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April 15, 1990

Dear Reader:

The debate surrounding Washington's economic policies toward developing countries has been profoundly affected by the dramatic events taking place across the globe. The inaugural edition of Washington Economic Watch captures this dynamic mood by providing an "insider view" of the central policy issues of concern to developing countries as they were discussed in Washington during the first quarter of 1990.

Herein you will find the most authoritative and complete statements made by senior U.S. government officials, summaries of U.S. congressional hearings, press commentary, and excerpts of policy analysis as relayed through select Washington journals. You will also find policy studies published by Washington "think tanks" and the research divisions of the multilateral financial institutions.

This information is organized according to functional categories as indicated by the corresponding tabs. Within each category we have generally presented official policy statements first, followed by congressional testimony, and concluding with analyses by experts in the field and opinion editorials.

Please take note of the attached "contact sheet" of source institutions participating in the Washington Economic Watch project. This list of addresses is a bibliographic source for obtaining all publications in the digest which interest you. Please direct requests for publications to the institutions themselves.

The Overseas Development Council is delighted to have your participation in the launching of this project. We very much welcome your reactions so that we might improve future editions.

Sincerely,

Richard E. Feinberg

Richard E. Feinberg
Executive Vice President
Overseas Development Council

PN-ABH-213

P.S. Please note:

Some publications have been excluded from our digest, on the assumption they already have widespread distribution in the developing world. These include Foreign Affairs, the OECD DAC Chairman's Report, most United Nations publications, and the regional development bank annual reports. We have also chosen not to include widely circulated publications of the Bretton Woods Institutions, including Finance and Development, The IMF Survey, the World Development Report, World Debt Tables, and Social and Economic Indicators of Development. Please let us know if, in fact, you do not already receive these publications, and we will reconsider our source pool.

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Washington, DC 20001
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Washington, DC 20036
202-466-6410

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Washington, DC 20002
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Washington, DC 20036
202-785-1141

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Cambridge, Mass. 02138
617-868-3900

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Washington, DC 20005
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Santa Monica, CA 90406-2138
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Menlo Park, CA 94025
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Washington, DC 20036
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Washington, DC 20002
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Washington, DC 20036
202-452-1999

2. U.S. Governmental Organizations

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Washington, DC 20500

Office of Management and Budget
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17th St. & Penn. Ave., NW
Washington DC 20503

Council of Economic Advisors
Old Executive Ofc. Bldg.
17th St. and Penn. Ave., NW
Washington, DC 20500

Office of National Drug Control
Policy
Executive Office of the
President
Washington DC, 20500

Office of the United States
Trade Representative
Winder Building, #600
Seventeenth St.,NW
Washington, DC 20506

Department of Agriculture
14th St. and Independence Ave.,
SW
Washington, DC 20250

Department of Commerce
14th St. and Constitution Ave.,
NW
Washington, DC 20230

Department of Defense
The Pentagon
Washington, DC 20301

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Forrestal Building
1000 Independence Ave., SW
Washington, DC 20585

Department of Justice
Tenth Street and Constitution
Ave., NW
Washington, DC 20530

Department of State
2201 C St. NW
Washington, DC 20520

Department of the Treasury
1500 Pennsylvania Ave. NW
Washington, DC 20220

African Development Foundation
1625 Massacusetts Ave., NW
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Congressional Budget Office
House Office Bldg. Annex II
Second and D Streets, SW,
Fourth Floor
Washington, DC 20515

Drug Enforcement Agency
C Street between 18th and 19th
Streets, NW
Washington, DC 20240

Environmental Protection Agency
401 M St. SW
Washington, DC 20460

Export-Import Bank of the United States
811 Vermont Ave., NW
Washington, DC 20571

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Washington, DC 20429

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Washington, DC 20551

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Washington, DC 20548

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Washington, DC 20523

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Washington, DC 20003

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Washington, DC 20527

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National Academy of Sciences
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Washington, DC 20418

International Trade Commission
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Washington, DC 20431

Organization of American States
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Washington, DC 20036

Organization for Economic Cooperation and Development
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Washington, DC 20036-4095
785-6323

The World Bank
1818 H St. NW
Washington, DC 20433

3. <u>Journals</u>

Congressional Quarterly
1414 22nd St. NW
Washington, DC 20037

Foreign Policy
2400 N St. NW
Washington, DC 20037-1196

International Economy
1050 Connecticutt Ave. NW Suite 1220
Washington, DC 20036

LatinFinance
2121 Ponce de Leon Blvd.
Suite 1020
Coral Gables, FL 33134

National Journal
1730 M St. NW Suite 1100
Washington, DC 20036

Report Outlines President's Agenda And Review of U.S. Trade Policy

Where the nation is going in trade policy is detailed in the recently published 1990 Trade Policy Agenda and 1989 Annual Report of the President of the United States on the Trade Agreements Program. *Below,* Business America *publishes excerpts from the report covering the 1990 agenda and the review of the 1989 agenda. The report was prepared by the Office of the U.S. Trade Representative, with contributions from the Departments of Commerce, Agriculture, Treasury, State, Labor, the National Security Council, and the Office of Management and Budget. The report (stock number 041-001-00352-5) can be purchased for $5 from the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20230; tel. (202) 783-3238.*

The 1990 Agenda

As the 20th century enters its last decade, the world trading system stands at a crossroads, poised between further liberalization and expansion on the one hand, and protection and contraction on the other. In 1990, the Bush Administration will support and strengthen free trade forces throughout the world by successfully concluding the Uruguay Round in December.

The Administration will also be extremely active in pursuing a variety of bilateral and regional measures that complement its multilateral aims.

Based upon a firm belief in competition, the United States has led the world's effort to tear down trade barriers. As tariff walls have tumbled, global trade has skyrocketed from $61 billion in 1950 to roughly $3 trillion in 1989.

The Bush Administration believes in building upon this success. The Administration has a clear vision of the world it seeks: one where entrepreneurs, not governments, determine how industries and farms compete and nations trade. The Administration is committed to developing a global trading system based upon open markets and clear, enforceable rules of fair play for all areas of trade.

To achieve this goal the Administration's trade policy agenda in 1990 will emphasize three objectives:

1. Strengthen and expand the international trading system by successfully negotiating an ambitious package of results in the Uruguay Round.

By December 1990 the Administration seeks to conclude Uruguay Round agreements which:

- Fundamentally reform international agricultural trade by phasing out export subsidies, substantially reducing all trade-distorting subsidies and access barriers, and harmonizing sanitary and phytosanitary regulations so farmers can grow what they want, when they want, and earn a decent income without government interference.
- Increase market access for goods by significantly lowering tariff and nontariff barriers.
- Establish rules governing trade in the "new areas" of services, intellectual property rights, and trade-related investment measures.
- Limit trade-distorting government subsidies.
- Increase developing nation integration and responsibility within the GATT system and limit trade restrictions justified on balance-of-payments grounds.

2. Complement Uruguay Round goals by conducting bilateral and regional market-opening and market-expanding initiatives.

In 1990 the Administration will continue to pursue opening foreign markets and eliminating trade barriers through a broad range of bilateral and regional trade initiatives. These initiatives aim to reinforce trends toward market-driven policies and eliminate unfair trade practices and barriers which inhibit opportunities for U.S. exporters. They are meant to complement the market-opening goals of the Uruguay Round.

These actions include initiatives in the following areas.

Pacific Rim

Japan: The United States is engaged in a wide range of initiatives with Japan designed to ensure the Japanese market operates in an open, competitive fashion. These initiatives include sectoral discussions and negotiations on satellites, forest products, semiconductors, telecommunications, construction services, and other areas.

In addition, Structural Impediments Initiative talks designed to address systemic barriers to competition and trade in Japan will produce a final report in July 1990. The United States expects an interim assessment in spring 1990 and both a "blueprint" for concrete structural change and "down payment" of substantive first steps by July.

East Asia: The United States is involved in intensive bilateral consultations and negotiations with the newly industrializing economies of East Asia, particularly Korea and Taiwan. The talks are aimed at lowering trade barriers in these countries, ensuring an open competitive environment as they develop, and increasing their responsibilities within the global trading system.

ASEAN-U.S. Initiative: The Administration is working closely with the ASEAN countries to open markets and protect intellectual property rights through the ASEAN-U.S. Initiative.

Asia-Pacific Economic Cooperation (APEC): The United States will actively participate in the APEC process (begun in Australia in 1989), particularly to forge agreement among the 12 APEC countries to work actively for ambitious Uruguay Round results.

North America

Implementation of U.S.-Canada Free Trade Agreement (FTA): In close cooperation with Canada, the Administration will continue to work to enhance the FTA's trade-creating and growth-promoting effects.

Mexico: The Administration will continue to work closely

with Mexico to develop closer trade and investment ties and promote Mexican economic development under the Trade and Investment Facilitation Talks initiated by Presidents Bush and Salinas in October 1989 and under the 1987 Framework Understanding (in the areas of agriculture, industry, services, tariffs, and investment).

Europe and the Mediterranean

EC 1992: The Administration is actively monitoring the EC 1992 project to ensure it does not result in new trade barriers at the EC's frontiers while it lowers them internally. Such efforts will include continued bilateral consultations and, where necessary, actions in multilateral fora.

Eastern Europe and the Soviet Union: The Bush Administration is taking several important steps to facilitate the movement of Eastern European nations and the Soviet Union toward market-driven economies and open-trading regimes. Such efforts include negotiating trade and investment agreements where appropriate and, in cooperation with major U.S. trading partners, integrating these countries into the global trading system.

U.S.-Israel Free Trade Agreement: The United States will work closely with Israel to implement the FTA.

Latin America and the Caribbean

The Administration supports several initiatives designed to facilitate Latin American and Caribbean economic development along market lines and lower trade and investment barriers. These actions include:

Caribbean Basin Initiative (CBI): The Administration is working to expand and improve CBI operation, particularly by working with Congress to ensure passage of CBI enhancement legislation.

Andean Trade Initiative: The Administration is working with Andean region nations to expand trade, spur economic development, and orient their economies away from trade in drugs. President Bush outlined an initial package of programs to fulfill these objectives on Nov. 1, 1989.

Sectoral Efforts

Steel Liberalization Program: In 1990 the Administration will implement the agreements reached under the 1989 Steel Liberalization Program in which countries agreed to eliminate subsidies and other practices distorting trade in steel.

Shipbuilding Initiative: The Administration will negotiate bilaterally and multilaterally in the Organization for Economic Cooperation and Development (OECD) an agreement to eliminate subsidies and other forms of assistance to shipbuilders. The U.S. has set March 31 as a target date for making substantial progress and mid-1990 for reaching an agreement.

3. Enforce and implement U.S. trade laws in the way that best advances the goals of open markets and fair trade.

The Administration will use U.S. trade laws to complement its multilateral and bilateral objectives of free markets and fair trade. This includes implementing 1988 Trade Act provisions including super 301, special 301, telecommunications, and "Buy America" provisions in ways which further U.S. multilateral goals.

In addition, the Administration is also committed to trade rules that will improve living standards and promote worker rights in all nations. The Administration will also continue to use its authority under section 301 as necessary to ensure open markets.

Finally, the antidumping and countervailing duty statutes, the Generalized System of Preferences, and trade law provisions designed to safeguard U.S. national security will all be faithfully implemented.

1989 Review

The President's Trade Policy Agenda submitted March 1, 1989, identified seven core objectives of the Administration's trade policy:

- To seek substantial progress in the Uruguay Round of multilateral trade negotiations.
- To broaden access to foreign markets, improve the protection of intellectual property, and eliminate or offset foreign unfair trade practices.
- To implement the Free Trade Agreements with Canada and Israel.
- To promote U.S. exports.
- To apply, as appropriate, temporary relief for injury caused by fairly traded goods.
- To eliminate trade restrictions in developing countries while helping their economies develop.
- To ensure appropriate consideration of trade objectives in any conflicts between trade and national security interests.

In 1989 the Bush Administration acted to fulfill these trade policy objectives both by advancing existing policy initiatives and, where necessary, by developing and implementing new measures for achieving its trade policy goals. As a result:

- Macroeconomic adjustments have continued to reduce the U.S. trade deficit without resort to disruptive protectionist trade measures.
- The United States has taken a leadership role in directing the Uruguay Round toward a sweeping reform of the trading system.
- New and ambitious market-opening initiatives have been launched with U.S. trading partners.
- U.S. trade laws have been implemented to open markets and advance the rights of Americans doing business at home and abroad.

Several trade policy accomplishments were achieved during 1989.

Reducing U.S. Trade Deficit

The U.S. trade deficit continued to shrink as U.S. savings rates rose and foreign demand growth remained strong. Favorable macroeconomic conditions together with a market-opening trade policy have helped assure a deficit correction to date based on record U.S. exports.

In 1989 the deficit fell by almost $8 billion to an estimated $111 billion. Exports grew $41 billion to a record $364 billion. Higher exports created almost 800,000 export-related jobs in manufacturing.

The Uruguay Round and the GATT

The United States and its trading partners launched the Uruguay Round of trade talks in 1986 to reform and expand the global trading system. Impetus for the round sprang from

the recognition that, in many important ways, world trade has outgrown the rules of the trading system embodied in the General Agreement on Tariffs and Trade (GATT).

Past multilateral rounds of trade negotiations have generally succeeded in reducing barriers to trade in areas covered by the GATT, primarily trade in manufactured goods. However, approximately one-third of all world trade occurs in areas such as agriculture, services, intellectual property, and investment, where GATT rules are weak or nonexistent. Moreover, these are areas where world trade has been growing most briskly.

In December 1988 trade ministers from around the world met to conduct a midterm review of progress in the talks and chart the course for the rest of the round scheduled to conclude in December 1990. Because of an impasse in the areas of agriculture, intellectual property, textiles, and safeguards, nations were unable to conclude agreements. In April 1989 the United States took the lead to break the deadlock threatening to prevent the talks from moving forward.

As the Uruguay Round heads toward its December 1990 conclusion, the U.S. team will continue to press for—and accept nothing less than—an ambitious package of results. To date, the United States has made more than 100 submissions in Uruguay Round negotiating groups.

The United States has made clear that it will strive for ambitious results in the round, including: comprehensive reform of agricultural trade; agreed upon rules of fair play for services, intellectual property, and trade-related investment measures; expanded market access for traded goods; limits on trade-distorting subsidies; and a more complete integration of developing countries into the global trading system.

In 1989 the United States took concrete steps in all these areas to advance negotiations and ensure U.S. views are forcefully and effectively advocated as negotiations continue.

Agriculture: In the agriculture negotiating group the United States tabled a comprehensive proposal in October 1989. The proposal promotes a more market-oriented trading environment in which income and other objectives could be achieved at less cost, program benefits would be more equitable, and market growth potential would be exhausted. It would bring about reforms in import access, domestic support, export competition, and sanitary and phytosanitary issues.

Services: At the October 1989 services negotiations the United States tabled a proposal for a draft services "framework agreement" to establish a comprehensive set of rules governing international trade in services. The U.S. proposal would let services providers throughout the world set up shop in foreign markets and compete like local firms, while operating in a fair, predictable environment. The U.S. proposal was the first concrete legal services framework text to be tabled in the GATT.

Intellectual Property: Progress on intellectual property was made by substantively discussing issues surrounding a comprehensive agreement on trade-related intellectual property rights. The United States outlined its objectives in an extensive October 1988 proposal. Those goals include the development of objective standards protecting intellectual property rights, effective enforcement of those rights, and an effective dispute settlement mechanism.

Trade-Related Investment Measures (TRIMs): The United States advanced talks in 1989 by proposing a "two-tiered" scheme which would prohibit certain TRIMs and establish rules governing the use of others. In January 1990 the United States tabled a draft agreement, the first legal text to be considered by the TRIMs negotiating group.

Market Access: In the market access area the United States has submitted integrated tariff/nontariff measure request lists for 23 trading partners. It has also submitted proposals for developing GATT rules to cover "rules of origin" and preshipment inspection.

Subsidies: In subsidies negotiations, in November 1989 the United States tabled a proposal that expands the class of "prohibited" international subsidies and clarifies which subsidies countries may take countervailing duty action against.

Balance of Payments: In the area of balance-of-payments rules, in December 1989 the United States and Canada introduced a proposal that would help prevent inappropriate use of GATT balance-of-payments provisions to justify long-term prohibitive import barriers.

In 1990 the United States is working to develop actual negotiating texts in these and other Uruguay Round negotiating groups for trade ministers' final approval in December.

GATT Membership: The Administration has also worked to bring new countries into the GATT. Currently 12 countries have formal accession applications pending. In 1989 work was completed on three (Bolivia, Costa Rica, and Tunisia). Six others, largely from Central and South America, are under active consideration.

U.S. Initiatives to Open Foreign Markets

In 1989 the Administration conducted a wide range of bilateral/regional as well as sectoral negotiations that have yielded tangible benefits for U.S. exporters. The talks are designed to reinforce the trend toward market-driven economies and an open trading regime.

Bilateral/Regional Negotiations

Western Europe: The Administration has welcomed the European Community (EC) effort to create a single market by 1992. However, the Administration has taken steps to ensure that as existing trade barriers come down within the EC, new ones are not erected at the EC's borders.

- USTR Carla A. Hills and her EC counterpart Frans Andriessen have agreed to meet monthly to discuss U.S.-EC trade issues.
- The Administration has established a high-level EC 1992 task force. Deputy USTR Julius Katz has been designated as the U.S. coordinator.
- The Administration strongly opposed a proposed EC requirement that would have discriminated against U.S. financial service companies. EC changes in its proposal lessen these concerns and better safeguard the rights of U.S. financial firms. The United States continues to monitor EC proposals in this area.
- In May 1989, at U.S. request, a GATT dispute settlement panel was established to examine EC oilseed subsidies. In November the panel ruled that EC subsidies violated the GATT. Talks continue with the EC to resolve the issue in light of the GATT finding.
- In February 1989 the Administration named the EC a "priority country" under the telecommunications provisions of the 1988 Trade Act. The United States is engaged in talks with both the EC Commission and individual member states

to ensure access to the EC market for telecommunication network equipment and service suppliers.

- In February 1989 the United States and the EC established a beef hormone task force to examine ways to resolve a dispute disrupting almost $200 million in two-way trade. The work of the task force has kept the dispute from escalating into a major trade confrontation.
- In June 1989 the United States clarified an earlier agreement with the EC on canned fruit. As a result, the EC cut its subsidy for canned fruit exports.
- The United States is actively challenging the EC's television broadcast directive in both the GATT and bilateral talks. The directive, adopted by the EC in October 1989, directs EC member states to reserve a majority of their transmission time for European works "where practicable."

The Soviet Union and Eastern Europe: The United States is actively engaged in working with the Soviet Union and Eastern European nations to facilitate the movement of their economies toward market mechanisms and open trade. In response to the dramatic political changes occurring in this region, the United States began several major new initiatives in 1989.

In December 1989, following the Malta Summit, President Bush announced the United States agreed to take several steps to improve economic and commercial ties with the Soviet Union. These include:

- Negotiating a trade agreement which is a statutory prerequisite to granting most-favored-nation trading status to the Soviets.
- Negotiating a bilateral investment agreement with the Soviet Union to foster increased investment opportunities.
- Supporting observer status for the Soviet Union in the GATT after completing the Uruguay Round negotiations, and agreeing to work with other countries to develop criteria for Soviet observership.
- Starting negotiations in December 1989 on a new long-term grain agreement between the United States and the Soviet Union.

As for Eastern Europe, in November 1989 the President designated Hungary as a beneficiary of the U.S. Generalized System of Preferences (GSP), which provides for duty free access to the U.S. market on selected products. Poland became eligible for GSP benefits on Jan. 9, 1990. In November the United States enacted $938 million in aid to Poland and Hungary. Among the package's provisions are preferred treatment for Poland, insurance for U.S. investors in Poland and Hungary, loan guarantees for U.S. firms trading with those countries, and funds for private sector development.

- In addition, the United States has started negotiations with Poland and Hungary on business and economic agreements. These will stimulate U.S. investment in those countries, provide and protect new business opportunities for U.S. business, and strengthen those nations' moves toward market-oriented economies.

Japan: A key Administration trade policy goal is to ensure that Japan, the world's second largest market, is open and operates on a truly competitive basis. This means the United States expects Japanese market decisions to be based on price and quality and not anticompetitive factors such as administrative guidance, collusion, *keiretsu*, or exclusionary business practices.

To achieve this goal the Administration is actively pursuing a three-part strategy.

First, Uruguay Round trade talks are being used to focus on a variety of Japanese market barriers. These include its closed agricultural market, limitations on services trade such as its restrictive distribution system, and discriminatory government procurement practices.

Second, the United States has sought increased openness and fairness in specific industry discussions covering construction services, telecommunications, forest products, supercomputers, semiconductors, and satellites, among others. Negotiations in 1989 yielded concrete results in several of these areas.

In construction, in November 1989 Japan agreed to discourage collusive bidding, increase available information on projects to foreign bidders, and not interfere with company decisions to form joint ventures.

In telecommunications, the United States signed an agreement with Japan in June 1989 to open Japan's market for mobile communications systems.

Third, the United States is vigorously addressing broad systemic barriers to trade through its Structural Impediments Initiative (SII). SII talks cover six issues: saving and investment, exclusionary business practices, pricing measures, land use policies, financial *keiretsu*, and the distribution system.

The Administration is seeking a "blueprint" for structural change from Japan as well as a "down-payment"—concrete steps—toward that change by the time the final report is due in July 1990.

The Pacific Rim: The United States is engaged in an active dialogue with Pacific Rim nations to reinforce that region's market-oriented trends.

- In November 1989 a senior delegation led by Secretary of State James Baker and including Secretary of Commerce Robert Mosbacher and USTR Hills attended the first Asia-Pacific Economic Cooperation Conference in Canberra, Australia. The 12 nations represented, accounting for about half the world's trade, strongly supported an ambitious, successful outcome for the Uruguay Round. They agreed to meet again in Singapore in 1990 and Seoul in 1991.
- The United States worked closely with the ASEAN nations (Singapore, Malaysia, Thailand, Indonesia, the Philippines, and Brunei) to encourage open markets and protection for intellectual property. The ASEAN-U.S. Initiative (AUI) report was completed in 1989. ASEAN and U.S. officials are working to develop a framework for closer cooperation as envisaged in the AUI study.
- In November 1989, after close consultation with the United States and other countries, Korea announced it would no longer justify its agricultural trade barriers in the GATT based upon "balance-of-payments" problems. Accordingly, Korea announced its intention to phase out such barriers.
- The United States and the Philippines signed an agreement in November 1989. It lays out a framework for working toward eliminating trade barriers, protecting intellectual property rights, and addressing foreign investor concerns.

Canada: The Administration has implemented the U.S.-Canada Free Trade Agreement (FTA) which took effect Jan. 1, 1989. Canada is the United States' single largest trading partner with more than $190 billion in goods and services traded each year.

- The U.S.-Canada Trade Commission is responsible for FTA oversight. Chaired by USTR Hills and Canadian Trade Minister Crosbie, it met in March and November and set up binational working groups to monitor and build on the FTA.

• Businesses in both nations have asked for even faster cuts in tariffs than originally agreed. As a result, both nations have announced accelerated tariff cuts on hundreds of products covering $6 billion in annual two-way trade.

• A select panel on automotive trade was established composed of distinguished private sector leaders from both countries. The group's mandate is to study the North American auto industry and investigate ways to improve its competitiveness.

• An important FTA aspect is its dispute settlement procedures. Several issues including landing rights for unprocessed fish are being handled through referral to FTA dispute settlement procedures.

Mexico: In August 1989 six U.S. Cabinet members traveled to Mexico to consolidate and further bilateral cooperation in a variety of areas, including trade. They demonstrated strong U.S. support for the efforts of President Salinas' Administration to remove trade barriers, relax restrictions on foreign investment, and restructure the Mexican economy. Mexico is the third largest U.S. trading partner with trade totaling $52 billion. In 1989 U.S. exports to Mexico rose 22 percent following a 41 percent growth in 1988.

When President Salinas visited the United States in October 1989, both nations signed a new understanding that establishes "Trade and Investment Facilitation Talks," a process for negotiating specific market-opening agreements. The understanding set out an action plan with negotiations in specified areas (e.g., standards and petrochemicals) possibly starting in March 1990. Initial results could follow in July.

Andean Initiative: To aid the Andean nations actively fighting in the war on drugs, on Nov. 1, 1989, the President announced the Andean Trade Package for Bolivia, Colombia, Ecuador, Peru, and Venezuela.

With this initiative we are:

• Doing all we can to enhance the benefits the Andean countries enjoy under GSP;

• Providing appropriate technical assistance to improve Andean country trade performance;

• Consulting with the affected parties and exploring possibilities for expanding mutually beneficial textiles trade consistent with current U.S. government policies and programs and the Multifiber Arrangement; and

• Working in the international arena to obtain a new International Coffee Agreement, proposing to quicken negotiations on tariff and nontariff measures within the Uruguay Round, consulting major U.S. trading partners on ways to enhance the region's trade, and supporting multilateral development banks as they work with the Andean nations to promote trade policy reforms.

Caribbean Basin Initiative: In November 1989, the President reaffirmed the Administration's support for the Caribbean Basin Initiative. He asked the USTR to coordinate an interagency effort to identify actions to improve the CBI's operation. The Administration also supports legislation to enhance CBI benefits for eligible countries.

Sectoral Negotiations

Steel and Shipbuilding Initiatives: The United States wants a company's competitiveness to determine its success in world markets rather than access to government subsidies and market barriers. U.S. steel and shipbuilding initiatives are designed to get government out of these businesses.

• On July 25, 1989, President Bush announced a Steel Trade Liberalization Program. Under the program, the Administration reached agreements with major U.S. steel trading partners to eliminate export and domestic subsidies, to remove quotas and other nontariff trade barriers to steel, and to seek to reduce and ultimately eliminate tariffs on steel. These countries (including Japan, the EC, Australia, Brazil, Korea, Mexico, Finland, Australia, Yugoslavia, and Trinidad and Tobago) account for more than 90 percent of U.S. steel trade.

• The United States is negotiating with the world's major shipbuilding nations to eliminate the massive subsidies and other forms of assistance that distort production and trade in this sector. The Administration has announced its intention to make substantial progress toward forging an agreement with these countries by March 31, 1990, and to reach an agreement by midyear to end such distortive practices.

Textiles: In addition, the Administration enforced its rights in the area of textiles and apparel under the international Multifiber Arrangement (MFA). The United States negotiated 18 agreements with foreign suppliers governing their imports of textiles and apparel. The agreements serve the dual purpose of ensuring the orderly development of textile and apparel trade while protecting U.S. producers from sudden import surges.

In addition, the United States is studying all viable options in an effort to develop an improved international trading regime for textiles and apparel to serve as a transition from the MFA to a strengthened GATT in the longer-term context of the Uruguay Round.

Trade Law Implementation

Since 1989 the Administration has acted vigorously to implement U.S. trade laws, in particular provisions of the 1988 Omnibus Trade and Competitiveness Act (1988 Trade Act). These efforts all have a common end: to open world markets and complement U.S. multilateral and bilateral efforts to ensure world trade occurs according to market principles.

The Administration's efforts have already yielded concrete results for U.S. firms that do business abroad. In general, Administration actions to implement U.S. trade laws fall into the following categories.

Section 301: The Administration has used section 301 to open foreign markets in the following ways.

First, the Administration implemented the super 301 provisions of the 1988 Trade Act by announcing its trade liberalization priorities on May 26, 1989. The Administration's priority countries and practices complement its Uruguay Round objectives.

Accordingly, those priorities focused on the areas of government procurement (Japanese barriers to satellites and supercomputers), standards barriers (Japanese forest products barriers), import quotas and restrictive licensing (Brazilian restrictions), trade-related investment measures (Indian investment restrictions), and services barriers (Indian insurance barriers).

On June 16, 1989, USTR initiated section 302 investigations into each of the six named priority practices. By statute, USTR must determine within 12 months (or 18 months in cases involving trade agreements) whether such practices are "unreasonable" or violate a trade agreement. Bilateral consultations on each of the six named practices were held throughout 1989.

Second, the Administration used the leverage afforded by the super 301 provisions to achieve significant market opening measures with Korea and Taiwan. In May 1989 Korea agreed to eliminate foreign investment restrictions, improve access for agriculture, and decrease protection for Korean infant industries. Taiwan began to lower tariffs and remove other trade restrictions as part of a four-year action plan.

Third, in 1989 USTR used its section 301 authority to initiate other investigations or conclude market-opening agreements in a variety of cases. Such actions included the initiation of investigations in the cases of Thai cigarette restrictions and discriminatory government procurement of tollbooth equipment in Norway, and the conclusion of agreements on Korean wine restrictions, and EC export restrictions on copper scrap.

Fourth, the Administration implemented the special 301 provisions of the 1988 Trade Act pertaining to intellectual property protection.

Whether in patents, copyrights, trademarks, integrated circuits, or trade secrets, creativity and invention are the lifeblood of U.S. business. The ability to protect an idea and reap the rewards of that effort is central to U.S. economic success. Yet inadequate intellectual property rights protection and enforcement around the world now costs U.S. companies an estimated $40 billion to $60 billion each year.

As part of the U.S. effort to strengthen intellectual property rights protection globally, on May 26, 1989, the Administration designated 25 countries for special attention under the provisions of the 1988 Trade Act. Eight countries (Brazil, India, Korea, Mexico, People's Republic of China, Taiwan, Thailand, and Saudi Arabia) were given the highest priority in the U.S. effort to improve protection and enforcement of rights.

Progress was made with all eight designees toward obtaining improved protection and enforcing intellectual property rights. Korea, Taiwan, Saudi Arabia, and Mexico stood out for their willingness to meet U.S. concerns.

In addition, after consultations with the United States, Argentina agreed to address U.S. concerns over inadequate intellectual property rights protection for pharmaceuticals. Argentina expressed a willingness to improve pharmaceutical patent protection and modify how those products are registered.

Telecommunications Provisions of 1988 Trade Act: On Feb. 18, 1989, after conducting the investigation required by section 1374 of the 1988 Trade Act, USTR named the EC and Korea as "priority foreign countries" in the telecommunications area. The United States has entered into discussions with both the EC and Korea to attain market access for U.S. telecommunications network equipment and service suppliers.

In addition, countries were also reviewed under section 1377 of the 1988 Trade Act. Each year this section requires USTR to determine whether a nation complies with telecommunications trade agreements or otherwise denies mutually advantageous market opportunities to U.S. firms. As a result of a U.S. finding of violation under that review, Japan agreed to open its third party and cellular radio markets.

Generalized System of Preferences: On Jan. 1, 1989, Taiwan, Korea, Hong Kong, and Singapore were removed from the program as a result of the 1988 decision to "graduate" them due to their degree of economic development and export competitiveness. As of July 1, 1989, changes that resulted from the 1988 Annual Review of the GSP were implemented.

Petitions covering 80 products were accepted for the 1989 Annual Review for changes in GSP treatment as were eight petitions relating to country practices. Four country practice cases were continued from the previous year. They are all now under review with a Presidential decision due in April 1990.

Antidumping/Countervailing Duty Provisions: In 1989 the U.S. Department of Commerce, which jointly administers U.S. antidumping and countervailing duty laws with the U.S. International Trade Commission (USITC), reviewed 23 dumping petitions and nine countervailing duty petitions, compared to 78 and 22 in 1988.

National Security Import Restriction Provisions: In 1988-89 four products were subject to investigations under section 232 which authorizes the President to regulate commodity imports that threaten or impair national security. The products were bearings, petroleum, plastic injection molding machines, and uranium. In each case it was determined that imports did not constitute a national security threat.

Trade Acronyms

ASEAN—Association of Southeast Asian Nations

BIT—Bilateral Investment Treaty

CBI—Caribbean Basin Initiative

CP—Contracting Party

CVD—Countervailing Duty

EC—European Community

EFTA—European Free Trade Association

Eximbank—Export-Import Bank

FTA—Free Trade Agreement

GATT—General Agreement on Tariffs and Trade

GSP—Generalized System of Preferences

MFA—Multifiber Arrangement

MFN—Most Favored Nation

MTN—Multilateral Trade Negotiations

NME—Non-market Economy

OECD—Organization for Economic Cooperation and Development

SII—Structural Impediments Initiative

TAA—Trade Adjustment Assistance

USDA—U.S. Department of Agriculture

USITC—U.S. International Trade Commission

USTR—United States Trade Representative

February 5, 1990

Communication from the United States

The following communication has been submitted by the delegation of the United States for circulation to the members of the Negotiating Group on Textiles and Clothing.

Introduction

In a statement circulated to this negotiating group last December (MTN/NG4/W/33), the United States delegation expressed views on possible modalities which would permit the eventual integration of the textile and clothing sector into the GATT on the basis of strengthened rules and disciplines. We indicated in that statement that we would be making more detailed proposals on alternative modalities at this time, and that we would be prepared to elaborate on the concepts suggested in W/33 in greater detail.

The United States delegation reaffirmed in December and will do so again that our objectives in these negotiations is to help bring about through negotiation the eventual integration of textiles and clothing into GATT on the basis of strengthened GATT rules and disciplines and to ensuring that this process contributes to the further liberalization of trade.

We would also like to reaffirm that the process requires procedures that ensure that all relevant trade measures affecting trade in textiles and clothing are integrated and that GATT rules and disciplines have been sufficiently strengthened to make integration viable.

Duration of Integration Process

As we stated in December, the successful integration of this sector into GATT will require a transition arrangement of sufficient duration to ensure an orderly and equitable adjustment in trade terms as well as in terms of the domestic production processes of each participant. We believe a transition mechanism, similar to those outlined below, of at least ten years duration would be appropriate to accomplish these objectives. In other words, assuming sufficiently strengthened GATT rules and disciplines exist, we propose that the transition mechanism start on January 1, 1992 and that the special safeguard arrangement for the textile and clothing sector end on December 31, 2001.

Criteria for the Integration Process

As we stated in December, it is important that any transition mechanism be evaluated by this group according to certain criteria. For the United States, it is important that the transition mechanism be simple, equitable, transparent, predictable and certain; that the mechanism allow trade patterns to be driven by market forces as early as possible and to the maximum extent possible, and that it allow an adjustment to GATT rules concomitant with the operation of market forces.

As we indicated in December, we believe that certain modalities for a transition mechanism offer certain concrete advantages to a mechanism based on the Multifiber Arrangement when evaluated according to these criteria. We believe a multilaterally agreed global, or non-selective, quota system or a tariff rate quota system, as elaborated below, offer substantial advantages for the transition to GATT; most significantly, the gradual opening of markets to competitive forces, transparency, equity and certainty. These alternatives also offer the progressive movement from selectivity to most-favored-nation (MFN) treatment for supplying countries.

We reiterate that the Swiss suggestion of the possibility that different participants could adopt different techniques or modalities is something which should be carefully studied.

Global-Type Quota System

The global, or non-selective, quota system that we envision is outlined by illustration in the attached graphics. We foresee a comprehensive quantitative limit, by product category, which would be divided among country allocations or guarantees (covering trade from those countries with whom we have bilateral agreements), and a non-selective "global basket" that would expand to provide growth. In the first year, the global basket would be increased by a certain uplift (or growth) factor, and would be open for competition from all parties, including those with country allocations. In addition, countries would be able to contribute their guarantees to the basket or to other countries.

Each year, over a ten-year timeframe, the country allocations would shrink by one-tenth of the original amount, and the global basket would increase by a growth factor and by adding to it the ten percent taken from each of the country allocations. The growth factor during the ten year transition would be determined through multilateral negotiation, but would vary

depending on the import sensitivity of the product involved and would increase over time.

As illustrated, the global basket would gradually take over the country shares of the quota, and in the final year of the transition, the overall quota would be in place only in the form of the global basket. The transition system would end, under this scenario, at the end of the tenth year of the transition.

The product category coverage of a global-type quota system would be determined by individual participants; however, we intend that product classification under a transition mechanism be a contribution to liberalization of trade. For the United States, this would mean consolidating our existing product categories so as to allow more flexibility for exporters and possibly the removal of certain products from coverage during the transition.

Tariff Rate Quota System

As suggested in W/33, tariff rate quotas offer an additional modality for integration of this sector into the GATT. We envision a tariff rate quota system with a structure and duration similar to the global or non-selective quota system outlined above. The attached graphic illustrations therefore also show the structure of a tariff rate quota system, which would feature a two-tier tariff system with country allocations and a global basket for the lower tier (with lower tariffs), shifting over time toward the global basket. Imports within the quantitative limits of the lower tier would enter at applicable duty rates. However, additional imports above and beyond these quantitative limits would be permitted at substantially higher penalty tariff rates.

We would offer one important caveat to the proposal for a tariff rate quota system, and that is the establishment of a special mechanism to ensure that exports from non-market economies are subject to equivalent tariff disciplines as those from market economies. We do not yet have definitive views on the form of this special mechanism, but believe it an essential part of any tariff-based transition modality.

MFA-Based Transition System

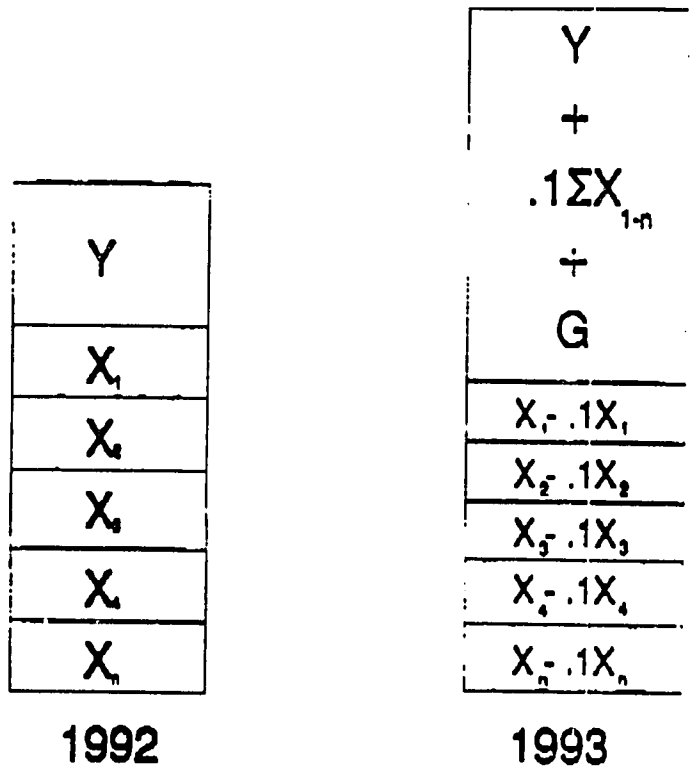
As discussed above, we have carefully examined the range of proposals for a MFA-based transition arrangement. We feel that we should take full advantage of this existing multilateral forum

by thoroughly considering new and improved trading regimes for the transition back to GATT.

For this reason, we believe that alternatives to a MFA-type system offer many advantages and must be seriously explored. Nonetheless, we are of course prepared to continue work in this group on a system extrapolated from the MFA, as suggested by many participants.

Example 1A: Global Quotas

Category: Dresses
(Cotton and Man-made Fiber)



X= Country Allocation (Agreement Countries);

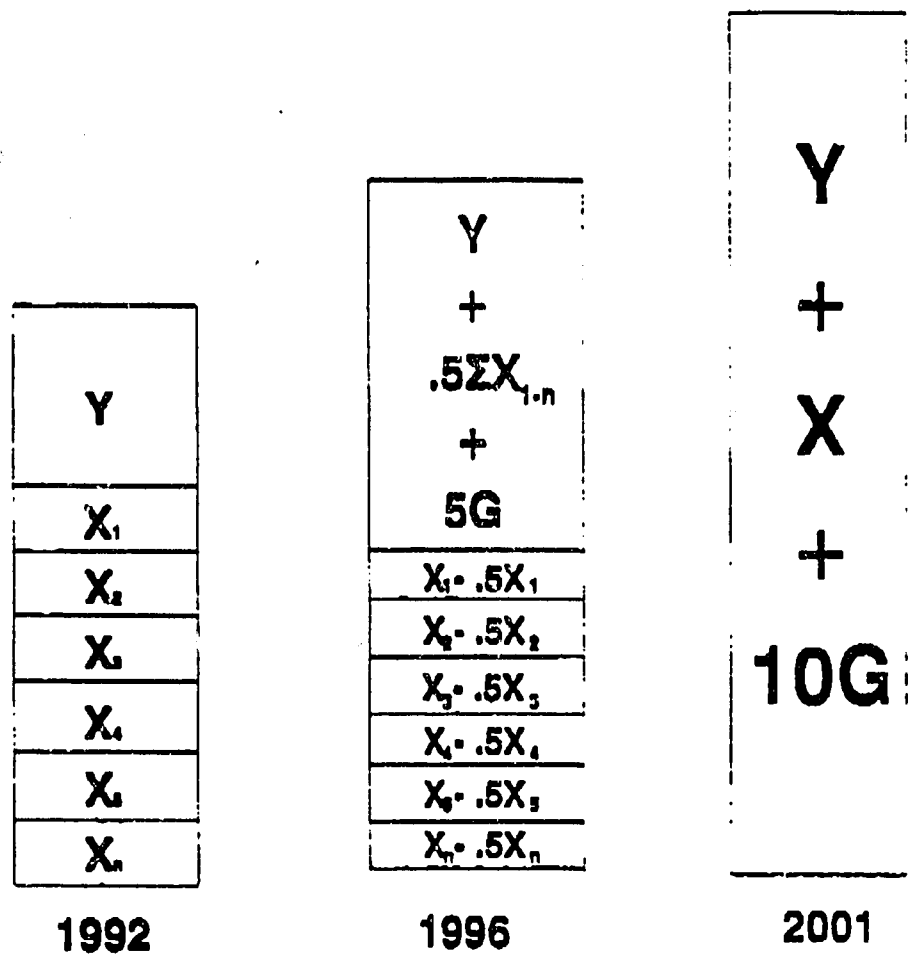
Y= Global Basket (Non-Agreement Countries Plus Growth in First Year);

G= Growth Factor

Example 1B: Global Quotas

Category: Dresses

(Cotton and Man-made Fiber)



X= Country Allocation (Agreement Countries);

Y= Global Basket (Non-Agreement Countries Plus Growth in First Year);

G= Growth Factor

QUOTA COVERAGE AND GROWTH RATES

PRODUCT SENSITIVITY	1992-1994	1995-1997	1998-1999	2000-2001
VERY HIGH	X	X+1	X+2	X+3
HIGH	X+1	X+2	X+3	X+4
MODERATE	X+2	X+3	X+4	X+5
NO COVERAGE				

X= Basic Growth Rate

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10:00 AM

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Maintaining U.S. Lead in Global Software Market May Depend on Effective Intellectual Property Laws

The overwhelming lead the U.S. holds in the global computer software market may be in jeopardy without effective intellectual property laws, according to a paper published today (3/7) by the Office of Technology Assessment (OTA). The economic implications of under-protecting or over-protecting software could impact sectors as diverse as telecommunications, transportation, and finance, says the agency.

