WALTER STERLING SURREY MEMORIAL SERIES

Emerging Markets and International Development: Options for U.S. Foreign Policy

Moeen A. Qureshi

Jeffrey D. Sachs

Neil McMullen

Gregory F. Treverton

Richard S. Belous
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Editors

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Contents

Walter Sterling Surrey Fund for International Cooperation Advisory Council iv

Foreword v

About the Authors and Editors vi

The Walter Sterling Surrey Memorial Series vii

Emerging Markets and International Development: Options for U.S. Foreign Policy

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Editors

The Importance of Emerging Markets in the Developing World: An Introduction **1**
by Richard S. Belous, S. Dahlia Stein, and Nita Christine Kent

1. Emerging Markets in the Post-Cold War World . . . **8**
by Moeen A. Qureshi

2. Emerging Markets and Foreign Aid **15**
by Jeffrey D. Sachs

3. Key Factors Behind Emerging Markets **21**
by Neil McMullen

4. Foreign Aid and Security Interests **27**
by Gregory F. Treverton

National Planning Association **31**

NPA Officers and Board of Trustees **32**

Selected NPA Publications **35**

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Foreword

WALTER STERLING SURREY was a prominent Washington, D.C., attorney. For 35 years, Mr. Surrey headed the international law firm of Surrey & Morse, which merged with Jones, Day, Reavis & Pogue in 1986. Throughout his life, Mr. Surrey worked tirelessly to promote international trade and commerce, particularly among nations having different cultural, economic, and political systems. He strongly believed that international trade is the most equitable and efficient means to create and distribute wealth throughout the world. He maintained that an open and competitive international trading system leads to greater understanding and mutual respect among countries and that lasting world peace can be achieved only after such understanding and respect are established.

Mr. Surrey was associated with the National Planning Association for almost 40 years. He first came to NPA in the early 1950s as a member of its International Committee. He joined NPA's Committee on Changing International Realities—which has since become NPA's Global Economic Council—when it was established in 1975 and remained actively involved in the Committee's work until his death in 1989. He was elected to the NPA Board of Trustees in 1965 and served as its Chair from 1977 until 1989.

Following Mr. Surrey's death, NPA, with the aid of the Surrey family, established the Walter Sterling Surrey Fund for International Cooperation. The purpose of the Fund is to expand NPA's research in international economic, social, and political policies.

This fifth publication in the Walter Sterling Surrey Memorial Series is devoted to *Emerging Markets and International Development: Options for U.S. Foreign Policy*. This series is produced through the Walter Sterling Surrey Fund for International Cooperation in conjunction with NPA's Global Economic Council. This volume of the Surrey Series was made possible through support provided by the Office of Private and Voluntary Cooperation, Bureau for Humanitarian Response, U.S. Agency for International Development, under Cooperative Agreement #FAO-0230-A-00-3065-00, and the Carnegie Corporation of New York. The views expressed by the authors are their own and do not necessarily represent the views of their organizations, USAID, the Carnegie Corporation, or the National Planning Association.

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The Walter Sterling Surrey Memorial Series

Walter Sterling Surrey Memorial Lectures

1992: "Opportunities and Challenges in Global Capital Markets," by Henry Kaufman, President, Henry Kaufman & Company, Inc.

1993: "Why Economic Reforms in the Former Soviet Republics Have Not Worked Thus Far," by Marshall I. Goldman, Kathryn Wasserman Davis Professor of Soviet Economics, Wellesley College, and Associate Director, Russian Research Center, Harvard University.

1994: "North-South Relations and Foreign Aid Reform: A Realistic Approach," by Charles F. Doran, Andrew W. Mellon Professor of International Relations, Paul H. Nitze School of Advanced International Studies, Johns Hopkins University.

1995: "Foreign Development Assistance: Is It Still Necessary?" by Barber Conable, a former Congressman and a former President of the World Bank.

1996: "Emerging Markets in the Post-Cold War World," by Moeen A. Qureshi, a former Prime Minister of Pakistan and current Chairman, Emerging Markets Partnership, and Chair, NPA Board of Trustees.

Walter Sterling Surrey Memorial Publications and Authors

1992: *Global Capital Markets in the New World Order*

Henry Kaufman

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1993: *The Former Soviet Republics and Eastern Europe: Struggling for Solutions*

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John Hicks

The Importance of Emerging Markets in the Developing World: An Introduction

by Richard S. Belous, S. Dahlia Stein, and Nita Christine Kent

THE FALL OF COMMUNISM is seen by many people as the single greatest event of the end of the 20th century. However, as Lawrence Summers, Deputy Secretary of the U.S. Department of the Treasury, recently told the National Planning Association's Global Economic Council (GEC), "When the history of the 20th century is written, the picture may be quite different from how we currently envision it." Dr. Summers asserted that the rapid escalation and growth of emerging markets could well overshadow the fall of Communism in importance. In fact, he noted that in economic terms, only the Industrial Revolution and the Renaissance equal in importance the current rapid growth in many developing countries.

Many private sector and government analysts point to emerging markets as a potential major source of U.S. economic growth and profit in the coming years. The U.S. Department of Commerce's International Trade Administration (ITA) recently predicted that the greatest commercial opportunities will be found in the 10 Big Emerging Markets (BEMs). The ITA considers the following to be BEMs: South Korea, the Chinese economic area, the Association of Southeast Asian Nations (ASEAN), India, South Africa, Poland, Turkey, Brazil, Mexico, and Argentina. According to some estimates, by the end of this decade, the 10 leading BEMs could account for the same value of U.S. exports as either Japan or Europe, and by 2010 they are expected to double their share of world exports to nearly 27 percent. The ITA projects that by 2020, U.S. exports to the BEMs are likely to exceed U.S. exports to Japan and Europe combined.

NEW MARKETS AND POLICY OPTIONS

The developed world currently represents more than 60 percent of total world output, while the developing nations represent less than 40 percent. However, conservative projections indicate that by 2020, this situation could be reversed, with the developing world representing well over 60 percent of total world output. China could soon be the world's largest economy, and many other developing nations will be included in the list of the top 10 economies by 2020. In fact, membership in the Group of Seven (G-7) countries, the 7 largest economies in the world, could be quite different in the first few decades of the 21st century than it is today. The current G-7 may have to become the G-15 or the G-20 if no current members are to be excluded.

