electrical engineers as the United States -- even though it has half the total population of the United States. Japan, France, Germany, Sweden and others have all started technology programs designed to cut into the U.S. lead. In 1962 the United States accounted for 75% of major country R&D, but by 1975 we accounted for only 50%. The U.S. share of world trade in most high technology areas has declined sharply during the 1970's. Other nations have begun offering special tax breaks for companies that employ new technologies. These and other indications show that the United States has a huge problem.

Energy -- The NICM asserts that one of our strengths is the high energy intensity of the economy, since that means we have a lot of energy conservation potential ahead of us. Maybe, but the record indicates most of the easy conservation steps have already been taken. An alternative view is that our high energy intensity is going to leave us very vulnerable to future oil price hikes.

Foreign Investment -- The NICM asserts foreign investment will pour into the United States. It probably will, but this is not always a "plus". Much of it will be for the purpose of acquiring U.S. technology. All of it will have the effect of increasing the outward flow of repatriated earnings from the United States -- which will tend to offset the inflow of repatriated earnings from U.S.-owned companies overseas, hence putting greater pressure on the U.S. current account.

Other Factors -- The NICM did not address factors which many economists view as the keys to the next couple of decades. These include:

- Slow global economic growth. If the industrial countries grow 3 percent annually rather than 4 percent, the world will lose one trillion dollars of production by 1990. That will make trade liberalization more difficult and will increase global competition for the more slowly-growing trade "pie".

- European unemployment. Even the most optimistic assessments of European economic prospects indicate that European GNP growth will not be sufficient to reduce the unacceptably-high present rates of unemployment to tolerable levels. Protectionism and political instability in Europe are all-too-real dangers.

- LDC Debt. The non-oil LDC's have accumulated debt that is now over $400 billion. Earning the foreign exchange to keep debt service to reasonable levels looks very difficult -- particularly given the slow growth expected for industrial nations.

- LDC exports. As LDC's increasingly export manufactured goods of moderate and low technological content, they create rising industrial nation structural unemployment for less skilled labor. This cannot be offset by increased demand for the skilled labor which will make the more sophisticated products the United States and other industrial nations will sell to the LDC's.

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