The findings of the OTA paper, **Computer Software and Intellectual Property**, were discusses by James W. Curlin, Manager of OTA's Communication and Information Technologies Program before a hearing of the Subcommittee on Courts, Intellectual Property, and the Administration of Justice of the House Committee on the Judiciary today (3/7).

The U.S. dominates the world software market with a 70 percent market share, and the domestic industry produces approximately $60 billion annually in domestic sales and services. This lead is threatened, however, by the rapidly developing software industries in Europe and Japan. The U.S. must remain aware of shifts in the world economy such as the changes proposed by the European Economic Community in 1992 and the current political restructuring of Eastern Europe and the Soviet Union. The U.S. faces a serious competitive challenge from the prospect of unified markets and standards in Western Europe, says OTA.

Laws governing intellectual property, such as copyright, patent, and trade secret laws, impact on innovation and investment in the U.S. software industry. The importance of intellectual property laws will magnify as the international software industry continues to unfold, says OTA.

What to protect? How much? For how long? Against what? These are all questions that burden those who attempt to implement intellectual-property protection for software because software is not comfortably accommodated by either copyright or patent protection.

Like many other new technologies, software challenges traditional intellectual-property frameworks. Some argue that software, like many other electronic technologies, poses particularly severe challenges to policy makers and the courts. The rapid evolution of computer software and hardware technologies makes the crafting and refining of software protections parallel to aiming at a target that is still over the horizon, says OTA.

Since there is no agreement on common terminology, it is difficult even to discuss protection issues with precision, says OTA. (For instance, the legal and technical communities do not have consistent definitions for important terms such as "algorithm" or "interface.")

Finally, international scope of the software market requires domestic laws to be harmonized with treaty obligations and the laws of other nations.

Software is vital to defense and civilian operations and to many critical industrial sectors. Appropriate legal protections for it can speed the pace of technological advancement in software and its dissemination throughout the economy; inappropriate laws and regulations can shift the focus from technological advance to the court system. Developments in the computer hardware industry will follow accordingly.

Intellectual-property protections for software will shape competition in the new international markets. For example, standards and interfaces will help determine the extent to which computer software and hardware developed by different producers -- and different countries -- are compatible. The degree of compatibility will shape the future of global information networks and access to them, says OTA.

(more)

The OTA background paper, Computer Software and Intellectual Property, examines the scope of protection for computer software under existing laws and provides an overview of the often conflicting views and concerns of various stake holders. The paper was prepared at the request of the Subcommittee on Courts, Intellectual Property, and the Administration of Justice of the House Committee on the Judiciary and its chairman, Rep. Robert W. Kastenmeier.

OTA is a non-partisan analytical agency that serves the U.S. Congress. Its purpose is to aid Congress in dealing with the complex and often highly technical issues that increasingly confront our society.

Copies of the background paper are available from the U.S. Government Printing Office (GPO), Superintendent of Documents, Washington, D.C., 20402-9325; phone (202) 783-3238. The GPO stock number is 052-003-01181-6; the price is $2.00.

CONGRESSIONAL COMMENT

Rep. Robert W. Kastenmeier (D-WI), Chairman, Subcommittee on Courts, Intellectual Property, and the Administration of Justice of the House Committee on the Judiciary

"How to deal with computer software as intellectual property under the law continues to be a thorny issue. This report reminds us again that the issue is an urgent one and that we cannot afford to let things slide, or we will slide, indeed, out of the lead we now enjoy in world software markets."

REPORT

United States Department of Agriculture
Foreign Agricultural Service
Washington, D.C. 20250-1000
FAX: (202) 382-1728

STATUS OF 1989/90 U.S. SUGAR IMPORT QUOTA THROUGH JANUARY 7, 1990

WASHINGTON, JANUARY 24 -- The Foreign Agricultural Service of the U.S. Department of Agriculture today reported that preliminary U.S. Customs Service data show sugar imports under the 1989/90 quota for the period January 1, 1990 through January 7, 1990 were 18,696 metric tons. There were no polarization adjustments for this period. Total entries and adjustments for January 1, 1989 - January 7, 1990 were 1,145,667 metric tons. Effective January 18, 1990, the import quota was increased to 2,583,050 metric tons (excluding speciality sugar). The new country allocations are shown below.

NOTE: Imports are reported on an actual weight basis adjusted by Customs upward by a factor of 1.035. When final polarization results are received or when adjustments are made to raw value on final vessels, cumulative import data are adjusted accordingly. A country's excess of cumulative entries and adjustments over its quota allocation is carried over to and counted against the country's allocation for the next quota period. Country quota allocations are shown below in metric tons, raw value, for the period January 1, 1989 - September 30, 1990. The conversion factor to short tons is one metric ton equals 1.10231125 short tons.

Data by country are as follows in metric tons, including the new allocations:

Country	Entries 1/1-1/7	Pol. Adj. 1/1-1/7	Cumulative Entries & Pol. Adj.	Quota Allocation 1989/90	Excess Entries Pol.Adj.
Argentina	---	---	53,022	104,160	---
Australia	---	---	111,218	201,054	---
Barbados	---	---	7,472	16,957	---
Belize	---	---	11,848	26,646	---
Bolivia	---	---	7,706	19,379	---
Brazil	---	---	57,166	351,238	---
Canada	---	---	10,490 1/	26,646	---
Colombia	---	---	40,189	58,136	---
Congo	---	---	704	16,070	---
Costa Rica	---	---	21,254	49,758.5	---
Cote D'Ivoire	---	---	7,319	16,070	---
Dominican Republic	---	---	222,578	426,331	---
Ecuador	---	---	11,975	26,646	---
El Salvador	---	---	30,388	71,034.1	---
Fiji	---	---	9,682	21,737	---
Gabon	---	---	778	16,070	---
Guatemala	18,696	---	66,014	116,272	---
Guyana	---	---	7,178	29,068	---
Haiti	---	---	7,639	16,070	---
Honduras	---	---	20,539	47,490.4	---

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Country	Entries 1/1-1/7	Pol. Adj. 1/1-1/7	Cumulative Entries & Pol. Adj.	Quota Allocation 1989/90	Excess Entries & Pol. Adj.
India	---	---	8,316	19,379	---
Jamaica	---	---	11,793	26,646	---
Madagascar	---	---	7,238	16,070	---
Malawi	---	---	10,647	24,127	---
Mauritius	---	---	21,240	29,036	---
Mexico	---	---	12,447	16,070	---
Mozambique	---	---	13,689	31,490	---
Panama	---	---	0	69,312 2/	---
Papua New Guinea	---	---	7,327	16,070	---
Paraguay	---	---	7,772	16,070	---
Peru	---	---	44,843	99,316	---
Philippines	---	---	192,707	382,729	---
St. Kitts and Nevis	---	---	7,294	16,070	---
Swaziland	---	---	30,276	38,757	---
Taiwan	---	---	12,877	29,068	---
Thailand	---	---	14,684	33,912	---
Trinidad-Tobago	---	---	7,402	16,957	---
Uruguay	---	---	7,049	16,070	---
Zimbabwe	---	---	22,907	29,068	---

1/ Unexplained downward adjustments of 763 metric tons by U.S. Customs. 2/ Panama quota allocation is currently suspended but not reallocated to other countries.

NOTE: The U.S. Customs Service is responsible for tracking the sugar quota. This report provides preliminary unofficial quota data and is subject to change by Customs. The report is provided as a courtesy to the U.S. and foreign sugar trade.

STATUS OF 1989/90 U.S. IMPORTS FOR CERTAIN SUGAR-CONTAINING ARTICLES

Preliminary U.S. Customs data indicate that cumulative imports of certain sugar-containing articles under quota for the period Oct. 1, 1989-January 7, 1990, in metric tons were as follows:

HTS	Quota Allocation	Cumulative Imports
9904.60.20	2,722	244
9904.60.40	6,350	511
9904.60.60	76,204	6,017

Sugar Import Notice (4-90)
Sugar Group (202) 447-2916

UNITED STATES DEPARTMENT OF
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WASHINGTON, D.C. 20230

BUREAU OF
THE
CENSUS

IMPORTANT: This release contains sensitive economic data not to be released before 8:30 a.m. EST Friday February 16, 1990.

CB-90-30
FT900 (89-12)

Haydn R. Mearkle (301) 763-7754
Richard M. Preuss (301) 763-7754

U. S. MERCHANDISE TRADE: DECEMBER 1989

Seasonally Adjusted Imports and Exports

Imports (Customs), Exports (F.A.S.) and Trade Balance

The Bureau of the Census, Department of Commerce announced today that December imports of $38.3 billion and exports of $31.1 billion resulted in a merchandise trade deficit of $7.2 billion, $3.1 billion less than the November deficit of $10.3 billion. December imports were $2.4 billion less than November imports of $40.7 billion. December exports were $0.7 billion more than November exports of $30.4 billion.

The November to December change in exports reflected increases in capital goods ($1.0 billion), consumer goods ($0.3 billion), automotive vehicles, parts and engines ($0.2 billion) and foods, feeds and beverages ($0.1 billion), and decreases in other merchandise ($0.7 billion), and industrial supplies and materials ($0.1 billion).

The November to December change in imports reflected decreases in capital goods ($1.1 billion), industrial supplies and material ($0.6 billion), automotive vehicles, parts and engines ($0.3 billion), consumer goods ($0.2 billion) and foods, feeds and beverages ($0.1 billion); other merchandise was virtually unchanged.

Selected Commodity and Country Detail
(Not Seasonally Adjusted)

Exports of manufactured goods at $23.2 billion were $0.5 billion more than in November and $0.2 billion more than the $23.0 billion January to November average. Manufactured goods showed increases in airplanes, ADP equipment and office machinery, artwork and antiques, spacecraft and parts, specialized industrial machinery, airplane parts, power generating machinery, scientific instruments and iron and steel mill products. Decreases were shown in vehicle parts, gem diamonds and chemicals-plastics.

Imports of manufactured goods at $30.0 billion were $2.8 billion less than the $32.9 billion of November and $1.8 billion less than the $31.8 billion January to November average. Manufactured goods showed decreases in clothing and footwear, toys, games and sporting goods, vehicle parts, iron and steel mill products, electrical machinery, telecommunications equipment, power generating machinery, gem diamonds, paper, paperboard and products, organic and inorganic chemicals and general industrial machinery.

Imports of petroleum products at $4.1 billion were $0.3 billion less than the $4.4 billion of November and virtually the same as the January to November average. The 226 million barrels of December were 27 million barrels less than the 253 million barrels of November and 18 million barrels less than the January to November average of 244 million barrels. The December average price per barrel ($17.97) was $.64 more than the $17.33 November average price and $1.27 more than the January to November average price of $16.70.

The December figures showed a surplus with Western Europe of $0.6 billion, an improvement of $1.3 billion after a November deficit of $0.7 billion. Deficits were recorded with Japan $3.5 billion ($4.0 billion), OPEC $1.2 billion ($1.8 billion), Canada $1.0 billion ($1.1 billion), Taiwan $0.7 billion ($1.0 billion), China $0.5 billion ($0.8 billion), Republic of Korea $0.3 billion ($0.5 billion), Hong Kong $0.2 billion ($0.4 billion), and Brazil $0.1 billion ($0.2 billion). The November deficits are shown in parentheses.

Carry-over in December was $1.0 billion (2.7 percent) for imports and $0.9 billion (2.9 percent) for exports. For November revised imports carry-over was $0.2 billion (0.5 percent), down from the original $0.9 billion (2.2 percent). November exports carry-over was $0.2 billion (0.7 percent), revised down from $0.8 billion (2.6 percent).

SPECIAL ANNOUNCEMENTS

With the release of the January 1990 U.S. Merchandise Trade statistics on March 20, 1990, the following changes will occur in the presentation of the monthly data:

UNITED STATES AND CANADA DATA EXCHANGE

Under the terms of a Memorandum of Understanding, the United States and Canada agreed to replace their bilateral export statistics with counterpart import statistics no later than January 1990. This data exchange will enable the Census Bureau to publish complete Schedule B commodity detail for segments of U.S. export trade previously estimated as a single monthly value for "undocumented" exports to Canada. This "undocumented" value, which currently averages over a billion dollars a month, will now be distributed in the appropriate commodity classifications. For 1989, the distribution of the "undocumented" data will occur when the Census Bureau publishes its final 1989 data in mid-to-late summer. Analysts should consider this fact when making comparisons at the detail level, particularly Exhibits 3, 4, and 5.

ADJUSTMENT FOR SEASONAL AND WORKING-DAY VARIATION

The Census Bureau will revise its seasonal adjustment procedures to capture more of the seasonal patterns at the detailed commodity level. Instead of the current aggregate adjustment, we will adjust at each end-use commodity level for which there is significant stable seasonality. This detailed data will be summed for publication and the results will be presented for the same six broad end-use groups currently shown in Exhibits 3 and 4. The detailed seasonal data will be available on request.

ADJUSTMENT OF MERCHANDISE TRADE DATA FOR PRICE CHANGE

In compliance with the Omnibus Trade and Competitiveness Act of 1988, the Census Bureau will present seasonally adjusted merchandise trade data on a constant dollar basis (1987 = 100). Publication of this data should improve the ability of data users to examine trends in import and export volume. The deflators used to adjust the trade data will be based upon monthly price indexes published by the Bureau of Economic Analysis to adjust the National Income and Product Accounts. The data will be presented for the same six broad end-use groups currently shown in Exhibits 3 and 4.

The Census Bureau considers this data to be the result of experimental methodology, subject to revision as we gain experience in the series through 1990. A technical paper on the methodology used will be available when the January data are released.

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EXHIBIT 2. EXPORTS AND GENERAL IMPORTS AND MERCHANDISE TRADE BALANCE, SEASONALLY ADJUSTED AND NOT SEASONALLY ADJUSTED: JANUARY 1987 TO DECEMBER 1989

In millions of dollars. Details may not equal totals due to rounding and other statistical procedures. (R) - Revised.

Period	Trade Balance		Exports		General Imports	
	Seasonally Adjusted	Not Seasonally Adjusted	Seasonally Adjusted	Not Seasonally Adjusted	Seasonally Adjusted	Not Seasonally Adjusted
1987						
January-December....	-152,119.1	-152,119.1	254,121.9	254,121.9	406,241.0	406,241.0
January.....	-13,810.2	-13,452.6	18,378.6	17,345.9	32,188.9	30,798.5
February.....	-11,813.8	-10,956.4	19,372.5	18,853.9	31,106.3	29,810.3
March.....	-12,264.8	-10,628.8	19,982.0	21,835.5	32,246.8	32,464.3
April.....	-12,066.4	-11,613.4	20,250.3	20,677.7	32,316.7	32,291.1
May.....	-13,370.3	-12,410.5	20,113.6	20,759.5	33,483.9	33,170.0
June.....	-12,759.6	-13,721.3	21,381.5	21,636.7	34,141.1	35,358.0
July.....	-12,451.2	-14,430.9	22,475.4	21,379.0	34,926.6	35,809.9
August.....	-13,659.9	-13,747.1	20,846.5	20,079.1	34,506.4	33,826.2
September.....	-12,345.3	-12,483.8	21,669.4	21,183.7	34,014.7	33,667.5
October.....	-14,116.6	-15,297.8	22,136.8	22,777.8	36,253.4	38,075.6
November.....	-11,890.6	-11,932.2	23,328.1	23,278.7	35,218.7	35,210.9
December.....	-11,570.4	-11,444.3	24,187.2	24,314.4	35,757.6	35,758.7
1988						
January-December....	-118,525.9	-118,525.9	322,426.4	322,426.4	440,952.3	440,952.3
January.....	-10,496.0	-9,873.8	24,668.9	23,161.6	35,164.9	33,035.4
February.....	-11,486.3	-11,178.5	24,839.0	24,315.6	36,325.3	35,494.1
March.....	-9,575.7	-7,655.9	26,762.3	29,342.8	36,338.0	36,998.7
April.....	-9,316.1	-8,233.3	26,043.6	26,727.8	35,359.7	34,961.1
May.....	-8,690.3	-7,914.8	27,446.9	28,192.7	36,137.2	36,107.5
June.....	-10,597.8	-11,738.3	26,706.0	26,802.5	37,303.8	38,540.8
July.....	-8,460.6	-10,210.9	26,612.9	25,186.4	35,073.5	35,397.3
August.....	-10,144.8	-11,006.4	27,477.9	26,539.0	37,622.7	37,545.4
September.....	-9,172.3	-9,237.0	27,578.1	27,066.6	36,750.4	36,303.6
October.....	-9,232.1	-10,251.1	27,889.0	28,544.1	37,121.1	38,795.2
November.....	-10,549.3	-10,824.1	27,538.0	27,565.2	38,087.3	38,389.3
December.....	-10,804.6	-10,401.0	28,863.8	28,982.1	39,668.4	39,383.9
1989						
January-December....	-108,576.0	-108,576.0	364,349.8	364,349.8	472,925.8	472,925.8
January.....	-8,897.2	-8,737.5	28,980.1	27,294.6	37,877.3	36,032.1
February.....	-9,381.2	-8,723.6	28,839.1	27,963.5	38,220.3	36,687.1
March.....	-9,484.5	-7,016.0	30,064.5	33,130.8	39,549.0	40,146.8
April.....	-8,285.6	-6,817.9	30,759.1	31,367.2	39,044.7	38,185.1
May.....	-10,079.1	-9,624.6	30,455.2	31,271.1	40,534.3	40,895.7
June.....	-8,007.0	-8,957.2	31,285.8	31,536.9	39,292.8	40,494.1
July.....	-8,241.0	-10,729.7	30,468.0	28,726.7	38,709.0	39,456.4
August.....	-10,100.6	-10,904.4	30,561.5	29,609.5	40,662.1	40,513.9
September.....	-8,513.2	-8,596.8	30,680.3	30,009.0	39,193.5	38,605.8
October.....	-10,248.7	-11,498.2	31,034.4	31,906.1	41,283.1	43,404.3
November(1)(R).....	-10,291.7	-10,561.5	30,373.8	30,351.9	40,665.5	40,913.4
December.....	-7,169.2	-6,408.6	31,108.5	31,182.5	38,277.7	37,591.1
(1) November as published last month	-10,497.6	-10,769.7	30,191.8	30,169.8	40,689.4	40,939.5

EXHIBIT 7. EXPORTS, GENERAL IMPORTS AND MERCHANDISE TRADE BALANCE-- COUNTRIES, ECONOMIC AND GEOGRAPHIC AREAS, NOT SEASONALLY ADJUSTED: 1989 AND 1988

In millions of dollars. Details may not equal totals due to rounding and other statistical procedures.
(-) Represent zero. (R) - Revised. (X) Not applicable. (Z) - Less than one half unit of measurement shown.

ITEM	TRADE BALANCE			EXPORTS			IMPORTS		
	December 1989	November 1989	Cumulative to date	December 1989	November 1989	Cumulative to date	December 1989	November 1989	Cumulative to date
Total.....	-6,408.6	(R) -10,561.5	-108,576.0	31,182.5	(R) 30,351.9	364,349.8	37,591.1	(R) 40,913.4	472,925.8
Developed countries.....	-3,439.1	(R) -5,581.4	-55,425.6	19,585.7	(R) 19,499.7	234,730.0	23,024.8	25,081.1	290,155.6
Canada total.....	-972.8	(R) -1,123.0	-9,622.2	5,783.1	(R) 6,557.9	78,587.8	6,755.9	7,680.9	88,210.0
Compiled.....	(X)	(X)	(X)	5,170.5	5,023.7	62,679.9	(X)	(X)	(X)
Undocumented.....	(X)	(X)	(X)	612.6	(R) 1,534.2	15,907.9	(X)	(X)	(X)
Western Europe.....	555.5	-741.0	-1,290.3	8,732.3	8,351.5	100,434.8	8,176.8	9,092.5	101,725.1
EEC.....	580.4	-325.1	1,462.6	7,423.9	7,286.5	86,591.5	6,843.5	7,611.6	85,128.9
United Kingdom..	277.7	138.2	2,623.8	1,677.5	1,813.1	20,866.1	1,399.8	1,674.9	18,242.3
Fed.Rep.Germany.	-591.9	-696.6	-7,350.8	1,459.5	1,443.9	16,882.9	2,051.4	2,140.5	24,833.7
France.....	-26.9	-197.7	-1,443.6	1,035.0	963.8	11,585.0	1,061.9	1,161.5	13,028.6
Italy.....	-306.7	-505.2	-4,713.5	647.3	590.4	7,232.4	954.0	1,095.6	11,945.9
Japan.....	-3,485.1	-3,999.8	-49,002.0	4,072.6	3,751.8	44,583.9	7,557.7	7,751.6	93,585.9
Australia, New Zealand, Rep of South Africa.....	463.3	282.4	4,488.9	997.7	838.5	11,123.6	534.4	556.1	6,634.7
Developing Countries.....	-2,879.0	-4,624.7	-51,341.9	10,600.5	9,938.4	117,848.2	13,479.5	14,563.1	169,190.1
Mexico.....	-6.9	-353.3	-2,217.5	2,060.2	2,000.7	24,968.8	2,067.1	2,354.0	27,186.3
Brazil.....	-102.4	-174.5	-3,579.6	505.7	434.9	4,799.4	608.1	609.4	8,379.0
Newly Industrialized Countries (NICS)...	-1,429.4	-2,075.2	-24,298.3	3,505.9	3,269.4	38,457.6	4,935.3	5,344.6	62,755.9
Singapore.....	-143.9	-120.5	-1,597.1	706.1	699.6	7,352.7	850.0	820.1	8,949.8
Hong Kong.....	-233.6	-399.9	-3,434.6	514.2	483.7	6,304.0	747.8	[illegible]	9,738.6
Taiwan.....	-726.0	-1,025.2	-13,002.7	1,125.2	965.7	11,322.9	1,851.2	1,990.9	24,325.6
Rep. of Korea.....	-325.8	-529.6	-6,263.9	1,160.5	1,120.4	13,478.0	1,486.3	1,650.0	19,741.9
Egypt.....	166.9	199.3	2,383.1	177.3	227.0	2,609.6	10.4	27.7	226.5
OPEC.....	-1,161.7	-1,788.6	-17,366.5	1,475.1	1,036.2	13,234.5	2,636.8	2,824.8	30,601.0
Venezuela.....	-423.8	-458.5	-3,750.3	227.0	206.7	3,035.7	650.8	665.2	6,786.0
Indonesia.....	-216.4	-203.2	-2,286.2	107.6	129.2	1,256.3	324.0	332.4	3,542.5
Saudi Arabia.....	-343.8	-347.0	-3,695.4	344.7	327.3	3,576.0	688.5	674.3	7,181.4
Nigeria.....	-365.3	-414.6	-4,734.7	33.6	38.6	491.8	398.9	453.2	5,226.5
Other Developing....	-345.5	-432.4	-6,263.1	2,876.3	2,970.2	33,778.3	3,221.8	3,402.6	40,041.4
Eastern Europe and Selected Asia	-104.8	-494.2	-2,936.7	982.0	801.1	11,114.3	1,086.8	1,295.3	14,051.0
U.S.S.R.....	401.8	378.7	3,568.5	446.3	426.4	4,271.2	44.5	47.7	702.7
China.....	-498.3	-823.8	-6,181.1	443.4	306.6	5,807.4	941.7	1,130.4	11,988.5
Other Europe & Asia.	-8.3	-49.1	-324.1	92.3	68.1	1,035.7	100.6	117.2	1,359.8
Unidentified Countries (1).....	14.3	51.5	394.5	14.3	51.5	394.5	(X)	(X)	(X)
Timing adjustments..	(X)	87.3	733.7	(X)	61.2	262.8	(X)	-26.1	-470.9

Item	TRADE BALANCE			EXPORTS			IMPORTS		
	December 1988	November 1988	Cumulative to date	December 1988	November 1988	Cumulative to date	December 1988	November 1988	Cumulative to date
Total.....	-10,401.8	-10,824.1	-118,525.9	28,982.1	27,565.2	322,426.4	39,383.9	38,389.3	440,952.3
Developed countries.....	-6,808.4	-7,107.8	-70,769.6	18,095.0	17,627.8	206,805.4	24,903.4	24,735.6	277,575.0
Canada total.....	-959.0	-814.8	-9,775.9	5,517.8	6,307.2	71,622.0	6,476.8	7,122.0	81,397.9
Compiled.....	(X)	(X)	(X)	5,066.9	4,956.5	60,974.0	(X)	(X)	(X)
Undocumented.....	(X)	(X)	(X)	450.9	1,350.7	10,648.0	(X)	(X)	(X)
Western Europe.....	-1,251.2	-1,695.9	-12,585.1	8,239.5	7,204.4	87,857.7	9,490.7	8,900.3	100,442.8
EEC.....	-1,008.5	-1,210.3	-9,183.2	7,019.6	6,254.3	75,755.3	8,028.1	7,464.6	84,938.5
United Kingdom..	-101.7	-105.5	388.0	1,633.7	1,509.6	18,364.4	1,735.4	1,615.1	17,976.4
Fed.Rep.Germany.	-1,356.1	-1,155.4	-12,014.3	1,293.0	1,138.0	14,347.6	2,549.1	2,293.4	25,361.9
France.....	-202.4	-230.1	-2,538.8	899.9	793.1	9,9[illegible]	1,102.3	1,032.2	12,508.5
Italy.....	-380.8	-472.8	-4,800.6	644.8	555.9	6,7[illegible]	1,025.6	1,028.7	11,576.0
Japan.....	-5,162.1	-4,957.7	-51,793.5	3,315.6	3,233.7	37,725.2	8,477.7	8,191.4	89,518.7
Australia, New Zealand, Rep of South Africa.....	563.9	360.7	3,384.8	1,022.1	882.5	9,600.4	458.2	521.8	6,215.6
Developing Countries.....	-3,447.9	-3,547.5	-45,975.7	9,980.6	9,133.7	106,726.6	13,428.5	12,681.2	152,702.3
Mexico.....	-49.2	-102.2	-2,631.3	1,917.9	1,954.5	20,628.4	1,967.1	2,056.7	23,259.7
Brazil.....	-351.6	-400.6	-5,027.8	408.0	344.8	4,266.5	759.6	745.4	9,294.3
Newly Industrialized Countries (NICS)...	-2,575.2	-2,599.4	-28,214.2	3,164.3	2,642.6	34,815.9	5,739.5	5,242.0	63,030.1
Singapore.....	-216.9	-164.9	-2,205.7	556.6	519.1	5,767.6	773.5	684.0	7,973.3
Hong Kong.....	-388.7	-498.1	-4,550.4	526.9	433.5	5,687.4	915.6	931.6	10,237.8
Taiwan.....	-1,188.6	-1,115.4	-12,584.8	974.3	828.4	12,129.1	2,112.9	1,943.8	24,713.9
Rep. of Korea.....	-780.9	-821.1	-8,873.3	1,156.5	861.5	11,231.8	1,937.4	1,682.6	20,105.1
Egypt.....	214.9	190.5	2,112.1	239.5	203.7	2,332.5	24.6	13.2	220.4
OPEC.....	-658.3	-475.1	-8,967.9	1,326.0	1,240.8	13,994.3	1,984.3	1,715.9	22,962.2
Venezuela.....	42.3	32.9	-545.5	458.6	424.1	4,611.9	416.3	391.2	5,157.4
Indonesia.....	-113.6	-212.1	-2,091.5	128.6	84.4	1,058.9	242.2	296.5	3,150.4
Saudi Arabia.....	-270.6	-31.2	-1,844.1	319.9	332.5	3,776.1	590.5	363.7	5,620.2
Nigeria.....	-242.1	-150.7	-2,921.8	27.5	29.6	356.7	269.6	180.3	3,278.5
Other Developing....	-28.5	-160.7	-3,246.6	2,924.9	2,747.3	30,689.0	2,953.4	2,908.0	33,935.6
Eastern Europe and Selected Asia	-153.3	-209.2	-1,988.6	898.8	763.4	8,686.4	1,052.1	972.6	10,675.0
U.S.S.R.....	168.3	196.4	2,187.9	272.8	259.4	2,768.9	104.5	63.0	586.0
China.....	-284.3	-349.5	-3,489.5	533.9	449.3	5,021.4	818.2	798.8	8,510.9
Other Europe & Asia.	-37.3	-56.1	-682.0	92.1	54.7	896.1	129.4	110.8	1,578.1
Unidentified Countries(1).....	7.8	40.3	207.9	7.8	40.3	207.9	(X)	(X)	(X)
Timing adjustments..	(X)	(X)	(X)	(X)	(X)	(X)	(X)	(X)	(X)

(1) The export totals reflect shipments of certain grains and oilseeds and satellites launched in the United States by [illegible] organizations that are not in the country/area totals.

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INFORMATION

COVERAGE

The data in this release--

A. Include government and non-government shipments of merchandise,

B. Reflect the movement of goods into and out of (1) the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands and (2) U.S. Foreign Trade Zones,

C. Exclude (1) shipments between U.S., Puerto Rico, and U.S. possessions, (2) shipments to U.S. Armed Forces and diplomatic missions abroad for their own use, (3) U.S. goods returned to the U.S. by its Armed Forces and (4) in-transit shipments,

D. Reflect the total arrival of merchandise from foreign countries that immediately entered consumption channels or warehouses or Foreign Trade Zones.

MONTHLY RELEASE SCHEDULE

ISSUE		DATE	DAY
January	1990	3-20-90	Tuesday
February	1990	4-18-90	Wednesday
March	1990	5-17-90	Thursday
April	1990	6-15-90	Friday
May	1990	7-17-90	Tuesday
June	1990	8-17-90	Friday
July	1990	9-18-90	Tuesday
August	1990	10-18-90	Thursday
September	1990	11-16-90	Friday
October	1990	12-18-90	Tuesday
November	1990	1-18-91	Friday
December	1990	2-15-91	Friday

TIMING ADJUSTMENTS AND REVISION POLICY

A portion of the monthly statistics arrives too late for inclusion in the transaction month. Therefore, monthly data include actual month's transactions as well as a small number of transactions for previous months.

The Census Bureau revises the aggregate seasonally adjusted and unadjusted export, import and trade balance figures as well as the "end-use" totals for the prior month. SITC and country detail data are not revised.

The timing adjustment shown in Exhibits 5 and 7 is the difference between monthly data as originally reported and as recompiled.

VALUATION

Import data are Customs import value, except where C.I.F. value is indicated. Export data are f.a.s. value. They are explained below:

1. Customs Import Value - U. S. Customs Service appraised value of merchandise; generally, the price paid for merchandise for export to the U. S. Import duties, freight, insurance, and other charges incurred in bringing merchandise to the U. S. are excluded.

2. C.I.f. Import Value - Customs value (defined above) plus freight, insurance and other charges (excluding U. S. import duties) incurred in bringing merchandise from the exporting country to the first port of arrival in the United States.

3. F.a.s. Export Value - f.a.s. (free alongside ship) value of merchandise at the U. S. port of export, based on transaction price including inland freight, insurance and other charges incurred in placing the merchandise alongside the carrier at the U. S. port of exportation.

COMMODITY INFORMATION

Adjusted for Seasonal and Working-Day Variations

Commodities exported and imported are initially classified under the Harmonized System (HS). This system describes and measures the characteristics of commodities traded. Combining trade into six "end-use" categories (Exhibits 3 and 4) makes it possible to examine commodities according to their principal uses. These categories are used as the basis for computing the seasonal and/or working-day adjusted data. The seasonally adjusted export and import totals are derived by adding the six "end-use" categories. Not seasonally adjusted "end-use" categories are shown for comparison.

The seasonally adjusted three-month moving averages shown in exhibit 8 are computed by summing the subject month, the two prior months, dividing by 3, and plotting at the subject month. The averages are an analytical tool to aid in trend analyses and should be used as such. The selection of a three-month time frame to compute the moving averages is arbitrary; any combination of months can be used.

Not Adjusted for Seasonal and Working-Day Variations

Commodity data appearing in Exhibit 5 are classified in terms of the Standard International Trade Classification (SITC) Revision 3 and compared to 1988 data in terms of SITC Revision 2. Data for both years are arranged by principal commodity groupings.

Agricultural commodities consist of non-marine food products and other products of agriculture which have not passed through complex processes of manufacture, such as raw hides and skins, fats and oils, and wine.

Manufactured goods conform to the SITC, Revision 3 Classification sections that include chemicals and related products, N.S.P.F.; manufactured goods classified chiefly by material; machinery and transport equipment; miscellaneous manufactured articles, N.S.P.F.; and commodities and transactions not classified elsewhere.

Reexports are foreign merchandise entering the country as imports and which at the time of exportation are in substantially the same condition as when imported. Reexports, included in overall export totals, appear as separate line items in Exhibit 5.

Advanced Technology Products (ATP)

About 500 of the approximately 22,000 commodity classification codes used in reporting U.S. merchandise trade have been identified as "advanced technology" codes and meet the following criteria:

1. The classification code contains commodities whose technology is from a recognized high technology field (e.g., biotechnology).
2. These products represent leading edge technology in that field.
3. Such commodities constitute a significant part of all items covered in the selected commodity classification code.

The aggregation of the commodities results in a measure of advanced technology trade which appears as a separate line item in Exhibit 5.
This measure differs from broader SIC industry-based measures which include all commodities produced by a particular industry group, regardless of the level of technology embodied in the commodities.

ADDITIONAL INFORMATION SOURCES

Additional data and information regarding coverage, valuation, estimating procedures, and qualifications are obtainable from:

FOREIGN TRADE DIVISION
BUREAU OF THE CENSUS
WASHINGTON, D. C. 20233

An electronic version of FT900 is available through CENDATA, the Census Bureau's on-line information facility. Contact Customer Services, DUSD, Bureau of the Census, Washington, D.C. 20233 or call 301-763-4100.

CRS REPORT FOR CONGRESS--Raymond J. Ahearn, Richard Cronin, Larry Storrs

SUPER 301 ACTION AGAINST JAPAN, BRAZIL AND INDIA: RATIONALE, REACTIONS, AND FUTURE IMPLICATIONS

SUMMARY

The Super 301 provision of the Trade and Competitiveness Act of 1988 requires the Executive Branch to identify "priority" foreign trade barriers and to seek their removal under timetables and the threat of retaliation. This provision has become the subject of a growing domestic and international debate. Many supporters view the Super 301 provision as a forceful and active approach to promoting and defending U.S. commercial interests. Many opponents argue that the Super 301 provision is undermining the postwar multilateral system of trade rules the United States helped to construct and is currently trying to strengthen.

Under the terms of Super 301, the Bush Administration in May 1989 identified three "priority countries" -- Japan, Brazil, and India -- and six "priority practices" in those countries as major barriers to U.S. exports. The administration's choice of countries and practices was influenced by both domestic and foreign policy considerations. Domestic pressures weighed heavily in the decision to identify Japan as a "priority country." A foreign policy concern that Japan not stand alone contributed to the Administration's decision to include two other countries. Generalized displeasure within the Administration concerning the allegedly uncooperative positions of Brazil and India in the ongoing Uruguay Round of multilateral negotiations played a role in their selection.

The specific "priority practices" cited appeared to be ones the Administration thought were amenable to negotiated solutions or were emblematic of broader issues being negotiated in the Uruguay Round. In identifying practices, the Administration tended to downplay some of the Super 301 statutory criteria that called for the selection of practices that have the greatest potential to increase U.S. exports. In part, it seems, to lessen potential domestic criticism of the kinds of practices that were identified, the Administration initiated a separate negotiation with Japan on structural impediments to trade.

The extent to which Japan, Brazil, and India agree to enter into negotiations with the United States and the costs associated with reaching agreement or failing to reach agreement may be key influences on any evaluation of the effectiveness of Super 301 as a market opening process. Current prospects appear moderately good that some progress will be made in reducing five of the six "priority practices." The prospects for success in the structural impediments dialogue with Japan in the near term appear remote.

Partial settlement of the six complaints could support congressional views that Super 301 is an effective market opening process. Yet, even if the Super 301 actions yield some market openings, some Members of Congress may compare the benefits to the diplomatic costs associated with unilateral action. Regardless of the fate of Super 301, pressures in the United States to act unilaterally in certain trade circumstances are likely to remain strong.

January 8, 1990

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STATEMENT OF
CLAYTON YEUTTER
SECRETARY OF AGRICULTURE
BEFORE THE
SENATE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY
FEBRUARY 7, 1990

Mr. Chairman and Members of the Committee, I welcome the invitation to appear today to discuss the 1990 Farm Bill. The making of farm policy in 1990 will be truly historic. The road that we take over the coming months will be vital to U.S. farmers, the American public, and, in fact, the world.

As you know, we have been working very hard at the USDA and within the Administration for many months to develop proposals that we believe will best serve our nation's food and fiber industries and all Americans. Yesterday we unveiled our ideas. This morning, I would like to bring into focus the more than 50 initiatives we are proposing as modifications to the 1985 farm bill.

From the start, one goal has been to develop a set of proposals which recognize that U.S. agriculture operates in a world marketplace. Our policy must be one that commits U.S. agriculture to compete, because without greater access to foreign markets U.S. agriculture will stagnate. We have sought also to be sensitive to environmental concerns.

We believe that the 1990 farm bill should be based on the Food Security Act of 1985. We propose continuing the market oriented transition of that legislation. That calls for provisions which ensure that farmers respond to market signals, not government programs. Our proposals on price support

programs, stocks policies, planting flexibility, and credit are all designed to strengthen the link between market conditions and farmers' decisions.

Providing farmers more planting flexibility must be a key element of the 1990 farm bill. We will submit to you a comprehensive flexibility proposal which should enhance farm income while simultaneously fostering environmentally sound production practices.

Perhaps no set of agricultural issues will receive more scrutiny during the 1990s than the relationship between agricultural production and conservation and environmental concerns. We are, therefore, proposing a broad-based environmental initiative that includes research; education; land management and acreage retirement programs directed at water quality, wetlands, wildlife, trees, and erosion; a multi-year set-aside; and the more flexible production alternatives I have already mentioned. We have crafted these proposals to target specific areas and problems so that environmental benefits are maximized without undermining the competitiveness and productive capacity of U.S. agriculture.

USDA has been known as the "People's Department" for 127 years, and as we begin the last decade of this century, we find that spending on food and nutrition programs accounts for half of our budget. We propose full funding for USDA's domestic food assistance programs for the needy. In addition, we will strengthen and improve food program administration. We also

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propose a number of changes in our marketing and inspection service programs to improve their effectiveness in assuring the safety of the nation's food supply.

Virtually all indicators of farm sector well-being have improved since 1985. Farm income is up, farm failures are down, farmland values are recovering, and debt-to-asset ratios have improved. Commodity surpluses have all but disappeared, some idle land has returned to production, and farm program spending is down.

We have a unique challenge in 1990. U.S. farm policy will be written while our government concurrently engages in the most significant multilateral trade discussions ever. However, it would be incorrect to state that farm legislation will be unaffected by the GATT negotiations or that the GATT will not be affected by actions taken in Washington. Clearly there is a relationship between these two imortant initiatives. As the world's major agricultural exporter, changes in agricultural trading rules will obviously affect the United States--and we intend to do everything in our power to make sure these changes are for the better. They can only get better.

The dominant issue in both the multilateral trade negotiations and the 1990 farm bill is the same--a stronger agricultural economy for America. Our farm bill proposals, which combine increased production responsiveness, aggressive export assistance targeted at unfair competition, market-oriented loan and storage programs, and greater research funding should signal

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to our competitors the resolve we have to compete in world markets.

Last week President Bush presented his FY 1991 budget to the Congress. There is a small increase in the overall USDA budget, and new initiatives for research, water quality, and food safety. Nevertheless, there are real limits on the amount of available Federal resources. As you know, the Gramm-Rudman-Hollings law calls for a reduction in the federal deficit to zero in FY 1993.