Although the rise of emerging markets in the post-Cold War world creates new challenges and opportunities for U.S. business and labor, the role of the United States in this process of international economic and political development is not clear. Further, as Dr. Summers noted, an isolationist body of opinion has been growing in the United States during the post-Cold War era. But contrary to the arguments of isolationists, the frustration and despair in the less developed countries are detrimental to the United States in the long run. While the United States may be unable to control events in the developing world, Dr. Summers contends that it should "lead by example and advice." In the 1950s, many developing countries looked to the Soviet Union as a model of economic development; today, many in the developing world are turning to the United States and its allies as models of development. As Dr. Summers cautioned, "In many ways, the United States sits at the center. How well the United States does in international trade and foreign aid and development assistance will influence others."

This fifth volume in the Walter Sterling Surrey Memorial Series examines why emerging markets are vital to U.S. business and labor and suggests ways the United States can play an influential role in fostering international development. Several of the authors explore the reasons that certain nations in the developing world are experiencing strong economic growth while others are stagnating. Some of the authors also look at the positive role that U.S. aid and development programs can play in fostering economic transformation.

In Chapter 1, Moeen A. Qureshi—who presented the fifth Walter Sterling Surrey Memorial Lecture—examines the growing interest and involvement of foreign private enterprise in emerging markets since the mid-1980s, outlines the evolution and likely prospects of emerging economies in various regions of the world, and proposes a strategy and role for the United States in dealing with emerging markets.

Mr. Qureshi, who is Chairman of Emerging Markets Partnership and Chair of NPA's Board of Trustees, attributes the increased foreign involvement in emerging markets to the impressive growth in some of the major emerging markets and the dramatic transformation of attitudes in these countries toward private capital, as well as their increased political and economic stability. The euphoria that existed in the early 1990s, however, seems to have waned in part because of various financial crises such as the Mexican peso crisis and the collapse of Barings Bank and in part because of the slowness of some governments in implementing promised liberalization policies. Although the fundamentals in most emerging markets continue to be good, Mr. Qureshi notes that investors are still somewhat cautious.

Mr. Qureshi stresses the importance of infrastructure in supporting sustained growth in these countries and notes that because of this causal link, the objectives of foreign investors are now more synchronized with those of local governments than ever before. He emphasizes that the United States has important economic, commercial, and political interests in emerging economies, but it must define its priorities. According to Mr. Qureshi, building special commercial and investment ties with Latin America and the Caribbean should be the top U.S. regional priority.

Mr. Qureshi urges the U.S. government and private sector to develop adjustment policies and training programs to counter the sometimes painful effects of trade liberalization and cross-border investment. He recommends providing maximum support to government and multilateral agencies for the development of infrastructure and suggests developing a comprehensive strategy to support U.S. private investment abroad. Concluding that fundamental economic and sociological trends are propelling the emerging economies to a more important place in the global economic community, Mr. Qureshi calls for public and private sector leaders to seize this opportunity and build a "partnership for prosperity" that will increase employment and income in the United States and the emerging markets alike.

FOREIGN AID, SAVINGS, AND INVESTMENT

In Chapter 2, Professor Jeffrey D. Sachs of Harvard University examines the role of foreign aid in promoting development. He disagrees with both those who say that market reform alone will displace the need for foreign aid and with those who believe that donor money can solve all problems. Noting that we are at a pivotal moment in world history, Dr. Sachs finds it perilous and short-sighted that, rather than seeing this period as "presenting both opportunity and danger," many in the United States view the international scene as safe and have turned their attention to domestic interests.

Democratization and market liberalization are occurring at historically unprecedented rates, and the world is closer now than ever before to becoming the democratic, market-oriented global community that the United States has been trying to help create for most of this century. However, the situation remains fragile. Dr. Sachs emphasizes that most developing countries are starting from a position of such crisis, including hyperinflation, massive debt, and infrastructure collapse, that their transition process is painful and tenuous. It is in this context that foreign aid, if used tactically and implemented properly, can be a valuable catalyst for economic development and can help consolidate political and economic reform.

Using examples of U.S. assistance to post-World War II Germany and, more recently, to post-Cold War Poland and Russia, Dr. Sachs contends that aid can make a profound difference if it is given in a timely, strategic way and for the short term rather than the long term. He concludes that in its own self-interest, the United States should give foreign aid selectively and conditionally to help create a stable world based on democratic and market-oriented values.

In Chapter 3, Georgetown University Professor Neil McMullen examines the key factors that create emerging markets. He defines the criteria for recognizing a country as an emerging market and analyzes the reasons that some countries develop in this way and the lessons that can be drawn from their experience. He suggests that emerging markets are "central to recent historical developments, rather than peripheral."

According to Dr. McMullen, the defining characteristics of true emerging markets are rapid growth in GDP and exports and the development of a more mature middle-class market in which

the demand for goods and services is growing faster than GDP growth. He specifies that there must be significant demand growth in areas of specific interest to the global market. Based on these criteria, only nine "Class A" emerging markets exist, primarily in Asia with the addition of Chile in Latin America. Dr. McMullen notes that some economies are on the brink of emerging and others that were thought to be emerging markets, such as Mexico, have not measured up.

Dr. McMullen identifies the one critical variable that makes all else possible—a strong domestic savings rate. He contends that true emerging markets have achieved success in three key areas: economic efficiency, progrowth equity, and macroeconomic stability. Dr. McMullen concludes that the main story of the late 20th century is not just the fall of Communism but also the emerging market approach to growth, and he emphasizes that the economic future of the United States lies with these economies.

SECURITY AND DEVELOPMENT

In Chapter 4, Dr. Gregory F. Treverton of the RAND Corporation focuses on foreign aid and security in the post-Cold War world. He examines U.S. foreign policy during the Cold War, when security meant safety from immediate external threats such as nuclear war. At that time, the United States defined its security interests broadly to include the entire so-called free world, and the constant external threat to this sphere of interest unified Americans and ensured that government institutions, rather than the private sector, were the primary players in protecting U.S. interests.

According to Dr. Treverton, although the immediate threat of a hostile Soviet Union is gone and current American perceptions hold that the world is chaotic but not gravely threatening, the United States still has many national security interests. These interests are now defined in economic terms and are based on the stability of the core countries of Europe, North America, and East Asia. The United States also has an interest in integrating other regions into the economic core, in promoting stability in the Middle East and former Soviet Union, and in decreasing the threat from terrorism and from weapons of mass destruction.