For FY 1991, which will largely be unaffected by the new farm bill, the budget specifies a baseline spending cut of $1.5 billion in farm price and income supports. However, even with this reduction, outlays for price and income supports are expected to be $2 billion more than in FY 90. Our goals for fiscal policy mean that greater savings must be achieved in the farm programs throughout the nineties.

We have not proposed specific changes for achieving budget savings but Chapter V of the President's budget summarizes some of the approaches we have in mind. Target prices and/or payment bases could be reduced; or payment limits could be tightened. All of these can affect deficiency payments. We prefer to work with the Congress in determining the most propitious way to the achieve the necessary budget objectives within a sound policy framework.

Mr. Chairman, I would now like to discuss some of the proposals in more detail.

Price and Income Supports

Our top priority in the price/income support area is to reduce the rigidity of present programs. We have learned how costly it can be to design programs based upon assumptions and expectations which do not materialize. We believe our new proposal is adaptable enough to deal with any eventuality, whether surplus or shortage.

Our production flexibility proposal uses the concept of normal crop acreage (NCA). We propose to make deficiency payments on historic cropping patterns, regardless of which NCA crop is grown in the future. This means that producers will make planting decisions among NCA crops based on market prices, not target prices. Production will then be more responsive to market conditions, i.e., we'll have greater production of crops in scarce supply and lower production of crops in surplus. This should also foster a greater use of crop rotations with their attendant environmental benefits. The cost to the nation's economy of vast idled acreage would be reduced, because we would permit planting on idle acres under certain specified conditions.

All of us have puzzled over how to deal with stockholding policies. We believe that our proposals will provide significant improvements in this difficult area. The basic thrust of our approach is that decisions by farmers on when to store and when to sell should be determined more by market forces and less by government decree. We propose to accomplish this by shortening the farmer-owned reserve (FOR) contract period to 9-12 months;

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eliminating price or quantity triggers for entry or release; eliminating the required FOR minimum quantity levels; and establishing a standardized minimum CCC resale price for commodities acquired through price support activities. The effect of these changes will be to accommodate the storage of a considerable quantity of grain from one year to the next, but defer to the farmer decisions on when to store and when to sell. In addition, these changes will eliminate a complex array of adjustment formulas, rules, and regulations.

We are proposing that the formula for adjusting loan rates for feed grains and wheat be used also for cotton and rice. There is no sound reason to continue the inequities represented by the rice and cotton loan rate minimums. These changes will allow cotton and rice loan rates and market prices to be more reflective of actual market conditions.

We propose no changes in the soybean price support program. But soybean growers should benefit from our flexibility proposal under which soybeans will for the first time compete with other crops for acreage on the basis of relative market returns.

Milk price support adjustments in the dairy program have played a positive role in reducing the surpluses and high program costs that saddled the dairy industry just a couple of years ago. We offer modest revisions that will allow us more flexibility to respond to changes in supply and demand conditions, as indicated by the expected volume of dairy products acquired by the Government.

We propose changing the peanut program so that the support level is no longer a function of the cost of production. Peanut supports should be more consistent with other programs and more closely aligned with market prices. We also propose bringing the wool and mohair and honey programs into conformity with our program crops by shifting income support to the target price concept.

International Programs

Our proposals for export programs build on the progress that has occurred since the passage of the 1985 Act. We are proposing to extend the programs which have been instrumental in that task, and we are recommending legislative changes to strengthen other programs. After completion of the Uruguay Round all programs will be reassessed.

We propose reauthorization of the Export Enhancement Program (EEP) without mandated program levels or programming requirements. The EEP has proven an important part of our trade policy strategy to achieve a successful Uruguay Round. We want our competitors, especially the European Community, to know that we stand ready to use this program to the maximum extent. We want them to phase out their export subsidy practices which have severely distorted world markets for many years. Those subsidies have cost American farmers billions of dollars in exports and in income.

We also propose to extend the Targeted Export Assistance program and the Food Security Wheat Reserve. The 1985 Act

established a minimum annual program level of $5 billion for GSM-102 short-term credit guarantees and a maximum program level of $1 billion annually for GSM-103 intermediate-term credit guarantees for FY 1989 and 1990. We propose that these program levels be continued.

We are committed to helping to feed needy people in low-income developing countries. Many of our foreign food aid programs, including P.L. 480 and the Food for Progress Program, must be reauthorized this year. The Department is working with the Interagency Food Aid Subcommittee to develop legislative recommendations for these programs. We are particularly interested in revisions which will improve program operations and administration. Those will be forthcoming soon.

Conservation and Environment

Our conservation proposals extend and enhance the authorities in the 1985 Act, and the activities we have undertaken with other Federal agencies. We will focus on measures that maintain the long-term productivity of our agricultural resources, and measures that will stimulate the adoption of environmentally sound production systems. This can be done in most instances without imposing new regulations that could impair the profitability of our farmers. American farmers share with the rest of the Nation a longstanding concern for the quality of our environment and the conservation of our land and water resources. Through research and technical assistance, greater production flexibility, and targeting of key

problem areas, American farmers will become even better stewards of nature.

The authorization period for the Conservation Reserve Program (CRP) should be extended through 1995 and the focus of this program should be directed particularly at problems related to water quality and wetlands. An authorization level of 40 million acres is, in our judgment, adequate to address these problems.

Most water quality issues can be resolved through voluntary adoption of known production practices that reduce environmental risks. Research, technical and financial assistance programs now underway in USDA and in many states will encourage adoption of those practices. We are proposing an expanded effort in these areas. In particular, more effort will be required to address cropping activities in the vicinity of public water supplies, cropland in areas where dangerous runoff is conveyed directly into groundwater, areas that provide protection of wildlife habitat, and areas identified for conversion from intensive cropping under state water quality planning.

To respond to the loss of wetlands, we propose including wetland restoration as part of the CRP. Up to 2.5 million acres of cropped wetlands could be restored and protected under this program through the use of easements.

We have also recommended several changes in annual commodity programs that should reduce the use of agricultural chemicals. Our flexibility proposal will enable producers to plant a mix of

program crops on permitted acres without losing base history or deficiency payments. We also propose to protect base history when conservation crops such as forage legumes and grasses are planted but not harvested. Intensive cropping patterns should thereby be reduced, with a substantial gain in environmental benefits.

We also wish to foster improved maintenance of land idled under annual crop programs. Accordingly, we propose strengthened rules for planted cover crops, and we propose to cost share for the establishment of perennial vegetative cover on a portion of land idled under acreage reduction programs. This will reduce erosion and weed problems and improve water quality and wildlife habitat.

Increased tree planting is another objective of our CRP proposals. We propose that shelterbelts and windbreaks be established under less restrictive CRP rules. This will complement the Presidential initiative, "America the Beautiful," which will result in planting and maintaining 1 billion trees per year in urban and rural areas. This program will enhance stewardship of our Nation's natural resources, improve wildlife and fish habitats, and have atmospheric benefits such as offsetting increased emissions of carbon dioxide.

Farm Credit

The time has come to reform our farm credit programs by emphasizing that they should be consistent with a commercial, market-oriented industry. In other words, they should fill a

carefully defined credit niche; they should not be disguised welfare programs. Our Farmers Home Administration should provide targeted assistance to beginning farmers with demonstrated management capabilities. Greater emphasis should be placed on improved loan application and reporting procedures, and on financial disciplines that are required of commercial borrowers.

Farmers Home Administration (FmHA) credit programs will continue the shift toward the use of loan guarantees initiated in the 1985 Act. Under our proposal existing FmHA borrowers and beginning farmers who receive direct operating loans would face tighter loan eligibility and application requirements, limits on the period of eligibility for FmHA loans, requirements for demonstrated farming abilities, and a needs test for limited resource loans. Many of these changes would also apply to guaranteed operating loans in order to facilitate the eventful transition of FmHA borrowers to commercial sources of credit. The proposals would also strengthen FmHA's authority to subsidize guaranteed loans so as to make these loans more affordable and to encourage direct borrowers to shift to this source of funding.

The farm ownership loan program will be targeted to disadvantaged applicants, beginning farmers, and expanding family farms. More stringent requirements for loan eligibility and application procedures, borrowers' equity, and farming experience are added.

Finally, we are proposing that FmHA guaranteed loans be made eligible for the Farmer Mac secondary market that is being

established. This should facilitate an efficient FmHA guaranteed lending program offering the lowest possible interest rate to the farmer.

Disaster Protection

Multi-peril Federal crop insurance has not achieved the objectives intended when it was expanded in 1980. Consequently, in the President's FY 1991 budget we have proposed eliminating the program. Participation has remained under 45 percent of eligible acres and, until this past year, was under 25 percent, even though premiums and delivery costs are heavily subsidized. In addition, the program has not provided a viable replacement for ad hoc disaster legislation, which has cost an average of $600 million annually since 1981.

In an ideal world, Federal disaster protection for farmers would be of reasonable cost; provide producers with catastrophic protection in the event of a widespread disaster; not crowd out insurance services provided by the private sector; and provide farmers with a risk management tool that is equitable and does not reward inefficiency. These objectives have proven difficult, if not impossible, to achieve.

We, therefore, propose a standing disaster protection program to replace multi-peril crop insurance. This would provide the catastrophic protection farmers need and, hopefully, avoid costly and inequitable ad hoc legislation. Disaster payments would be available to producers in counties where crop yields fall below 65 percent of normal. Once a county is

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declared eligible, individual farmers would receive assistance on the difference between the producer's harvested yield and 60 percent of the normal harvested yield for the county. The payment rate on eligible losses would be 65 percent of a 3-year average market price. Producers of 200 crops currently covered by Federal Crop Insurance, plus hay and forage, would be eligible. These crops account for over 93 percent of total U.S. cropland.

Private insurers may develop companion policies that provide protection not covered by this disaster assistance program. By providing protection on catastrophic losses, private insurers are better able to cover types of agricultural risks that are effectively insurable. Further, hail and fire insurance would continue to be available. Moreover, the disaster assistance program would provide protection to those producers who have not participated in the crop insurance program in the past because they felt it failed to address their risk management needs.

We must recognize that risk is a fundamental characteristic of agriculture. Farmers who protect themselves against risk will benefit therefrom when conditions are adverse. If the government attempts to compensate producers every time a loss is incurred, farmers' incentives to self-protect against loss from price and yield risks are reduced and the adverse effects of normal price and yield variation are magnified.

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Marketing and Inspection Services

In the area of marketing and inspection of agricultural products, we have several priorities. The number one goal is to ensure a safe and wholesome food supply. Just last fall, we established new procedures within USDA to respond promptly to food safety problems and our FY 1991 budget includes a special food safety initiative. We have also established a close working relationship with the Environmental Protection Agency and the Food and Drug Administration in order to resolve issues such as pesticide tolerance. In addition, a comprehensive food safety proposal has already been announced by the President.

We recommend amending the Agricultural Marketing Agreement Act of 1937 to authorize civil fines and penalties against handlers for non-payment of assessments. Nearly 50 percent of marketing order violation cases involve failure to pay assessments.

Many of the activities carried out by the Animal and Plant Health Inspection Service (APHIS) represent services rendered to a particular individual or group importing plants or animals from foreign countries. In these cases, we need user fee legislation so that the user or person requiring the APHIS service bears the financial burden.

We also propose legislation to require that all our corn exports be officially tested for aflatoxin. This will help correct our tattered quality image in world markets.

Food and Consumer Services

We support reauthorization of our food assistance programs, which have become so important to the nutritional well-being of low-income Americans. Benefits of the Food Stamp Program will be fully funded and support for the Temporary Emergency Food Assistance Program (TEFAP) will be continued. This represents a substantial commitment of the Department's limited financial resources.

TEFAP should be reauthorized so that both surplus and purchased commodities may be donated. This program fills an important need for many low-income Americans who have difficulty using, or choose not to use, other food assistance programs. Funding of $120 million for purchased commodities and $50 million for administrative funding would be provided.

The Food Stamp Program is the cornerstone of our national effort to provide nutritional assistance to low-income Americans. Proposed Food Stamp legislation would strengthen program accountability because the needy are best served by strong programs administered with integrity. We support proposals that will increase family income, thereby decreasing the need for food assistance. We believe that Food Stamp beneficiaries should take the maximum advantage of child support services.

We support a major effort to improve food program administration by increasing coordination among programs that serve low-income Americans. We are working through the White

House Low-Income Opportunity Board and with other Federal agencies to achieve this.

Our proposals for food stamps also set aside special demonstration grants to reach out to homeless people. Most are eligible, yet few participate. We believe that innovative activities will increase their participation, improve their nutritional status, and help give them a better quality of life.

Science and Education

In the area of science and education, our proposals identify priority research and extension programs and provide additional funding authority to conduct a National Initiative for Research on Agriculture, Food and Environment.

A provision of the National Initiative would strengthen the ability of institutions with less well developed research capabilities to conduct advanced research and train the talent which will be required in the future in our agricultural sciences.

Scientists recognize the potential to solve agricultural problems ranging from animal diseases to environmental issues through the application of advanced biotechnology. In this regard, our provisions recognize the importance of genome mapping programs for crop plants and livestock species on a national scale and provide for USDA leadership in this area. Our proposal also recognizes that the development of non-food, non-feed uses of agricultural commodities is seen as a way to open new markets for U.S. agriculture and thereby strengthen demand.

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With respect to environmental and health issues, our proposals recognize an important role for the USDA in research and extension education on food safety, rural water quality, global change and for environment and natural resources education. Sustainable agriculture practices are recognized as a means to address environmental concerns, and we propose to more effectively integrate such research into the land-grant system.

In view of political changes taking place around the world, and of the need to compete in world markets, we are also proposing to expand our international research and education programs and our international development activities through scientific cooperation and exchange programs.

Conclusion

Mr. Chairman, the 1990 farm bill proposals I have outlined today build on the market orientated international competitiveness initiatives of the Food Security Act of 1985.

While enhanced competitiveness is the major focus of our proposals, they were developed within the context of concern for the environment, food safety, nutritional needs of the poor, and first and foremost, the economic well-being of American farmers--family farmers.

We are committed to helping farmers identify and respond to new practices that allow them to reduce costs, increase profitability, support a safe environment, and produce a reliable supply of safe and affordable food. We do not perceive these

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objectives to be incompatible if we deal with them in a sensible, objective, systematic manner.

In closing, Mr. Chairman, we stand ready to work with the Committee and the Congress to develop new legislation that will help U.S. agriculture and the American people meet the challenges and opportunities of the 1990s.

David Malone

Pacific Rim Economic Cooperation: Some ASEAN Perspectives

Advocacy of new mechanisms to enhance regional economic cooperation among Pacific Rim countries has turned into a growth industry within policy circles on both sides of the Pacific. A recent proposal for a new regional economic forum was offered in January 1989 by Australian Prime Minister Bob Hawke, and a ministerial-level meeting is now expected to take place in Canberra in November to discuss the issue further. This meeting warrants close attention for the insights it will provide into the nature of future economic and trade policy cooperation among the Pacific Rim nations.

Critical to the shape of any Pacific economic cooperation are the countries of the Association of Southeast Asian Nations (ASEAN). Of the world's 10 fastest growing economies, four — Singapore, Thailand, Malaysia and the Philippines — belong to ASEAN. (The other ASEAN members are Brunei and Indonesia.) During the last four years, ASEAN countries have increased their share of world trade from 2 percent to 4 percent, a figure projected to double again over the next four years. These countries form a link between North Asia and the South Pacific economies of Australia and New Zealand. Furthermore, as neighbors of Indochina and the People's Republic of China, and as the crossroads of Asia, they are important geopolitically.

For these reasons, meaningful cooperation in the Pacific Rim will not occur without ASEAN participation. Yet recent discussions with knowledgeable parties in several ASEAN countries indicate that their governments are ambivalent about the concept. Thus the success of any cooperative effort will depend a great deal on how well its advocates deal with ASEAN's concerns.

The Proposals

Hawke's proposal is catalyzing the debate in the region. The prime minister called for enhanced regional cooperation within a new forum to, first, help press forward the Uruguay Round of negotiations on GATT (General Agreement on Tariffs and Trade); second, discuss obstacles to trade within the region; and third, foster economic policy cooperation in the area. The prime minister suggested that the Organization for Economic Cooperation and Development (OECD) could provide a model of sorts for the forum.

Hawke's is one of many proposals for greater Pacific cooperation, several of which have come from Americans. In 1988 Secretary of State George Shultz suggested trans-Pacific cooperation on security as well as economic issues. Since then Senators Bill Bradley and Alan Cranston, among others, have issued their own initiatives.

James Baker, George Bush's secretary of state, announced on June 26, 1989, his intention to explore with ASEAN leaders the creation of a new mechanism for multilateral economic and trade cooperation in the Pacific region. Although some news reports suggested that Baker's proposal might compete with Hawke's, nothing in the secretary's speech suggests any real incompatability between the two men. Indeed, specifics were left for later. As a result, attention has continued to focus on the Hawke proposal.

Range of Concerns

Concerns in the ASEAN countries about greater economic cooperation in general and the Hawke proposal in particular cover a broad spectrum from the general to the specific, from who will play to what the game will be. One frequently raised question is what precisely is meant by the term economic cooperation. International economic policy coordination does not have a good name in ASEAN, not only because it has had mixed success among the Group of 7 industrialized democracies, but also because it is seen as a cover for U.S. pressures on dynamic Asian economies to liberalize their trade practices and exchange rate policies.

In some quarters, it is thought that the United States might seek to incorporate defense and security considerations into what Hawke is promoting as an economic institution. Others are not enthused by the potential of using OECD as a model, viewing it as a locus for the kinds of effete discussions of

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social policy that have led to a decline of Western dynamism relative to that of East Asia.

Among some circles, the need for a new cooperative organization is questioned. One view holds that the economic development of the area is proceeding swimmingly and that there is no reason to argue with success. That view might change if Japan comes up with a "Santa Claus" package as an incentive to set up the new forum.

Fast-breaking geopolitical changes in the area, particularly in Indochina, suggest to others that now is not a good time for new institutions. A strong ASEAN is seen to inhibit both China and the Soviet Union.

Potential Players

The forum's proposed composition also poses problems to some. A forum that is dominated by Japan and/or the United States is a frightening prospect; some in the ASEAN area are worried about renewed designs in Tokyo, particularly in the Ministry of International Trade and Industry (MITI), for "co-prosperity" in Asia.

Even before the events of Tiananmen Square, the proposed membership of China, Taiwan, and Hong Kong was being questioned as being more than a new institution could handle. None of the three may be invited to the November meeting. Another uncertainty is how to deal with the Soviet Union and Latin American nations if these Pacific Rim actors express interest in joining. Such issues raise questions about how coherent a group might eventually emerge.

Institutional Issues

Beyond concerns about membership, there is a real fear that a forum for regional economic cooperation would undermine ASEAN. Through annual ministerial-level consultations with the United States, Japan, the European Community (EC), and Canada, the association now gives its members a profile in the world that far outstrips what bilateral ties with the major economic powers would warrant. ASEAN has become a geopolitical unit to be reckoned with, and to some extent it counterbalances the weight of China and Japan, a significant achievement for nations living in the shadow of those giants.

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There is also palpable concern about the role the forum might play. Some ambiguity in discussions on the Hawke initiative has left the impression that the eventual goal is the establishment of a trading bloc along the lines of the EC's integrated market or the Free Trade Agreement binding Canada and the United States — notwithstanding Hawke's clear statement that this should not be the case. While the prospect of a trading bloc is greeted with enthusiasm in some ASEAN circles, uncertainty over what actually is intended for the forum has led to fears elsewhere that it could undermine the Uruguay Round.

Those in favor of a trade bloc contend that a forum dedicated only to consultations on trade and economic questions will simply waste time, money, and effort. (The waste of time and effort might be counterbalanced if the organization is able to blunt U.S. protectionism, but that is thought to be unlikely.)

If the forum is to be merely consultative, many ASEAN researchers believe it should be nongovernmental or at least not exclusively governmental. The existing Pacific Economic Cooperation Council is often mentioned as a useful and increasingly professional institution bringing together governments, academics, and private sector representatives on regional issues. Early thoughts of marrying Hawke's ideas with the council's existing capabilities seem to have faded over the months, however.

There are other institutional concerns. A new forum would require a secretariat. Secretariats cost money. The smaller bureaucracies in the area, moreover, might have trouble coping with the demands of yet another international organization — a concern noted even in New Zealand.

Domestic Worries

Last but not least are concerns about the forum's potential effect on domestic policies. Could the United States, for example, use the forum to target ASEAN members for unfair trade practices under the so-called Super 301 provisions? While the likelihood of that happening may seem remote in Washington, concerns on this score run high in Thailand. Alternatively, or simultaneously, the United States could use the forum to exert pressure on exchange rate questions. If that were to happen, would pressure for further disciplines on export financing be far behind?

Multilateral economic organizations bring to mind mainly the International Monetary Fund and the World Bank, which in turn evoke thoughts of structural and policy adjustment. While some ASEAN economies, such as Singapore, are highly flexible, others, like the Philippines, are not. What would a multilateral regional forum be pressing ASEAN countries to do? Will the forum create an opportunity for an independent secretariat and other members to scrutinize and criticize domestic economic policies?

A Pacific OECD?

Not surprisingly, the concern that a forum along the lines of the OECD might provoke unwelcome scrutiny of domestic economic, trade, and social

policies was mentioned only by researchers and other nongovernment interlocutors who have little sympathy with the wish of governments to protect themselves. The weight of this concern relative to the others should not be exaggerated. It is striking, nonetheless, simply because it is often not expressed at all.

ASEAN concerns about setting up an OECD-style forum are easy to overlook because the Hawke initiative has generated more discussion among the industrialized governments involved about who should play than about what the game should be. While ASEAN countries have views on who should participate in any cooperative effort — and these vary — they feel that there should be more to the examination of the initiative than its proposed membership. Having received few answers to their substantive questions along these lines by the time of the July ASEAN meeting, it is hardly surprising that they refused to sign on to the team. To them, the Hawke proposal is not just another "process" initiative.

It is no coincidence that the ASEAN Secretariat is weak. ASEAN researchers confirm that member governments want it that way. All internal efforts aimed at strengthening the economic capabilities of the secretariat have been emasculated by its members. The availability of data, or lack thereof, in the ASEAN countries is a related issue. Research institutions within these countries have great difficulty in obtaining the type of data they would need to formulate authoritative policy prescriptions.

Governments in Asia are acutely aware of the type of analysis the OECD Secretariat produces in large quantities not only on the world economy in general but also on member countries. They know that these findings are publicized. That is one of the reasons references to a Pacific OECD are not particularly welcome to many in Asia. Governments know that their ability to inhibit criticism from domestic research facilities could probably not be duplicated in a multilateral research and policy organization that included Western countries used to criticism of their own policies.

The OECD evolved from a unique set of circumstances dating back to World War II, the Marshall Plan, and the Organization for European Economic Cooperation. If the OECD did not exist today, its members might not be moved to invent it. Members have grown accustomed to the OECD's brand of polite criticism and prescription (on an often bewildering range of issues) over the years. Liberal democracies, frequently under pressure to adopt more "accommodating" policies, can and do make use of OECD findings and advice when adopting necessary but unpopular measures. Governments have also learned to ignore the OECD when it suits them to do so.

To governments in the developing world, however, even those of ASEAN, the OECD experience must look quite risky and potentially painful. Policy advice on issues considered highly sensitive by ASEAN governments is clearly unwelcome unless very gingerly (and privately) tendered — as is mostly the case for recommendations made by the IMF, World Bank, and Asian Development Bank.

Indeed, the lack of enthusiasm shown by several ASEAN countries toward efforts by the OECD to draw them into a structured dialogue on issues of mutual relevance suggests that the OECD will have to work harder to convince these governments that its brand of research and policy work is of potential value to them — rather than of potential danger.

"ASEAN attitudes indicate that these countries might be more comfortable with a consultative (and hence less effective) forum than with a strong international institution backed by an authoritative secretariat."

More broadly, ASEAN attitudes indicate that these countries might be more comfortable with a consultative (and hence less effective) forum than with a strong international institution backed by an authoritative secretariat. This is why the Pacific Economic Cooperation Council is often mentioned as a model in the ASEAN area.

Other Sensibilities

Whatever one may think of ASEAN reservations about a strong regional agency to promote multilateral economic and trade cooperation, it will be important to remain sensitive to them. There are other sensibilities as well. EC protests over the Hawke proposal during the ASEAN meeting last July were understandable, given some continuing ambiguity over the forum as a possible new trade bloc. While not a major obstacle, the protests serve to remind that the creation of a new forum must be carefully managed.

An important unknown factor is the position of the Japanese government: MITI is said to favor the initiative, while others in Tokyo worry that it might complicate relations with Japan's Asian neighbors. However, given the caution traditionally displayed by Japan on multilateral institutional issues, it seems unlikely that Tokyo will play a lead role, at least initially, in developing a new forum or in strongly influencing the debate at the November meeting. (Former Prime Minister Nakasone's 1988 call for a Pacific forum to enhance economic and cultural cooperation in the area has not been followed up).

In sum, viewed from the ASEAN perspective, the Hawke initiative is not yet a done deal, and the prospect of genuine Pacific Rim economic cooperation raises uncomfortable questions. However, if ASEAN concerns are addressed satisfactorily at the November meeting, the ASEAN governments might yet agree to a forum down the line. The Canberra meeting will be worth watching closely.

EDITORIAL/OPINION

Shipping Costs Hurt Poor Lands

By ALEXANDER J. YEATS

Developing countries are making concerted efforts to reduce the tariffs developed countries levy on their exports. But their preoccupation with import duties may have diverted attention from the transport and insurance costs that also constrain trade.

For many developing countries, particularly those distant from markets in industrialized countries, the average tariff now is far less than the average transport rate.

India and Indonesia, for example, face average tariffs of about 5% in developed country markets, whereas their average freight costs are 15% to 17% of the value of their exports.

On some products freight costs are considerably higher: Indian textiles face an average freight rate of 25% of the value of the shipments. Major Caribbean exports to the United States, such as sugar, produce, clothing and bauxite, face nominal freight rates of 20% to 50% in spite of the Caribbean nations' proximity to the U.S. market.

Transportation costs, like tariffs, often increase with the level of product processing. The freight rate for Ghana's exports of cocoa beans runs about 5%, but the the rate for cocoa powder and coca butter is 10% of their value. Brazil's exports of cut timber have a 13% average freight rate while wood manufacturers pay more than twice as much.

There is considerable evidence that this "escalating" structure of freight rates is due to the arbitrary pricing policies of liner shipping cartels that charge what the traffic will bear. Nonetheless, their effect is to create a bias against further commodity processing in developing countries.

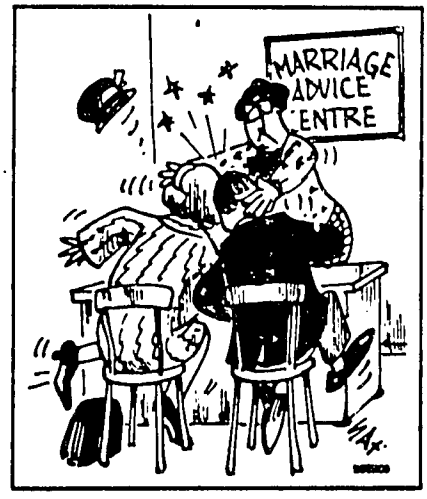
Many African countries are following advice from abroad to increase their exports. Yet while the major exports of sub-Saharan Africa face low foreign tariffs and non-tariff barriers, transportation and insurance costs are substantial. Freight rates on many of these countries' exports, such as ores, timber, oilseeds, vegetable oil and textiles, range from 20% to 75% or more of the value of shipments.

There is evidence that these costs are increasing. In the 1940s, freight rates for Africa's major commodity exports averaged about 17% of their value, a figure that has risen to almost 30%.

One key factor behind the increase is anti-competitive shipping practices, such as cargo reservation schemes. The deterioration of ports and related infrastructure also plays a major role. As a result, countries like Benin, the Congo, Ethiopia, Egypt, Mauritania and Togo pay one-quarter to one-third of their total annual foreign exchange earnings just for transport services on their imports and exports.

While many developing countries claim they wish to expand their trade with one another, high freight costs are a major constraint to this exchange. Freight rates frequently are more favorable on shipments from developed countries to developing countries than from one developing country to another.

Nominal transport cost on Asian, African and Middle Eastern goods exported to Latin America exceed, often by 50% or more, transport charges on similar products shipped from North America or Europe. The negative effects of these adverse freight costs are further increased by tariffs levied on the value of the shipment, including insurance and freight.



The south-north structure of liner conference routes is certainly a factor, since goods traded among developing countries often must be shipped on very indirect and costly routes. The neglect of transport infrastructure and anti-competitive shipping policies also are important.

While some may view transport costs as essentially "natural" or "fixed" and therefore not subject to a high degree of government control, there is considerable evidence to the contrary. In particular, significant freight savings could result from the adoption of policies to encourage active competition in maritime transportation.

For example, the cargo reservation schemes adopted by many developing countries may result in associated costs that average 10 times the level of corresponding benefits. The repeal of Chile's cargo reservation system, under which a fixed percentage of exports and imports had to be carried on national ship lines, resulted in a reduction of roughly one-quarter in the average liner freight costs for importers and exporters.

Anti-competitive policies also extend to port operations. Some ports are employers of last resort, forced by government policies to use labor-intensive methods that raise freight rates well above those that could be achieved with more efficient procedures. A specific consignment of goods that costs $18,000 to handle in Barbados faces port charges less than one-tenth as high in Freeport, the Bahamas, or St. Croix or St. Thomas in the U.S. Virgin Islands.

The transport cost barriers facing developing nations need to be examined more closely, because developing countries' own policies can have a major influence on them. Little would be gained if long and difficult multilateral negotiations succeed in lowering the tariff barriers facing developing countries only to have these reductions offset by the rising cost of exporting their goods.

Alexander J. Yeats is an economist with the World Bank, Washington. The views expressed in this article are those of the author and not necessarily those of the World Bank.

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Statement of the Honorable
David C. Mulford
Under Secretary of the Treasury for International Affairs
before the Subcommittee on
International Finance and Monetary Policy
of the
Committee on Banking, Housing, and Urban Affairs
U.S. Senate

Last spring Secretary Brady launched the Administration's initiative to strengthen the international debt strategy. In the past year, these concepts have been forged into far-reaching country reform programs, concrete actions by the IMF, World Bank and creditor governments, and financing packages between debtor countries and their creditor banks which include substantial reduction of debt and debt service burdens.

The watershed agreement between Mexico and its commercial banks was formally completed last month with the signing ceremony in Mexico City. Costa Rica and its creditors have reached an agreement in principle on a comprehensive debt and debt service reduction package. Chile's buyback of commercial bank debt in November was financed by resources made available under the strengthened debt strategy. Last month, the Philippines completed its new financing package with commercial banks, which included a highly successful direct buyback of commercial bank debt. Earlier this week Venezuela and its creditor banks announced an agreement in principle on a financing package which includes a broad range of options for debt and debt service reduction.

I am thus pleased to inform the Subcommittee that the strengthened debt strategy is very much alive and well. My progress report today will reiterate the objectives of the strategy, outline creditor government actions, detail the reform efforts in some of the debtor countries, and focus on the design and benefits of the financing agreements in Mexico, Costa Rica, and the Philippines. I will also summarize the elements of the recent Venezuelan package, as we understand them, and touch on the prospects for Argentina and Brazil.

NB-723

Objectives of the Debt Strategy

The major tenet of the debt strategy can be summarized in one sentence: Highly indebted countries must successfully implement market-oriented macroeconomic and structural policy reforms in order to achieve sustained growth and ultimately resolve their debt servicing problems. In advancing the strengthened debt strategy, our key objectives are to:

- Reinvigorate the policy reform efforts in the highly indebted countries. While a number of the major debtors initiated vital macroeconomic and structural reform programs, by the end of 1988 efforts to sustain these programs in several countries were stalled by debtor fatigue and pessimism. The strengthened debt strategy, by offering the prospect of significant debt and debt service reduction by the commercial banks, has provided important incentives for many debtor countries to maintain difficult but essential reform efforts. The strategy reaffirms the role of the IMF and the World Bank in encouraging strong debtor reforms, in particular measures to encourage repatriation of flight capital and investment.

- To mobilize financial resources from the private sector more effectively in support of debtor reforms. By the end of 1988, new lending from commercial banks had virtually dried up, banks were disposing of their LDC exposure in the secondary market, and low investment and continued capital flight hobbled economic growth in debtor countries. The strengthened debt strategy is designed to harness commercial bank willingness to engage in debt and debt service reduction for the benefit of debtor countries, as a complement to new lending by a smaller group of banks, and to develop measures to promote new investment and c pital repatriation.

- To redirect IMF and World Bank resources to back debt and debt service reduction for commercial banks. In order to strengthen the capacity of the IMF and World Bank to promote meaningful reform programs in debtor countries, the strengthened debt strategy permits debtor countries to use resources from the international financial institutions (IFIs) to back the reduction of debt and debt service by commercial banks. IFI resources can be used to finance cash buybacks of bank debt, to purchase collateral for debt and debt service reduction instruments, and to provide limited interest support for such instruments.

- To provide continued creditor government support. Creditor governments continue to play an important role under the strengthened debt strategy through their contributions to the international financial institutions, rescheduling of official debt in the Paris Club, ongoing export finance, and efforts to reduce (where appropriate) impediments to debt

and debt service reduction stemming from tax, regulatory, and accounting regimes.

The strengthened debt strategy has been broadly endorsed by the international community. Last May, the IMF and the World Bank moved expeditiously to adopt guidelines governing their support for debt and debt service reduction. Several debtor countries have subsequently adopted medium-term, market-oriented economic reform programs, with greater recognition of the importance of measures to promote investment and capital repatriation. This is the first essential step in the process.

The second step for most countries has been the negotiation of multiyear rescheduling agreements with official creditors in the Paris Club. The final step -- negotiations with commercial bank creditors -- has now been completed for four countries -- Mexico, the Philippines, Costa Rica, and now Venezuela. Morocco is now actively negotiating with its banks. Other countries are moving to avail themselves of similar support within the next year as they adopt strong medium-term economic reform programs with the IMF and World Bank. These countries include Bolivia, Nigeria, Ecuador, and Uruguay. The new president of Brazil is putting together his program after his inauguration last week.

Role of Creditor Governments

Creditor governments have moved rapidly to support the strengthened debt strategy. At their urging, the IMF and the World Bank developed and put into place guidelines for IFI support for debt and debt service reduction. A number of creditor countries have pledged financial support to enhance specific financing packages. The Government of Japan is in the process of providing $10 billion to support the strengthened debt strategy with specific commitments so far for Mexico, the Philippines, Costa Rica, and Venezuela. The United States, through USAID, has provided concessional resources to both the Philippines and Costa Rica to back debt and debt service reduction. In addition, official export credit agencies continue to provide critical trade finance to many of the major debtor countries.

Creditor governments have also made substantial contributions through Paris Club reschedulings. Reflecting the medium-term horizon of the debt strategy, the focus of the Paris Club is now on multi-year rescheduling agreements (MYRAs) for the debtor countries. Since in many cases creditor governments have been willing to reschedule interest as well as principal on official loans, the official reschedulings have continued to provide "new money" and therefore more relief than bank reschedulings. Official relief continues to be available only for countries with an IMF adjustment program.

The U.S. Government and other official creditors are also providing special treatment ("Toronto terms") to the least developed countries which are pursuing sound economic reform programs. In addition, the U.S. government has announced a willingness to forgive up to $1 billion in economic assistance loans to Sub-Saharan African countries pursuing economic reform programs. Congress has provided for this purpose in an appropriations act, nine countries have signed agreements, and four more countries have been declared eligible for the program.

Creditor governments have also initiated efforts to identify and, where appropriate, remove any impediments to debt and debt service reduction in their tax, regulatory, and accounting regimes. In the United States, the Securities and Exchange Commission has clarified the accounting treatment for the debt reduction bonds and debt service reduction bonds held by banks as a result of the Mexican financing package. In addition, the Department of the Treasury has clarified the tax treatment of the new bonds, in particular the determination of the amount of the tax loss. Neither the SEC clarification nor the Treasury clarifications break new ground, but instead rely on longstanding standards and rules to remove uncertainties as to how these financial instruments would be treated.

I would now like to touch on specific developments in individual debtor countries.

Mexico

Mexico has maintained a strong record of implementing macroeconomic and structural reforms in its efforts to resolve its debt problem. Mexico's past adjustment performance -- exchange rate reform, tax reform, liberalization of its trade regime, industrial diversification, and measures to reduce the fiscal deficit and curb inflation -- has provided the backdrop for economic recovery. However, the fall in oil prices in 1986, following on the 1985 earthquake, disrupted Mexico's economic progress. While the Mexican economy has been recovering from these shocks, growth has been sluggish, key debt ratios have remained high, and substantial financing gaps have persisted even after significant adjustment in the trade balance.

The Administration of President Salinas has pressed forward with reform efforts, including efforts to reduce the size and scope of the public sector. Recently, Mexico has taken measures to privatize the state airline, its major copper mine, and the state telephone company (one of the five largest companies in Mexico). Deregulation has been pressed in the trucking industry and the financial sector. New regulations have significantly liberalized Mexico's foreign investment regime. These regulations streamline and expedite registration requirements, increase the transparency of Mexico's foreign investment laws, reduce performance

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requirements, and open up areas formerly excluded from foreign participation.

Mexico's agreements with its key creditor groups incorporate all elements of the strengthened debt strategy:

- Strong macroeconomic and structural reforms as conditions for drawing IMF and World Bank resources;
- Meaningful debt reduction;
- Substantial debt service reduction;
- New money;
- Bank waivers to permit subsequent debt buybacks;
- Full participation by commercial banks;
- IMF and World Bank enhancements in support of debt and debt service reduction;
- Substantial debt/equity swaps;
- Capital repatriation; and
- Multiyear Paris Club rescheduling.

Mexico and its creditor banks completed negotiations on a comprehensive medium-term financing package in July 1989. Signature of the final agreement started last month, with the actual exchange of debt instruments expected by the end of March. The financing package provided commercial banks with a choice of vehicles to participate:

- Debt Reduction Bonds that replace existing medium-term debt at a discount of 35% with full repayment occurring in 30 years.

- Debt Service Reduction Bonds that carry a fixed interest rate of 6.25% with full repayment occurring in 30 years.

- New financing during 1989-92 equal to a total of 25% of existing exposure that has not been converted into debt and debt service reduction instruments.

The debt reduction and debt service reduction bonds are supported by enhancements totaling $7.1 billion from the IMF, World Bank, Japan, and Mexico's own resources. The principal of both bonds will be fully secured by collateral in the form of 30-year zero coupon bonds. Interest payments will be enhanced by 18 months of rolling interest support.

The United States Department of the Treasury will sell Mexico sufficient non-marketable 30-year zero-coupon Treasury bonds to be used as collateral for these transactions. Pricing zero-coupon bonds is complicated by a number of factors. At the time of the pricing Treasury had only issued non-marketable zero coupon bonds on two other occasions -- the Morgan/Mexican debt reduction deal in 1987-88 and the initial issue of zeros to REFCORP in October, 1989. Furthermore, Treasury has not itself

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issued zero coupon bonds directly in the public market. The Treasury STRIPS market, a derivative market resulting from the stripping of Treasury coupon instruments by market participants, remains smaller than the coupon market and somewhat volatile. As a result, there were few pricing precedents and no easy or obvious market guidance since a number of possible pricing benchmarks exist.

The Treasury pricing decision for the zero-coupon bond for Mexico was based on principles reflecting both the size of the Mexican transaction and the precedent of the 1987-88 Mexican purchase of zeros. The earlier Mexican deal was priced off the coupon rate because the STRIPS market was deemed to lack sufficient depth and the size of the transaction was large relative to the then outstanding STRIPS market. The current transaction size of approximately $35 billion face amount is even larger relative to the STRIPS market today. Treasury judged that the STRIPS quotation would again be inappropriate for pricing a transaction of this size and scope. The existing STRIPS yields would be severely affected if a transaction the size of the $35 billion face amount of Treasuries for Mexico were issued in the public market. It is likely that the STRIPS yields would be driven toward the coupon yields.

The specific pricing formula for the Mexican transaction involved the average 30-year U.S. Treasury coupon borrowing rate for the 3-day period ending January 5, 1990 of 8.05%. A fee was charged by Treasury in the form of an adjustment of the annual yield by 1/8%, which is identical to the fees charged for Treasury special issues over many years. The Treasury's final borrowing rate from Mexico was 7.925%.

<u>Benefits to Mexico of its Agreement with Commercial Banks:</u>

The commercial bank package will generate substantial debt and debt service reduction benefits for Mexico:

- Over 85% of Mexico's bank debt will undergo substantial cuts in interest or principal.

- Mexico's debt obligations to commercial banks will be slashed significantly:

  - The debt reduction bonds cut bank debt immediately by about $7 billion.
  - The debt service reduction bonds are the economic equivalent of a further implicit reduction in the stock of debt of $7.75 billion.
  - Up to an additional $3.5 billion of debt will be retired in the debt/equity swap program by 1992.

- Debt service savings total over $12 billion during the 1989-92 period.

  - -- Annual interest payments to commercial banks will be cut by $1.5 billion (nearly one-third).
  - -- Principal amortization payments will be reduced by $6.7 billion over this period.

- Of even greater importance, the burden of principal payments on $42 billion of Mexico's bank debt are lifted from the shoulders of the Mexican people; this is because Treasury 30-year zero-coupon bonds provided as collateral up front will assure full repayment of the remaining principal amounts of both the debt and debt-service reduction instruments in 2019.

- Overall, the Mexican Government estimates that the net effect is that Mexico's total external debt will decline from $95 billion at the end of 1989 to the equivalent of $80 billion in March 1990. Furthermore, external net transfers will be reduced by more than $4 billion annually, which is equivalent to 4% of GDP.

However, these positive results do not convey the full importance of the Mexican Agreement. To complete the assessment, it is necessary to compare these positive results with the results that would have flowed from the type of all new money solution that characterized the previous debt strategy:

- Mexico's total debt in 1992 would have been some $24 billion higher than will now be the case, if we include the implicit effect of debt service reduction.

- Rather than perpetually rescheduling principal, the new agreement's defeasance arrangement removes from Mexicans the burden of future principal payments on $42 billion of Mexico's bank debt.

- The medium-term time horizon of this package (four years) increases the stability of Mexico's economic and investment climate, as compared to the traditional 12-18 month financing pact, which we found could take most of that time to put together. Furthermore, the annual benefits of reduced interest payments, debt reduction, and defeasance extend well beyond the 1989-92 period of the package.

- The new agreement frees up substantial Mexican resources for productive investment (about 4% of GDP), which otherwise would be used to service ever-growing debt.

- The fact that virtually all of Mexico's commercial banks participated in this package contrasts sharply with the growing free rider problem under the old strategy. Finally, there is no doubt that if the old strategy of concerted new lending had been tried for Mexico, the equivalent of $7.5 billion in new money would not have been forthcoming. It was clear by the end of 1988 that most banks had decided to withdraw from providing fresh money to debtor countries. This was one of the key reasons for changing the old debt strategy.

The final and perhaps most notable benefit of the agreement is the growing confidence in Mexico's economy. Since the agreement was announced last summer, domestic interest rates have fallen, resulting in savings on servicing the government's domestic debt and a reduced fiscal deficit equivalent to 4-5% of GDP. In addition, net private capital inflows in 1989 totalled about $3 billion, indicating increased investor confidence. These positive developments, combined with Mexican reform efforts, have contributed to an expansion in the Mexican economy. Growth has increased from 1.1% in 1988 to an anticipated 2.5% in 1989. The economy is expanding at a fairly rapid pace, with substantially lower inflation.

These early indicators bode well for Mexico's capacity to achieve sustainable growth in the future. Current projections are that these benefits will help produce growth of 5-6 percent by 1994 and will halve Mexico's debt service and interest service ratios. For these benefits to crystallize, it will be vital for Mexico to sustain its reform efforts.

Other Financing Packages

The strengthened debt strategy is designed to be flexible and responsive to individual debtor country needs. As a result of the case-by-case approach, the financing packages which emerged from debtor/bank negotiations in the Philippines, Costa Rica and Venezuela differ markedly from the Mexican package.

The agreement between the Philippines and its commercial banks places greater emphasis on new money and direct cash buybacks because Philippine conditions are materially different from those in Mexico. The Philippine economy has realized steady growth for a number of years and its debt burden is not as heavy as Mexico's. The Philippines also is the beneficiary of substantial foreign assistance commitments for the period ahead. The impact of debt and debt service reduction would have been small relative to Philippine financing needs because medium-term bank debt only accounts for about 25% of total Philippine indebtedness.

These factors are reflected in the agreement reached between the Philippines and its commercial banks. New lending was necessary to fill projected financing gaps, while direct cash buybacks were an efficient means of enlisting the support of banks prepared to exit the Philippines at a steep discount. The elements of this agreement include the following:

- The Philippines completed a direct buyback of $1.3 billion in early January at a 50% discount. This is equivalent to a 20% reduction in its stock of medium-term commercial bank debt. The buyback was funded by IMF, World Bank, Philippine and official support totaling $667 million (including $95 million from the U.S. Agency for International Development).

- Banks rescheduled remaining outstanding debt.

- Voluntary new lending from commercial banks amounted to about $700 million.

- Commercial banks have rescheduled the remaining debt and have granted waivers to permit the Philippines to launch additional debt and debt service reduction arrangements.

This agreement offers substantial benefits to the Philippines. It fills the projected financing gaps for 1989-90 while achieving net debt reduction. After taking into account the substantial new lending contemplated, we estimate that the net debt reduction and the net debt service reduction on bank debt will still amount to 10%. Because the net debt reduction is permanent, these benefits will extend well beyond 1990. Further reduction of commercial bank debt is contemplated since the Philippines has committed to reopen its debt/equity swap program and expects additional debt and debt service reduction operations as a result of broad commercial bank waivers. These longer-term benefits should help to stabilize the medium-term economic and investment climate in the Philippines, provided of course that the Philippine government successfully implements needed reforms in its investment policies.

The debt strategy is not only flexible enough to accommodate different debtor profiles, but is also designed to apply to smaller debtor countries such as Costa Rica. Costa Rica has a heavy debt burden and has significant projected financing gaps for several years. Negotiations with commercial banks were also complicated by Costa Rica's arrears problem, accounting for $325 million of $1.8 billion owed commercial banks.

In October 1989, Costa Rica reached agreement with its Bank Advisory Committee on a package we expect will be completed by spring 1990. The financing agreement deals effectively and stringently with the arrears problem, while realistically

recognizing the limits on Costa Rica's capability to service its bank debt. Elements of the agreement include:

- A projected cash buyback of outstanding debt, including arrears, at an 80% discount.
- An exchange of the remaining principal for a par bond with a reduced interest rate of 6.25%.
- Substantially less favorable treatment for the remaining arrears, which requires a 20% downpayment on the outstanding balance by Costa Rica, rescheduling of the balance for 15 years in a mortgage-style bond, and a market rate of interest.
- IMF, World Bank and official support to fund the buyback and provide interest support for the par bond.
- Principal is not collateralized in this transaction.

Given the depth of Costa Rica's discount, the direct benefits of the financing package to Costa Rica are very substantial. We estimate that the arrangement, when implemented, would retire about 60% of Costa Rica's bank debt and reduce interest payments by about 60% annually. The agreement will put the troublesome arrears problem behind Costa Rica, and reduce Costa Rica's debt service burden to a level which reflects more realistically its ability to pay.

Venezuela and its creditor banks reached an agreement in principle earlier this week on a comprehensive financing agreement which included both a significant new money feature as well as several debt and debt service reduction options. During the past year, the Government of Venezuela has been implementing the most comprehensive economic adjustment program in its history. The purpose of the program is to eliminate distortions in the Venezuelan economy and to open the economy for international trade and investment. The bank financing package provides financial support for this adjustment effort. Elements of the agreement include:

- A cash buyback program at a price to be set by Venezuela, taking into account the secondary market price of Venezuelan debt.
- Principal reduction bonds at a discount of 30% and interest reduction bonds at an interest rate of 6.75%. Both of these options would be in the form of 30-year bonds, with principal collateralized by zero-coupon bonds and 14 months of interest support. Warrants would be included with each bond giving the holder the right to value recovery payments after 6 years if Venezuelan

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crude oil prices exceed a specified price, up to a ceiling specified in the warrants.

- Temporary interest reduction. Under this option, banks would exchange their debt for a 17-year bond with reduced interest rates of 5% for the first two years, 6% for the third and fourth years, 7% for the fifth year, and a market rate thereafter.

- New financing during the period 1990-92. Banks would exchange existing debt obligations and provide new money in the form of bearer bonds, resulting in a 20% increase in exposure for those banks selecting this option.

It is too early to assess the specific benefits of this financing package to Venezuela because we can not at this time estimate the likely bank response to the options available under this package. I would note, however, that this financing package contains the broadest range of options yet offered under the debt strategy.

The new debt strategy was also used by Chile to implement its direct cash buyback in November. Chile chose not to enter into broad debt reduction negotiations with commercial banks because it is close to recovering voluntary access to financial markets and its earlier debt conversion programs were very successful in reducing its commercial bank debt. Instead, Chile completed a limited direct buyback, using resources from the international financial institutions to purchase $140 million in commercial bank debt at a discount of 41%. The buyback should be viewed as the latest stage of the Chilean debt reduction program. Since 1985, Chilean debt/equity swap and buyback programs have retired $7.8 billion in debt, equivalent to over half of its medium- and long-term commercial bank debt at end-1985. In many ways, Chile could be viewed as the laboratory for the strengthened debt strategy. The Chilean experiment indicates that a strong commitment to reform combined with reduction in bank debt can result in normalization of debt service and sustainable growth.

Prospects for Argentina and Brazil

Among the major debtor nations, Brazil and Argentina are the largest countries that have yet to make significant progress under the strengthened debt strategy. This lack of progress does not reflect adversely on the debt strategy, but instead stems from protracted delays by both countries in implementing appropriate economic adjustment policies.

The IMF will need to play a crucial central role in providing a framework for economic adjustment in both these countries. Resources from the World Bank and the Inter-American Development Bank will also help promote structural and sectoral adjustment.

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Argentina and Brazil remain candidates for the strengthened debt strategy, once they have established credible domestic economic policies with the help of an IMF-supported adjustment program. A full range of options for debt and debt-service reduction could then be exercised for both nations.

Argentina. The government of Argentina has been preoccupied for the last eight months with stabilizing the nation's economy, a process that remains elusive. While the government has held preliminary discussions with its commercial bank creditors, it cannot focus on serious negotiations as long as the domestic situation remains unstable. Negotiations with the commercial banks, once they begin, will also be complicated by the existence of some $6 billion in arrears to banks since April 1988. We do not expect progress in negotiations with commercial banks until Argentina can show progress in implementing far-reaching economic reforms.

Brazil. Since falling out of compliance with its IMF standby arrangement in late 1988, Brazil's economy and its relations with the international financial community have deteriorated. In February 1990, inflation reached a monthly record of 73% and the 1989 budget deficit stood at about 7% of GDP. Brazil's inability to revive its standby led to the withholding of a $600 million new money tranche from creditor banks and to a halt in policy-based lending from the World Bank. Most bilateral credits have also been frozen.

The Brazilian government imposed a de facto moratorium on interest payments to creditor banks last September to conserve liquid reserves prior to the Presidential election. Interest arrears to creditor banks now exceed $5 billion.

Last week the President of Brazil launched a new program for economic reform. We are now studying this program and look forward to discussing it with the Brazilian authorities. We also understand that they are developing a number of ideas for handling their debt situation. Any financing package would need to address as a matter of priority Brazil's interest arrears. In our view, Brazil will need a comprehensive, medium-term financing package, including a wide-ranging menu of options for debt and debt-service reduction. The first priority, however, is the successful implementation of Brazil's economic program.

Assessment of the Debt Strategy

The financing agreements to date feature the new mechanisms for commercial bank support anticipated by the strengthened debt strategy and furnish new incentives for sustaining sound policies in debtor economies. The Mexican, Costa Rican, and Venezuelan packages assured comprehensive support by the full banking community, while the Philippine and Chilean arrangements focus on

selective debt reduction. Good performance deserves such support by the commercial banking community. Debtor nations cannot resolve their external debt problems through their own efforts alone.

Practical implementation of the strategy has required an adjustment of expectations by both the debtor nations and commercial banks. Initial debtor country expectations of debt relief were high, while the extent of acceptable debt reduction varied from bank-to-bank.

My own sense is that many debtor countries and commercial banks have been coming to terms with the new reality. Debtor countries are recognizing that debt relief alone is not a panacea for their economic problems. Sound policies are the essential prerequisite for success. In the agreements negotiated thus far, commercial banks have acknowledged that their diversified interests can only be reconciled through diversified options, that innovative forms of new lending are still possible, and that debt and debt service reduction for performing countries can support adjustment and improve the quality of their remaining claims.

Looking ahead, I would offer a note of caution to debtor nations and commercial banks alike:

- Debtor nations can not afford to relax their adjustment programs simply because they may be able to obtain a measure of debt relief. If the reform process is not sustained, these countries will have squandered their best opportunity to put their debt problems behind.

- The strong reserve position of commercial banks, which we commend as financially prudent and conducive to debt reduction, should not be used as a screen for failing to negotiate solutions with the debtor countries. Perpetual reschedulings, with minimal debt reduction, debt service reduction or new lending, can only contribute to future arrears and undermine the reforms needed for sustained growth.

- Both debtor nations and commercial banks must avoid the temptation of funding medium-term gaps through arrears. Such a temporary and illusory solution can only undermine the reform effort, dissipate market and investor confidence, and replace cooperation with confrontation.

- Finally, no matter how overpowering the debt problem appears in its totality, we must continue to focus our efforts on a case-by-case basis on those elements of the problem which can be solved and then expand on our successes. We must continue to recognize that there are no easy, all encompassing global solutions.

Conclusion

The international community has made significant progress in transforming the strengthened debt strategy from general concepts to practical results in the financing packages that have emerged thus far. While it is still too early to assess the strategy fully, a number of important developments have already occurred:

- The strengthened debt strategy has already renewed resolve in a number of debtor countries to complete the adjustment process. These countries are making significant strides in reforming their economies.

- The strategy is flexible. It can respond to specific country circumstances, whether the debtor is large or small, or close to returning to voluntary lending. It can offer commercial banks a wide range of options to suit their particular needs.

- The agreements in Mexico, the Philippines, and Venezuela indicate that new bank lending and debt reduction can coexist in the same financing packages.

- The reduction in domestic interest rates and capital reflows in Mexico resulting from the bank package are evidence that an important contribution of the strategy may be the restoration of confidence in the debtor country's economy.

- The strategy has the potential to extract debtor countries from the spiral of constantly escalating debt. This not only frees up resources for productive investment, but also boosts optimism in the debtor countries that sustained economic development and improved living standards are still achievable targets not just etherial goals.

- Finally, by combining fundamental economic reform in the debtor countries with substantial debt and debt service reduction by commercial banks, there is now a realistic hope that flows of capital in the form of repatriated flight capital and direct investment will be provided as the "new finance" needed by debtor countries to sustain their recovery. Such a result offers a far more credible solution for long-term growth than a perpetual dependence on new rounds of concerted lending by unwilling commercial banks.

March 5, 1990

IMF Survey

Managing Director's Address . . .

Camdessus Explores Prospects for Growth in Latin America

Discusses Experience of Costa Rica, Mexico

Following are the remarks by Fund Managing Director Michel Camdessus, on the occasion of the 40th Anniversary of the Central Bank of Costa Rica, in San José, Costa Rica, on March 2, 1990:

I have come to [San José today to] reaffirm most strongly the IMF's interest in, and concern for, all the countries of Central America, whose Central Bank Governors are present today. I have seen in our Executive Board an increasing interest—and a well-justified one—in complementing our traditional country-by-country approach to economic problems by a broader regional perspective. This regional approach could be particularly applicable to the Central American region.

This is a region that has suffered severely in recent years, through political turmoil in several countries, and through long and bitter wars; the resulting dislocations have prevented these countries from realizing their economic potential. Fortunately recent events have brought much better prospects for peace, stability, and cooperation, in this region as in other parts of the world. In this new environment, the countries of Central America must face great challenges:

- economic reconstruction;
- the fight against poverty; and
- re-establishment of economic growth and social stability.

I would like to examine the prospects for growth in Latin America in the 1990s while also emphasizing Costa Rica's experience. In brief, I can say that the prospect is for growth, but there will be a need for strong *(Please turn to page 76)*

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Debt Crisis, Though Difficult, Is Manageable, Says Camdessus

(continued from front page) efforts and regional solidarity. This will not surprise you, because you all know that societies are built by work, effort, and discipline.

* * * *

The first positive element that I would not have dared to suggest a few years ago is that it is possible to solve the debt problem: each country has the potential to find a solution to its debt problem, with the support of the international community. Certainly we have had to strengthen the debt strategy, and clearly it is frequently difficult to implement, for all the participants, but already we can see promising results. The debt crisis, although still difficult, has been reduced to a manageable problem.

The recent experiences of Mexico and Costa Rica illustrate both the strengths of the strategy and the practical obstacles that we encounter in implementing it.

Mexico is, of course, an important test case, as it has been from the outset of the debt crisis. It provides a good example of how the strategy can be made to work for a large country, provided its government is prepared to act courageously: and it shows the sort of program that the Fund is willing to support. Mexico is implementing a comprehensive program of structural reforms, which are designed to modernize the economy and restore external viability. This program incorporates a far-reaching liberalization of the trade and financial systems, accompanied by a major divestiture effort in the public sector and a reform of the rules governing the entry of foreign capital to encourage direct investment. These structural reforms are buttressed by tight fiscal and monetary policies, to produce a climate of financial discipline and a more stable economic environment. A keystone of this discipline is a large reduction in the government's deficit and the emergence of a primary fiscal surplus equivalent to over 8 percent

". . . each country has the potential to find a solution to its debt problem."

of GDP: this fiscal improvement was achieved through efforts to reduce non-interest expenditure and raise revenues. Prices are also being adjusted flexibly, including the most important price which is the exchange rate; regular depreciations have maintained the competitiveness of the tradable goods sector. This ambitious program is strongly supported by financial assistance from various governments (especially Japan), the IMF, the World Bank, and the I.D.B., and by a financing package agreed with the commercial banks. This is producing a significant reduction of debt service that will clearly help Mexico's external position. The Mexican authorities have stated publicly that the recently finalized package constitutes a key component for a solution to their external debt problem, and it was gratifying to hear President Salinas say that debt will not be a problem for Mexico for the next few years.

This economic program is already producing important benefits for Mexico. The economic performance is stronger in terms both of growth and inflation. This is attracting a reflow into Mexico of flight capital, and both private savings and investment have risen. Provided Mexico persists with good policies, it should stay on the path to sustained growth and external viability.

The Mexican example also shows, unfortunately, how difficult it is to put together a workable strategy, which incorporates both the policy reforms to produce the transformation and recovery of the economy, and a financing arrangement which reconciles the divergent objectives of the various partners. The Fund has the responsibility—an uncomfortable one at times—of supporting Mexico in its search for practical solutions to the many technical problems that arise when putting together a financing arrangement involving debt reduction. We are ready to share the lessons from this experience with all countries that need it.

Costa Rica has also had to make a great effort to stabilize its

"We in the Fund have been very concerned that smaller countries with good economic programs might be left out in the cold."

economy. It has faced what in my opinion were excessive delays in its financial negotiations. We in the Fund have been very concerned that smaller countries with good economic programs might be left out in the cold. Fortunately, agreement was finally reached between the banks and Costa Rica—the first comprehensive package involving debt reduction for a smaller debtor. Allow me to express my deep appreciation to those who have been instrumental in assembling this package, and who are still working hard to finalize it.

We know now that the debt strategy can produce satisfactory arrangements that are tailored to the specific needs of the smaller countries. And here I would draw some lessons from the skillful way in which Costa Rica has conducted its negotiations. In particular, Costa Rica introduced in a pragmatic manner a package of sound economic policies, endorsed by the international community: the IMF was able to play its role in this process, with the stand-by arrangements approved in late 1987 and early 1989. The authorities have continued to implement their policies—with difficulty from time to time—at the same time as maintaining a constructive spirit of dialogue in their long negotiations with the banks. The agreement with the banks embodies several important innovations—such as the linkage of enhancements for debt-bond exchanges to a targeted minimum level of reduction of principal. In my view, Costa Rica offers us a significant example of how to produce a debt restructuring that gives adequate support to a country's adjustment efforts and economic reforms.

Both the Mexican and Costa Rican experiences feature a relatively recent aspect of the Fund's policies on financing assurances, and one that is frequently misinterpreted. Following a change in Fund policies last year, the Fund is prepared, in some circumstances, to be the first to disburse financial assistance to a debtor country, at the outset of its economic program, even if an agreement has not been reached with the commercial banks. We do this because we believe it is essential to do all we can to help a country that wants to introduce a strong economic recovery package, as soon as it is ready to do so. In such circumstances the Fund must be ready to step in quickly. We only do so when we are reasonably convinced that satisfactory negotiations with the banks are moving toward completion or that the government and its creditors are fully committed to start real negotiations in good faith.

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The second positive element is that the prospects for stronger growth in the developing countries are better now than they were a few years ago. This is because of what I have called the "silent revolution." There has really been a marked improvement in the approach to economic policy in Latin America.

We see this improvement constantly, in the IMF, because of the stronger and more far-reaching economic programs that governments of a significant number of countries are asking us to support, with both advice and financial assistance. Many of these programs aim at sound and sustainable growth over the medium term. Their targets are realistic and achievable, although ambitious. The policy packages that are designed to achieve these targets are also realistic. They are consistent with the objectives, they are mutually reinforcing, and they are backed by a commitment to persevere in implementing policies for as many years as will be needed.

What are the main elements of these programs? Tight fiscal policies, which also make it possible to pursue a prudent monetary policy, in which low inflation is the key objective. Price policies, which are designed to let market forces be the principal guiding influence on price formation. And policies that open the economy to full participation in the world economy, so that the country benefits more fully from the international division of labor: among these, trade liberalization and a realistic exchange rate policy that maintains competitiveness are obviously the two main elements.

This barrage of policies usually complements a program of far-reaching structural reforms, which aim at removing inefficiencies and distortions, modernizing the economy, and improving the quality of investment. In this way the long-term potential of the economy is raised, and hence the prospects for an improvement in the population's living standards. Obviously the type of structural reforms will vary from country to country, according to their circumstances. It is the broad recognition, in so many countries, that the only effective way to achieve real prosperity is to persevere with structural policies, in tandem with sensible macroeconomic policies, that is the silent revolution.

"We know now that the debt strategy can produce satisfactory arrangements that are tailored to the specific needs of the smaller countries."

There is no alternative to this approach: and so long as these policies are implemented with conviction and continuity, a country will not only achieve progress but also receive strong support from the international community.

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Another promising feature is that the goal of *sustainable* growth is increasingly understood to mean also a high *quality* of growth. It is not enough to achieve efficient growth in the narrowly technical sense, important though that is. It is also essential that the fruits of progress be shared among all sectors of the population. I welcome the increased attention that is being paid to questions of income distribution and poverty alleviation by the IMF and other international institutions, by aid donors, and by the countries with which we work. In addition to distributional questions it is important that governments try to protect the lot of the underprivileged and socially disadvantaged, and give priority to expenditures that improve the quality of human capital—education, public health, etc. This can only be done by making cuts in unproductive prestige projects or by reducing military expenditures that have little justification (especially in the present global and regional context). This is because these social expenditures are the ones that improve the quality of life of the population directly and create the basis for the future development of the country.

High quality growth also respects the environment. Mankind has been late to awaken to the threat to the future of the human race, and indeed to all life on our planet, from short-sighted growth policies that have sought quick results while allowing a dangerous degradation of the physical environment. The efforts to protect the environment in an intelligent way are not only a luxury for the rich countries. The time has come for everyone to face the problem of the environment. I would suggest that the economics profession has the responsibility to broaden its concept of sustainable growth, to incorporate the idea of quality growth, and that means a concept that includes the social and environmental aspects.

"One should not expect the banks to resume new lending on their previous scale: nor is it desirable."

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A fourth consideration is whether there will be sufficient financing for this growth. I think there will, provided countries promote an adequate level of domestic saving, because external finance will remain scarce. Several factors lead me to this conclusion:

- The global shortage of savings, the resulting competition for scarce financial resources, and continued high real interest rates. Naturally I hope that, over time, a stronger fiscal policy in several of the industrial countries, and an easing of their inflationary pressures, will permit an eventual easing of monetary policy and produce a substantial reduction in world interest rates, but it would be foolhardy to undertake a premature easing;
- One should not expect the banks to resume new lending on their previous scale: nor is it desirable. It is reasonable to expect the banks to maintain their support for their long-term customers, and to countries that are creating growth and business opportunities, but on a very selective basis and within limits. Do not expect to see them making new loans anywhere else!
- The international institutions will continue to provide worldwide assistance on an appropriate scale—and I hope that the IMF will be in a position to do its part, on the basis of the increase in IMF quotas that is finally near to approval. With respect to official bilateral assistance, this is expected to grow only moderately. There may be a tendency to concentrate assistance either on the most needy in humanitarian terms (e.g., the poorest in sub-Saharan Africa or Asia) or on the countries that are implementing fundamental economic reforms and deserve international support—for example those in Eastern Europe and elsewhere that are engaged in dramatically transforming and modernizing their economies, introducing market-oriented reforms, and integrating their economies more closely into the world economy.

This is definitely a sobering prospect. But I am confident that countries that implement strong and healthy policies, and show a good economic performance, will attract adequate financing from abroad —including, not least, their own resources held abroad, plus direct and portfolio investment. I do not underestimate the importance of international financial solidarity—which will be as essential tomorrow as it is today. But it will be essential for all countries to realize that the strength of their economic policies and their capacity to generate domestic savings will be the two most important elements.

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Finally, this leads me to stress one particular dimension of solidarity, which is regional cooperation.

Central America was a leader in the efforts to achieve economic integration in Latin America in the sixties and seventies. Since the early eighties, however, this process was interrupted, due to the great difficulties that several of the countries were facing. I hope that the recent progress toward peace and security will give new impetus to this strategy of integration. I believe it is important to support all efforts to achieve this goal. I can say this with conviction since my own country was able to enjoy the positive effects of a similar process. If you asked me to summarize in a few words the lessons of the integration experience in other parts of the world, I would stress only two of them: that regional arrangements are most beneficial when they are outward looking rather than purely defensive; and that they produce good results only if each one of the partners is promoting economic growth through the implementation of sensible economic policies, which put more emphasis on internal adjustment than on external financing. Certainly, these are the optimal conditions for any country to benefit from regional cooperation.

Finally, I would like to say that the Fund realizes how difficult it is for governments to face the challenges of the present decade. The IMF is ready to assist this region and each of the Central American countries. One of the Fund's main tasks is to facilitate adjustment and reform and to give confidence to those who implement strong economic programs that will lead them, for the common good, to the path of growth, social stability, and integration in the world economy.

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"Impact of the Debt Overhang"

STATEMENT OF

Stuart K. Tucker

Fellow
Overseas Development Council

before the

Subcommittee on International Debt

of the

Committee on Finance

U.S. Senate

1 March 1990

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Mr. Chairman and members of the subcommittee, thank you for inviting me here to speak on impact of the debt overhang. The following views are my own and do not necessarily reflect the opinions of my colleagues at the Overseas Development Council or its Board of Directors.

When speaking of Third World development in the 1990s, clearly there is one issue which overrides all others: the debt crisis. However, citizens in the United States do not seem to see the issue as affecting their self-interest in the same way that the developing countries view it.

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First, I will review the U.S. self-interest in resolution of the debt problem. Then, I will point to the impact that the 1980s debt crisis will have on development in the 1990s, which constitutes a substantial humanitarian reason for action to resolve the debt problem.

I. The Debt Crisis and the United States

In 1986, arguably one of the worst points in the debt crisis, a poll of American public opinion revealed that only 7 per cent of Americans thought that debt relief should be among the top priorities for U.S. efforts to help the poor countries in the world. Debt relief ranked behind a dozen other policies including military bases and promotion of U.S. investment abroad. Furthermore, 80 per cent of those polled said that the United States should help its own economy before helping reduce the debt burden in the Third World. The poll found only slight evidence that Americans understood the nature of U.S. economic interdependence with the Third World.[1] More often than not, Americans view the domestic economy as being quite separate from the international economy. Yet, the terms "domestic" and "international" are no longer meaningful terms.

You would think that the oil crises of the 1970s would have taught well the lesson of interdependence. Yet, industrial-country governments have been slow to react to the implications of the current Third World debt crisis. The slow reaction of public opinion and U.S. policymakers

alike is due to a dim understanding of the relevance of the debt crisis to U.S. prosperity.

The oil crises of the 1970s, mounting debt burdens, and global recession in the 1980s have precipitated a debt crisis and a dramatic drop of developing-country incomes.[2] Though on the surface it appears that the United States has largely recovered from the recession, we are facing a series of economic difficulties fostered by the debt crisis.

U.S. prosperity has been diminished, because of our pooly performing financial and trade relations with the troubled Third World. These debtor countries have dramatically cut the size of their imports from us, and increased their exports to us, in order to earn enough currency to service their debt. The continuing crisis is a major cause of the large U.S. trade deficits and our own rapidly growing status as a debtor nation.[3] U.S. exports to developing countries are now about $60 billion less than they could have been in the absense of debt and recession in developing countries in the 1980s. Over the course of the 1980-87, we lost over $330 billion of export sales.[4] More to the point, due to these lost exports, we lost 1.8 million jobs--well over one-fifth of our current level of unemployment. And to use a politicians words, these were "good" jobs.[5]

U.S. investments in developing countries have suffered as well. Profit rates for U.S. direct investment in the Third World were cut in half during the early 1980s.[6] And of course, the very stability of the

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world's financial system has been shaken repeatedly by the debt crisis. Once, these very same debtor countries were the most vibrantly growing markets for our goods and services. Now, cities and farms across the United States are suffering income losses and unemployment, instead.

II. Debt and Prospects for Development in the 1990s

In the Third World, knowledge of the impact of the debt crisis on living standards is widespread, indeed unavoidable.

Curtailed Income. Whereas the per capita income of highly-indebted countries grew by 4.0 per cent annually during 1965-80, their income fell by 1.4 per cent per year on average through 1988. The per capita income of the 17 highly-indebted countries in 1988 was 10 lower than in 1980. Subsaharn Africa's income fell by 19 per cent over the same period. Debtor-country income is now one-third less than what it would have been in the absence of recession and debt. These countries have lost over a decade of time in their struggle to develop. Over the course of 1980-88, the 17 highly-indebted countries lost over $2 trillion (in constant 1986 values) in foregone income--nearly four times the amount of their payments to creditors.[7]

Furthermore, the prospects for making up the lost time are bleak as well. In the early 1990s, per capita income of debtor countries is expected to grow about 1.5 or 2.0 per cent annually, far below the 4.0

per cent sustained throughout the 1950s, 1960s and 1970s. Even if income per capita grew at 4.5 per cent per year (0.5 per cent faster than in the "golden years"), the income of the highly-indebted countries would not catch up to the extension of that 1965-80 trend line (4 per cent growth from 1980 onward) until the year 2077. This dampens development hopes for the lifespan of the generation born in the 1980s.

Reduced Consumption. With the collapse of income, many debtor countries cut savings and sacrificed investment in the 1980s in order to meet consumption demand. However, consumption in the 1990s will be significantly constrained by the impaired income growth that will result from the low investment.

Public Sector Capacity Reduced. The recession and debt crisis of the early 1980s led to dramatic retrenchment of public spending priorities. Interest payments of public sector debt rose from 9 per cent of Latin American government spending in 1980 to 27 per cent in 1986. The orthodox policy prescriptions of the IMF kept Latin American governments from boosting government spending as a portion of GDP during the debt crisis. Consequently, other programs had to be cut to cover the interest burden. Unfortunately, the short, sharp pain inflicted by this policy has turned out to be not so short-lived.

Greatly complicating the problem, Latin American governments are still hampered by capital flight and an inability to tax equitably or progressively.

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Social Programs Pared Back. During the early 1980s, Latin American governments have responded to this reduced public sector capacity by cutting back social spending on health, education, social security, welfare, housing, and community amenities. Between 1980 and 1985, social spending in these areas was cut from 44 per cent of the government budget to 36 per cent. Although Latin American governments certainly were plagued by inefficiencies in the public sector, the major impact of the social spending cuts has been a cut in investment in schools, books, health clinics, and housing. In general, operating expenses instead of investment received what funding existed. Therefore, the infrastructure of social programs has eroded and will demand larger attention in the 1990s, even though the funding is not going to increase. Thus, Latin America has a growing "social debt" which will reduce its development potential in the 1990s and thereby increase the future costs of development.

Trade Imperatives. The debt crisis has forced debtor countries to maintain structural merchandise trade surpluses in order to have the foreign exchange surpluses necessary to service the debt overhang. Import compression is still the order of the day. The import shortages in the 1980s have cut into capital expenditure, which in turn will curtail future growth. The global trade imbalances caused by the debt have spawned a number of North-South trade conflicts, especially over labor-intensive manufacturing trade, where resides the most Third World employment potential.

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Also worrisome is the advance of technological change with little technology transfer. Many countries in the Third World in the 1980s have either faced huge debt problems or long-term declines in their commodity prices and therefore have not been able to afford to develop technological capacity. The continuing economic stagnation gives little hope of attracting large scale foreign investment in technology-intensive industries. The absence of technological advance in developing countries will only make trading more difficult in future decades.

Environmental Degradation. Diminishing agricultural trading opportunities and the long-term economic slowdown caused by the debt crisis have pushed along the urbanization process in developing countries. Some of the world's worst environmental problems are being created in Third World urban cauldrons. Diminished governmental capacity means few services reach the urban slums.

The export imperative has pushed many debtor countries into cash export crops that are not easily grown in their climates. Furthermore, high trade and health standard barriers exist in the buying countries. Thus, the use and abuse of pesticides in debtor countries has remarkably risen in attempt to increase productivity of agricultural goods acceptable to industrial-country markets.

The lack of cash to purchase energy has led many populations with access to forest products to cutting down the trees and burning them for

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energy. These poor populations are making the choice of sacrificing the future of the land in order to survive in the present--and who can blame them? Few would choose otherwise.

In short, soil erosion, chemical contamination, deforestation, overcropping, and other biosphere disruptions are natural outgrowths of the stagnant economic conditions in debtor countries.

Political Instability. On the one hand, many Latin American military governments have been discredited by their handling of their economies during the 1980s. On the other hand, now the mantle of leadership is on the shoulders of democrats, who have no more tools, and perhaps less maneuvering room, than their predecessors to handle these problems. We have begun to see a wave of populists running on anti-repayment platforms--and they are not only populist, they are popular. Political durability is not likely to be a feature of any Latin American leader in the 1990s.

Population Pressures Worsening. The rural poor have been known to opt for more children when their incomes are most at risk, because the children can be used as unpaid laborers (this is also a characteristic of some urban poor populations as well). Thus, in subsaharan Africa, where income has fallen the most, population growth rates have actually increased, despite international efforts to institute family planning. During 1965-80, subsaharan African population grew at a rate of 2.7 per cnet per year. During the early 1980s, it grew 3.1 per cent annually.

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In the 1990s, it is expected to grow 3.2 per cent per year. The need for income growth, therefore, will grow, not decrease in the 1990s.

Narcotics Production. In a climate of economic stagnation or retreat, socially unacceptable behavior becomes an option whose benefits outweigh the risks. As demand for narcotics has increased in consuming countries, and as international interdiction efforts on trade and production increase, the price differential between legal and illegal crop production has widened. This is being matched in developing countries by an economically rational supply response. When legitimate economic activity in the debt era is so unprofitable and people are being pushed to the margin of existance, it is no wonder that Third World farmers are turning to the illegal, but highly profitable, activity of narcotics production to make a living. Yet, the bulk of U.S. international anti-narcotics policy is aimed at punishing the producers. The tools used by U.S. policy (trade barriers and production suppression) have the very recognizable economic effect of dramatically increasing narcotics prices and causing a surge of new entrants into illegal production.

Long-term Standards of Living. Not all development initiatives have come to a halt during this period, infant mortality, child mortality, literacy, and life expectancy figures have continued to improve in most developing countries. However, continuation of progress depends on the slow effects of long-run investments in health and education. We have

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already begun to see a slight slowdown in the rate of progess in these physical standards of living.

III. Conclusion

Absolute poverty is a major problem to be addressed in the 1990s, and it has large effects on the welfare of the U.S. economy. Managing the international system through its financial and trade traumas may be more difficult in the period ahead. The environment will loom ever larger over all our economic choices. Social ills (such as narcotics trade) become pronounced during such long periods of economic stagnation.

Even if the financial side of the debt crisis were to be resolved by the Brady Plan, the world would have to live with its effects for some time to come. This is the human tragedy within which all development policies in the 1990s must operate.

For U.S. business, many profitable opportunities have gone down the drain or will never exist, because of this tragedy. Yet, even without this direct U.S. self-interest, the United States has substantial humanitarian reasons for action on the debt crisis.

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The Wall Street Journal, Jan. 4, 1990

Let's Merge the World Bank and the IMF

Speaking of Business

By Lindley H. Clark Jr.

At the end of the 1980s we have a great deal to be thankful for, but not much of it is economic. Sure, the U.S. apparently is embarked on the eighth consecutive year of an economic expansion, but the distance between these allegedly good times and recession is so slight as to be almost imperceptible. In world markets, America's competitive problems loom almost as large as ever, and inflation, despite all the happy talk from the White House, is still very much with us.

Many nations, of course, would love to have America's problems. The developing countries, by and large, aren't making much headway. The economically strapped nations of Eastern Europe seem to be opting for something close to western-style politics, but there are limits to what Western nations can do for them economically.

Poland and Hungary are members of the World Bank and the International Monetary Fund, and have been getting some advice and money from those institutions. Romania is also a member, though a rather inactive one, and may eventually get some help. Some of the other nations eventually may seek to join the two international agencies.

In the circumstances, the West might at least try to get its economic act together. A small start might be to merge the World Bank and the IMF.

Aloys Schwietert, the chief economist of Swiss Bank Corp., toyed with that idea in the latest issue of the bank's "Economic and Financial Prospects." He saw gains in efficiency, since the two institutions in some ways overlap with one another. The Group of Ten recognized a problem and got together last year to spell out what each institution was supposed to do.

The effort was something less than a smashing success, as the group's "guidelines" show. "Reading the text carefully," Mr. Schwietert says, "you can only conclude that two different architects are being entrusted with more or less the same ultimate goal without defining the appropriate division of labor between them nor offering a coordination or arbitration mechanism. This leads to overlaps and 'alphabet-soup conflicts.'"

After thinking this over, Mr. Schwietert apparently decided not to call outright for a merger. He pointed out, quite correctly, that both organizations have been highly useful in the years since World War II. Moreover, the bank has a staff of 6,500 people from more than 100 member countries, and the fund has 1,700 staff members from roughly the same countries. The task of merging two such massive bureaucracies almost boggles the mind. Mr. Schwietert instead tries to get off the hook by tossing the ball to the bank-fund supporters: If there should not be a merger, why not?

Why not, indeed? My 30-year-old desk encyclopedia says that the fund exists so that its member-contributed money can be used "on application of member nations, to buy foreign currencies to discharge international indebtedness." Simply put, the fund was created to make the Bretton Woods system of fixed exchange rates workable. Despite the best efforts of the IMF, fixed rates fell apart in the early 1970s, but the fund has soldiered on.

How did the fund manage? Well, there will be no attempt here to bad-mouth the World Bank, root and branch, but it is a fact that the bank in recent years has been less aggressive than the fund. Meanwhile, niches were opening up. The needs weren't always for the short-term currency loans that the fund's founders had in mind, but so what? A need was a need. The fund's staff hasn't always been the initiator as the IMF has moved into medium-term lending; it has received an occasional push from larger members, such as the U.S.

The IMF had no trouble finding things to do in the early 1980s. The less-developed nations were running into severe trouble servicing loans from banks in the U.S. and other countries.

Sebastian Edwards, an economist at the University of California at Los Angeles, considered this period in a National Bureau of Economic Research study last year (Working Paper No. 2909). As Mr. Edwards says, the fund took a case-by-case approach to the troubles of the debtor nations, believing that the "right" economic policies and some bank-loan rescheduling would quickly clear everything up.

"Things, however, did not work out as expected," Mr. Edwards says gently, "and in the following years the fund came to recognize that it had badly underestimated the magnitude of the problem."

More important, perhaps, the fund failed to recognize that the nature of the problem had changed. In the early 1980s there was some fear that the developing nations would default in such numbers that many banks would fail and the world financial system would collapse. That danger essentially has disappeared. Some banks still have Third World debt problems, but the great majority have increased loan-loss reserves and reduced their exposure to Third World debt. They are now in pretty solid shape.

The need of most of the developing countries now is, well, development. This is not the sort of task that the IMF was set up for or that it can be realistically expected to handle. It is, on the other hand, exactly what the International Bank for Reconstruction and Development, to use its long-winded title, was established for.

There is some question as to whether the IMF is any longer needed, even as part of a bank-fund merger. There are still monetary problems around, heaven knows, and there will be more as Eastern Europe tries to get more involved with the West economically. But lately most of the monetary problems have been handled by the Organization for Economic Cooperation and Development, the Bank for International Settlements, the Group of Ten, the Group of Seven, the Group of Three or some other group.

The IMF and the World Bank, however, have compiled a great deal of experience that could been highly useful as the 1990s unfold. The problems are so enormous that the world needs all the expertise it can muster. The bank and the fund, merged, might accomplish a great deal.

The times are so trying that it would be foolish to allow debtor nations to go on playing one institution against the other to secure better terms—or to require debtors and would-be debtors to satisfy the terms of first one international organization and then satisfy pretty much the same terms set by another.

It's time to merge the bank and the fund. As Mr. Schwietert asks, if not, why not?

The Washington Post, March 23, 1990

Rowland Evans and Robert Novak

The IMF's Poison Pill

Dan Quayle returned from his fifth Latin American sojourn with a sober warning: the U.S. taxpayer is supplying a suicide pill for the Western Hemisphere's infant democracies.