In looking at how the post-Cold War redefinition of U.S. interests has changed the role of foreign assistance policy, Dr. Treverton sees good and bad news. Unlike the Cold War period in

which U.S. interests were broadly defined, in the future the United States will become more selective in its use of foreign aid. Noting that the causal connection between current levels of foreign assistance and the emergence of new trading partners is difficult to make, he believes that developing countries will inevitably have to depend on private capital and their own ability to attract and use it.

On the positive side, Dr. Treverton sees a strong constituency in favor of foreign assistance that is used to further U.S. strategic interests and to provide humanitarian relief. The low foreign aid budget and the low priority given foreign assistance by the government are, in some sense, opportunities for future improvement. Dr. Treverton argues that, given the new global realities, the U.S. security budget should be reconstructed to take money from traditional defense costs and invest it more strategically in preventive efforts, such as diplomacy or foreign aid, that are also less costly. He concludes that the United States must reshape its institutions and policy concepts to match its changed interests in a very different world.

CHALLENGES AND OPPORTUNITIES

The issues presented by these authors have been of major interest to the business and labor members of the National Planning Association. For example, NPA's Global Economic Council devoted an entire meeting to analyzing the future of emerging markets in the developing world. At a recent conference, the GEC explored the way the world looked 20 years ago and the way it may look 20 years from now. Professors Theodore Geiger of Georgetown University and Max Corden of the Johns Hopkins School of Advanced International Studies both noted that the world faces enormous economic opportunities as well as political and social challenges. Drs. Geiger and Corden predicted that the number of emerging markets will grow in the next 20 years and that many either marginalized or economically stagnant developing nations could become productive members of the world's trading and economic systems in the next few years. This major shift could bring many positive economic benefits to key developing nations and the world economy as a whole.

Thus, in terms of economic factors, both Drs. Geiger and Corden were very optimistic in looking at the developing world, but they emphasized that much more than economic variables will

matter in the long run. The fate of these economies will also be influenced by political and social factors. They noted that before World War I, there had been a real opportunity to expand the world's trading and economic systems. However, wars, racial violence, and isolationism checked and reversed many of those opportunities in the early part of the 20th century. They cautioned that similar political and social forces in the early part of the 21st century could blunt or reverse the recent progress made by some developing countries.

While it is wrong to think that the United States can control the flow of events around the world, it is equally misguided to think that isolationism will benefit either the United States or developing nations in the long run. Institution building—which can often be facilitated by foreign aid and developmental assistance—has played and will continue to play an important role in fostering international development. A more liberalized and fair international trading system also will help spread the phenomenon of emerging markets throughout the developing world.

Many nations in the developing world are poised to experience significant economic growth. But if the United States and other industrialized nations retreat from their responsibilities as world leaders, much of the groundwork for this growth may be undone. Political, military, ethnic, and other forms of conflict and instability could block the growth process in key parts of the developing world. This would have serious implications for the growth potential of the United States, not to mention the implications for world peace, in whose defense the United States has repeatedly become involved internationally in the past.

It is important for the United States to remain engaged in the world. It is also important for the United States to continually question the forms its involvement should take and how this interaction can be made more efficient and effective. We hope that the thoughts and recommendations put forth by the distinguished authors featured in this series will contribute to the formulation of sound U.S. policy in these areas.

1

Emerging Markets in the Post-Cold War World

by Moeen A. Qureshi

THE TERM "EMERGING MARKETS" is somewhat imprecise, but however defined, and even excluding Russia, these markets account for nearly two-thirds of the world's population, and they are growing at two or three times the rate of industrialized countries. According to reliable estimates, their share of world gross domestic product (GDP) and world trade will exceed that of Europe or Japan within the next 20 years.

I will focus on three major aspects of the U.S. relationship with emerging markets: (1) the growing interest and involvement of foreign private enterprise and business in emerging markets; (2) the evolution and likely prospects of five disparate segments of emerging markets—Asia, Latin America, eastern Europe, central Asia, and Africa; and (3) a proposed strategy and role for the United States in dealing with emerging markets.

THE GROWING INTEREST AND INVOLVEMENT IN EMERGING MARKETS

At the end of 1994, there was an explosion in the flow of private capital into emerging markets. Total long-term private capital and investment flows into these markets had increased more than fivefold since the mid-1980s. Foreign direct investment was about $70-$80 billion a year.

Why did these flows occur in such large quantities? First, there had been a dramatic transformation in the attitudes toward private capital in emerging markets. This opened up new fields of enterprise for the private sector—most important, in infrastruc-

ture, previously a domain of governments. Second, foreign investors wanted to share in the extremely impressive growth that was occurring in the major emerging markets. Third, some of the highly successful emerging markets had experienced political stability as well as economic stability. Fourth, most of the rapidly growing emerging markets had fostered an investor-friendly environment that attracted capital. Finally, the development of financial markets in the emerging markets had created new possibilities for foreign private enterprise to access capital and resources, allowing them to undertake much larger investments and projects than previously. The effective pursuit of these policies has caused the dramatic explosion in the flows of foreign private capital into the emerging markets.

In 1995, Asia, particularly the Pacific Rim countries, continued to experience sustained growth and stability. Most Latin American countries, with the notable exception of Mexico, also showed steady, though much slower, growth. Generally, the economic situation in eastern Europe and central Asia also appeared healthier. But in today's global economy, good fundamentals, good macroeconomic management, or even economic growth do not alone determine investor actions. These can be disturbed by unpredictable events. There were indeed such events during 1995 that tempered the flow of capital.

The growth of capital and the euphoria that existed during the early 1990s seem to have diminished. Several incidents created this mood of caution. The Mexican debacle was the most spectacular and unsettling event. Its effects were felt not only in Latin America, but also throughout the emerging markets. The second event was the collapse of Barings Bank. Barings was a reputable, well-established institution, and its difficulties shook investor confidence. A third event involved the Enron Corporation in India, where a local government abrogated a signed contract while significant construction was taking place.

However, investor reactions are sometimes influenced more by underlying policies, attitudes, and regulatory environments than by individual events. In 1995, even though some governments such as China and India had announced a major liberalization of their policies, they were slow to implement them. By contrast, when governments established equitable and transparent policies—as India did in the telecommunications sector and Pakistan did in the energy sector—they were able to attract strong financial and technical investors.

Other positive developments in 1995 included progress in the further development and deepening of capital markets in some of the emerging countries. Several important joint ventures took place between U.S. and European financial institutions and the emerging markets, and some interesting and innovative developments occurred, such as the establishment of new debt insurance companies. In short, the legacy of 1995 is mixed. While the fundamentals of the emerging markets continue to be good, investor reactions are still somewhat shaky.