Everywhere he went, the story was the same, the vice president told President Bush and key Cabinet members over lunch Monday. Restrictions imposed by the International Monetary Fund in return for loans are ruinous to the Latin economies. When somebody at the table said that the IMF has replaced communism as the threat to Latin American democracy, there was no disagreement.

Still, the Bush administration is on the verge of increasing the U.S. contribution to the IMF by 50 percent—$12 billion—which is sure to be approved by Congress. Quayle's intervention offers a sliver of hope that more U.S. green for the IMF be made conditional on the IMF's dispensing of U.S.-style economic advice.

Quayle is now familiar enough south of the border that he gets told the truth, and he got an earful about the IMF on his latest trip "from everybody, almost without exception." To get IMF loans, debtor nations are forced to increase taxes and devalue currency—the austerity formula that, worldwide, is almost guaranteed to put rioters in the street and often sends governments packing.

Argentina's new President Carlos Menem told Quayle he wants to reduce the value-added tax but faces IMF demands for a 2-percentage point increase. Much the same came from Brazilian, Chilean and Paraguayan leaders, all trying to convert from military dictatorship to democracy. Quayle told Bush and his luncheon guests that in Brazil, Portugal's President Mario Soares informed him that he twice was defeated because of the IMF and was not elected until he stopped following its advice.

"Calling for higher taxes is certainly not our economic policy that has proved so successful," the vice president later told us, adding: While democracy is winning the hemisphere's "political debate" against communism and militarism, "we are on the threshold of losing the economic debate." If the IMF's poison pill stunts economic growth, "democracy's going to be blamed."

Even apart from destabilizing advice, upping the U.S. ante would still be dubious. The IMF's track record is miserable. Its loans are supposed to encourage market economies, but what they do is spawn government ministries that then manufacture plans cut to IMF specifications.

Conservative Republican senators wrote Treasury Secretary Nicholas Brady five months ago deploring the shift in Third World debt from private banks to multinational lending institutions. "We fear that the result is a weakening of private responsibility," they warned. Although loans in arrears have reached 10 percent (and growing) of the IMF's debt, a new policy permits lending to countries that have failed to reach agreement with private creditors.

The senators also pointed out that while creative accounting makes the $12 billion a "swap" (dollars for special drawing rights), in fact the money comes straight from U.S. taxpayers. So, while direct U.S. aid to fledgling democracies in Latin America and Eastern Europe is measured in lowly hundreds of millions, taxpayer billions pour into the IMF's bottomless pit.

But the battle against increased U.S. funding was fought—and lost—in 1983, even though the administration then was more conservative and Congress much more conservative than today. Seven years later, IMF lending is essential to the Brady Plan for solving the Third World debt crisis.

Perhaps closer to the point, the Treasury is hopelessly and institutionally committed to IMF expansion. Soon after Quayle sounded off to Bush, the T-men called the vice president to offer a "briefing."

But Quayle's warnings did reach responsive ears. Secretary of State James A. Baker III and Budget Director Richard Darman, whose days in the Treasury did not endear the IMF to them, nodded in agreement.

That offered hope, if not for saying no to the IMF or even limiting U.S. funding, then at least for making it conditional on new lending guidelines to extract the poison from the pill. Otherwise, democracy—not the international bureaucrats—will be blamed for its own suicide.

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The Los Angeles Times, Feb. 16, 1990

Mexico After the Brady Plan

Foreign Investment Is Key

By ALEJANDRO RAMOS

MEXICO CITY — Almost a year after Treasury Secretary Nicholas Brady launched the plan that bears his name, and which constitutes the principal reply of the Bush administration to the international debt crisis, Mexico has formalized its role as the "pilot nation" of this controversial economic proposal.

Its promoters have called the plan signed on Feb. 4 "historic," while its critics maintain that it is little more than a breathing space that leaves Mexico as much on the razor's edge as ever. The 90 million Mexicans who will function as guinea pigs in this operation will have the final vote as to its success or failure.

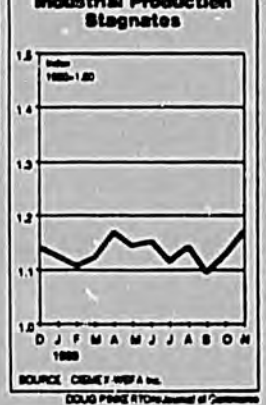
For the moment, the Brady plan is the flag of the U.S. government, of the private banks and of the multilateral financial institutions such as the International Monetary Fund and the World Bank, and will be used by them to prove that the international financial system has no leaks.

They hope to demonstrate, through its use, that even nations with debt levels as high as Mexico's can remain afloat, providing that proper steps are taken.

The role of guinea pig is not new for this nation. Mexico was classified as a "model nation" in terms of the privatization of its economy, liberalization of its trade and strict payment of the service on its debt even before the Brady strategy for debtors was defined.

Mexico complied rigorously with the terms of the Baker plan launched by the U.S. Treasury in 1985, which finally was recognized as a crashing failure. Between 1983 and 1989, Mexico transferred approximately $90 billion to its creditors. All the while, the total amount owed increased.

The experiments with Mexico really predate the Baker plan. They began in 1982, when it first became fashionable to lend debtor countries more funds with which to maintain their payments against old debts.



This model, which obligates highly indebted nations — Mexico is the second largest debtor among the developing nations, after Brazil — to bring their balances of payment into surplus positions, also has impoverished their peoples.

Data from the Economic Commission for Latin America indicate that during the past six years the inhabitants of the Latin American nations have retrogressed 20 years in terms of their standards of living, and that extreme poverty is becoming increasingly widespread.

In Mexico and other nations of the area there was a real deterioration in education, health care, nutrition and job creation, reaching the point where governmental policies were rejected by voters as outbursts of social instability developed.

Although there were several different interpretations regarding the exact meaning of the terms of the agreement between the private banks and the Mexican government, there was general agreement that the amount of the Mexican foreign debt would be reduced by about $2 billion a year over a period of four years.

This figure was arrived at after the creditor institutions chose one of three options contained in the Brady plan: reduction of the total amount owed by 35%, reduction of outstanding interest to a fixed rate of 6.25% or the granting of new credits. Ninety percent of the nearly 500 banks that were involved in the restructuring chose one of the first two options, only a handful selected the third.

The final result left all those who signed content, including the Mexican government, as represented by President Carlos Salinas de Gortari, who said that a new era had begun that would be characterized by economic growth and greater personal well-being. In short, the crisis was a thing of the past.

For this to become reality, however, and for the Brady plan to meet with a better end than the Baker plan, it will be necessary for the Mexican government as well as the international financial community to work actively to promote direct investment in Mexico.

Mexico faces a deficit in its balance of payments of $6 billion this year, even after the debt restructuring has been taken into consideration.

It is the government's hope that foreign investors will place a minimum of $2.5 billion in new industrial projects this year, and that Mexicans who have substantial bank holdings abroad will speed up the return of some of these funds. In 1989, according to Mexican figures, more than $3 billion held in foreign bank accounts returned to Mexican accounts.

To be able to cover the current account deficit in this fashion is a step in the right direction. It may even become more significant than the debt negotiations themselves, particularly in view of the fact that the economic program based on a price and wage freeze is deteriorating rapidly. Last month, for example, inflation returned to high levels of over 4% monthly.

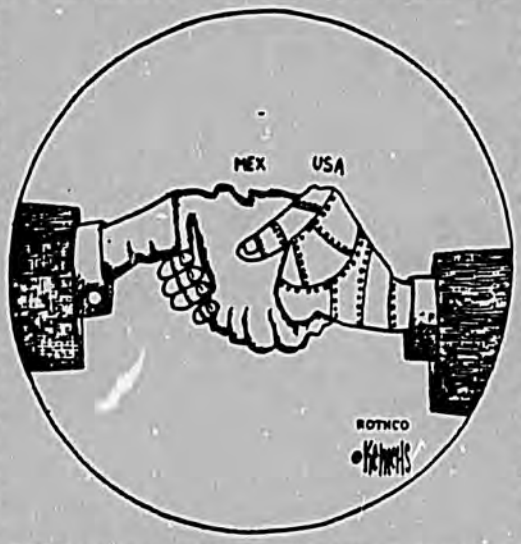
"Viva Mexico!" Mr. Brady exclaimed in good Spanish following the signing the debt agreement. In the opinion of many Mexicans, he should have also made mention of the Virgin of Guadalupe, the national religious symbol known for her miracles.

Alejandro Ramos is deputy editor of El Financiero, a daily newspaper in Mexico City.

Hurdles On Track To Recovery

By LUIS RUBIO

MEXICO CITY — Consolidating the ongoing Mexican economic reform is in the forefront of President Carlos Salinas de Gortari's priorities. The economic reform already has incorporated Mexico's economy into the world markets both by almost completely liberalizing imports and by increasing exports of both raw materials and manufactured goods. The economy has begun to grow in per capita terms, but the recovery faces major hurdles.



There has been virtually no investment in infrastructure since 1982 and investment in new ventures or in expansion of existing plants has lagged behind. The challenge today is to rapidly increase the levels of investment and to secure markets for Mexican goods in the rest of the world.

The need for investment is obvious in many ways. Electricity production, for instance, has just barely kept up with demand. If no new investment is channeled to this sector, Mexico could begin to experience brown-outs as early as late 1991.

The same goes for old roads that need maintenance and new roads that are needed to increase the levels of efficiency and for businesses to be able to guarantee terms of delivery for a much more demanding international market. A similar situation characterizes railroads, telephones and other means of communication. Part of the investment necessary to increase and upgrade infrastructure and services may come from private sources, once all of these are privatized. Other sectors will need stepped-up government investment — all without raising the fiscal deficit as in the past.

Securing markets abroad is a much more complex proposition. The largest and most obvious market — the United States — has tended to introduce quotas and other protectionist measures that limit our export growth.

Negotiations to reduce these barriers have been going on for some time, with positive results in the case of steel. Textiles, the fastest growing Mexican manufacturer export, is still on the negotiating table. Other sectors, such as automobiles, petrochemicals and pharmaceuticals, will follow.

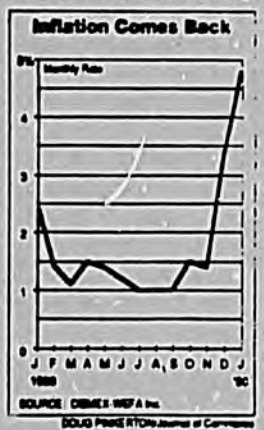
Ultimately, trade and investment are two sides of the same coin. Free flows of trade go — or should go — with free flows of investment. Mexico began liberalizing its trade barriers in 1986, fully liberalized them in 1988, and then almost fully liberalized foreign investment restrictions early in 1989. So far, only small flows of new investment have materialized, while trade flows have literally exploded, beyond the $30 billion mark. Domestic private investment has begun to pick up, most often in plant expansion to cope with a growing domestic demand without having to reduce exports.

Mexico became an exporter of goods other than oil only in the last half decade. Prior to that Mexican and multinational firms produced basically for the domestic market. When the domestic market weakened, they sought export opportunities. As soon as domestic demand began to pick up again, however, these exports markets were immediately abandoned.

Herein the first major challenge of the Salinas administration as domestic demand begins to grow, many firms might find it easier to shift production from the export markets to the domestic arena, hence reversing the so far very successful integration of Mexico's economy into the world markets. The challenge is, plainly, to avoid a new balance of payments crisis.

The second challenge of the administration is to secure new investment flows. Mexican capital flight has begun to return — some $3 billion in 1989 — and a few new investment projects are in the offing. But the greatest chunk of new investment will have to come from abroad. It's a simple matter of numbers: there is not a single Mexican industrial or financial group capable of bidding $6 billion or $7 billion for a concern such as Telefonos de Mexico, the state-owned phone company, much less of making the investments necessary to upgrade the quality and expand the size of the system.

The third challenge of the Salinas administration is to secure markets abroad. The development of closer trade ties between Mexico and the United States does not reduce the need of Mexico to develop markets elsewhere. Once again, the link between trade and investment is absolute. The more Mexico trades with Europe and Japan, the greater the investment flows from these countries.



Over the next few years Mexico's economy will require several billions of dollars in new investments to modernize and become competitive. What happens on both of these fronts — trade and investment — over the next three or four years will largely determine how closely tied as trading partners Mexico and the United States will end up being and what options Mexico will have to pursue elsewhere.

Luis Rubio is director of Centro de Investigacion para el Desarrollo, a think tank in Mexico City.

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EDITORIAL/OPINION

Emperor Brady Has No Clothes

By CHRISTOPHER WHALEN

During the signing of the "first" Brady plan debt reduction package, Mexican President Carlos Salinas de Gortari said that "the difficult process of renegotiating Mexico's foreign debt has ended." Of course Mr. Salinas knows that this isn't true, but he promised the Mexican people a deal and a deal is what they got.

Speaking for the United States, Treasury Secretary Nicholas Brady said, "The agreement with (Mexico's) commercial bank creditors . . . will provide lasting benefits for the people of Mexico," a statement that proves beyond doubt that the weak link in the Bush cabinet does not understand his own plan.

The Brady plan is a political success, but a financial and economic failure. Sold as a panacea for all heavily indebted countries, it is really a financial assistance program for the one country in Latin America that Washington cannot completely ignore: Mexico. It offers nothing to the region's other heavily indebted nations.

The tangible benefits, such as they are, are two: a face-saving arrangement to support an unpopular government in Mexico, and a political "bridge" whereby the Bush administration can claim success in dealing with a problem that has no good solution. To the extent that official Washington *believes* that a substantial benefit has accrued, Mexico is in considerably worse shape than it was in 1989.

The Brady plan does not satisfy Mexico's immediate cash needs, yet sufficient new loans have been made to delay economic restructuring. The roughly $700 million in interest rate reductions are more than offset by the cost of new debt incurred to make the plan work. Indeed, by emphasizing "debt reduction" while in fact increasing the overall level of debt, the Brady plan effectively cuts Mexico off from the two most important sources of financing: direct investment and commercial banks.

Commercial banks generally won't book new sovereign Mexico risk because they know that the government has not attacked the real sources of the country's economic stagnation.

For example, while Mr. Salinas has begun the reform process, in terms of tangible economic savings for his country, the effects are minimal. Contrary to government claims, liquidation of inefficient state-owned companies, on a scale of 10, barely ranks one or two in terms of the value of assets sold.

Protectionist investment laws remain in place, taxes on the private sector have increased significantly and key export sectors are depressed. A startling report from Mexico's state oil company, Pemex, predicts that even with new investment in exploration and development, Mexico cannot remain a net exporter of petroleum through the year 2000. Yet, politically, there is little prospect of privatizing Mexico's uniquely inefficient oil industry.

As a result, foreign direct investors, who typically take advice from commercial bankers, are extra cautious about equity investments in Mexico. The idea that foreign investors will supply billions in capital needed to support Mexico's economy, not just the border assembly plants known as maquiladoras, is perhaps the Brady plan's greatest flaw.

Yet massive new cash inflows have occurred. In 1989, the World Bank approved $1.9 billion in new credits, and a further $3 billion is promised for 1990. The International Monetary Fund and Japan have also supplied billions of dollars of new financing, while the U.S. Treasury and the Federal Reserve System have made available substantial sort-term credit facilities.

"OK, so he discovered fire. But what's he done since?"

Ironically, World Bank and IMF guarantees extended to commercial banks under the Brady plan ensure that multilateral loans will continue. Because Mexico can't otherwise service its foreign loans, it inevitably will pressure the IMF and World Bank for new funds under threat of defaulting on guaranteed debt — an event that would endanger the World Bank's coveted AAA credit rating.

Foreign loans have enabled Mr. Salinas to support an overvalued peso and thereby import food and consumer goods necessary to satiate an aggrieved populace.

Yet fundamental problems remain. Rates on Mexican treasury bills are again near 50%, the high for 1989, while internal debt now exceeds $65 billion. Inflation in January alone was nearly 5%, one-third of officially projected inflation for all of 1990. Hard currency reserves are below $4 billion, and a currency devaluation of 30% to 40% is considered inevitable.

Instead of reducing debt and building confidence through proven methods such a debt-for-equity swaps, Mexico has lost a great opportunity.

By following the advice of senior U.S. Treasury officials, foreign debt has been emphasized instead of domestic reform. As a result, the reform process has slowed to a crawl, bank loans are unavailable and new investment, not surprisingly, has failed to meet expectations. If this is the benefit to which Mr. Brady refers, other indebted Latin nations should start running.

Mexico's government has blamed poor economic performance on external debt while refusing to attack real problems such as centralized economic management and the issuance of domestic debt. When Mr. Salinas' commitments with respect to currency stability and inflation are not kept, increased social and economic pressures will become the pretext for requesting new assistance from Washington.

Christopher Whalen is senior vice president for trade finance for The Whalen Co. in Washington.

THE NEW YORK TIMES, TUESDAY, JANUARY 16, 1990

To Help New Democracies, Cut Aid to Israel, 4 Others

By Bob Dole

WASHINGTON

It's always a little risky to predict history's verdict on contemporary events. But even from today's sometimes short-sighted perspective, it is safe to declare 1989 as one of the watershed years of the 20th century — the year in which Communism collapsed and the long dormancy of freedom suddenly and dramatically blossomed in places from Poland to Panama.

In fact, events have been moving so fast that, in some ways, we're all playing catch-up in our own analyses and policy prescriptions. A little caution makes great sense in such a volatile environment.

But this much is already clear: We do have an enormous opportunity to consolidate and expand freedom's gains and, at the same time, to enhance America's security and economic potential.

If the new democracies and free market economies fail, the long-term cost to America and to the cause of freedom will be enormous. But if they succeed, it will mean that the United States could enjoy increased security, reduced defense budgets and armament levels and expanded markets for our exports and our ingenuity. Simply put, there is no better investment we can make in America in 1990 than finding ways to support the new democracies.

That's the good news. The bad news is that supporting freedom is not free. It will cost bucks — big bucks. And we must find those bucks within the constraints of our own crushing budget deficits and a foreign aid budget that is already stretched to the breaking point.

We may be able to increase marginally our overall foreign aid expenditures. But the reality is that we are not going to have much more foreign aid money in the next few years, at least until the so-called peace dividend kicks in (if it ever materializes).

Cut 5% from the main recipients.

The immediate answer must include reallocation of what we are spending on foreign aid now.

Let me make this point clear: I am certainly not suggesting abandoning or short-changing our long-time friends around the world. They remain very important to us, and their needs are just as real and pressing as those of the new democracies.

What I am suggesting is to re-examine some of the huge aid programs in a few countries — the so-called earmarked countries — that take most of our current aid budget. Right now, the big five — Israel, Egypt, the Philippines, Turkey and Pakistan — receive more than two-thirds of our foreign aid.

Does it make sense, at this historic moment, to provide these countries practically all of our aid at the cost of foreclosing dramatically promising new aid initiatives in Eastern Europe or other important countries? What about, for example, those Latin American nations in the front lines in the war against drugs?

Consider this simple fact. A 5 percent cut in current aid programs for the big five would provide about $330 million — enough to respond to the needs of new democracies such as Poland, Hungary, Panama and countless needy countries that under current allocations will receive not one penny of American aid.

Perhaps an even larger across-the-board cut and reallocation would be warranted, as the democratic revolution gains momentum. That would represent a better balancing of our limited resources with our changing priorities.

No doubt, these proposed reallocations will raise a hue and cry. But can't we convince our friends who would "lose" a tiny amount of their aid how much it is in their interest, too, to help insure against the failure of new democracies and free-market economies?

Can't those pressure groups that have turned some of our foreign aid programs virtually into "entitlement programs" realize that making some minor adjustments in aid allocations can simultaneously serve the countries of their special interest, and serve America?

And can't my colleagues in Congress, who have forced the President to swallow a few huge earmarked aid programs, stand up to domestic political pressure and resist the temptation to politicize foreign aid? Can't they instead support an amended foreign aid strategy that more completely serves the national interest?

Even despite Congressionally mandated aid programs, the President has the authority to make the small reallocations of foreign aid that I believe are warranted. I encourage him to consider seriously making those reallocations now. I stand ready to work hard to insure that the Congress and the American public will back him up.

To me, it boils down to this: Are big gains for freedom worth a small cut in a few huge foreign aid programs? I say yes. □

Bob Dole, Republican of Kansas, is the Senate minority leader.

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Congressional Staff Forum
on
International Development

Director
William E. Hellert

February 2, 1990

MEMORANDUM

TO: ODC Staff

FROM: Laura Rawlings

SUBJECT: Baker Testimony

Senate Foreign Relations Committee
Members in Attendance: Chair Pell (D-RI), Helms (R-NC), Biden (D-DL), Luger (R-IN), Sarbanes (D-MD), Kassebaum (R-KS), Cranston (D-CA), Dodd (D-CT), Pressler (R-SD), Kerry (D-MA), Murkowski (R-AK), Simon (D-IL), Mack (R-FL)

EXECUTIVE SUMMARY

Baker called for the consolidation of the "**democratic revolution**" globally and asked for Congress to find a way to give the Administration increased flexibility in responding to this challenge. He specifically asked for a re-examination of **earmarks**, but was cautious in stating that he had "no one particular country or countries in mind". The question of earmarks caused considerable debate, with Kassebaum reiterating her support for ending all earmarks, Cranston supporting a reduction in aid for Turkey, Murkowski supporting a reduction in the request for Panama, and Simon coming out in favor of earmarks. Kassebaum, Murkowski, and Simon all expressed concern over reductions in aid to Africa.

Other points of interest to U.S.-developing country policy included: 1) Baker's strong call for the U.S. to use $881 million --the highest figure in Function 150-- to clear the **arrearages** to multilateral agencies, which he says will play an expanded and critical role in the 1990s; 2) a strong focus on combatting **narcotics** which included a plea by Baker to be able to support cooperative Caribbean nations by having flexibility in Function 150 as well as a request for $441 million to use in Andean anti-narcotics operations; 3) concern over the situation in **Cambodia** expressed by Baker, Kassebaum, and Kerry; 4) the fact that aside from a brief laundry list in the "newly emerging democracies category," there was no mention of South America or foreign debt, or lack of growth.

BAKER PRIORITIES

Baker identified five key foreign policy goals for the 1990's:

1. **Consolidating Democracy:** based upon cooperation with the Soviet Union to resolve regional conflict, especially in terms of supporting a "new generation" of democratic leaders in the Western Hemisphere. He also called for supporting the Philippines, Pakistan, and efforts at reform in South Africa.

2. **Promoting Open Markets Bilaterally and Multilaterally:** Multilaterally by using the existing tools of GATT, the IMF and the World Bank. Bilaterally by engaging in a "major drive" to reduce government control, including supporting the countries that are courageously engaging in difficult structural adjustment such as Poland, Mexico and Venezuela.

3. **Establishing a Secure Global Environment:** As the East-West parameters become redefined, the U.S. will continue to support constructive efforts in other areas such as: Esquipulas, Tela, Middle East peace, and the resolution of Soviet involvement in Nicaragua and Cuba.

4. **Working Together to Address Transnational Global Challenges:** which include the environment, drugs, and terrorism.

5. **Strengthening and Renewing our Alliances:** Baker stressed the "critical" need to build on the alliances that have created a successful post WWII international structure. This includes NATO, the EC, and the Helsinki Accords. Concerning trade, it addersses alliances with Japan, the Free Trade agreement with Canada and the need to "broaden the mutual agenda" with Mexico.

These areas represent an "intimate link to fundamental American values," which serves as the rationale for their promotion.

FUNDING

Total: $20.8 billion for Function 150. This represents an 8.9% increase from last year's FY 1990 appropriation level. This money is based on a core budget and six funding initiatives:

1. **Eastern Europe:** $300 million. For structural adjustment, private sector initiatives, the environment, and trade.

2. **Panama:** $500 million. For economic reconstruction.
note: Murkowski called for greater detail and specificity in how the funds were to be used.

3. **Andean Anti-Narcotics:** $441 million. $137 million for military and $214 million for economic anti-narcotics programs.

4. **Arrearages:** $888 million. To be undertaken over five

years, for specific programs within the United Nations, other international organizations, and multilateral development banks. note: Sarbanes support

5. **Moscow Embassy:** $270 million. For tearing the old one down and rebuilding a new, secure facility.

6. **Refugee Assistance:** $70 million. To address the liberalized Soviet emigration policies.

In conclusion, Baker reiterated his call for ending earmarks or develping an alternative solution that would give the Administration the flexibility it needs to be able to respond to these challenges.

DISCUSSION

Referring to a question by Chair Pell on **United Germany**, Baker responded that the U.S. supports four basic principles: 1) self-determination, 2) a unified NATO and Economic Community, 3) a peaceful and stable unification process, and 4) the Helsinki Act recognizing the inviability of frontiers and the right to peaceful change.

Helms called for an investigation into a 10 year military and economic cooperation agreement between **China** and **Iran** as well as investigations into the disappearance of several Christian bishops in China.

Simon called for investigation into the problems of **water resources** in arid areas, especially in Africa and the Middle East.

Responding to a question by Helms regarding Soviet MIGs in Cuba and Soviet **missiles, gunships, and helicopters** in Nicaragua, Baker said that he had been informed that the helicopters were for civilian use and that the MIGs would be discussed in Moscow.

Dodd asked what factors would be necessary in order to have the sanctions against **Nicaragua** lifted. Baker responded that the U.S. would "begin to normalize relations" with Nicaragua if it were determined 1) that free and fair elections had taken place --which remains a difficult proposition given that the U.S. has been unable to monitor them-- and that 2) Nicaragua was not supplying arms to the FMLN in El Salvador. Baker suggested that despite the fact that the Soviet Union's condemnation of this practice was considered legitimate, Nicaragua seemed to be uncooperative.

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CONGRESSIONAL RESEARCH SERVICE--Larry Nowels/Ellen C. Collier

Foreign Policy Budget: Issues and Priorities for the 1990s

SUMMARY

World events in 1989, such as new governments in Eastern Europe and Panama, have brought new opportunities and challenges to U.S. foreign policy. A fundamental issue is how to fund new foreign policy objectives that cost money at a time when the budget deficit impels overall reductions. Options include approving additional amounts for foreign policy programs, shifting funds from the defense sector, shifting foreign policy programs to other budgets, managing within existing limits, or shifting funds among programs in the international affairs budget.

Foreign policy programs are funded within the International Affairs Budget Function. The funds are appropriated through the State, Justice, and Commerce Department, the Foreign Operations, and the Department of Agriculture appropriations acts. The President has asked Congress to appropriate about $21.6 billion, an increase of approximately $1.6 billion, or 8%, from FY1990 appropriated levels. International affairs outlays for FY1991 would represent about 1.5% of total Federal spending. About half of the proposed growth for foreign policy programs is for full U.S. current and past payments to international organizations and financial institutions. The budget also seeks increased funding for international drug control activities, Moscow Embassy construction, refugees, and East European aid. The overall composition and program structure of the international affairs budget, however, is not significantly different from past years.

The FY1991 budget includes $4.1 billion for the Department of State and nearly $1 billion for the U.S. Information Agency (USIA). State Department funding would grow by about one-third and includes full funding for U.S. payments to U.N. organizations and peacekeeping activities, plus payments owed from previous assessments. The USIA budget would increase by about 6% in FY1991. One immediate issue is whether funds for the Voice of America, Radio Liberty and Radio Free Europe should be reduced or redirected in view of the dramatic changes in the Soviet Union and East Europe.

Security-related programs in the international affairs budget total about $8.2 billion, a substantial portion although small in comparison to the approximately $300 billion defense budget. Three fundamental issues are the size of security aid, the rationale for allocating aid among recipients, and the congressional practice of "earmarking" amounts for selected countries. For FY1990 Congress earmarked over 80% of the Economic Support Fund and military assistance for Israel, Egypt, Pakistan, Turkey, Greece, Jordan, Morocco, and Poland. Senator Dole recently proposed that the President reduce the security assistance earmarks by 5% each, making available about $350 million that could be used elsewhere. Although supportive of the concept, the Administration decided not to pursue the Dole proposal.

Appropriations for programs that foster economic growth in developing countries total about $10 billion for FY1991, including some funds also regarded as security-related. Key issues concerning economic assistance center on the structure and focus of American assistance and how to address global problems related to narcotics production, the environment, and growing refugee needs.

ISSUE DEFINITION

During 1989 dramatic upheavals in the Soviet Union and Eastern Europe suddenly confronted U.S. foreign policy with a new world situation. These and other changes on the international landscape pose a challenge to the direction of American foreign policy and patterns of spending. Some believe that traditional allocations of budget resources for foreign policy may no longer reflect current needs and have called for a budget for FY1991 that takes into account these significant changes, as well as growing threats to U.S. security from such sources as drugs, terrorism, and environmental degradation. U.S. resources have been constrained by a continuing budget deficit, and various foreign policy needs compete not only with each other but with domestic and defense needs as well. As policymakers and Members of Congress consider the President's $21.6 billion FY1991 appropriation request for foreign policy programs, they will be confronted with a series of broad policy questions: What goals and strategies will U.S. policymakers adopt to replace those of the Cold War? Do the new world realities increase or decrease the need for foreign policy funds? What major considerations should determine the overall international affairs budget for FY1991? Within the foreign policy framework, which programs should have priority?

BACKGROUND AND ANALYSIS

A fundamental issue is how to fund new foreign policy objectives at a time when the budget deficit impels overall reductions. Options include (1) approving additional amounts for foreign policy programs, a difficult prospect given the Federal deficit; (2) shifting funds from the defense budget to international programs that promote national security in a broad sense, a practice utilized in selected cases in 1989; (3) shifting some of the existing programs that contribute to national security, such as U.N. peacekeeping operations, from the foreign policy to the defense budget, or programs that primarily benefit U.S. citizens, such as the Export-Import Bank, to a different budget; (4) managing within existing budget limits by improving the efficiency of foreign policy programs so that new functions can be undertaken without further spending; and (5) shifting funds among programs in the international affairs budget, an action that has been common in the past but which involves sharp trade-offs between competing foreign policy objectives. This last option has received added attention stemming from a recent proposal made by Senator Dole to reduce foreign aid levels to some of the largest recipients of U.S. economic and military assistance to address new pressing needs in Eastern Europe, Panama, and the drug-producing nations.

The management of U.S. foreign policy at a time of significant international change involves much more than decisions regarding budget allocations. Matters concerning trade and investment policy, defense strategy and structure, arms control, and technology transfer, among others, are very important issues, but tend not to be driven by foreign policy budget decisions and are not discussed here. (For reports on these topics, see the Guide to CRS Products.) Instead, this issue brief focuses on budget issues related to foreign policy programs. It discusses the scope of the international affairs budget and the components of foreign policy programs.

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Foreign Policy as Part of the Federal Budget

Foreign policy programs are generally funded within the part of the Federal budget known as the International Affairs Budget Function, also referred to as Function 150. Representing one of many accounts within the budget, international affairs programs compete against defense and domestic activities for scarce resources each year during the budget decisionmaking process. Yet, to some extent, foreign policy, defense, and domestic spending are interwoven and often overlap. For example, Function 150 funds assistance to countries providing the U.S. military with bases overseas and pays for expenses of the Arms Control and Disarmament Agency, activities that have a direct impact on defense policy and spending. Alternatively, the Defense Department, as well as domestic agencies, such as the Drug Enforcement Administration and the Customs Service, play a major role and allocate significant amounts of money in international narcotics control efforts.

Although small in terms of overall Federal spending (see Appendix, Figure 1), in recent years the size and composition of the international affairs budget have been controversial, with the Administration generally supporting higher amounts than Congress has been willing to approve. Consequently, the level of funding for Function 150 has declined since 1985 (see Appendix, Figure 2).

Composition of the International Affairs Budget

Numerous foreign policy programs are supported within Function 150. About 73% of the costs are associated with U.S. foreign assistance activities. Another 17% make up the expenses of administering the State Department and the U.S. Information Agency. The remaining funds support U.S. contributions to international organizations (6.5%), trade and export promotion programs (2.3%), and other activities. (See Appendix, Figure 3.)

Congress appropriates money for these foreign policy programs in three major spending bills. The Foreign Operations, Export Financing, and Related Appropriations Act includes money for nearly all foreign assistance programs and the Export-Import Bank. The State, Justice, Commerce, and Related Agencies Appropriations supports the State Department, USIA, U.S. assessed contributions to international organizations, and the expenses of other small foreign policy agencies. P.L. 480 food aid program is funded within the Department of Agriculture Appropriations. Tables 1, 2, and 3 in the Appendix of this issue brief set out the funding levels for each of these international affairs programs for FY1989 and FY1990. The programs funded in each of these three appropriations are grouped and discussed below according to major foreign policy issue areas and are not necessarily grouped as they appear in the appropriation bills.

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The Foreign Policy Budget Request for FY1991

The President has asked Congress to appropriate about $21.6 billion, an increase of approximately $1.6 billion, or 8%, from FY1990 appropriated levels. In real terms, taking into account inflation, the new foreign policy budget request would grow by about 3.6%. [The budget document submitted by the Office of Management and Budget shows a $20 billion international affairs budget authority request for FY1991, a $1.4 billion increase over FY1990. Those figures, however, include off-setting receipts, trust funds, and other items. The analysis here considers those amounts for which Congress will appropriate funds.]

The additional funding amounts requested for FY1991 are concentrated largely in a few programs, including:

- **contributions to international organizations and peacekeeping** -- a $711 million increase over FY1990 (+101%) that would provide full funding for current U.S. payments to these organizations, plus arrearages accumulated in past years.

- **State Department expenses** -- up $114 million (+6.4%) from FY1990.

- **Moscow Embassy construction** -- $270 million (new for FY1991).

- **Voice of America radio construction** -- a $40 million (+48%) rise.

- **contributions to multilateral development banks (MDBs)** -- $267 million above FY1990 (+18%), mostly for past arrearages.

- **East Europe assistance** -- $300 million.

- **international narcotics programs** -- up about $233 million (+79%) from FY1990.

- **refugee assistance** -- an $82 million (+22%) increase.

The Administration characterizes its request for Function 150 as making selective foreign policy funding increases that emphasize U.S. participation in international organizations and financial institutions, international narcotics control activities and American support for political and economic change in East Europe. Nevertheless, the overall composition and program structure is not significantly different from past years. This may draw criticism from those Members who had asked the President to reexamine foreign policy budget priorities in light of the considerable international changes and to submit a FY1991 proposal that reflected new global realities. Some have argued that the budget should contain higher levels for foreign assistance, particularly for countries in Eastern Europe, and that such increases can be accommodated through transfers from the defense budget. Already, some Senators have proposed a $511 million aid package for East Europe in FY1991, over $200 million more than the requested amount. Others believe that reduced East-West tensions permit reductions in military assistance and greater spending for

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economic development programs and may question the nearly $200 million increase for military aid while development assistance remains about the same.

Diplomacy and Administration of Foreign Policy

One of the first needs of foreign policy is an infrastructure of U.S. representatives, diplomats, negotiators, consuls, and other officials to conduct U.S. relations with other nations. The Department of State was established in 1789 for this purpose. As the U.S. role in the world has increased, additional agencies including the U.S. Information Agency and the Arms Control and Disaramament Agency have been established for conducting policy in specific areas. Following are some of the major budget issues concerning the foreign policy establishment.

Lack of Full FY1990 Funding for State Department and U.S.I.A.

When the State Department Appropriation act was passed, the authorization legislation for funding foreign policy agencies for FY1990 was incomplete. Pending an authorization bill, the State, Justice, Commerce Appropriations Act, 1990 (P.L. 101-162) required that the Department of State and U.S.I.A. operate at FY1989 levels or the amounts passed by the Senate, whichever is less. The budget proposals for FY1991 assumed that after the enactment of the Foreign Relations Authorization Act (P.L. 101-246, signed Feb. 16, 1990), Section 614 would be repealed and the full amount appropriated for FY1990 for State and U.S.I.A. would be available.

Legislation to repeal Section 614 (H.J.Res. 442) was referred jointly to the House Foreign Affairs and Appropriations Committee on Nov. 17, 1989. The Foreign Affairs Committee reported the bill with amendments on Feb. 6, 1990, and Representative Smith of Iowa of the Appropriations Committee introduced a clean bill incorporating the foreign affairs amendment, H.J. Res. 471, on the same day. As yet no further action has been taken on the measure, apparently because a budget waiver is required. Thus, in some cases less money is available for State Department and USIA programs than was appropriated. Particularly affected are contributions to international organizations, exchange of persons programs, and Voice of America construction programs.

Support for U.S. International Leadership

A basic issue is whether the total amount for foreign policy agencies and their activities is adequate, especially if the United States wishes to continue to play a leading role in world affairs. For FY1991, the President has requested $2.66 billion for the Department of State's administration of foreign affairs, a $365 million, or 16% increase over levels currently available. Over half of the increase -- $270 million -- is for Moscow Embassy construction costs. (See CRS Issue Brief 87232, Embassy Construction Controversies: Moscow and Washington.) While the budgets for foreign policy agencies have grown during the past The budget 10 years, the growth has been less than it appears because of the decline in the value of the dollar relative to other currencies. Some foreign policy officials complain they do not have enough personnel to handle additional workload growing from the rapid developments in the world. On the other hand, during the budget crisis in 1987, some State Department officials

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felt reductions might prompt useful reforms. A closely related issue is whether the State Department's allocation of budget and personnel adequately reflect changing needs, such as the increasing importance of economic relations. The categories used for presenting the State Department budget for FY1990 make it difficult to know which bureaus are getting how much, but Section 302 of the Department of State Appropriations directed the Department to submit a budget presentation document for FY1992 that provides such information for each bureau and activity.

Contributions to International Organizations

Since 1985 the United States has accumulated significant arrearages in its payments to a large number of international organizations. Such arrears resulted in part from congressional and executive branch efforts to promote administrative reforms and financial restraint in such organizations. Appropriation shortfalls also have resulted from the lower priority given to full funding for international organizations relative to other programs amid efforts to reduce Government expenditures overall. For FY1990, the Administration requested and authorizing legislation provided for full funding for assessments for FY1990 and gradual repayment of the arrearages.

Nevertheless, appropriations for FY1990 ($615 million) fall short of the amounts necessary to begin the repayment of past arrearages. Citing the importance of these institutions, particularly in addressing trans-national problems, the Administration seeks nearly twice the FY1990 funding level for the U.N. and other international organizations. Of the $1.16 billion request, $464 million would cover U.S. arrearages through FY1990.

Some observers contend that in the future the United States should give increased emphasis to multilateral diplomacy and help develop international organizations into an efficient method of conducting international relations. Assessed contributions, in their view, are also a treaty commitment that should be scrupulously observed. Others contend that the United States cannot control the actions of international organizations and therefore that U.S. funds are more effectively spent in bilateral activities. (Issues related to voluntary contributions to international programs and international financial institutions are discussed in the section below on international development; issues related to U.S. contributions to U.N. peacekeeping operations are discussed in the section on international security. For further information, see CRS Issue Brief 86116, U.N. System Funding: Congressional Issues.)

Anti-terrorism and Diplomatic Security

There are several budget issues concerning how much priority to give to diplomatic security measures, which include protection against terrorism and espionage. After an increase in the number of terrorist attacks against American travelers and diplomats abroad, the Omnibus Diplomatic Security and Anti-terrorism Act of 1986 launched an effort to replace or improve U.S. facilities and protection of Government personnel throughout the world. For 1991 the Department of State is requesting $299 million for diplomatic security, representing 16% of its budget for salaries and expenses. One issue is whether the construction program is being properly monitored and proving effective, and whether the need for such measures

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is increasing or decreasing in the changing world. Another issue is whether diplomatic security measures are properly included in the foreign affairs budget, or whether they should be considered a responsibility of the Department of Justice or Defense.

Activities Abroad of Other Agencies

Not all agencies conducting activities abroad are in the foreign policy budget. Almost all Federal Departments and agencies now have some business overseas. An example is the Central Intelligence Agency, whose budget is hidden in the defense budget and which, according to public estimates, has 20,000 employees, approximately the same number as the Department of State.

One budget problem is allocating the costs of support provided by the embassies against the services provided by other agencies. Congress has expressed concern that the State Department's Foreign Affairs Administrative Support (FAAS) procedures may cause false economies for many other agencies. For FY1990 the State Department proposed that its own budget be reduced and other agencies be required to reimburse the State Department for their proportional use of additional function. For FY1991 the State Department seeks a restoration of $76.7 million for administration support services to other agencies, the same amount reduced from the FY1990 budget.

Public Diplomacy and Development of Democracy

Throughout the post-World War II era, the United States has conducted an information program through such instruments as the Voice of America, with a primary goal being to combat Soviet propaganda and international communism. It has also conducted other bilateral programs or contributed to multilateral programs aimed at political development and promotion of democracy. During the Reagan Administration, this segment of foreign policy came to be called public diplomacy. Following are some of the major budget issues relating to public diplomacy.

Future Role of Information Program and Official Broadcasting

Controversy over the purpose of the information program is long-standing. Since 1947 some observers have called for disseminating unbiased information while others have favored a more active advocacy of U.S. views. Often the U.S. Information Agency (USIA) has justified its budget requests primarily as an anti-Soviet instrument. In view of economic and political changes in the Soviet Union and Eastern Europe, it may be necessary to clearly define future USIA goals to determine financial needs. From 1982 through 1986 there was a steady growth in the USIA budget. The agency complains that real operating resources have declined since then. The $987 million USIA appropriation request for FY1991 is $56 million, or 6% more than currently available. Most of the increase -- $41 million -- is slated for continuing Voice of America radio construction modernization activities. Is further enhancement of the system necessary now that the Soviet Union has stopped jamming the broadcasts and the Soviet Union and other nations of Eastern Europe are now allowing much more openness in their own media?

Promotion of Democracy

The advent of new governments in Eastern Europe and in Panama in late 1989 dramatized the question of how the United States can contribute to their successful political development. Some programs, such as the National Endowment for Democracy and the provision of Economic Support Funds for the administration of justice have political development as a direct goal and in a sense the promotion of democracy is the aim of all the information and educational exchange programs. In 1989 Congress earmarked $4 million in direct support for Solidarity and democratic institutions out of a total aid package of $533 million promoting economic reform in Hungary and Poland. (See CRS Issue Brief 89138, East European Reform and U.S. Policy.) For FY1991, the President seeks $25 million for the National Endowment for Democracy, $8 million, or nearly 50% more than the appropriation for this year. How effective have political development programs been? Should the United States increase the funds it provides for the promotion of democracy, or are they better spent in seeking to improve the economic conditions in these countries?

International Security Programs

Throughout the past 40 years, a substantial part of the U.S. foreign policy budget has been dedicated directly to supporting American national security objectives. Although small in comparison to the roughly $300 billion defense budget -- security-related programs in Function 150 total about $8.2 billion -- these activities serve as a component of U.S. strategy of global deterrence, collective security, and forward defense. The easing of East-West tensions and its implications for U.S. security interests worldwide have already sparked a major debate over the extent and speed at which the United States should adjust defense spending to reflect these changes. Many believe that the same sort of assessment should take place concerning security programs funded within the international affairs budget.

Security Assistance

There appear to be three fundamental issues regarding security assistance budget decisions: the appropriate size of the program, particularly in relation to other defense programs and economic aid levels; the rationale for allocating aid among recipients; and the congressional practice of earmarking funds for selected countries of high interest. At present, the United States provides about $4.9 billion in military assistance and $3.2 billion in security-related economic aid channeled through the Economic Support Fund (ESF). (The ESF also supports U.S. efforts to stimulate economic growth and development in the Third World and is included below in the discussion on international development.) These levels would grow to $5.1 billion for military aid and $3.36 billion for ESF support in FY1991, roughly a 4% increase overall. Much of the additional ESF and military aid funding is planned for some of the countries -- such as the Philippines, Portugal, and Central America -- that incurred reductions from the President's FY1990 request and for larger amounts of assistance for the drug producing nations in the Andean region. In the past, security aid has promoted a range of American interests, such as supporting friends confronted by aggression and instability, maintaining access to military bases and

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facilities around the world, fostering the cohesion and strength of U.S. alliances, and defending democratic values. The rationale for security assistance often has been couched in terms of countering communist threats in the Third World. Some of the key questions facing policymakers are: Will reductions in East-West tensions diminish security threats encountered by American friends in the Third World or will regional conflicts remain dangerous? Will the United States be less interested in regional conflicts if they are not relevant to superpower competition? Will reduced tensions argue for a transfer of security assistance resources to economic development objectives? Do changes on the international scene suggest the continuation of security aid, but perhaps for different reasons than considered in the past? Over what time frame should the United States undertake any changes in security assistance policy?

Many in Congress regard the congressional practice of "earmarking" as a means by which lawmakers can establish their own priorities in the allocation of aid resources. The President regards it as undermining his flexibility in distributing a shrinking pool of funds and as an obstacle in responding to rapidly changing foreign policy needs. For FY1990, Congress reduced worldwide appropriations for ESF and military aid by about $550 million from the level requested but earmarked over 80% of the remaining funds for a number of countries, including Israel, Egypt, Pakistan, Turkey, Greece, Jordan, Morocco, and Poland. For the recipients not earmarked -- a group that included Central America, the Philippines, and the Andean nations -- the remaining discretionary funds of about $950 million fell about 40% below the roughly $1.6 billion requested by the President for this set of countries. Moreover, subsequent events in Eastern Europe, Panama, and most recently, Nicaragua, that came after final congressional action on the FY1990 appropriation placed additional pressures on the allocation of the non-earmarked ESF aid for FY1990. Senator Dole proposed in January that the President utilize a special waiver authority (Section 614 of the Foreign Assistance Act of 1961) and reduce the security assistance earmarks by 5% each. If applied to all earmarked countries, this plan would make available about $350 million that could be provided to some of the non-earmarked recipients as well as to those nations not envisioned as requiring U.S. assistance when the legislation passed Congress in November. The Administration expressed support for the Dole proposal in principle but following congressional consultations, decided against reducing aid levels earmarked by Congress for FY1990.

Consequently, security aid to a number of countries and regions is well below the amount requested for FY1990: Philippines -- $360 million requested, $264 million received; Portugal -- $175 million requested, $125 million received; Central America -- $593 million requested, $420 million received; the Caribbean -- $72 million requested, $5 million received; and sub-Saharan Africa -- $157 million requested, $44 million received. (It should be noted, however, that development and food aid levels for most of these countries did not decline.) Although the Administration decided against breaking earmarks for FY1990, officials are expected to make the earmark question a major issue during congressional deliberations on the foreign assistance budget this year. (See CRS Issue Brief 89014, Foreign Aid: Budget, Policy, and Reform.)

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International Peacekeeping

Another national security objective supported within the international affairs budget concerns U.S. contributions to international peacekeeping operations. The United Nations has maintained peacekeeping operations since 1948. In 1988 and 1989, the U.N. expanded its activities in helping to resolve a number of conflicts around the world, efforts that earned U.N. peacekeeping forces a Nobel Peace prize in 1988. Many argue that the United Nations is better equipped than major powers to mediate international conflicts and undertake police functions. Such U.N. involvement avoids a more direct involvement than might otherwise be required by the United States. Others, however, consider the U.N. efforts largely ineffective until issues have been decided by other forces and actors. In addition to maintaining newly created peacekeeping operations in the Persian Gulf, Angola, Namibia, and Central America, U.N. officials are involved in trying to help settle the Afghan war and may be asked in the near future to assist in other areas, including western Sahara and Cambodia. The United States supports international peacekeeping efforts through appropriations in both the Foreign Operations Appropriations ($33 million) and the State Department Appropriations ($82 million). Funding requested in the Foreign Operations Appropriations remains the same for FY1991, but significant increases are sought for U.N. peacekeeping operations supported in the State Department budget. Appropriations would triple to $247 million, a level that includes full payment for the $157 million U.S. arrearage. Key questions concern the effectiveness of the United Nations as an international peacemaker, what U.S. interests are served, and what are the appropriate financial costs that should be borne by the United States.

International Development and Economic Growth

A major part of the foreign policy budget supports programs that foster economic growth in developing nations and address humanitarian needs of people affected by natural disasters, wars, and poverty around the world. It is frequently argued that U.S. economic assistance directly furthers American national interests by helping to stabilize political and economic conditions in Third World democracies and by creating new and stronger trade and investment partners for American commercial objectives. Congress appropriated about $9.4 billion in FY1990 for economic assistance, consisting of contributions to the World Bank and other international financial institutions ($1.9 billion), bilateral assistance channelled through development accounts ($1.8 billion) and the Economic Support Fund ($3.2 billion) (ESF is a security-related economic aid program noted above), food assistance ($1 billion), and a range of other programs and administrative costs ($1.5 billion). The President is also expected to seek an additional $500 million for Panama for FY1990 and a $50 million supplemental for refugee aid. Economic assistance would grow to about $10 billion under the FY1991 request. The largest single increase is for U.S. contributions to international financial institutions -- up $267 million or 18% -- most of which would make up for past commitments that did not receive full appropriations. Other economic aid programs scheduled for increases in FY1991 are ESF (up nearly $150 million), disaster assistance (up $15 million or 60%), the State Department's narcotics program (up $37 million or 33%), refugee aid (up $82 million or 22%), and the Peace Corps (up $16 million or 9%). The President proposes $300

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million for Eastern Europe, with details on the plan coming later. Last year Congress approved a $533 million package for Poland and Hungary, $297 million of which required appropriations. For development assistance programs, including aid to Africa, the request is nearly identical to current amounts. The request for food aid is $80 million, or 8% below existing levels. Key issues concerning economic aid programs center on the structure and focus of American assistance and how to address what many regard to be pressing global problems related to narcotics production, the environment, and growing refugee needs around the world.

Proposals To Reform U.S. Economic Assistance

During the past two years, a number of groups, including a special task force of the House Foreign Affairs Committee, examined ways in which the United States provides foreign assistance and issued recommendations for significant reform. Several groups argued that general world economic, political, and security conditions had changed significantly since the last foreign aid reform effort in 1973, and that the program's design and structure are not appropriate for today's problems and needs. Some advanced their belief that economic assistance was only one part of an increasingly complex set of factors that contributed to development and growth in the Third World and that greater emphasis should be placed on mechanisms that enhanced trade and investment opportunities of developing nations. The House task force reported that U.S. foreign assistance legislation included too many goals and objectives and provided no meaningful direction for planning and implementing economic programs. Consequently, the task force recommended that American foreign aid should emphasize four principal policy objectives: (1) broad-based economic growth, (2) environmental sustainability, (3) poverty alleviation, and (4) political, social, and economic pluralism.

The proposals made by those advocating reform of U.S. economic aid programs and the continuing strict budget limits on foreign policy spending raise a number of important questions:

How will American aid programs support emerging economic needs in Eastern Europe and Panama while sustaining what many believe to be equally important and continuing requirements for current U.S. aid recipients? Will the increased focus and funding for Eastern Europe come at the expense of other countries and regions?

What is the appropriate emphasis within U.S. economic aid policy and World Bank programs on poverty-oriented, basic human needs activities, programs aimed at bolstering the private sectors in developing countries, and structural adjustment-type lending that is conditioned on broad-based policy reforms in recipient nations?

Should Congress provide the President with greater flexibility in managing economic assistance programs by reducing earmarks and providing lump-sum appropriations for development aid, instead of the current practice of setting specific amounts for various sectors, including agriculture, population, health, child survival, education, energy, environment, and the private sector?

Should there be a closer link and coordination between traditional U.S. economic aid programs and other U.S. export and investment programs, some of which are currently designed to enhance American trade opportunities but which many believe

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can play an important role in Third World economic growth? Should U.S. bilateral economic aid programs increase their emphasis on infrastructure projects, an area that currently is a minor component of the program, but one which some argue would offer benefits both to the recipient countries and to American businesses?

International Narcotics Control

As the use of illicit drugs has become a major domestic problem, reducing the supply of drugs through international narcotics control programs has become a high priority in U.S. foreign policy. Appropriations for this program in FY1990 totaled about $450 million and came from the domestic and defense as well as the international affairs budget. The President seeks $528 million in the Function 150 alone in FY1991, including $150 million for the State Department's international narcotics program (up 33%) and $346 million in economic and military assistance to Colombia, Bolivia, and Peru -- about twice the current amounts. Budget issues include how effective are international control programs at decreasing abuse of drugs in the United States? What international programs are most effective in reducing supply, and how should these programs be funded? (See CRS Issue Brief 88092, Drug Control: International Policy and Options.)

Refugee Assistance

Another global issue that has become a more expensive component of the U.S. foreign policy budget in recent years is assistance to refugees. The amount appropriated for FY1990 totaled $370 million for assistance to refugees in countries of asylum and the costs of admission for those allowed to settle in the United States. The number of refugees both in camps around the world and being admitted to the United States has continued to grow, increasing the pressure for more funds, and many feel that there exists a shortfall of at least $100 million for this year. The Administration has indicated that it will seek $50 million for FY1990. For FY1991, the budget requests $451 million, an increase of $82 million, or 22% above current levels. Issues include how many and which refugees to admit to the United States, the amount and designation of funds to assist camps abroad, and the sharing of the economic burden with other countries. (See CRS Issue Brief 89150, Migration and Refugee Assistance Budget.)

Environment

Threats such as depletion of the ozone layer have brought new public awareness that protection of the environment requires international cooperation on such measures as reforestation as well as national measures such as conserving or developing new sources of energy. Some believe that environmental degradation has become as much or more of a danger to U.S. national security than any military threat, and a growing amount of attention and funds are being devoted to the problem. The Agency for International Development plans to spend about $260 million on environment projects in FY1990 and the United States contributed $12 million to the United Nations Environmental Program. Issues include how much to integrate environmental protection into other development programs, the appropriate distribution of U.S. funds among bilateral and multilateral programs, and the priority of environmental programs relative to other domestic and international activities. (See CRS Issue Brief 89151, The Environment as a Foreign Policy Issue.)

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LEGISLATION

P.L. 101-162, H.R. 2991

Makes appropriations for the Departments of Commerce, Justice, and State, the Judiciary, and related agencies for FY1990. Passed House Aug. 1, 1989. Passed Senate Sept. 29, 1989. Signed into law Nov. 21, 1989.

P.L. 101-167, H.R. 3743

Makes appropriations for multilateral and bilateral economic assistance, military assistance, export financing, and other foreign operations for FY1990. Passed House and Senate Nov. 20, 1989. Signed into law Nov. 21, 1989.

P.L. 101-243, H.R. 3952

Urgent Assistance for Democracy in Panama Act of 1990. Authorizes funds for economic assistance to Panama and assistance to support democratic transition in Eastern Europe and Yugoslavia. Passed House and Senate Feb. 7, 1990. Signed into law Feb. 14, 1990.

P.L. 101-246, H.R. 3792

Foreign Relations Authorization Act, FY1990 and 1991. Authorizes appropriations for Department of State, U.S.I.A., Board for International Broadcasting, International Organizations and Commissions, and enacts other foreign policy measures. Passed House Nov. 21, 1989. Passed Senate Jan. 30, 1990. Signed into law Feb. 16, 1990.

H.J.Res. 471 (Smith of Iowa)

Repeals Section 614 of P.L. 101-162 (Department of State Appropriations) to remove limits on amounts that were placed pending authorization. This is a clean bill introduced Feb. 6, 1990, after Foreign Affairs Committee reported original bill H.J.Res. 442 with amendment. Referred to Committees on Appropriations and on Foreign Affairs.

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APPENDIX

Figure 1
U.S. BUDGET OUTLAYS - FY 1991

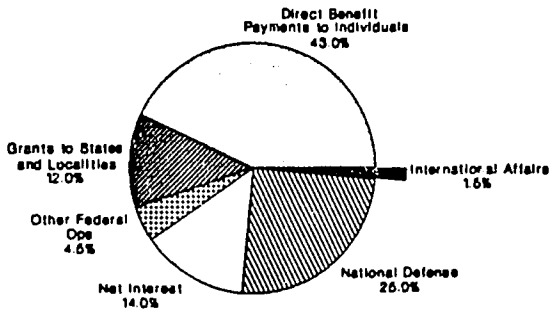

Figure 2
INTERNATIONAL AFFAIRS APPROPRIATIONS*
Fiscal Years 1981 - 1991

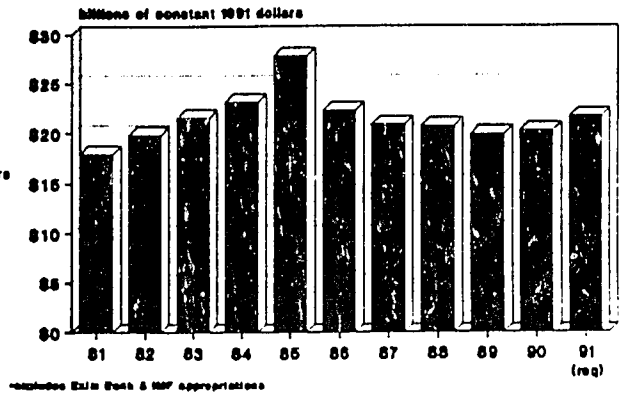

Figure 3
INTERNATIONAL AFFAIRS APPROPRIATIONS
Fiscal Year 1991 Request

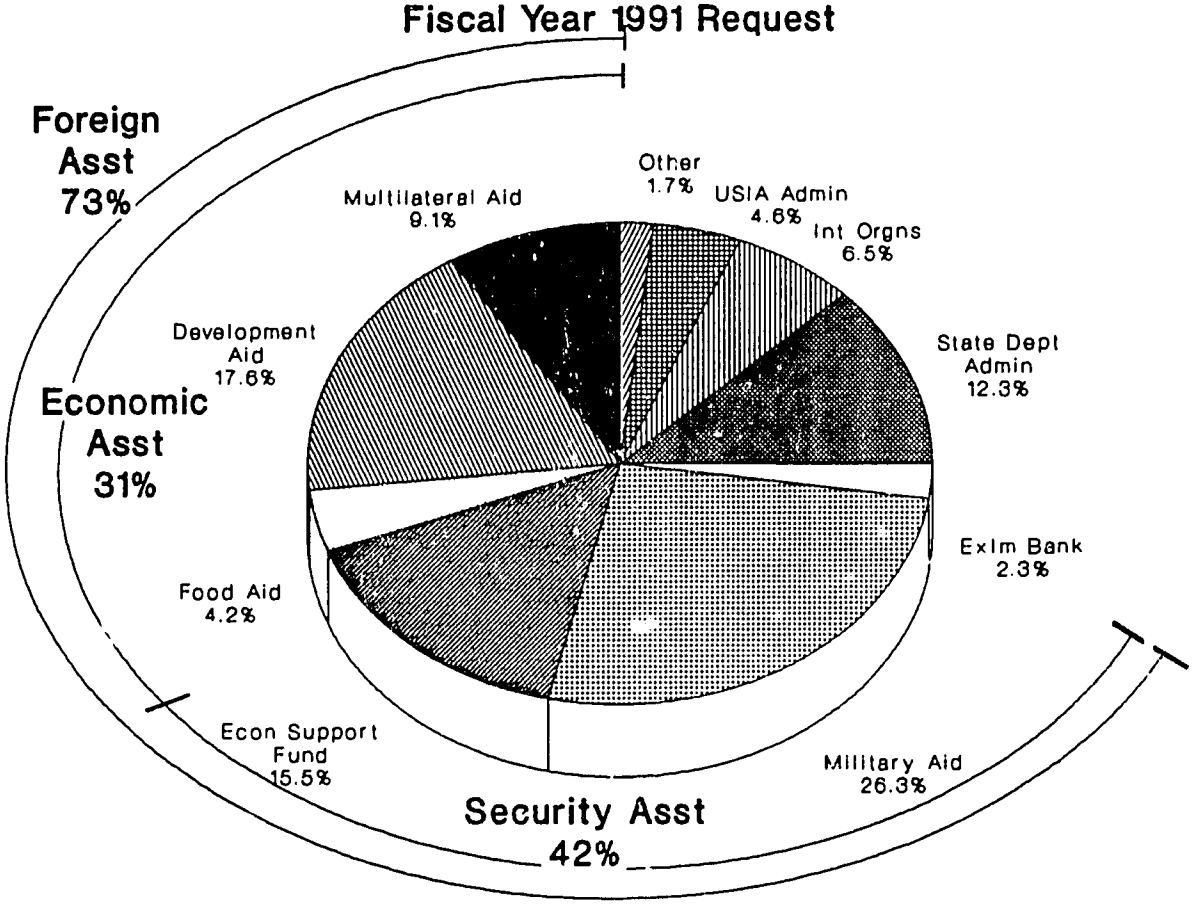

Table 1
FOREIGN OPERATIONS & EXPORT FINANCING APPROPRIATIONS
(millions of dollars)

	FY 1989	FY 1990 Approp*	FY 1991 Request	FY91 +/- FY90 ($)	FY91 +/- FY90 (%)
Multilateral Economic Aid:					
World Bank - IBRD	$50.0	$49.8	$110.6	$60.8	122.1%
World Bank - Int Develop Assc	$995.0	$960.9	$1,064.2	$103.3	10.8%
World Bank - Int Finance Corp	$4.9	$74.6	$40.3	$-34.3	-46.0%
Inter-American Dev Bank	---	$94.9	$103.8	$8.9	---
Asian Development Bank	$152.4	$175.0	$301.8	$126.8	72.5%
African Development Fund	$105.0	$104.5	$105.5	$1.0	---
African Development Bank	$7.3	$9.5	$10.1	$.6	6.3%
subtotal, Mult Development Banks	$1,314.6	$1,469.2	$1,736.3	$267.1	18.2%
Int Organizations & Programs	$226.1	$274.3 **	$225.0	$-49.3	-18.0%
IMF/Enhanced Structural Adj Fund	---	$139.4	$10.6	$-128.8	---
TOTAL, MULTILATERAL AID	$1,540.7	$1,882.9	$1,971.9	$89.0	4.7%
Bilateral Development Aid:					
Agriculture	$493.7	$481.6	$1,208.0 ***	N/A	N/A
Population	$197.9	$216.2		N/A	N/A
Health	$122.5	$125.1		N/A	N/A
Child Survival Fund	$71.0	$70.7		N/A	N/A
AIDs Prevention/Control	$40.0	$41.2		N/A	N/A
Education	$129.5	$132.3		N/A	N/A
Sel Dev Act/Science & Tech	$129.4	$142.9 **		N/A	N/A
Development Fund for Africa	$500.0	$561.8	$560.5	$-1.3	-.2%
Southern Africa Development Aid	$50.0	---	---	---	---
Development aid Deob/Reob Auth	$12.5	$39.0	$23.0	$-16.0	-41.0%
TOTAL, BILATERAL DEVELOPMENT AID	$1,746.5	$1,810.8	$1,791.5	$-19.3	-1.1%
Other Economic Assistance:					
Amer Schools/Hospitals Abroad	$35.0	$34.9	$23.0	$-11.9	-34.1%
International Disaster Asst	$25.0	$24.9	$40.0	$15.1	60.6%
Foreign Service Retirement	$40.5	$40.1	$40.3	$.2	.5%
AID Operating & IG Expenses	$442.5	$459.5	$481.7	$22.2	4.8%
Housing & Investment Guarantees	$22.0	$45.0	$48.0	$3.0	6.7%
African Development Foundation	$8.0	$8.8	$11.5	$2.7	30.7%
Inter-American Foundation	$16.6	$16.9	$16.9	$.0	.0%
Peace Corps	$153.5	$165.6	$181.1	$15.5	9.4%
Int Narcotics Control Program	$101.0	$113.0	$150.0	$37.0	32.7%
Anti-Terrorism Program	$9.8	$10.0	$12.0	$2.0	20.0%
Migration and Refugee Asst	$462.0	$368.4	$450.6	$82.2	22.3%
Emerg Migration & Refugee Fund	$50.0	$49.8	$25.0	$-24.8	-49.8%
Trade and Development Program	$25.0	$31.5	$30.0	$-1.5	-4.8%
Anglo-Irish Accord	---	$19.9	---	$-19.9	---
Mult Asst Intitiative-Philippines	---	$159.3	$200.0	$40.7	25.5%
East European aid	---	---	$300.0	$300.0	---
TOTAL, OTHER ECONOMIC ASSISTANCE	$1,390.9	$1,547.6	$2,010.1	$462.5	29.9%
Economic Support Fund:					
ESF appropriation	$3,258.5	$3,191.2	$3,344.0	$152.8	4.8%
ESF Deob/Reob authority	---	$18.0	$14.0	$-4.0	-22.2%
TOTAL, ECONOMIC SUPPORT FUND	$3,258.5	$3,209.2	$3,358.0	$148.8	4.6%
Military Aid:					
Military Asst Program (MAP)	$467.0	---	---	$.0	---
Int Military Ed & Training (IMET)	$47.4	$47.2	$50.5	$3.3	7.0%
Foreign Military Financing	$4,272.8	$4,827.6	$5,016.9	$189.3	3.9%
(grants)	($3,862.8)	($4,249.0)	($4,988.9)	($739.9)	(10.2%)
(concessional loans)	($410.0)	($404.3)	(---)	(-$404.3)	(---)
(administration)	(---)	($29.8)	($28.0)	(-$1.8)	(-6.0%)
(counter-narcotics)	(---)	($125.0)	(---)	(-$125.0)	(---)
(transfer)	(---)	($20.0)	(---)	(-$20.0)	(---)
Peacekeeping Operations	$31.7	$32.8	$32.8	$.0	.0%
TOTAL, MILITARY AID	$4,818.9	$4,907.6	$5,100.2	$192.6	3.9%
Export-Import Bank	$695.0	$612.4	$500.0	$-112.4	-18.4%
Recissions	---	$-50.0	---	$50.0	-100.0%
Military Financing Guarantee Reserve****	$574.0	$719.5	$587.1	$-132.4	-18.4%
TOTAL, FOREIGN ASST & EXPORT FINANCING	$14,044.5	$14,640.0	$15,318.8	$678.8	4.6%

* Levels adjusted for drug-initiative reduction (0.43%) and partial year Gramm-Rudman sequestration.
** Adjusted for transfer of $13.5 million from selected development aid account to int'l orgns.
*** Total requested for development assistance functional accounts -- budget does not specify individual accounts.
****Mandatory appropriation.

Table 2
AGRICULTURE APPROPRIATIONS - FOOD ASSISTANCE
(millions of dollars)

	FY 1989	FY 1990 Approp*	FY 1991 Request	FY91 +/- FY90 ($)	FY91 +/- FY90 (%)
Food Assistance (PL 480):					
Title I loans	$468.1	$305.6	$251.9	$-53.7	-17.6%
Title II grants	$630.0	$672.6	$646.0	$-26.6	-4.0%
TOTAL, FOOD ASSISTANCE	$1,098.1	$978.2	$897.9	$-80.3	-8.2%

* Adjusted for partial year Gramm-Rudman sequestration.

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Table 3
STATE DEPARTMENT, USIA & RELATED AGENCIES APPROPRIATIONS
(millions of dollars)

	FY 1989	FY 1990 APPROP *	FY 1991 REQUEST	FY91 +/- FY90 ($)	FY91 +/- FY90 (%)
STATE DEPARTMENT APPROPRIATION					
ADMINISTRATION OF FOREIGN AFFAIRS					
Salaries and expenses	$1,789.0	$1,792.4	$1,906.4	$114.0	6.4%
Office of Inspector General	---	$20.8	$23.3	$2.5	12.0%
Representation allowances	$4.6	$4.6	$4.6	$.0	.2%
Protection-foreign missions & officials	$9.1	$9.1	$9.1	$.0	.0%
Acquisition/maintenance of buildings	$240.0	$293.5	$317.8	$24.3	8.3%
Moscow Embassy construction	---	---	$270.0	$270.0	---
Emergencies-diplomatic & consular servs	$4.5	$4.6	$6.6	$2.0	43.5%
Payment to American Institute in Taiwan	$10.9	$11.1	$12.0	$.9	8.1%
Foreign Service Retirement Fund	$107.7	$106.0	$108.6	$2.6	2.4%
TOTAL:ADMINISTRATION OF FOREIGN AFFAIRS	$2,165.8	$2,242.1	$2,658.4	$416.3	18.6%
INTERNATIONAL ORGANIZATIONS AND CONFERENCES					
Contributions to int'l organizations	$485.9	$615.0	$1,158.5	$543.5	88.4%
Contributions to int'l peacekeeping	$141.0	$81.1	$247.4	$166.3	205.1%
Int'l conferences & contingencies	$6.0	$6.3	$8.2	$1.9	30.2%
TOTAL, INT'L ORGANIZATIONS & CONFERENCE	$632.9	$702.4	$1,414.1	$711.7	101.3%
INTERNATIONAL COMMISSIONS**					
Int'l Boundary/Water Comm: US & Mexico					
Salaries and expenses	$10.3	$10.5	$10.5	$.0	.0%
Construction	$3.2	$11.5	$10.0	$-1.5	-13.0%
American sections, int'l commissions	$4.3	$4.4	$4.4	$.0	.0%
Int'l fisheries commissions	$10.5	$12.1	$10.7	$-1.4	-11.6%
TOTAL, INTERNATIONAL COMMISSIONS	$28.3	$38.5	$35.6	$-2.9	-7.5%
OTHER					
U.S. Bilat Science & Tech agreements	$2.0	$4.0	$5.0	$1.0	25.0%
Payment to the Asia Foundation	$13.7	$13.9	$14.0	$.1	.7%
Soviet-E. European research & training	$4.6	$4.6	$4.6	$.0	.0%
Fishermen's guaranty fund**	$1.7	$.9	$.9	$.0	.0%
Fishermen's protective fund**	---	$1.0	$.5	$-.5	-50.0%
TOTAL, OTHER	$22.0	$24.4	$25.0	$.6	2.5%
TOTAL, DEPARTMENT OF STATE	$2,849.0	$3,007.4	$4,133.1	$1,125.7	37.4%
UNITED STATES INFORMATION AGENCY					
Salaries and expenses	$620.3	$634.9	$643.5	$8.6	1.4%
Office of the Inspector General	---	$3.6	$4.1	$.5	13.9%
Education & cultural exchange programs	$150.0	$158.1	$154.3	$-3.8	-2.4%
Radio construction	$65.0	$84.1	$124.7	$40.6	48.3%
Radio broadcasting to Cuba	$11.2	$12.5	$15.1	$2.6	20.8%
East-West Center	$20.0	$20.4	$20.0	$-.4	-2.0%
National Endowment for Democracy	$15.8	$16.8	$25.0	$8.2	48.8%
TOTAL, UNITED STATES INFORMATION AGENCY	$882.3	$930.4	$986.7	$56.3	6.1%
ARMS CONTROL AND DISARMAMENT AGENCY	$31.0	$33.4	$30.0	$-3.4	-10.2%
BOARD FOR INTERNATIONAL BROADCASTING					
Grants and expenses	$194.9	$190.0	$201.3	$11.3	5.9%
Israel Relay Station	$33.0	$183.0	$24.0	$-159.0	-86.9%
TOTAL, BOARD FOR INT'L BROADCASTING	$227.9	$373.0	$225.3	$-147.7	-39.6%
MISCELLANEOUS FOREIGN AFFAIRS ***	$39.4	$43.7	$44.9	$1.2	2.7%

* Adjusted for partial year Gramm-Rudman sequestration. Includes amounts that are currently unavailable for FY1990 until Sec. 614 of State Department Appropriation Act is repealed. For discussion, see section, "Lack of FY1990 Funding."

** Programs funded in the State Dept appropriation but not part of the 150 budget function.

***Commission for the Preservation of America's Heritage Abroad, Ukraine Famine, Security and Cooperation in Europe, for Study of International Migration, Competitiveness Policy Council, International Trade Commission, and Japan-US Friendship Commission.

AGENCY FOR INTERNATIONAL DEVELOPMENT

Congressional Presentation--Fiscal Year 1991, pp.456-457

FY 1991 U.S. ECONOMIC AND MILITARY ASSISTANCE - REQUEST

10:07 AM
16-Feb-90

	DA	ESF	PL 480 TITLE I	PL 480 TITLE II	NARC'S	PEACE CORPS	OTHER ECON	IMET	FMF	OTHER MILITARY	TOTAL
BILATERAL ASSISTANCE											
Africa	560,500	56,100	94,000	83,731	--	63,083	--	10,175	26,000	--	893,589
Asia/Near East & Europe	404,480	2,636,000	395,000	149,693	12,850	39,694	--	27,235	4,679,800	--	8,344,752
Latin America & Caribbean	374,567	651,900	184,000	67,420	46,600	35,360	--	12,880	283,100	--	1,695,827
Central Bureaus	428,953	--	144,000	345,156	50,550	42,925	--	210	28,000	--	1,039,794
Contingency Unallocated	--	--	--	--	--	--	--	--	--	--	0
Geographic & Central Programs	1,768,500	3,344,000	817,000	646,000	150,000	181,062	--	50,500	5,016,900	--	11,973,962
(Africa Fund)	[560,500]	--	--	--	--	--	--	--	--	--	[560,500]
(SADCC)	--	--	--	--	--	--	--	--	--	--	0
(PSRF)	--	--	--	--	--	--	--	--	--	--	0
(Andean Narcotics Init.)	--	[175,000]	--	--	--	--	--	--	--	--	[175,000]
Deob/Reob	23,000	14,000	--	--	--	--	--	--	--	--	37,000
Subtotal	1,791,500	3,358,000	817,000	646,000	150,000	181,062	--	50,500	5,016,900	--	12,010,962
ASHA	23,000	--	--	--	--	--	--	--	--	--	23,000
Disaster Assistance	40,000	--	--	--	--	--	--	--	--	--	40,000
Humanit. Relief (McCollum Amdt)	--	--	--	--	--	--	--	--	--	--	0
Private Sector Guarantees	[125,000]	--	--	--	--	--	--	--	--	--	[125,000]
Housing Guarantees	[100,000]	--	--	--	--	--	--	--	--	--	[100,000]
Housing Borrowing Authority	48,000	--	--	--	--	--	--	--	--	--	48,000
Operating Expenses	447,794	--	--	--	--	--	--	--	--	--	447,794
Operating Expenses-IG	33,884	--	--	--	--	--	--	--	--	--	33,884
Foreign Service Ret. & Dis.	40,341	--	--	--	--	--	--	--	--	--	40,341
Special Assistance Initiatives	500,000	--	--	--	--	--	--	--	--	--	500,000
TCIP Central America	[200,000]	--	--	--	--	--	--	--	--	--	[200,000]
TCIP Poland	[200,000]	--	--	--	--	--	--	--	--	--	[200,000]
Miscellaneous Trust Funds	5,000	--	--	--	--	--	--	--	--	--	5,000
Central Amer. Reconciliation	--	--	--	--	--	--	--	--	--	--	0
Advanced Acq. of Property	--	--	--	--	--	--	--	--	--	--	0
A.I.D. Loan Repayments	(460,000)	--	--	--	--	--	--	--	--	--	(460,000)
Misc. Trust Funds Receipts	(5,000)	--	--	--	--	--	--	--	--	--	(5,000)
Subtotal A.I.D.	2,464,519	3,358,000	817,000	646,000	150,000	--	--	--	--	--	7,435,519
Trade & Development Program	--	--	--	--	--	--	30,000	--	--	--	30,000
Inter-American Foundation	--	--	--	--	--	--	16,941	--	--	--	16,941
African Development Foundation	--	--	--	--	--	--	11,500	--	--	--	11,500
Peace Corps Trust Fund	--	--	--	--	--	400	--	--	--	--	400
Migration & Refugee Assistance	--	--	--	--	--	--	450,648	--	--	--	450,648
Emergency Refugee Fund	--	--	--	--	--	--	25,000	--	--	--	25,000
Misc. Trust Funds - DOT	--	--	--	--	--	--	3,643	--	--	--	3,643
Misc. Trust Funds - DOT Rec.	--	--	--	--	--	--	(2,743)	--	--	--	(2,743)
Overseas Priv. Invest. Corp											
(limit on direct loans)	--	--	--	--	--	--	[23,000]	--	--	--	[23,000]
(limit on guar. loans)	--	--	--	--	--	--	[185,000]	--	--	--	[185,000]
Receipts	--	--	(565,147)	--	--	--	(39,000)	--	(224,415)	--	(828,562)
Adjustments	--	--	--	--	--	--	--	--	--	--	0
Total: Bilateral	2,472,557	3,358,000	251,853	646,000	150,000	181,462	495,989	--	--	--	7,555,861

FY 1991 U.S. ECONOMIC AND MILITARY ASSISTANCE - REQUEST

10:07 AM 16-Feb-90	DA	ESF	---- PL 480 ---- TITLE I	TITLE II	NARC'S	PEACE CORPS	OTHER ECON	IMET	FMF	OTHER MILITARY	TOTAL
MULTILATERAL ASSISTANCE											
MDB's	--	--	--	--	--	--	1,736,269	--	--	--	1,736,269
I O & P	--	--	--	--	--	--	225,000	--	--	--	225,000
Total: Multilateral	--	--	--	--	--	--	1,961,269	--	--	--	1,961,269
TOTAL ECONOMIC ASSISTANCE	2,472,557	3,358,000	251,853	646,000	150,000	181,462	2,457,258	--	--	--	9,517,130
Anti-Terrorism Assistance	--	--	--	--	--	--	--	--	--	12,026	12,026
Peacekeeping Operations	--	--	--	--	--	--	--	--	--	32,800	32,800
Guarantee Reserve Fund	--	--	--	--	--	--	--	--	--	587,061	587,061
Asset Sales Prepayment	--	--	--	--	--	--	--	--	--	--	0
Adjustments	--	--	--	--	--	--	--	--	--	--	0
TOTAL MILITARY ASSISTANCE	--	--	--	--	--	--	--	50,500	4,792,485	631,887	5,474,872
TOTAL ECONOMIC & MILITARY	2,472,557	3,358,000	251,853	646,000	150,000	181,462	2,457,258	50,500	4,792,485	631,887	14,992,002

1/ Includes emergency and refugee programs in both Afghanistan and Pakistan.

WASHINGTON WEEKLY REPORT

A Review of Congressional Action Affecting Multilateral Issues and Institutions

Steven A. Dimoff, Editor

XVI-1
12 January 1990

U.S. MAKES INITIAL U.N. SYSTEM CONTRIBUTIONS AT YEAR'S END; FURTHER PAYMENTS CONTINGENT ON CONGRESSIONAL APPROVAL

Constrained by appropriations limited to the previous year's levels, the United States made only partial payments toward its 1989 obligations to the United Nations and major specialized agencies before the close of the calendar year. Further payments toward 1989 assessments are expected upon approval of a reprogramming request submitted by the State Department to relevant congressional panels on December 27, 1989. The reprogramming request is intended to notify Congress of State's plan to begin satisfying 1989 obligations to forty-six international organizations of which the United States is a member.

Reprogramming Fully Funds Thirty-Seven Organizations

Under the terms of the reprogramming request, the United States would honor its full obligations to thirty-seven of forty-six international organizations including the North Atlantic Treaty Organization (NATO) and the Organization of Economic Cooperation and Development (OECD) Several smaller U.N. specialized agencies, such as the International Civil Aviation Organization (ICAO) and the International Telecommunications Union (ITU), among others, would also receive full funding under the reprogramming request. Most major U.N. specialized agencies, including the United Nations regular budget, would receive partial funding of 1989 obligations until Congress approves the FY1990 State Department authorization. This action would restore FY1990 conference-approved appropriations levels for all State Department operations, including contributions to international organizations (background, see WWR, XV-38, 1 December 1989).

FAO Contribution Slated For Cut

While State Department sources indicated that the reprogramming request was intended to avoid any prioritizing of organizations based on responsivness to U.S. interests, the Food and Agriculture Organization (FAO) would receive less than one-half of its 1989 assessment of $61 million under the plan. The United States recently contributed $18 million to FAO--the minimum payment needed to retain its vote in the agency's governing council. The United States remains critical of the 1990-91 budget totaling $569 million, charging that it represents a real increase of 3 percent over the previous biennium. Additionally,

the United States opposed passage of a November 1989 General Conference resolution calling for FAO to provide economic development assistance to the Palestinian people in cooperation with the Palestine Liberation Organization (PLO). The U.S., which voted against the resolution, maintains that the resolution lends legitimacy to the PLO claim of control over a Palestinian homeland.

Reprogramming Takes Account Of Economic, Political Factors

Aside from the proposal to restrict FAO funding for calendar year 1989, State Department sources indicated that the reprogramming request attempts to accommodate several economic and political factors affecting the account. Noting that the reprogramming request assumes that most international organizations have been responsive to U.S. interests, the initial State Department judgement was that obligations to thirty-seven organizations would be paid in full. Most of these organizations' annual contributions total less than $1 million, and it was determined that arrearages to these organizations would not be "cost-effective." In addition, contributions to NATO and OECD have enjoyed high-level political support in the State Department as well as on Capitol Hill.

Full Payment To U.N. Dependent On Release Of FY1990 Appropriations

Upon approval of the reprogramming request, U.S. contributions to the U.N. regular budget and major specialized agencies would reach calendar year 1988 levels. For 1989 U.S. contributions to the U.N. regular budget, which totaled $130 million at the end of December, approval of the reprogramming request would release an additional $14 million -- to reach the $144 million level paid in 1988. The U.S. recognized 1989 U.N. regular budget assessment of $206 million would be paid when FY1990 levels are approved by Congress. The same plan is envisioned for full payment of contributions to major U.N. specialized agencies -- seemingly at the expense of contributions to FAO because Congress has not approved requested full funding for international organizations (WWR. XV-35, 3 November 1989).

Request Appeals For Passage Of FY1990 Appropriations

According to the State Department's letter accompanying the reprogramming request, the Acting Secretary for Management wrote, "This allocation is preliminary in that it is our earnest hope that necessary legislative action will be taken during the next session of Congress to restore the [international organizations'] appropriation to the Conference approved level of $622 million....in the event that this level is restored, all organizations except FAO would be paid in full under these estimates." Congress is expected to act on the reprogramming request within the fifteen-day period dating from the January 3rd opening of this session of Congress.