EMERGING MARKETS' EVOLUTION AND FUTURE PROSPECTS

One sector that holds significant potential for foreign private investment in emerging markets is infrastructure. This basic sector is critical to supporting sustained growth in these countries. The requirements for new infrastructure and for the rehabilitation of existing infrastructure are enormous in the emerging markets. In the countries of the Pacific Rim, their very rapid growth and development have put an intolerable burden on existing infrastructure. In Latin America, the background is somewhat different. There, the debt crisis of the 1980s resulted in the neglect of infrastructure. Governments had to reduce their expenditures on infrastructure investment. Because of that debt crisis, the backlog of investment in infrastructure in Latin America is probably about $100 billion.

Today, developing countries are spending about $200 billion on infrastructure investment, roughly 4 percent of their combined GDPs. About $15 billion of this is private investment. These expenditures are expected to increase over the next five years from the current 4 percent to 6-7 percent. In other words, there will be a private market of about $35-$45 billion a year for infrastructure investment in developing countries and emerging markets that will be available largely to foreign investment and enterprise. For once there is total synchronization of the objectives of foreign investors with those of local governments.

What are the prospects for growth in emerging markets? The stellar performance of the Pacific Rim countries is likely to continue. Over the past 17 or 18 years, some members of the Association of Southeast Asian Nations (ASEAN) have grown at an average rate of 7-8 percent, while others, as well as China, have grown nearly 10 percent per year. These economies have not only

been totally transformed, but they have also achieved a measure of political and economic stability. There are high expectations for continued growth in these countries. South Asia has grown more modestly at an average of about 4 percent a year. As a result of impressive economic liberalization and reform in India, its rate of growth is now about 6 percent.

The prospects for Latin America's growth are quite favorable because this region will benefit from the considerable investment it has made in difficult economic, political, and financial reforms. From 1990 to 1994, Latin America and the Caribbean region grew by about 3 percent, and most observers expect that this rate will at least double in the next few years. In fact, Latin America should emerge as the fastest growing region in the world after Asia.

The prospects for eastern Europe and central Asia are mixed. Countries such as the Czech Republic and Poland have successfully weathered a period of difficult internal adjustment, and they can build on an educated and skilled labor force. Others such as Romania and Bulgaria still face major institutional and other obstacles before they can achieve steady economic growth. It is arguable, of course, whether Russia is an emerging market. Although considerable rebuilding has already been done there, much more remains to be done. For a long time, central Asia was a cloistered backyard of the Soviet Union. It has immense natural resources, but it also faces immense problems in unlocking them. Some countries such as Kazakhstan and Uzbekistan are at the forefront in welcoming U.S. and European investors.

Africa is in serious danger of being marginalized and forgotten in the global economy. A few countries, especially those in northern and southern Africa, offer a fairly good environment for investment. Africa is not poor in natural resources; it is poor in governance. The risk-reward equation is not favorable for foreign private investors. The needs of most African countries for investment will have to continue to be met largely by governmental or other official sources.

THE STRATEGY AND ROLE FOR THE UNITED STATES

What should be the U.S. strategy and role with respect to emerging markets? The emerging markets might be perceived by some as today's hyperbole, but they are tomorrow's reality. The U.S. Department of Commerce has estimated that the 10 Big Emerging Markets, what it calls the BEMs, are likely to double

their share of world exports to nearly 27 percent by the year 2010—less than 15 years away. By then, they will be buying more U.S. exports than Europe and Japan combined. Therefore, the United States clearly has important economic, commercial, and even political interests in strengthening ties with this rapidly growing segment of the global community. I suggest a five-point agenda for the United States.

First, the United States must be clear about its priorities. Latin America and the Caribbean must be the top priority in building special commercial and investment ties. Historically, the United States has had close ties with Latin America, although there have been both positive and negative aspects of the relationship. From an economic point of view, Latin America is a natural backyard for the United States, and the United States has distinct comparative advantages in dealing with these nations. The U.S. government must take a strong proactive stance to support trade and investment in Latin America. This probably means extending the North American Free Trade Agreement (NAFTA) as rapidly as possible to the rest of Latin America. It also means mobilizing the U.S. government's various multinational and bilateral agencies to provide maximum support to U.S. private enterprise and investment in Latin America.

The Asian emerging markets must also be given a high priority, second only to Latin America, not only because of the natural link between the western seaboard and the countries of the Pacific Rim, but also because the United States cannot afford to neglect the most rapidly growing part of the world economy. The experiment of the Asia Pacific Economic Cooperation Forum (APEC) has been useful, and initiatives should be built on that foundation.

Eastern Europe, central Asia, and Africa should certainly not be ignored, and U.S. private enterprise has already made important inroads in these countries. However, these emerging markets do not require proactive official U.S. involvement and support.

Second, both the U.S. government and the U.S. private sector urgently need to develop policies and programs to deal with the short- and long-term effects of greater trade with and investment in emerging markets. Trade liberalization and cross-border investments bring mixed blessings. They will inflict some pain and will create, in some cases, industrial and labor displacement during the interim period of adjustment. Therefore, programs to alleviate the short-term costs of such adjustments and to promote the education

and training of the public should be the central building blocks of any U.S. strategy.

Third, the importance of providing maximum support to official and multilateral agencies for the development of infrastructure must be emphasized. Today in Latin America, 100 million people lack safe water, and 250 million people lack sewage services. Thirty percent of the region's population is without electricity, and 60 percent of the households do not have telephones. Only 15 percent of the region has paved roads. In Asia, there is an intolerable burden on infrastructure because of the very rapid growth that has taken place. In eastern Europe and central Asia, the problem is quite different. Previous systems in the energy sector have proved unsafe and have endangered the environment. Massive investments are now required to reclaim contaminated soil and to have pure water and pure air.

Fourth, a comprehensive strategy to support U.S. private investment abroad should be developed. This strategy should mobilize all of the policies and instruments at the disposal of the United States, including strengthening the operations of its official agencies such as the Export-Import Bank and the Overseas Private Investment Corporation to help U.S. private enterprise put together the resources it needs and reduce the risks it faces in making cross-border investments; influencing multilateral agencies such as the World Bank and regional development banks to make promotion of private investment their mainstream, not their peripheral, activity; and relaxing some of the severe investment restrictions that prevent insurance companies and pension funds from investing in certain types of assets that originate in developing countries and emerging markets.

Fifth, the U.S. program of foreign economic assistance must be redesigned and given a trade focus rather than an aid focus. Except for assistance to Israel and Egypt, the U.S. economic aid program is now of minimal size and does not begin to meet needs. Therefore, targeting U.S. economic assistance to large objectives such as alleviation of poverty, protection of the environment, or even promotion of human rights is totally ineffective. These issues are better handled by multilateral agencies, where U.S. leadership can more effectively pursue U.S. goals. The U.S. bilateral assistance program can be more effective in promoting U.S. trade and investment. Such an approach would be honest and transparent in its objectives. It would be helpful to both donor and recipient countries because both want investment in areas based on priority.

It would also help build the fast eroding constituency for foreign economic assistance in this country.

NEW ACTORS ON THE WORLD STAGE

The rapidly growing emerging markets are poised to occupy a much larger place in the global arena. This growth could be slowed by hostile policies of protectionism or containment by the Organization for Economic Cooperation and Development countries, but the basic trend will not be reversed. Fundamental economic and sociological forces are at work that are propelling the emerging markets to a much more important place in the global economic and political community. The emergence of these new economic actors on the world stage poses new challenges for U.S. leadership. Public and private sector leaders need the foresight and the vision to view these challenges as opportunities and to build a partnership for prosperity that will increase employment and income in both the United States and the emerging markets.

2

Emerging Markets and Foreign Aid

by Jeffrey D. Sachs

FOREIGN AID IS AN issue that strongly divides opinion leaders in the United States. In fact, foreign aid is deeply at risk not only because of a lack of support from average Americans and their wild misperceptions about the size of the foreign aid budget, but also because of the very serious divisions in the public sector about the role of foreign aid. On the one hand, many free market advocates say that market reform rather than foreign assistance is all that is needed to correct any problem. On the other hand, many debtor countries believe that donor money will solve all their problems. Both views are unrealistic.

THE CASE FOR U.S. INVOLVEMENT

A tremendous case for U.S. involvement and financial assistance can be made at this time, one of the most pivotal periods in modern world history. Today is a defining moment in the same way that the period after World War II was a defining moment, when the United States showed the most splendid global leadership of any country in modern history. The United States recognized its responsibilities, and it also recognized, with a mix of idealism, practicality, and action, that it could help shape the world. But with the end of the Cold War came the collapse of the view throughout the world that the state should be the guide of social and economic life. Instead, a new view is spreading that democracy and market economies should lead the way.

However, the United States does not view this new period as presenting both opportunity and danger. Instead, it sees the international scene as safe and is turning to domestic interests. This is

a dangerous and short-sighted calculation, especially when the amount of foreign aid available from the federal budget is minute compared with the opportunities. The United States spends about $6 billion a year on development and humanitarian assistance, only one-tenth of 1 percent of its gross national product (GNP).

A historically unprecedented sea change in ideas, particularly regarding economic reform, is taking place around the world, and not just in the post-Communist world. Eastern Europe, the former Soviet Union, China, India, Latin America, and much of Africa now understand that the only reliable engine of growth for poor countries hoping to catch up is a market system connected to the world economy. There has probably never been another time in world history when a change of view has been so radical, so fast, and so much in the right direction.

THE RAPID PACE OF ECONOMIC REFORM

About 3.4 billion people live in countries that are undergoing fundamental economic reform. Both India and China, which account for 2.2 billion people, are opening to the world in a way that was unthinkable 15 years ago, with clear results. China's economy is booming on the basis of its export-led growth. India, which started opening in 1991, is growing at about 6 percent, an incredible accomplishment for a country of more than 900 million people. In central and eastern Europe, 150 million people are living through radical market-based economic reform that is relinking these countries to western Europe. Another 290 million people are in the former Soviet Union, where implementation of reform has been tumultuous and the attempts to create market economies a struggle.

In South America, virtually the entire continent was under military dictatorship in 1980. Today the entire continent is democratic. Not all the countries are as prosperous or as stable as one would hope, but they are democratic and have achieved much more economic success than would have been expected 10 years ago. For the first time in 40 years, there is real hope for Brazil, which is potentially the huge engine of growth for the entire region.

Even in sub-Saharan Africa, which is usually omitted from such accounting, there have been about 30 democratic transitions in recent years. There has also been enormous economic reform, albeit starting from desperate situations. In many cases, the horrendous declines in living standards over the past 30 years were the result of war or the end of the anticolonial struggle. Often,

they were the result of disastrous economic policies that the newly independent countries themselves created—for example, in Tanzania and Zambia—or the disaster that continues today in Zaire under Mobutu Sese Seko. But it is important to note that some movement is now under way toward real economic reform and democratization in the region.

The number of democracies worldwide is increasing at a historically unprecedented rate. Among those who track political developments, the think tank Freedom House is probably the best monitor of who has become democratic and who has not. By its account, the number of democracies in the world has increased from 54 in 1984 to 108 in 1994. These achievements can be built on, leading to the kind of world the United States has been trying to help create for most of this century. That world is democratic and market-oriented, linked by trade and peaceful interaction and based on civil, political, and economic rights. It is a world that is closer now to being achieved than at any time in history.

THE FRAGILITY OF TRANSITION ECONOMIES

Even though countries are moving in the right direction, they are doing so partly because the previous authoritarian political and economic management left them in a state of despair and disaster. The developing world basically went bankrupt or suffered from bankrupt economic policies, whether the result of extreme socialism or more moderate statism. Many of these countries are starting the transition to market economies and democracies from conditions of hyperinflation, massive foreign debt, huge demographic and public health crises, and infrastructure collapse. They are turning in the right direction specifically because of the decades of economic abuse. And, precisely because almost all the countries mentioned have started from a point of deep crisis, the transitions are anything but assured. As these countries continue to struggle for basic financial stabilization, they could go either way.

THE POTENTIAL OF FOREIGN AID

This leads to the question of foreign aid. The United States needs a new consensus on foreign aid. Aid has to be understood tactically. One must recognize that foreign aid does not build economies, it does not create economic development, and it does not generally solve long-term social problems.

However, foreign aid does make possible economic development and the solution of deep social problems by recipient governments themselves, if the governments are well directed and want to achieve fundamental political and economic reform. The point of foreign aid, in general, is not to give money to build dams or bridges or roads, which can be financed by private sector activity or out of government budgets. What foreign aid can do is help consolidate a democratic transition and market-based reform. In other words, aid can underpin the political change to freedom, which has always been its greatest accomplishment. It is around this idea that the United States should try to form a consensus.