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Contributions To International Organizations
Reprogramming Request, FY1990

($ in millions)

U.N. SYSTEM (12)	FY1990 Requirement (Assessment) 1/	FY1990 Reprogramming Request 2/	FY1990 Final Propose Allocation
United Nations Budget	206.884 4/	144.303	206.884
Food and Agriculture Org. (FAO)	61.094	18.000	29.481
International Atomic Energy Agency (IAEA)	36.663	35.160	36.663
International Civil Aviation Org. (ICAO)	10.133	10.133	10.133
International Labor Org. (ILO)	48.798	34.054	48.798
International Maritime Org. (IMO)	.889	.889	.889
International Telecommunications Union (ITU)	5.043	5.043	5.043
U.N. Industrial Development Org. (UNIDO)	18.264	12.741	18.264
Universal Postal Union (UPU)	.797	.797	.797
World Health Org. (WHO)	71.073	65.354	71.073
World Intellectual Property Org. (WIPO)	.610	.610	.610
World Meteorological Org. (WMO)	6.162	6.162	6.162
U.N. System, Subtotal	466.410	333.248	434.797
INTER-AMERICAN ORGANIZATIONS (6)			
Organization of American States (OAS)	49.899	32.968	49.899
Pan American Health Org. (PAHO)	39.204	32.059	39.204
Others	14.719	11.332	14.719
Inter-American, Subtotal	103.822	76.359	103.822
REGIONAL ORGANIZATIONS (5)			
North Atlantic Treaty Org. (NATO)	27.233	27.233	27.233
Organization for Economic Cooperation and Development (OECD)	33.898	33.898	33.898
Others	1.780	1.780	1.780
Regional Organizations, Subtotal	62.911	62.911	62.911
OTHER INTERNATIONAL ORGANIZATIONS (28)	13.422	13.422	13.422
Grand Total, All Int'l Organizations	646.565	485.940	614.952

Notes:

1/ Reestimates of obligations primarily based on fluctuations in exchange rates.

2/ Currently under consideration by relevant congressional committees, it is proposed as an interim plan pending approval of FY1990 appropriations levels.

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3/ Estimates based on enactment of FY1990 appropriations levels approved by conferees.

4/ Though the 1989 U.N. regular budget assessment for the United States is $216 million, the U.S. withholds certain funds due to statutory restrictions and/or administration-announced policy.

December Payments Are First In 1989

Though submitting the reprogramming request for congressional approval in late December, the State Department made partial first payments toward 1989 obligations in mid-to-late December. In most cases, the contributions were made in recognition of financial hardship suffered by the agencies and the desire to begin making payments during the year in which they were due. Full payments of amounts requested in the reprogramming document were not made in the event Congress decided to recommend changes in the State-proposed formula. Among U.N. system organizations receiving partial U.S. contributions in December were the United Nations regular budget, $130 million; World Health Organization, $32 million; International Labor Organization, $20.4 million; International Civil Aviation Organization, $4 million; and the Food and Agriculture Organization, $18 million. In most cases, the payments were accompanied by a commitment to provide additional funding upon approval of the reprogramming request.

International Development NETWORKER

Interfaith Action for Economic Justice • Washington, DC • February 1990

Congress Appropriates 13.4 Billion for Foreign Aid Postpones Decisions on Major Changes

Before leaving Washington in late November Congress approved HR 3743, appropriating $13.4 billion in foreign aid funds for fiscal year 1990 (excluding PL 480 food aid). This total was about $700 million higher than the fiscal year 1989 level and $450 million below the Administration's FY 90 request.

The FY 90 foreign aid appropriation bill continues the welcome trend of gradually reducing security assistance and increasing development assistance. Development assistance will grow from 42 percent to 44 percent of the total, while security assistance will decline from 57 percent to 54 percent of the total assistance package.

Nevertheless, security assistance, at $8.1 billion, is still preponderant, compared to a total of $6.6 billion for development related programs ($4.9 billion for bilateral and multilateral development assistance and $1.7 billion for food aid).

See the table below which summarizes FY 90 appropriations and compares them to those voted for FY 89.

While there are few major surprises in the bill, there are several items that deserve special mention.

• The large increase in multilateral assistance reflects a $140 million contribution to a new International Monetary Fund facility, the Enhanced Structural Adjustment Facility (ESAF), for the purpose of providing reduced interest rates on IMF loans to the poorest debt burdened African countries. IAEJ supported the measure but expressed concern that economic policy reforms usually attached to such relief often have detrimental effects on poor people.

• The International Fund for Agricultural Development (IFAD) which provides valuable assistance to small farmers received $35 million toward the U.S. replenishment obligation, a vast improvement over the $2.5 million voted in FY 89.

• The Economic Support Fund increase includes a new $160 million multinational initiative for the Philippines. Although $20 million of the U.S. funding is to be channeled through non-governmental organizations (NGOs), many Philippine NGOs are skeptical about the prospects of its reaching groups that work with poor people.

• $85 million in military assistance was voted for El Salvador in spite of protest against the November murders of priests and others at the University of San Salvador and an attempt by their Congressional supporters to win approval of the withholding of 30 percent of this aid until those responsible were brought to justice.

• The largest percentage of increases were in the "other" assistance category and reflect funds voted to fight the "war on drugs" in Latin America and $532.8 million in assistance to Poland and Hungary.

FY 90 FOREIGN OPERATIONS APPROPRIATIONS
($ in millions)

	FY81 ACTUAL	FY89 ACTUAL	FY90 APPROP.
DEVELOPMENT ASSISTANCE	4999.2 47%	5935.8 42%	6570.3 44%
SECURITY ASSISTANCE	5444.3 52%	8045.7 57%	8103.8 54%
FOREIGN AID TOTAL	10540.0	144189.5	15029.6

Foreign Operations Appropriations for fiscal years 81, 89, and 90. Taken from Policy Note 90-1, available from IAEJ.

During 1989 the House Foreign Affairs Committee and many groups within the development, church and environmental communities, including IAEJ, devoted considerable time and energy to redrafting foreign aid policy guidelines to seek to make them more supportive of the efforts for equitable, participatory and sustainable development in Third World countries.

Continued on next page

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continued from first page

However, for the fourth consecutive year Congress failed to pass a foreign aid authorization bill and those interested in change will need to renew their efforts in 1990.

In addition, the events of recent months in Eastern Europe raise additional issues that must be faced in 1990 by those interested in the U.S. foreign assistance programs. For example, what should be the nature and rationale of a foreign aid program in the Post Cold War era? How can the U.S. use any "peace dividend" that results from defense-related cuts in a Cold War era? Will any new funds be available for meeting human needs internationally? How do we ensure that there will be a continued flow of United States and other donor resources to poor countries in the South, rather than a diversion of those resources to Eastern Europe? While wars continue to rage in many areas of conflict, tentative steps toward peace have been taken and may bear fruit in the next twelve to eighteen months. What will be the United States' role in post-conflict reconstruction? The decade of the 1990s will clearly provide many opportunities for action on behalf of international economic justice.

Policy Note Available

The Interfaith Action for Economic Justice International Development Policy Work Group has prepared an analysis of the Foreign Aid Appropriation Bill for fiscal year 1990. The note includes an expansion, and footnotes, of the chart on the first page of this Networker. For a copy or for bulk copies of Policy Note 90-1, please contact IAEJ.

"Poverty Effort" For Export-Import Bank

Public Law 101-271, the recently approved legislation governing the work of the Export-Import Bank, provides for higher levels of assistance to be available to countries which demonstrate effort or commitment to eradicate poverty.

The bill reauthorizes the tied aid credit program of the Export-Import Bank and provides funding for both the Inter-American Development Bank and a facility within the International Monetary Fund which is intended to benefit nations in sub-Saharan Africa.

This new "poverty effort" will specifically require that (a) borrowing governments work with citizens to put poverty eradication plans in place and (b) banks make budgetary and administrative changes to help countries achieve the goals of their plans.

Prepared by Nancy Alexander of Friends Committee on National Legislation

A New Model of South-North Partnership

Responding to rapid environmental degradation and serious poverty in the Philippines, a delegation of ten, key Philippine Non-Governmental Organization (NGO) leaders traveled to the United States last November to share their vision of equitable and sustainable development. In addition to participating in a major conference on the environment and international development, held in California, the delegation met in Washington with policy makers and roughly 80 of their U.S. counterparts. In a day-long forum - which pulled together people from the U.S. environmental, development, NGO and religious communities - the Philippine group shared their experiences in grassroots development and environmental activism, and presented an integrated vision for development which is community-based, equity-led, environmentally-sound and democratic in nature.

Energized by the Philippine group's vision, and encouraged by the reality of rapid communication through FAX and computer links, the U.S. participants formed a loose coalition called the Philippine Development Forum (PDF). Membership in the PDF is based upon a general acceptance of the development vision articulated by the Philippine NGO group. This is contained in a document entitled "Creating a Common Future: Philippine NGO Initiatives for Sustainable Development," which has been endorsed by a coalition of 85 Philippine organizations known as "Green Forum."

The PDF is designed to facilitate the sharing of information and analysis among U.S. groups about developments in the Philippines and to enhance partnership relationships between Philippine and U.S. NGOs. It will also coordinate Philippine/U.S. NGO action.

Four working groups were formed in a January meeting on the following issues: The U.S. Multilateral Assistance Initiative ($200M in new economic aid for the Philippines voted last year); the threatened development of geothermal power on Mt. Apo, one of the few remaining rain-forested areas and home to many tribal people; Asia Development Bank projects; and fair trade issues related to J.C. Penney's marketing of Philippine products.

Any NGOs interested in participating in the PDF are encouraged to contact Chris Cobourn (interim PDF Coordinator) at Columban Fathers Justice and Peace Office, PO Box 29151, Washington, D.C. 200017 202/529-5115.

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Congressional Staff Forum
on
International Development

Director
William E. Hellert

March 1, 1990

MEMORANDUM

To: ODC Staff

From: Anastasia Primbas

Subject: FY 1991 Foreign Assistance and Export Financing
House Appropriations Subcommittee on Foreign Operations and Export Financing

Testimonies: James A. Baker, III, Secretary of State
Members in Attendance: David Obey (D-WI), Matthew McHugh (D-NY), Ronald Coleman (D-TX), Mickey Edwards (R-OK), Jerry Lewis (R-CA), John Edward Porter (R-IL)

Summary:
Secretary Baker testified that the Administration is requesting $20.8 billion in discretionary budget authority for International Affairs Budget Function 150 in FY 1991. With respect to the accounts assigned the Foreign Operations Subcommittee, the request is $14.6 billion in discretionary budget authority for foreign assistance. The total foreign affairs request represents 2% of the federal budget, or 0.4% of the GNP.
Baker proposed a "new code of conduct on foreign assistance" by way of "constructive consultation." He repeatedly suggested that the Congress be "flexible", especially in considering the elimination of many earmarked programs which comprised the bulk (82% and 92%) of the Economic Support Fund and Foreign Military Sales in FY 1990, respectively.

Below is a breakdown of the Administration's request:

A. Funding initiatives, designed to respond to some of the most urgent requirements on the world stage

1. $300 million to Eastern Europe to promote
   * democratic institutions
   * training and technical assistance
   * environmental initiatives
2. $500 million to Panama
   * to restore financial stability
   * to revive private sector investment activity
3. $441 million to support Andean countries with anti-narcotics programs
4. $268 million to clear U.S. arrearages to the multilateral development banks
5. $70 million for urgent refugee admissions requirements

B. Core security assistance programs, which support U.S. allies and have played an important part in the emergence of new democracies around the world

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a. $5.1 billion Israel and Egypt
b. $573 million for Pakistan
c. $1.1 billion for NATO bases in Portugal, Greece, Turkey
d. $739 million for the Central American democracies
e. $650 million for the Philippines

C. International Development and Humanitarian Assistance
1. $1.74 billion to clear past arrearages to the World Bank and the Asian Development Bank
2. $2.89 billion to AID
3. $476 million for refugee activities
4. $898 million for PL-480 food aid
5. $181 million for Peace Corps
6. $225 million for voluntary contributions to international organizations
7. $150 million for international narcotics control

Discussion:

Chairman Obey expressed his displeasure at the budget request, suggesting that is was a replication of FY90 and did not display the changing political atmosphere which is taking shape globally. Specifically, he pointed out the reduction in export assistance funding through the Export-Import Bank, in voluntary contributions to UNICEF, and in U.S. support for the United Nations Environmental program. In contrast to these reductions, Obey emphasized the Administration's increase of military funding.
With regards to the Middle East, Obey asked if the U.S. could afford to reduce appropriations below the Administration's proposals. Baker stated that elimination of earmarks across the board was desirable so that the reductions not be directed against specific countries. With regards to Central America, Obey strongly urged a thorough, independent review of U.S. policy in El Salvador because he is not convinced that the existing policies under President Cristiani will produce peace. Baker deemed Obey's position as unfortunate considering the success of the bipartisan accord on Nicaragua.
Baker seemed to be at a loss for an answer when Matthew McHugh asked what would happen if the contras chose not to voluntarily reintegrate themselves into Nicaraguan society by April 25. Baker simply reiterated that the Administration and Congress should work together during the transition. With regards to the Dole proposal of a 5% cut for the largest earmarked countries, Baker replied that the Administration is not in favor of it because it targets specific countries. However, the Administration would be in favor of a 5% reduction of all earmarked countries.
John Edward Porter stated that the U.S. approved a World Bank loan to China even though martial law continues in Tibet. Furthermore, Porter suggested that human rights and a free economy in Hong Kong might be in jeopardy by 1997. Baker maintained that the loan was only a human needs loan and that the Administration is opposed to any type of military transfers and

economic status would not be beneficial to China.
Jerry Lewis expressed outrage that the Colonels who were accused of killing the Jesuit priests in El Salvador were still living a lush lifestyle. He suggested that the U.S. should have enough clout with the Cristiani government to influence their incarcerations. Baker agreed and stated that the U.S. was doing everything it could with the situation.

EASTERN EUROPE

Battle Over Aid, Round Two: Issues of Scope, Control

As Democrats revise proposed assistance upward, administration makes pitch for flexibility

Washington is still cheering the dramatic changes in Eastern Europe, but it has not yet reached a consensus on how to help bring economic reform up to speed with political developments.

This year's debate on Capitol Hill over aid to Eastern Europe is shaping up as more divisive — and potentially more partisan — than was last year's action on Poland and Hungary.

As they did last fall, Democrats in Congress are insisting that President Bush is not bold enough in advocating aid programs. House Majority Leader Richard A. Gephardt, D-Mo., prompted a spirited debate by reviving criticism of Bush as "timid" on foreign policy and by suggesting that the United States consider providing limited direct aid to the Soviet Union.

The administration has rejected the criticism, and Hill Republicans derided Gephardt's Soviet-aid proposal as a political blunder.

Underlying the partisan jockeying is a residue of disagreement from last year over how much to spend to promote free-market economic development, as well as political reform, in the Eastern European countries that have abandoned communism.

Many members of Congress in both parties say the West should not stint because there now is a historic opportunity to transform those countries into full-scale democracies. While agreeing about the opportunity, the administration argues that shoveling in aid dollars is not the best way to promote Western values in what used to be called the Soviet bloc.

With Congress moving at a deliberate pace, the administration and key members are working to avoid an all-out confrontation. The House Foreign Affairs and Senate Foreign Relations committees hope to produce bills by late March or early April authorizing new aid for the "emerging democracies" of Eastern Europe and Central America. Administration officials are hoping to reach an agreement with the panels similar to last fall's accord on aid to Poland and Hungary. *(Weekly Report pp. 400, 344; 1989 Weekly Report p. 3256)*

By John Felton

R MICHAEL JENKINS

Eagleburger: "We have got to be able to adjust" to needs.

How Much Is Enough?

Congress once again is pressing the administration to boost the overall amount of aid for Eastern Europe. The administration, in turn, is demanding that Congress allow it more flexibility in spending the money.

Bush last year made several limited proposals for aiding Poland and Hungary, only to have Congress demand more. Eventually, Congress authorized $738 million for the two nations over three years and appropriated $433 million for the first year, fiscal 1990.

Bush is now proposing a $300 million aid program for all the emerging non-communist countries of Eastern Europe in fiscal 1991. Only half of that amount would require new authorizations beyond what Congress has approved. The administration has provided no details about how the money would be spent, however.

Senate Foreign Relations Democrats in February proposed S 2040, with $511 million in new authorizations for Eastern Europe. A later version drafted by committee staff would allow $803 million in new authority — half for contributions to a new European development bank. House Foreign Affairs is drafting a bill allowing about $350 million, not counting the European bank funds. Officials say the U.S. first-year contribution to the bank could be $50 million to $70 million.

Deputy Secretary of State Lawrence S. Eagleburger on March 7 heard Foreign Affairs members of both parties say that Bush's $300 million request was too modest. Eagleburger is coordinating the Eastern Europe aid.

William S. Broomfield, Mich., the committee's ranking Republican, offered no alternative figures but suggested that Congress should pass a bigger aid package that "adequately reflects the challenges" ahead.

Several Democrats said the administration should be more willing to divert money from the Pentagon to what Tom Lantos, D-Calif., called "waging peace" in Eastern Europe.

Eagleburger vigorously defended Bush's request, saying it "adequately meets our responsibility."

He told the House Budget Committee on March 6 that he doubted the countries of Eastern Europe could absorb a dose of U.S. aid ranging between $1 billion and $2 billion.

"I am not sure, when it was over, we would have gotten our dollar's worth out of that kind of a heavy infusion of money all at one time," Eagleburger said. "And in fact, we may get more out of spending less each year for the next several years."

Eagleburger steadfastly refused to give details of how the administration would spend Bush's $300 million, an-

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swering most such questions with a simple "I don't know." Events are moving so fast in Eastern Europe, he said, that it would be "foolish" to lock in specific figures for spending that might not occur for another year.

Because of that uncertainty, Eagleburger said, Congress should give the administration broad "flexibility" to determine which nations get the aid, and under which programs.

Eagleburger noted that Congress last year gave the administration virtually no discretion in spending the aid for Poland and Hungary. Congress set exact amounts for particular programs, ranging from medical aid to the financing of Peace Corps volunteers.

In the future, he said, the administration must be able to shift funds among countries or programs. "If I need to get down on my knees to ask for [flexibility], I will do so," Eagleburger said. "We have got to be able to adjust to what is clearly a moving target."

Several House Foreign Affairs members said they accepted the pitch for flexibility, and the committee's draft bill would give the administration far greater freedom than last year's legislation.

The administration has objected to the draft proposed by the Senate Foreign Relations panel, which earmarks specific amounts for certain programs. But the Senate bill gives the administration freedom to choose which countries get which types of aid — and it allows the administration to shift, or "reprogram," funds among programs once it notifies Congress.

Kohl Retreats on Border

Bowing to intense pressure at home and abroad, West German Chancellor Helmut Kohl pledged March 6 to accept the border between Poland and Germany, imposed by the victorious powers after World War II, which places under Polish jurisdiction large, historically German territories.

Two days later, the Bundestag, West Germany's parliament, adopted a resolution proposed by Kohl's Christian Democratic Union calling for a border-guarantee treaty between Poland and the government of the united Germany that seems likely to emerge in the next few years, if not months. As a preliminary to such a treaty, the resolution called on the Bundestag and the East German Parliament to make identical declarations, after East German elections set for March 18, accepting the current border.

Kohl

Kohl's insistence that the border question could be resolved only by the government of a unified Germany had become a focal point for public uneasiness over the rapid movement toward reunification. *(Weekly Report p. 682)*

While insisting that he personally would not challenge the borders, Kohl had refused for weeks to say that the German government should unconditionally approve the status quo. He cited legal technicalities, but it was widely assumed that he was trying to avoid alienating the millions of West Germans whose families were expelled from the territories ceded to Poland in 1945.

But Kohl drew vehement opposition from all parts of the West German political spectrum — except from the far-right-wing Republican Party — and from government leaders in many other countries, East and West.

On March 2, he tried to finesse the problem by proposing that German affirmation of the border along the Oder and Neisse rivers be linked with Poland's renunciation of reparations claims. But that move set off a political firestorm culminating in a threat by the Free Democratic Party to withdraw from Kohl's coalition and thus bring down the government. After a stormy Cabinet meeting on March 6, Kohl announced his capitulation on the border question.

On March 8, Polish President Wojciech Jaruzelski brushed aside West Germany's move as inadequate. Among other things, he complained that the Bundestag resolution did not guarantee the Oder-Neisse border by name.

Aiding the Soviets

Sending aid to the Soviet Union never has been much of an issue for Congress. Few have seen any value in it or been willing to take the political heat for advocating help to an "enemy."

Even so, the United States in the past has provided several forms of aid to the Soviets, most importantly taxpayer-subsidized sales of grain. Congress last fall approved a plan by Bob Dole, R-Kan., the Senate minority leader, for $5 million in earthquake relief to Soviet Armenians. The Bush administration is now negotiating a broad trade agreement that eventually would allow the Soviets to benefit from reduced tariffs on exports to the United States.

Gephardt sparked a debate with his March 6 proposal for broader forms of aid to the Soviets. The proposal was part of his speech blasting Bush for having a "lack of vision" in responding to communism's collapse in Eastern Europe. "I believe that support of the process of democratization in the U.S.S.R. is in America's self-interest," Gephardt said. "A stronger Soviet economy will facilitate the process of peace. How can the Soviets pull Red Army troops out of Eastern Europe if they have no jobs and no homes for them to return to in Russia?"

In particular, Gephardt suggested providing the Soviets with food aid, Export-Import Bank export subsidies and private investment guarantees by the Overseas Private Investment Corporation (OPIC). Gephardt said he was encouraged to make such a proposal by Czechoslovak President Vaclav Havel, who in a Feb. 21 speech to Congress called for U.S. aid to bolster Moscow's steps toward democracy.

Gephardt got little outright support for his Soviet-aid idea, even from fellow Democrats. One of the few endorsing his plan was David R. Obey, D-Wis., chairman of the House Appropriations Subcommittee on Foreign Operations. Obey said the United States must respond to the "political earthquake" in Eastern Europe just as it did to the 1988 geological earthquake in Armenia.

But most other Democrats sidestepped the question or denounced any suggestion of aiding the Soviet Union. Unless the Soviets drastically reformed their economy, said Sen. Bill Bradley, D-N.J., aid would be "going down a rat hole."

Some Republicans gleefully said Gephardt — a 1988 presidential aspirant — had blundered, first by attacking a popular president and then by proposing to send taxpayer dollars to the Soviet Union.

"If you're going to start giving foreign aid to the hated commies ... you've got a real sales job to do in the

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United States," said Alan K. Simpson, R-Wyo., the Senate minority whip.

The day after Gephardt's speech, Secretary of State James A. Baker III appeared before a House Appropriations subcommittee and advocated expanded commercial relations with the Soviet Union — including trade agreements that would benefit the Soviet economy. But Baker rejected the idea of direct aid for Moscow, and he was joined by other administration officials.

White House spokesman Marlin Fitzwater called Gephardt "the Maxwell Smart of politics. Can you believe he wants to raise taxes on the American people to give money to the Soviet Union?"

Current Programs

Following is the status of U.S. aid programs in Eastern Europe:

• **Poland.** The United States in the past year has provided, or promised, more than $1 billion in aid, Eagleburger told House Foreign Affairs. That includes congressionally appropriated direct aid, such as food supplies and economic grants, and off-budget credits.

The three big-ticket items so far are: a $200 million grant as the U.S. share of a $1 billion international fund bolstering Poland's currency; a $200 million "bridge loan" by the Treasury (part of a $500 million international fund) to tide Poland over until it receives about $1 billion in loans authorized in February by the World Bank and the International Monetary Fund; and $125 million in subsidized food in fiscal 1990.

Eagleburger said Poland has not yet had to draw on the $1 billion fund that bolsters its currency reforms. If that trend continues, he said, it might be possible to shift the $200 million U.S. share to another purpose.

The United States also has participated in an international scheduling of Poland's payments on debts owed to governmental institutions.

Washington has not yet started the one program that Bush last year touted as the keystone of promoting long-term economic growth: a "private enterprise fund" to help commercial businesses get started. Congress authorized $300 million over three years, appropriating $45 million for Poland and $5 million for Hungary in fiscal 1990.

Eagleburger blamed the delay on trouble in getting conflict-of-interest clearances for Americans named to boards of directors that would supervise the program. The Agency for International Development sent names to the White House last October.

Congress last year also authorized a $200 million "trade credit insurance" program to subsidize U.S. exports to Poland through the Export-Import Bank. But Congress did not appropriate funds to cover potential losses — a reserve the administration insists it needs to get the program going.

Other programs funded by Congress are under way or well into the planning stages, officials said. Among them are medical aid; support for the development of political parties and other democratic institutions; educational, cultural and other exchange programs; and English-language training by the Peace Corps.

Some of the programs envisioned by Congress have turned out to be unexpectedly difficult or expensive. For example, Congress authorized $40 million over three years for environmental monitoring and cleanup in Poland and Hungary. But that money will barely begin to address those nations' problems. Harvard University Professor Jeffrey Sachs, an economics adviser to Poland, told Congress recently that replacing just one smokestack at one power plant in Krakow could cost $10 million.

Unless the Soviets drastically reformed their economy, said Sen. Bill Bradley, D-N.J., aid would be "going down a rat hole."

Compared with most other countries in the region, Poland has close to normal trade relations with the United States. Poland now has most-favored-nation (MFN) trading status, entitling it to reduced tariffs on exports to the United States.

• **Hungary.** The administration is working on modest-scale programs that Congress approved last fall as part of the Poland aid bill. For example, it has hired the State University of New York in Albany for a three-year project to provide technical aid to the Hungarian Parliament.

Hungary already has most-favored-nation trading status and is eligible for trade-benefit programs such as OPIC investment guarantees and U.S. export subsidies by the Ex-Im Bank.

• **Czechoslovakia.** The United States is giving limited assistance through the National Endowment for Democracy, which promotes political parties, labor unions and other "democratic" institutions overseas.

Havel told Congress his country was not requesting direct economic aid. But Eagleburger said he suspected that Czechoslovakia in fact will ask for such aid by the end of the year. "They are going to need some help," at least in the form of technical assistance, Eagleburger told the Budget Committee.

Bush has moved to extend MFN status to Czechoslovakia. The Ex-Im Bank said March 7 that it would resume lending for U.S. exports to Czechoslovakia for the first time since 1946.

• **Bulgaria.** The reform-oriented communist government has not yet requested U.S. aid (other than exchange programs), and the administration as yet has no plans for direct aid.

• **East Germany.** Administration officials have said they have no plans for direct aid programs, noting that West Germany has taken the lead and that the country's needs for outside assistance are uncertain because of the likely merger of the two Germanys.

• **Romania.** The United States already has provided $800,000 in emergency medical aid for Romania, and Baker in February announced planned shipments of 7,500 metric tons of butter and 500,000 metric tons of feed grain. Eagleburger said U.S. food aid will total about $80 million for fiscal 1990. The administration will consider more aid, including assistance for democratic "institution-building" and economic development, once Romania makes more political reforms, Eagleburger said.

• **Yugoslavia.** Because it broke with Moscow in 1948, Yugoslavia is the only longtime recipient of direct U.S. aid among the countries of Eastern Europe. The country already is eligible for all aid and trade privileges under U.S. law. The Ex-Im Bank has been active in Yugoslavia, recently subsidizing a sale of McDonnell Douglas DC-11 planes to the state airline.

However, direct U.S. aid to Yugoslavia has been minimal; in fiscal 1990, the United States is providing only $100,000 worth of military training.

Eagleburger said he expected that some economic aid will be provided by the end of the year. The United States also wants to provide training and technical help to promote market reforms, but does not have the money this fiscal year to do it, he said. ■

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Congressional Staff Forum
on
International Development

Director
William E. Hellert

March 21, 1990

MEMORANDUM

To: ODC Staff
From: Anastasia Primbas

SUBJECT: AID TO EASTERN EUROPE
House Foreign Affairs Subcommittee on International Economic Policy and Trade

Testimonies:
Panel I - Jeffrey Sachs, Harvard University
Panel II - Rep. Richard Gephardt (D-MO)
Panel III - Eugene Theroux, Baker & McKenzie;
William Archey, U.S. Chamber of Commerce;
Frank Kittredge, National Foreign Trade Council, Inc.
Kempton Jenkins, National Association of Manufacturers;

Members in Attendance: Chair Sam Gejdenson (D-CT), Toby Roth (R-WI), John Miller (R-WA), Doug Bereuter (R-NE)

Panel I

Summary:
Jeffrey Sachs stated that the United States' response to the events in Eastern Europe have been, thus far, insufficient. He emphasized the urgency of the situation and suggested that the US consider the following kinds of essential aid programs for the countries of Eastern Europe:

1. General support for balance of payments and stabilization
- In particular, he stressed the fundamental importance of the convertibility of currency in a market economy. Sachs also noted that loans from the World Bank and International Monetary Fund will not provide a sufficient amount of economic stabilization.

2. Technical Assistance
-Using Poland as an example, Sachs described how the US has not yet properly targeted its technical assistance resources and energies. He suggested that the US devote tens of millions of dollars to management consulting, which will have the potential of generating historically monumental returns. According to Sachs, state owned enterprises are still responsible for 90% of the production and employment in Poland. He emphasized that this sector needs proper preparation for privatization, which, in turn, will determine the strength of a Western-style economy.

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3. Reduction of debt burden

-Sachs stated that a large portion of Poland's debt is unpayable and he stressed that additional long-term loans will not solve the original debt problem unless it is reduced. He, thus, urged West Germany, Poland's largest creditor, to reduce the size of Poland's debt.

Discussion:

Chair Gejdenson suggested that there is a perception among Latin American and African countries that the US foreign assistance programs are unfairly distributed, particularly since the Eastern European countries have higher per capita incomes than the developing countries. Sachs explained that Poland's per capita GNP was $1,000 and debt/export ratio 6 to 1, hardly measures of economic success. Furthermore, he pointed out that whereas Poland's debt is 3/4 bilateral and 1/4 commercial, the Latin American debts are mainly commercial and will, hence, benefit from the Brady Plan. Moreover, Sachs emphasized that the US debt strategy has to represent the national interest and "satisfy our prerogatives."

Toby Roth expressed concern over US participation in a European bank where the Soviets would be eligible for loans. Sachs responded that it would be appropriate to provide large-scale assistance to the Soviet Union only if:

- They intensify reform efforts. According to Sachs, the Soviets have already cited the Polish model as the path they would like to follow.
- They step up their reduction of arms.
- They increase privatization and move more quickly towards a free market economy.

Sachs stated that the Soviet Union could benefit from $30 billion assistance per year, with the US contributing $6 or $7 billion of the total amount. He emphasized that by the time the Soviet Union has reached the aforementioned eligibility requirements, the US will already be saving $10 billion per year in decreased military spending.

According to Sachs, the total US tab for Eastern Europe would be a "prudent" $5 billion per year for a "well-defined short period." He emphasized that these countries are not "long-term basket-cases" that will become "wardens of the West."

Responding to questions from Doug Bereuter, Sachs stated that the privatization of Poland's para-statal structures should be completed within 2 years.

Panel II

Summary:

Richard Gephardt expressed concern that the US was not taking full advantage of the opportunities arising in Eastern Europe. His proposals include the following:

1. Technical and financial aid for:
    * private sector
    * agriculture
    * environment
    * emerging democratic institutions
    * MFN status
    * OPIC, Exim Bank loan guarantees
    * debt relief, working with other debtor nations
2. Free Enterprise Core
    * Voluntary organizations working in Eastern Europe
    * Members of Eastern European ancestry combine resources and skills
3. Freedom International student exchange program
4. Relaxing trade restrictions on hi-tech exports to the Soviet Union and Eastern Europe

Gephardt also remarked that the US should help support reform in the Soviet Union by waiving the Jackson-Vanik trade restrictions and pressing the Food for Progress aid program.

Panel III:
The last panel was comprised of experts from the private sector.

Eugene Theroux recommended that the programs of OPIC, the Trade Development Program, and the Exim Bank should be available for all of the countries of Eastern Europe. He also suggested that these programs be available to the Soviet Union, perhaps by way of separate legislation.

William Archey insisted that the US government needs to take more steps to realize that opportunities that are available in Eastern Europe. He agreed with the recommendations put forth by Theroux and he added:
    * granting MFN status
    * loosening immigration restrictions on Soviet managers and technicians
    * loosing export licensing controls
    * reviewing restrictions on imports

Kempton Jenkins strongly endorsed US participation in the European Bank for Reconstruction and Development (EBRD). He stated that "taking full advantage of the significant business opportunities in Eastern Europe and the Soviet Union 'is going to require a higher level of American business-government cooperation than we have seen in a long time'".

Frank Kittredge stressed that trade is essential to US economic strength and is, therefore, linked to national security. He further emphasized the importance of trade facilitation programs, U.S. participation in EBRD, and MFN status.

When it comes to supporting struggling economies, the West should bet on heavyweights in its own hemisphere, says an analyst at Kissinger Associates

Poland vs. Argentina

By Alan Stoga

Recently a senior Latin American cabinet minister wondered aloud whether "Poland is becoming the Argentina of Europe." He admitted that the reverse description would be equally apt: perhaps Argentina should be considered the Poland of Latin America.

The comparison is more than the shared symptoms of unserviceable debt burdens, recession, hyperinflation, and falling living standards. Both countries have pursued failed economic strategies for decades; both have overly centralized economies in which the state plays the determining role in allocating resources; both have intermittently — but with little success — attempted stabilization efforts during recent years; both are desperately in need of substantial injections of foreign capital and technology. And both have new governments which profess to be committed to underlying reform and structural change.

There are, of course, significant differences. Poland is struggling to free itself of 40 years of Communist dictatorship while Argentina seeks to create democratic institutions capable of resisting the siren song of military invention.

"When the U.S. Congress commits $1 billion to Poland and Hungary, it comes out of a contracting aid budget."

One of the biggest differences is that Western governments and investors are excited about Polish reform efforts and are committing substantial monies to help them succeed. For Argentina there is little excitement and less money.

What is true in the case of Argentina and Poland is to some extent true of most of Latin America and Eastern Europe. The industrial democracies are prepared to finance the transition from failed Communist economies to market-oriented ones as long as their governments embrace democracy. Western businessmen are competing with each other to invest in newly liberalized markets even while admitting the attraction is in large measure political.

Non-Profit Motives

For example, the chairman of ITT, one of the largest U.S. industrial companies, said recently that he was prepared to accept lower returns from investments in Eastern Europe than from other parts of the world, presumably to foster democratic change.

Moreover, these same Western governments, especially the United States, continue to insist that Latin American countries support net resource outflows, along with stabilization programs, as the cost of reentry into good standing in the world economy. And, with the important exceptions of Mexico and Chile, new investors are notable for their absence from the major Latin economies.

There are even instances where potential investments in Latin America have been explicitly scrapped in favor of Eastern European projects. U.S. West, for example, had been studying investment possibilites in Argentina's Entel privatization, but is reliably reported to have dropped the idea partly because of a management decision to pursue opportunities in Hungary and the Soviet Union.

This shift in emphasis is part fad,

continued on page 70 ►

Poland vs. Argentina

(continued from page 68)

part realistic assessment, and part misguided policy. Governments and industrial investors can change direction as abruptly and with as much cause as bankers and lemmings. The revolutionary change in Eastern Europe, as the whole post-war structure of politics and economics disintegrates, is exciting. It represents the end of an era and offers the possibility of defining a new geopolitical framework. But that is more justification to send journalists and statesmen than Marshall Plan-like aid and investments.

Yet, if Europe's drive toward a more integrated Common Market continues, countries like East Germany, Czechoslovakia, and perhaps Hungary could become low-cost production platforms for the world's largest and richest market. These countries' skilled — if badly managed — work forces, industrial traditions, and geographic proximity could be valuable assets for companies with large investments in Western Europe, if their governments succeed in creating viable macroeconomic frameworks.

It is clearly in the national interest of major European countries to promote a successful economic and political transition in the east. Reduced geopolitical tensions, access to much needed workers (to supplement aging European populations), and privileged entry to new markets are real, measurable benefits. It is less clear, however, that these benefits would accrue to the United States (or Japan) in equal measure or that, in a world of finite resources, U.S. national interests are better served supporting economic reform and recovery in Eastern Europe than in Latin America.

American Laissez-faire

Indeed, European and Japanese observers have wondered for years why the United States was prepared to take a laissez-faire attitude toward a Latin American debt and development crisis which crippled

North American exports and threatened social unrest on the country's borders. The Japanese have aggressively invested and targeted their foreign aid to build an unassailable economic base in East and Southeast Asia; the Europeans, led by the Germans, clearly hold the same hope for Eastern Europe.

Yet the United States — out of an inability to set priorities, an unwillingness to recognize that limited resources no longer match global commitments, or a failure to recognize that the post-war multilateral system is giving way to a regionalized world economy — continues to resist the idea that its national interest is intimately involved in achieving economic recovery and political stability in Latin America.

Whether fad, well-informed judgment, or short-sighted U.S. policy, Eastern Europe has become Latin America's competitor for scarce policy attention, foreign assistance, and high-risk investment dollars. When the U.S. Secretary of State visits Romania to promise $30 million in aid or when the Congress commits almost $1 billion to Poland and Hungary, these monies are squeezed out of a budget that is contracting, not expanding.

Latin "Africanization"

Some analysts in Washington are already worrying about the possible "Africanization" of Latin America as the region is pushed, like Africa in the 1980s, toward the fringes of the world economy. While this almost certainly is too dire a forecast, the risk is high that the Latin economies will, in the main, continue to be excluded from the technologies and the capital which are needed to modernize.

If this proves true, then the largest measure of fault will lie with the Latins themselves, not with Eastern European reformers or industrial country politicians. Among the major Latin American economies, Brazil, Argentina, and Venezuela largely wasted the past decade failing to create economic conditions which would attract the new investments needed for growth. While each of these countries — and most of their neighbors — are now governed by leaders committed to market-oriented economic reform, the legacy of past mistakes (and the continuing disparity between policy pronouncements and economic reality) weigh heavily. In this context, the attraction of Eastern Europe has profound consequences.

What should be the reaction in Latin America's capitals, from Mexico City to Buenos Aires? On the one hand, every country in the region needs to accelerate the pace of structural reform and to create predictable environments. On the other hand, Latin politicians — remembering their own difficulties in sustaining economic stabilization

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and restructuring programs — should anticipate that Eastern European reformers may also falter. The euphoria which has been generated by announcements of price reform in Poland or currency unification in the Germanies may gradually give way to skepticism about whether newly formed governments in those countries understand (or can stand) the political and social results of their reforms. Inevitably this will lead to a more sober assessment — by investors as well as governments — than now is occurring.

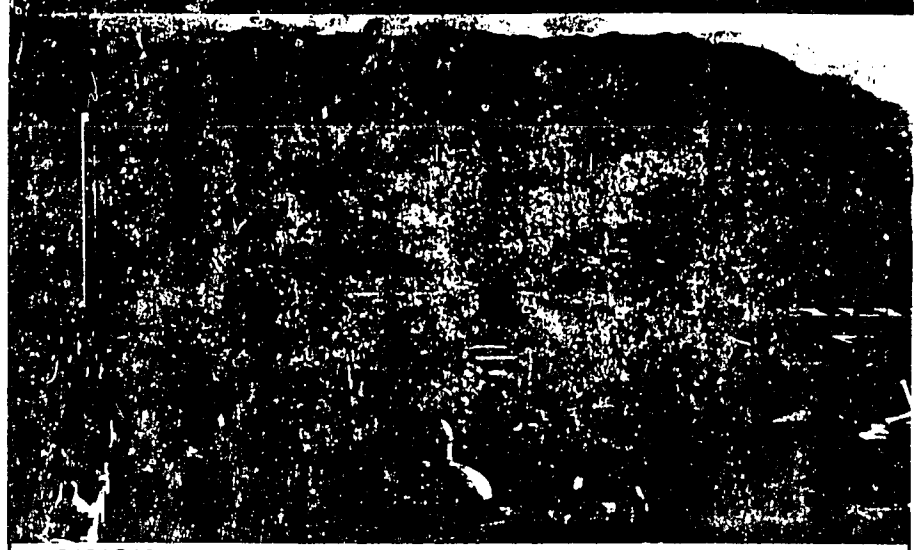
Indeed, the Eastern European countries themselves could learn much from the Latin experience in the 1980s. Mexico has demonstrated the value of implementing sequential reforms and of freeing (but also forcing) the private sector to compete internationally. Argentina has shown how quickly international sympathy for democratic change can dissipate if not followed by sustained economic reform. Chile has proven the virtue of providing investors with the opportunity to earn and to repatriate reasonable economic returns, even when dramatic political changes are in prospect. Brazil has indicated it is possible to squander the advantages of enormous natural resources and a well established entrepreneurial class with inappropriate public policy.

And all these countries have unequivocally demonstrated that debt relief is important, but the determining factor of economic success is the constancy and the quality of economic policy.

While these may be obvious lessons, they have been painfully learned by Latin Americans. In the international environment now emerging it is even more essential that they be put into practice throughout the region. Otherwise success in Eastern Europe may come at the expense of Latin America. And that would be another tragedy. ◻

Alan Stoga is a managing director and economic analyst with Kissinger Associates, a New York consulting firm.

A RELATIONSHIP WITH THE BIV IS YOUR KEY TO VENEZUELA



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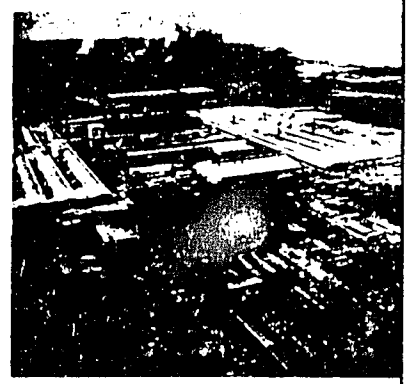

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$140 million; Deputy Treasury Secretary John E. Robson said on Jan. 8 that the net amount still due Panama, after "offsets," is about $200 million.