In Germany

The Marshall Plan was one of the greatest foreign policy successes in modern history. The money helped stabilize the fragile democracies of western Europe after World War II. These nations wanted to stave off Communist revolutions and to return to regional cooperation, open trade, convertible currencies, and a market-based approach to economic development. The Marshall Plan was remarkably successful in helping them accomplish these goals.

For example, in Germany in 1949, Chancellor Konrad Adenauer and his free market economics survived an opposition that wanted to nationalize all German industry. Adenauer won in the Bundestag by one vote, his own. The Marshall Plan's aid helped Germany continue Adenauer's economic policies and thus helped create one of the world's most stable and dependable democracies.

In Poland

Only a small amount of U.S. aid was given to Poland during the first post-Communist government and the Solidarity movement in 1989-90. About $1 billion came in the form of a so-called stabilization fund loan to help stabilize the Polish currency. This money played a pivotal role in the economic accomplishments of the first post-Communist government, accomplishments that became a road map for the rest of the region. Even though the amount of aid was modest relative to the size of the Polish economy, it was given in a timely way, right at the start of reform efforts, and it played a key role in promoting necessary policy measures.

As an economic advisor to the Polish government during this period, I advised the finance minister when he recommended a radical reform. The fact that he had some support from the outside

enabled him to put together an internal constituency that convinced the Polish people to allow him to proceed. The result is that Poland has been the fastest growing economy in Europe for the past three years.

Although it had the traditions and the markets, even Poland could have fallen into chaos. There were enormous doubts about the radical reform efforts, which many people thought would cause civil war and starvation. Timely foreign aid played a profound tactical role in consolidating an extremely fragile democratic opening and economic reform.

In Russia

Compared with the aid given to Germany and Poland when they were on the threshold of reform, the United States gave little to Russia in 1991-92. Although the United States did allocate a few hundred million dollars, which is not a small amount, it was totally insufficient for such a historic breakthrough involving a country of continental scale, a profound economic crisis, and 15,000 nuclear warheads. To put it in perspective, the Marshall Plan provided an enormous amount of money to Europe in 1948-49—around 2 percent of the United States' annual GNP at the time, or about $120 billion at the current rate.

In addition, whereas the reforms in Poland had foreign support, Russia's Yegor Gaidar, the reformist acting Prime Minister in 1992, did not have outside support, and he lost office at the end of the year. When Gaidar left, corruption returned. Recent years have been marked by a combination of considerable theft together with some real reform efforts. Thus, Russia remains an unstable country, still subject to demagogic appeals.

The truth is that the situation in Russia would have been tumultuous in any case. Nevertheless, the United States did not tactically direct its aid to support reform in the early days of Russian democracy. It did just that in Europe under the Marshall Plan, and there the United States was able to make a real difference.

A NEW PARADIGM FOR FOREIGN AID

Aid should not be given on a long-term basis to most countries or perhaps to any country because, as Milton Friedman and other economists have said, long-term aid creates a kind of dependency and statism that does not promote economic development. Aid

should be viewed as providing help in promoting democratization and economic reform. Fragile governments that are beginning the process of market-oriented and democratic transition need confidence and a base for governing. Aid can make a profound difference at that point.

The United States is trying to help many developing economies make fundamental social, political, organizational, and economic changes from a starting point of financial bankruptcy and hyperinflation. U.S. aid must be timely, tactical, and strategic. It must be timely so that it is given before the government falls or the reformers leave. It must be tactical so that funds will be used to support reforms, not mainly to build dams or roads. Money will bring enough stability to put policies in place allowing for that kind of economic development. Aid must also be strategic so that it is not given simply because a country is poor. The situation in many extremely poor countries becomes a tragedy when their governments do not use the aid honestly to promote development. But overall, aid can be used in the self-interest of the United States to help create a stable world based on democratic and market-oriented values.

U.S. aid thus should be selective and conditional, and it should be allocated to countries that are able to use it on these terms. Aid should also be time-limited. Two of the most important aid missions that the United States ever undertook were in South Korea and Taiwan at the end of the 1950s. The United States helped both countries start their economic growth "miracles," with the U.S. Agency for International Development (USAID) advising them to follow market-based economic strategies even though most of the developing world was following nonmarket strategies and had closed economies. USAID also told the Koreans and the Taiwanese that aid would end in around five years. These countries had to decide for themselves that they should begin to export, to open their economies, and to become competitive because if they did not, they might have nothing to live on. This combination of money, advice, and a strong message that aid is limited and so should be well used is the kind of aid program that would be the most effective throughout the world, and it is the program on which the United States as a whole can reach a consensus.

3

Key Factors Behind Emerging Markets

by Neil McMullen

IN DISCUSSING THE PHENOMENON of emerging markets, four basic issues must be addressed: (1) determining the criteria for an emerging market; (2) understanding why emerging markets occur; (3) recognizing the lessons that can be learned; and (4) realizing that emerging markets have been central to recent historical developments, rather than peripheral.

DEVELOPING COUNTRIES AS EMERGING MARKETS

Economic Growth and Exports

Two criteria determine whether a country can be designated as an emerging market. One is rapid growth, specifically rapid growth of gross domestic product (GDP) and exports. The second, not as widely recognized, is the presence of a significant middle-class market that has a demand for goods and services that is growing faster than GDP growth. This market is open and becoming a large share of GDP, with rapidly growing demand for automobiles, consumer electronics, appliances, residences, financial services, and travel services. Thus, emerging markets are countries that have significant demand growth in areas of specific interest to the global market, rather than rapidly growing countries that are emerging from subsistence agricultural situations. By these criteria, there are only nine countries that can be termed "Class A" emerging markets.

One requirement for becoming a Class A country is rapid, sustained GDP growth of 5 percent or more over the past five years.

TABLE 1
CRITERIA FOR EMERGING MARKET ECONOMIES

	Avg. GDP Growth	Years with GDP Growth >5%	Years with Export Growth >7%	GDP per Capita 1993 US$	GDP 1993 Bill. US$	GDS/ GDP 1992*
Asia Pacific	←	**1991 to 1995**	→			
Hong Kong **(A)**	5.6%	4	5	$18,100	$105	31%
Singapore **(A)**	8.6	5	5	19,850	53	41
Taiwan **(A)**	6.7	5	3	10,600	233	28
S. Korea **(A)**	7.5	5	5	7,650	337	31
Malaysia **(A)**	7.8	5	5	3,150	60	35
Thailand **(A)**	8.3	5	5	2,100	122	35
Indonesia **(A)**	7.8	5	5	750	138	37
China **(A)**	11.0	5	5	500	577	37
Philippines **(B)**	2.9	2	5	850	55	18
India **(B)**	4.2	3	5	300	270	22
Vietnam **(B)**	8.1	5	5	170	12	35
Latin America						
Chile **(A)**	7.3	4	4	3,200	44	26
Argentina **(B)**	6.1	4	2	7,200	244	15
Brazil **(B)**	3.3	2	3	2,950	460	21
Mexico **(B)**	1.0	0	5	3,600	325	17
Peru **(B)**	5.6	3	3	1,500	34	13
Colombia **(B)**	4.5	4	2	1,400	50	21
Middle East/SW Asia/Africa						
Israel	5.8	4	4	13,920	72	16
Turkey **(B)**	3.0	3	4	2,950	178	20
Pakistan **(B)**	4.2	2	2	450	53	14
S. Africa	1.0	0	1	3,000	120	19
Eastern Europe	←	**1992 to 1995**	→			
Poland	4.2	2	3	2,250	86	23
Czech Republic	0.0	0	5	2,750	27	29
Hungary	0.0	0	2	3,350	33	18
Russia	–12.0	0	4	2,350	350	37

Note: (A) and (B) refer to the country's designation by class, as defined in the text.
* Gross domestic savings as a percentage of gross domestic product.
Source: World Bank, *World Development Report,* various issues.

As Table 1 shows, in the 1991-95 period, eight of the Asia Pacific countries experienced five years of more than 5 percent growth annually. Another requirement is growth in export volume above 7 percent per year. All of the Asia Pacific economies met this test except Taiwan, which experienced two years in the early 1990s when its export growth was only about 4 percent. Based on the two criteria discussed above, eight Asia Pacific countries can be classified as Class A and three as "Class B," the next level of emerging market economies (see Table 1 for this classification). The Philippines have not done as well in GDP growth as in exports. India has performed better than the Philippines, with its exports increasing fairly dramatically, albeit from a low base. Vietnam is doing extremely well, although also starting from a very low base. However, Vietnam clearly lacks a large middle-class market.

In Latin America, the only country qualifying as a Class A emerging market is Chile. Argentina has performed well in the past five years, but its 1995 financial problems have kept it from attaining a 5 percent GDP growth rate, and its exports have not been dynamic. Brazil and Mexico have not reached the level of growth required to be called a Class A emerging market. Even though Peru's growth was negative in 1991 and 1992, during the past three years its economy has been strong, growing by 7 percent, 8 percent, and 9 percent. Peru might be the next Latin American country to be classified as a Class A emerging economy, although it may be unable to sustain those growth rates. Colombia is another country that has shown reasonable growth rates, but it is weaker in terms of exports.

Israel appears to be the strongest contender in the Middle East, although it probably should not be thought of as an emerging market, but rather as a rapidly growing mature market. Turkey and Pakistan do not qualify as Class A emerging markets in growth in either GDP or exports, but are consistent performers. South Africa's recent growth has been quite weak, and therefore it is not even at the Class B level.

For the transitional economies—Poland, the Czech Republic, Russia, and Hungary—the period from 1992 to 1995 was extremely negative in terms of growth. Poland and the Czech Republic have now begun to bottom out and grow at reasonable rates. Hungary also appears to have bottomed out, but it is not showing the same tendency to accelerate. Russia is at the bottom and may show zero or slightly positive growth in 1996. With respect to exports, the Czech Republic has done fairly well, and Russia has done quite

well. All of these economies are still a year or more away from being considered as Class B emerging markets, with Poland closest to achieving this status.

Overall, in terms of growth, true emerging markets exist mainly in Asia. Although some Latin American countries are there or on the brink, Mexico has not yet reached this level, especially in its GDP growth. During the past five years, Mexico's economic growth has been particularly weak and not just because of its 1994-95 financial problems. Mexico has not sustained three consecutive years of 5 percent real growth since the early 1980s, so it may be questionable whether Mexico is even a Class B emerging market. It does have a large middle class and growing exports, but per capita income growth has been negative for several years.

China and India have low per capita incomes but very large markets. Therefore, they have a substantial middle class. Some Asia Pacific countries that have small markets such as Singapore and Hong Kong have quite high per capita incomes, so they too have a significant middle class.

An important factor in defining emerging markets is to determine which countries are on the threshold. The point is that some of the countries usually viewed as emerging—Mexico, for example—have not measured up, at least not by Asian Class A standards, and are in a much weaker position than some others. Thus, there are only 9 strong candidates for the Class A emerging market category. Another 10, including the Philippines, Argentina, Brazil, Mexico, and Turkey, are on the brink or should be soon.

Savings

Savings is the critical variable that makes all else possible. Table 1 shows that in terms of gross domestic savings as a percentage of GDP, most of the Asia Pacific countries are above 30 percent. The exceptions are Taiwan at 28 percent, India at 22 percent, and the Philippines at 18 percent. Among the Latin American countries, only Chile is above 25 percent. Of the transition economies, the Czech Republic and Russia have high savings rates of 29 percent and 37 percent, respectively, but their allocation system was so poor that a significant proportion of their savings has been wasted on the production of unnecessary and low productivity equipment and structures.

Domestic savings is the basis for the phenomenal growth rates of 7 percent or more for a sustained period. There are three

legs to the savings stool: efficiency, equity, and stability. True emerging markets have achieved success in all three areas.

Efficiency, Equity, and Stability

There is a tradeoff between welfare and efficiency. What is unique to emerging markets, and the main lesson to be learned from them, is that they have managed to achieve efficiency and equity in a way that no other group of countries has, particularly the western European and North American economies.

The basis for the emerging markets' success in the area of efficiency is high savings, leading to investment in infrastructure and to extremely high levels of private investment generally. This high level of investment is combined with comparatively low taxes and an economy that relies primarily on market incentives to motivate people to allocate resources. This is the efficiency component.

The first aspect of the equity component is equity policies that are progrowth. These progrowth equity policies involve high levels of effective investment in human capital, most importantly in education at the primary and secondary levels. Emerging markets do not put money into showcase universities that educate only the elite, which is the tendency in some of the other developing countries. The second aspect of the equity component is that most of the emerging countries have undertaken successful land reform. As a result of their high domestic savings rates, they have been able to make enormous improvements in rural infrastructure. This has had the effect of being both progrowth and equity-enhancing. It provides a better environment for the poorest people who live in the rural areas, and it provides the resources with which, by their own hard work, they can make their lives much better in a fairly short time. Thus, the equity component of the successful emerging markets is a high level of education and human capital formation throughout the society, combined with rural programs that draw on savings to improve the standard of living for poor people. These programs also tend to keep the people in the countryside instead of migrating to and overburdening the cities.

The third leg of the stool is stability—specifically, macroeconomic and balance-of-payments stability. The growth of emerging markets is export- and investment-led, not consumption-led, as is the growth of the U.S. economy, for example. In terms of macro stability, these countries have kept government deficits down to levels that have not crowded out private sector investment and

During the Cold War, there was a direct correspondence between what the government did and how U.S. interests were defined, as long as the threat was primarily the Soviet Union and as long as the interests were defined in external terms. This combination ensured that security was a kind of government monopoly. Private citizens and companies were involved, but the set of government institutions created in the Cold War acted as the primary protectors of security. Today, none of those attributes of U.S. national interests nor those aspects of how interests are defined exist.

U.S. INTERESTS TODAY

In the absence of an overarching threat, the general perception in the United States today is that the world is chaotic but not gravely threatening in the way it was during the Cold War. It is no surprise that in the post-Cold War world, people are preoccupied with concerns closer to home and are less attentive to events far away.

Because America now perceives its security and interests increasingly in economic terms, its main focus is on the security and stability of the core countries—those of Europe, North America, and East Asia. The United States trades mainly with these countries and considers them essential to its security, defined primarily in economic terms.

Another U.S. interest involves a second set of countries that could become integrated into the economies of the core countries. This set includes Latin America, eastern Europe, and Southeast Asia. These countries have a chance of becoming part of that core if they demonstrate stability, democratic reform, and economic growth.

Americans have a powerful interest in two zones of the world—the Middle East and the former Soviet Union—that could threaten the core interests of the United States. These regions also contain most of the world's fossil fuel. If things should go wrong in these areas, the security and stability of the core on which America's broad security and economic interests depend could begin to be threatened.

In addition, there are two related national security interests. One is safety from weapons of mass destruction—nuclear, chemical, and biological—in the hands of rogue regimes or outlaw states. The United States also has a stake in preventing the kind of

terrorism or crime against world institutions, including its own, that would again begin to threaten the stability of the core. Vulnerability to terrorist actions threatens the psychological stability of the core, even if it does not yet threaten the physical security of any one country.

U.S. INTERESTS AND FOREIGN AID

What do these redefined interests mean in terms of U.S. foreign aid policy? There is good news and bad news. The bad news is that the United States is becoming more selective in defining its interests. In the future, the broad economic argument for foreign assistance will have to be treated with some skepticism. It is certainly true that American jobs and productivity have benefited greatly from increased U.S. exports to newly developed parts of the world. But it is also true that the parts of the world that have been the most useful and fruitful in terms of economic interchange are not the areas that have recently been the recipients of much foreign assistance. Thus, the causal connection between current levels of foreign assistance and new trading partners is hard to make. If the level of foreign assistance that was available during the Marshall Plan were available now, this situation might be different. The countries that the United States would like to see emerge as important trading partners are those that inevitably will have to depend on private capital, on their private sector policies, and on their own ability to invest.

The good news is that the constituency needed to support foreign assistance for strategic and humanitarian purposes does indeed exist. Most Americans seem to understand the need to target U.S. foreign aid to countries that are strategically crucial. It is no accident that the United States allocates a huge part of its foreign aid to the Middle East and recently spent a considerable amount on the former Soviet Union. As hard a case as it is to make, particularly regarding the former Soviet Union, Americans generally appear to have been made aware that the United States has a stake in these two regions to ensure that events do not threaten the stability and well-being of the core on which U.S. security depends. Humanitarian reasons continue to be an important argument for foreign assistance as well. Americans are a charitable people and do not like seeing other people suffer if they can do something about it.

AN OPPORTUNITY TO RESHAPE U.S. INSTITUTIONS AND FOREIGN AID POLICY

The United States spends little on foreign assistance. The current foreign aid budget is about $16 billion, compared with the budget of the Pentagon, which is still $250 billion, or to a single operation such as Desert Storm, which cost between $60 billion and $75 billion. If the U.S. security budget were to be reconstructed, some money could be taken from defense and spent in other areas such as diplomacy and foreign assistance. Strategic investments in these areas could help avoid problems that might require billions of dollars more if a shooting war developed.

One reason that the foreign assistance budget is in such a perilous state is that no administration or secretary of state has cared a great deal about it. They have not spent much money or time defending their own budgets, much less that of foreign aid, whereas secretaries of defense and directors of central intelligence have spent considerable time on Capitol Hill lobbying for their budgets.

Organizationally as well as conceptually, the United States remains very much a prisoner of World War II and the Cold War. All U.S. institutions were designed with those events in mind. The United States now has an opportunity to reorganize its institutions and its foreign aid policy for the task of promoting its interests in a world that differs greatly from that of the Cold War. This kind of reorganization has certainly occurred before. In the 1930s, the War Department and the State Department were not considered major departments of government, but the Commerce Department was considered quite important. Thus, the idea that the United States can reshape its institutions and its policies to match its changed interests in a changed world is indeed good news. It is an opportunity that lies ahead.

National Planning Association

The National Planning Association is an independent, private, nonprofit, nonpolitical organization that carries on research and policy formulation in the public interest. NPA was founded during the Great Depression of the 1930s when conflicts among the major economic groups—business, labor, and agriculture—threatened to paralyze national decisionmaking on the critical issues confronting American society. NPA is dedicated to the task of getting these diverse groups to work together to narrow areas of controversy and broaden areas of agreement as well as to map out specific programs for action in the best traditions of a functioning democracy. Such democratic and decentralized planning, NPA believes, involves the development of effective government and private policies and programs not only by official agencies but also through the independent initiative and cooperation of the main private sector groups concerned.

To this end, NPA brings together influential and knowledgeable leaders from business, labor, agriculture, and academia to serve on policy groups. These groups identify emerging problems confronting the nation at home and abroad and seek to develop and agree upon policies and programs for coping with them. The research and writing for the policy groups are provided by NPA's professional staff and, as required, by outside experts.

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In developing its staff capabilities, NPA increasingly emphasizes two related qualifications. First is the interdisciplinary knowledge required to understand the complex nature of many real-life problems. Second is the ability to bridge the gap between theoretical or highly technical research and the practical needs of policymakers and planners in government and the private sector.

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