Putting Panamanians in Charge

One immediate question for Washington is how to turn Panama over to Endara's new government, which owes its existence to the U.S. invasion.

Administration officials have insisted that Endara and his aides are making the important decisions and that U.S. combat forces are merely playing a supportive role. And Treasury's Robson, in discussing plans for aid, said, "We did not go down there to shove some preconceived plan in their face. They're a sovereign nation."

But Edwards said he left Panama on Jan. 5 concerned that "to a large extent we are continuing to run things because we are choosing to do that and that we will set the timetable for turning those functions over to the Panamanians."

As an example, Edwards said that the U.S. military is making the major decisions on public security and that the government's new "Public Force" — the successor to the military — was waiting for U.S. permission to take over some security functions.

"To a large extent, what's taking place in Panama is being directed" by the U.S. military, Edwards said.

Hakim noted that much of the world still sees Panama's new government as a U.S. creation. "If the Endara government is going to get any legitimacy, the choices will have to be left to that government," he said.

A Singular Case?

The military success of the invasion would not necessarily be duplicated if the United States decided to intervene elsewhere in the world, Les Aspin, D-Wis., chairman of the House Armed Services Committee, said Jan. 12.

Releasing his panel's report on the invasion, Aspin said that U.S. forces "had some advantages that are unlikely to be repeated" elsewhere. For example, he said, the United States already had 13,000 troops stationed in Panama and American military planners had detailed information about the capabilities of the Panamanian Defense Forces.

"If Panama has made anyone think that military intervention in the Third World is easy, they should think again," Aspin said, adding that the U.S. forces also were "lucky" because the Panamanian military put up little resistance and because Noriega loyalists did not seize American citizens as hostages. ■

FOREIGN AID

Help for Starving Angola Gives Congress Food for Thought

Advocates see a chance to pull assistance program out of the cross-fires of civil war, politics

In the past year, Angola, a war-torn southern African nation where an estimated half of the 9 million residents suffer from food shortages, has gotten about $3 million in U.S. food aid. All in surplus American food, it was the lowest amount of such aid the United States had sent to the country in six years.

By contrast, Egypt got $177 million in food aid, in the form of low-interest loans. Egypt is the second-largest recipient of overall U.S. foreign assistance, and, according to World Bank estimates, its residents consume more calories per capita than do those of the United Kingdom.

The reason for the disparity is politics, some members of Congress say, with the administration using food as a tool to manipulate foreign governments. State Department officials counter that the politics are being worked by Congress, which has handcuffed aid programs to countries — among them Angola — that have communist governments.

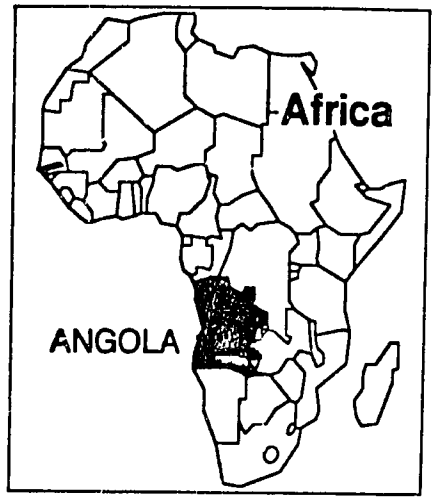
This year, with Congress expected to act on a wide-ranging farm policy bill, some key lawmakers have set their sights on overhauling how the United States manages its food aid programs, hoping to help the neediest countries.

"World hunger demands a new policy of food security," says Patrick J. Leahy, D-Vt., chairman of the Senate Agriculture Committee and the Appropriations Subcommittee on Foreign Operations.

After years of State Department resistance, the Bush administration appears willing to consider rethinking how the United States allocates aid through its Food for Peace (PL 480) program.

An acknowledgment that the program needs change comes from Phillip Christianson, assistant administrator of the State Department's Agency for International Development (AID), one of the agencies responsible for carrying out the program. Christianson advocates creating a "food aid czar" to oversee the complicated bureaucratic process.

By Thomas Galvin



BARBARA SASSA-DANIELS

But other State Department officials and administration agencies that have a say in the process likely would be reluctant to yield their clout. And another roadblock could come from farm state members of Congress determined to ensure that the program offers the biggest chances for U.S. farmers to sell their crops.

Changes to the program, such as shifting its emphasis from loans to donations of U.S. produce, may not play well with farmers, who view the program as an effective way to sell their surplus crops. The food programs are "very important to members with large agriculture interests in their districts," says an aide to Bill Emerson, Mo., ranking Republican on the House Select Committee on Hunger.

Angola: A Case Study

To many policy-makers, Angola, which the World Bank estimates has a per-capita calorie supply comparable to Ethiopia's, would be considered among the neediest. But aid has been slow because of a civil war between the Marxist government and a guerrilla movement and, in the United States, political battling between the executive branch and members of Congress

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over support to the guerrillas.

With vast oil reserves and a generally solid agriculture base of coffee and cereal crops, Angola's population probably would not suffer from famine if not for the war. But according to the U.N. Food and Agriculture Organization, the conflict has made Angola face an "exceptional food emergency." In addition to disrupting food growth and distribution, the war has saddled it with such health problems as high infant mortality and the highest percentage of amputees in the world.

The guerrilla movement, the National Union for the Total Independence of Angola (UNITA), led by Jonas Savimbi, has been seeking control of Angola ever since it gained its independence from Portugal in 1975. Conservative members of Congress, among them Sen. Jesse Helms, R-N.C., and Rep. Dan Burton, R-Ind., along with some moderates, such as Sen. Dennis DeConcini, D-Ariz., have lined up behind Savimbi as a "freedom fighter" trying to oust a regime backed up by Cuban troops.

Savimbi gained a valuable ally when Ronald Reagan was elected president in 1980. Reagan successfully lobbied Congress to drop a 1976 restriction on aid to Savimbi's group, and in 1986 the CIA began sending about $10 million to $15 million in military supplies annually to UNITA.

In 1988, a regional peace settlement set up a framework to remove Cuban troops from Angola by 1991 and South African forces from Namibia. Nevertheless, U.S. lawmakers have been unable to reach a consensus on policy toward UNITA because the 1988 agreement did not settle the war.

Savimbi has vowed to fight until the government, the Popular Movement for the Liberation of Angola, led by President José Eduardo dos Santos, agrees to free and open elections. Officials in Luanda have left open the possibility of a coalition government, but they refuse to negotiate directly with Savimbi.

Since late December, when the Luanda government launched a new offensive, 150 people have been reported killed. Ways to end the fighting and jump-start peace talks were one topic of a Jan. 11 meeting in Washington between President Bush and Portugal's prime minister, Anibal Cavaco Silva.

With conservatives fearful that the Bush administration lacks Reagan's commitment to Savimbi and would abandon the rebels, Helms and Burton have been pressing to require assistance to UNITA and prohibit any aid to the government until free elections are held.

INTERNATIONAL COMMITTEE OF THE RED CROSS

Hundreds of Angolans line up for relief supplies in a 1985 photograph.

Politics and Bureaucracy

The 35-year-old Food for Peace program helps feed foreign countries in a variety of ways. Shipping surplus U.S. food directly is one way. Another is long-term low-interest loans that let countries buy commodities, which are sometimes sold on local markets to finance economic development projects.

But countries like Angola and Ethiopia have seen little of this aid because of poor relations between their Marxist governments and Washington. The PL 480 program's detractors call it an "old vestige of the Cold War," lacking the clear objectives that would help it meet world development and food needs.

Senate Agriculture Chairman Leahy wants to restructure the program so political and foreign policy considerations are given less emphasis when the administration decides who will receive assistance. The program must be revamped so "all those engaged in food aid" have a "dependable level of food commitments, not subject to wild fluctuations or political manipulation," he says.

Leahy and Richard G. Lugar of Indiana, ranking Republican on the committee, are banking that their strong foreign policy credentials will prove decisive when they shepherd the farm bill through the Senate. As the new chairman of the Appropriations Subcommittee on Foreign Operations, Leahy is the Senate's lead man on foreign policy spending, and Lugar is the influential former chairman of the Foreign Relations Committee.

Along with Tony P. Hall, D-Ohio, chairman of the House Select Committee on Hunger, the senators hope to put together a bipartisan package that would clearly delegate the program's responsibilities and insulate the main executors of Food for Peace from political pressures. Congress should "depoliticize the program as much as possible," Hall says.

Administered by the AID, the PL 480 program donates almost 2 million metric tons a year for disaster relief, economic development and feeding programs. Current law stipulates that private voluntary organizations, such as Catholic Relief Services, must distribute two-thirds of the food. But some of the food can be sold to pay for distribution and shipping — a process called "monetization."

The United States also can donate commodities earmarked for sale to countries that encourage private enterprise and agricultural economic reform.

The responsibility for deciding which countries receive aid falls to an interagency group consisting of representatives of the AID; the Agriculture, State and Treasury departments; and the Office of Management and Budget. Members of Congress have criticized the system for being slow in reacting to food crises and approving requests for emergency assistance.

A reason for delays is turf differences that arise when so many agencies are involved. Critics also have singled out the State Department for using the program to achieve its own political goals.

"Never have we seen such an extreme factoring in of political considerations by the U.S. government than under the Reagan administration," says Jeff Clark, a former staffer on the Hunger Committee.

How to Revamp the System?

As a preliminary step toward revamping the system, staff aides on the Senate Agriculture Committee met with representatives of each member of the interagency group to solicit their views last fall. Congress' auditing arm, the General Accounting Office, also is studying how the group makes decisions; that report is expected in March.

Leahy's goal is to restructure PL 480 to emphasize economic development and emergency aid. Almost half of total Food for Peace aid is targeted for developing markets in the recipient country, which some experts feel is unrealistic in countries that have extremely poor economies. A Hunger Committee staffer says the notion that countries "are building markets with food aid is laughable."

Under Leahy's concept, PL 480 would be divided into three parts: emergency relief, aid for developing a country's overall economy, and helping establish specific markets. While Leahy would still use economic aid and market support to further foreign policy goals, more emphasis than now would be placed on emergency feeding through the private organizations.

For example, under the current system, one of the agencies responsible for the program can hold up aid to a country deemed to be suffering from a food crisis. Leahy wants to change the process so whoever has responsibility for meeting a country's food needs will have the final word on who gets assistance.

While the political element can never be fully removed, up to 95 percent of the decision making could be insulated from political and foreign policy pressures, Hall says.

While acknowledging that PL 480 should be revised, Christianson, AID's assistant administrator, says, "Getting a decision . . . could be as hard as getting food aid."

The idea of a "food aid czar" is not new. During the Kennedy administration, George S. McGovern held the post after he left the House and before South Dakota elected him to the Senate.

But proposals to change the program face domestic pressures. Emerson, who serves on both the House Hunger and Agriculture panels, says, "I don't see any fundamental changes needed in PL 480." He argues that channeling the program's focus from loans could cost farm state support. "Good will from farm states is a very important factor," he says.

Food-aid loans give U.S. farmers a more reliable market for disposing of their surplus crops abroad. Decreasing the availability of loans and substituting donations that Congress would have to appropriate annually could cut into farm exports.

In the Senate, where farm state members constitute a sizable bloc and count Minority Leader Bob Dole, R-Kan., among them, altering the program may be difficult if farmers believe that changes may hurt them.

Meanwhile, Lugar aide John Ziolkowski warns of leverage from foreign policy quarters. No matter how new legislation is crafted to insulate the program from politics, he says, it will be difficult to deal the influential secretary of state, James A. Baker III, out of the key decisions. "With a guy like Baker at State, you won't legislate him out of the process," he says.

Finger-Pointing Over Delays

Advocates of making the program less susceptible to political pressure complain that administrative delays have held up aid in the past. For example, although Angola has suffered from the civil war for years, the AID's Office of Foreign Disaster Assistance (OFDA), which operates much like the food donation program, did not begin trips into the country until August 1988 to assess the crisis. The OFDA blames the Angolan government for delaying the assessment teams.

That assessment, needed before the United States can give any direct aid, was agreed to after extensive lobbying by Rep. Mickey Leland, D-Texas, a Hill staffer said. Leland, the Hunger Committee chairman who died in an Aug. 7 plane crash in Africa, had prodded the AID to begin its investigation into Angola's food needs, the staffer said.

Leland's successor, Hall, calls malnutrition in Angola "a terrible crisis . . . and we took sides" in the war.

The State Department and the OFDA, which was responsible for making the assessment, deny that political interference delayed the assessment and subsequent aid to Angola. OFDA Director Andrew Natsios says that, after compiling information on government-held areas, he sent a request to the State Department that Angola be declared a disaster area. The declaration was made two weeks later, in June 1989, he says.

Carl Troy of the State Department blames Hill restrictions on aid to communist-controlled nations for preventing additional direct government relief efforts. PL 480 language bars direct aid to a government that is controlled "by a world communist movement."

But Jeff Clark, who coordinated a congressional delegation to Angola in 1988, says that while the Bush administration appears willing to move faster, the State Department under the Reagan administration forestalled aid to Angola by making up "phony baloney" excuses why it could not be sent. By early 1987, "the administration had all the indications that it needed that the situation was bad and getting worse," but it delayed action "because it wasn't desirable" to the administration "for anyone to comprehend the crisis in Angola," he says.

Crisis May Mean Hope

Any changes in the Food for Peace program aside, attention to Angola will probably increase in the next decade. Recent drought has heightened concerns, which CARE representative Rudy Ramp says will help the country gain assistance. "Host governments and sponsors respond more quickly" in a crisis, he says.

The 1988 Angola-Namibia peace pact may provide an opening, albeit limited, to increased aid, and with a more moderate government taking control of South Africa, opposition to UNITA by Hill liberals — who were angered by Savimbi's close ties with the pro-apartheid regime of former President P. W. Botha — may diminish, Hall says.

Private volunteer groups have also begun working in Angola. Both Catholic Relief Services and CARE have offices in the country and plan to begin $10 million in food programs in 1990. The OFDA also expects to send about $3 million of its own money, split between government-held areas and those controlled by UNITA, for nutrition and seed programs.

If Congress doesn't take advantage of diminishing tensions in the world to "craft a bill with vision," Hall says, an opportunity to use U.S. resources to feed the hungry will be wasted. "We get a lot more mileage out of humanitarian services" than using food as a weapon, he adds. ■

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Philippines: U.S. Foreign Assistance Facts

CONGRESSIONAL RESEARCH SERVICE
--Larry A. Niksch

SUMMARY

The United States became heavily involved in the Philippine internal crisis during the last period of the Marcos government, as Washington viewed internal deterioration as a threat to U.S. interests in the Philippines and East Asia. The government of Corazon Aquino, which replaced the Marcos regime in February 1986, faces major problems of reviving democratic political institutions, regenerating economic growth, alleviating massive poverty and hunger, and combatting a formidable communist insurgency.

The Aquino government has brought forth democratic political processes despite threats of military coups d'etat. A new constitution received a huge majority in a national plebescite in February 1987, and elections for a new Congress were held in May 1987. Aquino still faces potential opposition from elements of the military, as shown by a nearly successful coup d'etat of December 1989.

The government has also changed many of Marcos' economic policies. Prospects for economic growth have improved, but the government has not yet implemented effective measures to address unemployment and poverty in the rural Philippines.

The Aquino government has rolled back communist political influence in the big cities with its cease-fire policy and democratization program, even though a cease-fire failed in February 1987. The insurgency continues to grow in some rural areas, but it has declined in others. The key to the future is whether the Aquino government can affect economic, political, and military conditions in the countryside in ways favorable to the government.

With regard to aid, the U.S. Government has made a "best efforts" pledge of $481 million annually in FY1990 and FY1991 in an agreement on military base rights in October 1988. The Bush Administration also has requested $200 million for FY1990 as the initial U.S. contribution to a multi-nation aid program launched in July 1989. However, congressional action on FY1990 foreign aid has resulted in a $96 million shortfall in bases-related aid and a $40 million shortfall in the contribution to the multi-nation aid program.

The Heritage Foundation Backgrounder

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The Center for International Economic Growth

January 30, 1990

JAPANESE FOREIGN AID: DEFINING AMERICA'S INTERESTS

INTRODUCTION

Just a quarter-century ago, Japan was borrowing money from the World Bank. Now Japan is giving its money away. This summer Tokyo pledged another $35 billion for its foreign aid program, bringing total spending commitments between 1987 and 1992 to $65 billion. If these figures are correct (and they may not be), and if Japan carries through on its assistance promises (it has not always), it will become the world's largest foreign aid donor, a position held by the United States since the end of World War II.

Japan's emergence as a big-time donor is to be welcomed. The question is: What goals will be furthered by the Japanese largesse? American aid, by and large, has sought humanitarian and economic benefits for the recipient country and economic and security benefits for the U.S. So far, according to Bush Administration officials, Tokyo is shortchanging the humanitarian and security goals. Japan has been using its aid mainly as a kind of subsidy to Third World purchasers of Japanese exports. These subsidies then are labeled "aid to the poor."

Ill-Founded Reaction. While the Bush Administration's concern about the Japanese foreign aid program is well founded, its reaction is not. It proposes to send representatives from the U.S. Agency for International Development (AID) to instruct the Japanese on how to establish an effective assistance program. The problem is that AID's record on this is extremely poor. To make matters worse, the Bush Administration proposes to counter Japan's use of foreign aid to finance exports by spending American money in a similar manner. Congress plans on holding hearings on this issue, perhaps as early as this spring.

The poor of the world will be losers if Tokyo and Washington use foreign assistance funds to battle one another for export markets. History

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

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demonstrates that the best means by which a poor country can develop – as the new governments in Eastern Europe reaffirm – is through a free market economy. America, therefore, instead of competing with Japan's aid program, should work with the Japanese to construct programs that promote market-oriented economic growth and sound economic policies in less developed countries.

JAPANESE FOREIGN AID AND AMERICAN INTERESTS

The U.S. long has understood the importance of worldwide economic prosperity. Humanitarian reasons alone argue for a world free from poverty. In addition, worldwide economic prosperity creates markets for American products, meaning jobs for Americans, and gives Americans access to a greater variety of imported products. Finally, a prosperous world promotes America's security interests. Countries with healthy, growing economies are less susceptible to internal disorder and communist subversion. It was for these reasons that the U.S. aided Western Europe and Japan after World War II.

In the past decade, Japan has become a major foreign aid donor. In 1987, the Japanese government unveiled a $30 billion foreign aid program. This summer it pledged an additional $35 billion, for a nominal total of $65 billion to be spent by 1992. Of the additional $35 billion Tokyo claims that $13.5 billion will go to its Export-Import Bank, $7 billion to its Overseas Economic Cooperation Fund, and $14.5 billion to a recycling fund for grants, loans, and other aid to less developed countries. There is confusion, however, about just what these figures represent. The Japanese government has been unable or unwilling to provide a clear accounting of where the initial $30 billion was supposed to go and where and how much of it in fact has been spent.

Disguised Subsidies. Such confusion has been typical of the Japanese programs. When reporting the figures for its foreign aid program, which the Japanese call "economic cooperation," Tokyo usually reports the pledges or promises of funds to be spent. The Japanese tend to be generous in their pledges. On disbursements, or the actual money spent, the figures are less accessible.

In Japan's Official Development Assistance (ODA) Report released in March 1989 by the Ministry of Foreign Affairs, for example, it is unclear whether the figures are the pledges or disbursements. The figures sometimes also are listed as a percentage of the total ODA program. This makes it difficult to determine just how much money was actually spent in any particular country. The U.S. Agency for International Development (AID), by contrast, provides detailed figures on actual spending, spelling out where the assistance goes. Such data allow policy makers to determine effectiveness of their programs. Critics of the Japanese program persuasively maintain that much of Tokyo's foreign aid is not aid at all, but thinly disguised subsidies to boost exports of Japanese goods and services, often at the expense of policies promoting Third World economic growth.

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STRUCTURE OF JAPAN'S ASSISTANCE PROGRAM

Most of Japan's foreign assistance funds are administered as part of the Official Development Assistance program. In 1987, some 65 percent of Tokyo's total ODA disbursements went to Asia.[1] Between 1983 to 1988 Japan has been increasing its aid to Africa from $286 million to $593 million. Japan now is the largest donor in Ghana, Kenya, Nigeria, and Zambia.

The main ODA programs include:

Grants. These are funds given by Japan directly to developing countries without requiring repayment. The Ministry of Foreign Affairs approves grant requests from less developed countries and draws the funds from its own budget. Most grants go for specific economic development projects. A more general program is the Aid for Increased Food Production and Food. Its relatively modest outlays provide funds for less developed countries to purchase approximately 300,000 tons of food annually. This is Japan's contribution under the Food Aid Convention of 1980, in cooperation with the U.S. and European Community. In addition, used farm equipment and fertilizers occasionally are given to needy nations.

Technical Cooperation. Technical assistance projects also funded by the Ministry of Foreign Affairs, recruit and train technicians, both Japanese and foreigners. The program provides the staff and equipment for most of Japan's development projects. Areas of staff training include: medical care and public health, mining and industry, public works and utilities, and agriculture. This technical cooperation program also dispatchs experts and survey teams to less developed countries to determine local needs, provides equipment and materials, and dispatchs development teams to analyze progress.

International Lending Institutions. Japan, like the U.S., contributes to such international lending institutions as the International Monetary Fund (IMF), World Bank, Asian Development Bank, and the United Nations Development Program. As of last April, Japan was contributing 9.43 percent of World Bank funds and 4.53 percent of IMF funds and has a respective percentage vote in these bodies. The U.S. was contributing 16.33 percent of World Bank funds and 19.14 percent of IMF funds.[2]

Loans. Long-term, low interest loans from the Japanese government to developing countries must be approved by the Ministries of Foreign Affairs, Finance, International Trade and Industry, and Economic Planning Agency. Project loans go mainly to private Japanese companies involved in specific projects in such areas as telecommunications, transportation systems, power generation, irrigation and water management in less developed countries. These loans are to pay for the goods and services needed for a project.

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1 *Japan's Official Development Assistance 1988 Annual Report*, Ministry of Foreign Affairs, p. 24.
2 International Monetary Fund Annual Report 1989 and World Bank Financial Statements.

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Commodity loans allow countries suffering balance of payments problems to import such necessary commodities as rubber, fertilizer, and grain. Debt relief loans help countries pay their creditors or refinance existing loans. Debt relief usually is offered when Japanese exporters are in danger of not being paid by less developed nations.

ORGANIZATIONS THAT DEAL WITH JAPAN'S ASSISTANCE PROGRAM

Three major institutions, often with overlapping responsibilities, manage Japan's assistance program:

The Japanese Export-Import Bank (Eximbank). The Eximbank, an independent government institution with commitments of $10 billion in 1988, finances services needed for Japan's international economic cooperation programs. Under Japan's Official Development Assistance (ODA), the Eximbank conducts the programs that include the loan aid to the public and private sectors of less developed countries. Further, the Eximbank oversees foreign direct investments by the Government of Japan and by the Japanese private sector in less developed countries. Additionally Eximbank assists Japanese companies to finance their exports by using Export-Import credits.

For example, suppliers credits go to Japanese firms exporting plants, equipment, and services to less developed countries. Buyers credits are extended to Third World importers of Japanese products. Import credits go to Japanese businesses importing natural resources. For specific projects and overseas investments Eximbank lends funds for such programs as direct foreign investments and joint ventures.[3]

The Overseas Economic Cooperation Fund. The OECF administers the Official Development Assistance program. In March 1988, some 63 countries were receiving OECF loans for development purposes. In 1987, the average interest rate for the loans was 3 percent. The repayment period was 25 to 30 years with an average of 28 years.

These loans are used primarily to purchase equipment and services needed for such Japanese capital projects in less developed countries as bridges, dams, electrical plants, and roads. The project loans to foreign governments include: Project Loans, Engineering Services Loans, and Rehabilitation Loans. Program Loans include: Structural Adjustment Lending, Sector Adjustment Lending, Commodity Loans, Financial Intermediary Loans, and Sector Loans.[4]

3 The Import-Export Bank of Japan, Annual Report 1988.

4 "What Is The OECF?" The Overseas Economic Cooperation Fund Roles and Function, OECF, 1989.

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The Japan International Cooperation Agency. JICA designs all of the overseas development projects. This agency decides what resources a project will need, what kinds of materials will be used, and every detail of how the project will be conducted. It also recruits foreigners for technical training in Japan, dispatches Japanese experts and survey teams around the world through the Overseas Cooperation Volunteers to work on projects, trains Japanese experts for technical assistance, and supplies the necessary equipment for the program.[5]

FOREIGN AID AS TRADE AND INVESTMENT FINANCING

Over the past decade, Japan has been criticized for using its foreign aid primarily to finance Japanese exports and overseas investments. Tokyo is accused of doing this by tying its grants, loans, and other forms of assistance to the exports from Japanese firms for aid projects. Bowing to such criticism, Tokyo claims that it has begun untying its assistance. The evidence suggests the contrary.

Example: transportation and telecommunications equipment (usually abbreviated as Transcom), which includes construction vehicles, telephones, and the infrastructure for each, are frequently exported as part of development assistance. In the past few years, Japanese exports of such equipment to Asian countries increasingly has been financed through foreign aid funds. In 1987, Japan exported $1.6 billion in Transcom products to China, Indonesia, Malaysia, the Philippines, and Thailand. In that same year, $1.4 billion in Japanese aid was sent to these same countries earmarked for purchases of Transcom products. By contrast, in 1987, the U.S. exported $3.8 million in Transcom equipment to the countries with only 3 percent or $11 million financed by American aid. (See Table)

Restricting Bids. The Japanese foreign aid program prevents other countries from securing contracts for equipment and services supplied to poorer countries as part of Tokyo's assistance programs. Critics observe that, when a prospective client for aid is identified, JICA representatives are sent to that country to develop a program. The project design predictably favors Japanese companies. This means that even if there is competitive bidding, Japanese companies have the advantage and usually get the contract. At times, moreover, bidding is restricted to Japanese companies.

The Japanese also appear to use such overseas capital projects as bridges, telecommunication systems, power plants, roads, dams, and hospitals to help Japanese businesses. While such projects may be most needed by developing countries, Tokyo tends to promote them generally in economically more advanced countries where Japanese firms invest heavily. Not only does this help

5 JICA reports: "JICA: Japan's ODA Programme, A Development Study," "JICA at a Glance," and "The Japan International Cooperation Agency."

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Japanese Aid and Transcom Exports
(millions of current U.S. dollars)

	1984	1985	1986	1987
China	301	567	502	568
Indonesia	195	196	397	526
Malaysia	216	224	135	183
Philippines	51	92	67	88
Thailand	245	199	217	288
Total Exports	1,008	1,277	1,316	1,658
Japanese Aid*	297	589	513	1,403
Aid Share of Exports	30%	46%	39%	85%

U.S. Aid and Transcom Exports
(millions of current U.S. dollars)

	1984	1985	1986	1987
China	39	107	158	204
Indonesia	36	44	73	42
Malaysia	40	31	33	28
Philippines	60	44	28	36
Thailand	75	54	71	79
Total Exports	250	280	361	381
U.S. Aid*	0	0	0	11
Aid Share of Exports	0%	0%	0%	3%

* Total Five Countries
Source: United Nations Trade Data and OECD Development Assistance Committee ODA commitments.

Japanese investments in such countries, it also improves the infrastructure in a manner that attracts new Japanese investments.

To help American businessmen gain Japanese foreign assistance program contracts, U.S. AID sponsored a conference last May in Washington. The result was the opposite of AID's intention. Rather than being encouraged to seek opportunities for American business participation in Japanese projects in developing countries, many American businessmen concluded that the purpose of the conference was to demonstrate the impossibility of gaining contracts in Japanese capital projects. The Japanese aid officials participating in the AID conference were typically vague, offering absolutely no information on procurement practices of their programs. At the conference, the American businessmen found it impossible to apply for contracts from Japanese funded projects. No evidence was offered of any foreign company securing major contracts from Japanese funded programs. When asked if any American firm had ever received a substantial contract, Japanese officials responded that they did not know of any. By contrast, overseas projects funded by American foreign aid frequently use non-American suppliers and

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contractors. In practice AID often allows third country procurements for its economic support funds.

Further, one crucial way to promote development in less developed countries is for developed countries to keep their markets open to exports from third world countries. Trade protection closes markets to these countries and fosters economic stagnation.[6] Japan's market is closed to many imports from less developed as well as industrial nations; therefore, while there are serious questions concerning the effectiveness of Japan's aid program, there is no question that its trade policy robs Third World countries of markets for their goods and thus of opportunities to better their economic conditions. Trade is crucial to the Third World. A report issued by the U.S. AID last February finds that all of the foreign assistance given by more developed countries to less developed countries does not quite offset the damage done to poorer countries through trade protectionism.[7] Therefore, Japan might assist in eliminating worldwide poverty by reforming its own trade practices.

Disturbing Report. With their new, more prominent role as a foreign aid donor, the Japanese will be offering more advice to less developed countries. As a consequence of its expected increased contributions to the IMF and World Bank, it will have a greater voice in decisions made by those organizations. How it will use this voice is another matter. It is not certain that Japan will be pushing the policies of less government control and regulation of the economy necessary for economic growth. A report issue last August by Japan's Ministry of International Trade and Industry (MITI) states:

> In the case of developing countries, merely eliminating factors which hamper private sector economic activities does not necessarily guarantee the success of economic and social development....In such cases, the governments of the developing countries should provide support guided by industrial policies that would include bringing together industry and government to form a consensus on future planning and decision making...[8]

"Industrial Policies" is a term synonymous with the economic planning and overregulation typical of most less developed economies. Industrial policies usually mean government subsidies, and using public funds for certain businesses. This policy attempts to pick the winners and the losers among competing industries and usually results in trade protectionism to promote the development of domestic industries. Such policies, especially in less

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6 *Development in the National Interest: U. S. Economic Assistance Into the 21st Century.* A Report by Alan Woods, Agency for International Development, Washington, D. C., 1989. Hereinafter referred to as the Woods Report.

7 *Ibid.*

8 "White Paper on Economic Cooperation," Ministry of International Trade and Industry, August 1989.

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developed countries, hamper the private sector, restrict competition, and hinder economic growth. When Japan has used such techniques in its own domestic economy, consumers have suffered. If MITI's remarks are a reflection of Japan's development philosophy, then little help can be expected from Tokyo in dealing with the fundamental causes of world poverty.

CRAFTING A U.S. RESPONSE

If Japan's foreign assistance program continues to be used mainly to assist its exporters, with little emphasis on promoting market-oriented economic growth in Third World economies, then U.S. interests in global prosperity and opened markets are threatened. Prosperous countries are better able to purchase American goods and to provide products for the U.S. market. Further, prosperous countries tend to be less susceptible to internal disorder and subversion. Rather than recognize the threat to U.S. interests, the Bush Administration merely plans to station U.S. AID officials in Tokyo to help the Japanese to develop a foreign aid program similar to that of the U.S. and increase the American use of export financing.

The problem is that the ability of the U.S. program to assist less developed countries has come under considerable criticism for its own inadequacies. In a widely acclaimed report, "Development in the National Interest," released by AID last February, little correlation was found between the amount of aid money received by a recipient country and the degree of economic growth achieved. For example, some countries that received substantial funds per capita, such as Tanzania, had very poor development records. Further, the report found that countries with fewer restrictions on trade and foreign investment and a greater reliance on market mechanisms enjoyed greater growth. A report also released last February by the Task Force on Foreign Assistance, chaired by Representative Lee Hamilton, the Indiana Democrat, and Representative Benjamin Gilman, the New York Republican, finds AID's effectiveness limited and suggests a greater emphasis on promoting economic growth. Before AID thus attempts to promote an approach similar to its own efforts in Japan, it must be sure that its efforts can deal with underdevelopment in less developed countries.

Fruits of Freedom. In addition, some policy officials, including many within AID, have criticized the U.S. program and maintain that more assistance should be spent directly on alleviating what they call "basic human needs" — illiteracy, high infant mortality rates, and low levels of health care. The lesson of the past decade is that such problems can only be resolved through economic growth. Free countries such as the Republic of China on Taiwan and South Korea, for example, have done a better job at meeting basic needs

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than the economically (and politically) tightly regulated People's Republic of China and North Korea. The free economics enjoy a generally faster rate of economic growth.[9] The basic human needs approach tries to treat the symptoms of poverty while failing to address the causes. This in the long term, could result in increased poverty.

Bad to Worse. In light of this, capitol projects, including such things as roads, hospitals, and schools, at least tend to help the economy over time by providing the necessary infrastructure for any functioning economy. Congress last year tried to pressure AID to devote more resources to the basic human needs policy with the Global Poverty Reduction Act. If AID officials intend to tell the Japanese to abandon capital projects in favor of the basic human needs approach, they would be forcing Japan to move from bad to worse.

Aside from sending AID officials to Tokyo, the Bush Administration also plans to combat Japanese export financing by increasing American export financing. The plan would be used to promote American exports through the use of U.S. foreign assistance funds. It would increase the support funds from $10 million in 1989 to $100 million by 1990. The U.S. Export-Import Bank would control the funds through an account called the war chest.[10] This approach is subject to the same criticism U.S. officials direct toward the Japanese and contradicts the Administration's stated desire to end export financing. There is little indication that this will have any impact on Japanese behavior. Rather, this program would create another special interest group with American business reaping the benefits. Further, this program will divert resources away from beneficial programs that emphasize economic development. Both approaches – sending AID officials to Tokyo and increasing the use of the U.S. war chest – are inadequate.

WHAT THE U.S. GOVERNMENT SHOULD DO

This spring, Congress will hold hearings on the subject of Japanese foreign assistance and what the U.S. policy response should be. American policy makers would do well to focus on free market economic growth in less developed countries as means of eliminating poverty. Congress should seek to discover how well the Japanese program conforms to this approach. The American response to the Japanese should include the following:

1) Do not send AID officials to Tokyo to advise the Japanese how to establish an aid program. The U.S. has its own problems running a foreign aid program. After spending $250 billion in the Third World since 1961, the U.S. has had a poor record in promoting economic growth. The U.S. should hold back

9 Stephen Moore and Julian L. Simon, "Communism, Capitalism, and Economic Development: Implications for U. S. Economic Assistance," Heritage Foundation *Backgrounder* No.741, December 8, 1989.
10From the statements of John D. Macomber, President of the U. S. Export-Import Bank before the U. S. Senate Banking Committee, September 13, 1989.

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advising the Japanese on how to establish an effective assistance program until it has demonstrated that it can run an effective program itself.

2) Send AID representatives to Tokyo to find out more about the Japanese program. AID officials should focus on getting the numbers and statistics about Japan's programs. The Japanese are very secretive about the tied aid nature of its program. Finding out how the Japanese spend their foreign aid money would be a prerequisite to working with the Japanese in the future on development strategies.

3) AID and Japan should emphasize sound economic policies that help Third World countries. The main focus of foreign aid should be to create economic opportunity in less developed countries that will trigger the economic growth that raises the quality of life for all people. Relying on the "basic human needs" approach, which neglects the economic basis of prosperity, and using capital projects as a way to promote the donors' industries – with little consideration of potential impact on the economic, social, and environmental situation in a developing country – only diminishes the effectiveness of promoting economic growth.

4) Abandon the "war chest" approach in dealing with Tokyo's foreign aid program. By using the U.S. program as a way to promote American exports changes America's foreign aid mission from promoting economic growth to promoting its exports. Likewise, this approach may lead to the continuation of the Japanese export supports, which the Administration and Congress seek to end. Rather than promote exports, the U.S. and Japan should open their markets to goods from less developed countries, which would provide opportunities for economic growth.

ONCLUSION

As Japan becomes one of the world's largest foreign assistance donors, U.S. policy makers must ask what interests Tokyo's aid program is promoting. Economic prosperity, which creates markets for exports, and enhances political and social stability in Third World countries is in the interest of both the U.S. and Japan. This interest, however, is served neither by Tokyo's capital projects approach nor Washington's basic human needs approach because they do not lift less developed countries out of perpetual poverty. What is as bad, Japan's use of aid funds to promote its exports and America's retaliation through the use of a similar policy tells less developed countries that America's rhetoric about concern for the world's poor and the benefits of free markets is just an excuse to subsidize America's own business.

Opening Markets. The U.S. and Japanese could work together to promote market-oriented economic growth in less developed countries. U.S. policy makers should start by learning more about the Japanese program and finding out where their money goes. The U.S. and Japanese should work to end trade barriers, which do real damage to Third World economies, and open American and Japanese markets to products produced in less developed

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countries. Finally, the U.S. Congress and the Bush Administration should reform the Agency for International Development. making the promotion of economic growth in less developed countries its prime objective.

The U.S. now has an opportunity to make great strides promoting economic growth in the Third World and the newly independent Eastern European countries. By working with the Japanese to promote economic growth through a sound foreign assistance program, less developed countries will have the best chance to reform their stagnant economies.

Bryan T. Johnson
Research Associate

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OVERSEAS DEVELOPMENT COUNCIL

Briefing Paper by Laura B. Rawlings

CONGRESSIONAL STAFF FORUM ON INTERNATIONAL DEVELOPMENT

SUB-SAHARAN AFRICA: From Crisis to Sustainable Growth A Review of the World Bank Report

February 23, 1990

Sub-Saharan Africa
(1988 data unless otherwise indicated)

Population: 451.2 million
Life Expectancy: 51
GNP Per Capita: $330

Economic Growth Indicators:	1965-73	1973-80	1980-87
GNP per Capita:	2.9%	0.1%	-2.8%
Agricultural Production:	5.9%	2.5%	0.5%
Manufacturing:	10.1%	8.2%	0.6%
Gross Domestic Investment:	9.8%	4.0%	-8.2%
Energy Production:	28.9%	1.6%	0.0%
Exports (1980 $ values):	15.1%	0.2%	-1.3%
Imports (1980 $ values):	3.7%	7.6%	-5.8%

Official Development Assistance: '80: $7.1 bil; '87: $11.0 bil

External Public Debt Indicators:	1970	1980	1987
Billions of Dollars	$5.4	$41.2	$105.9
Percentage of GNP	13%	21%	81%

In its new publication, Sub-Saharan Africa, from Crisis to Sustainable Growth, the World Bank engages in an extensive examination of the distinguishing characteristics, causes and possible solutions to this continent's seemingly endemic crisis. The publication takes a bold step beyond the recitation of the familiar litany of factors inherent to the crisis by examining some of the root causes of Africa's stagnation, including ineffective economic and management policies of African governments, as well as exogenous factors. It then goes on to call for the implementation of a "highly ambitious" strategy which, it claims, would effectively reverse the stagnation that has often characterized Sub-Saharan Africa, most notably in the 1980s.

Standing on the threshold of the 1990s, Sub-Saharan Africa's problems stand out starkly, in human and economic terms:

1) In terms of its gross national product (GNP), Sub-Saharan Africa is the most heavily indebted region in the world. Its long-term debt has risen 19 fold since 1970, currently standing at $134 billion --the equivalent of its gross national product (GNP) or three and one-half times its export earnings.

2) At an average of 6.3 children per woman, Africa has the highest total fertility rate in the world. With 45% of Africans under 14 years of age and a population already growing at a rate of 2.9%, population growth is now close to outpacing economic growth.

3) Growth in population has outpaced growth in agriculture. Throughout the 1960s, population and agriculture each grew at approximately 2.7% annually. However, from 1970 to 1985 agricultural growth slowed to 1.4% --about half the pace of population growth.

4) Economic reversal has come in many forms. Returns on investment have plummeted, from 31% in the 1960s to 2.5% in the 1980s. Exports have declined both in terms of volume (0.7% a year since 1973, including petroleum exports) and market share (from 7% in 1970 to below 4% in 1985 for its three primary exports). As the World Bank points out, "if Sub-Saharan African countries had maintained their 1970 market share of non-oil primary exports ... their export earnings would have been $9 to $10 billion a year higher in the mid-1980s --the equivalent of their debt service payments."

Reversing the crisis presents an "extraordinary challenge" not only to Africa, but also to those institutions involved with promoting Sub-Saharan African development. Essentially, in order to achieve such basic necessities as food security, job creation, and modest improvements in living standards, Sub-Saharan Africa must register at least 4 to 5% annual growth.

What will it take to meet this "highly ambitious" challenge? The World Bank outlines a "strategic agenda for the 1990s" based on:

1) Continuing Structural Adjustment: by consistently and vigorously instituting free market liberalization policies, while taking measures to deflect the adverse impact of these austerity measures on the most vulnerable sectors of society.
2) Human Resource Development: by achieving food security through emphasizing agriculture and training. At the least, a small group of skilled workers must be prepared to meet the technological and scientific demands required for full participation in the 21st century.
3) Building Institutional Capacity: by making public sector management accountable, especially in terms of following through

on sub-contracting orders with the private sector; by promoting "bottom up" development through empowerment of local and non-governmental organizations --especially in terms of women and the informal sector; overhauling public institutions, by cutting staff, instituting hiring practices based on skill, introducing wage competitiveness, and linking salaries to performance.
4) Resuming Growth: by building infrastructure including roads, water, communications, and basic services; using cost-based pricing; improving revenue gathering; and mobilizing the private sector.
5) Preserving Africa's Natural Resources
6) Promoting Regional Integration and Cooperation
7) Political Renewal: This is possibly the study's strongest message --it calls for government accountability in everything from investment to human rights. It calls for government by the people and for the people in order to modify the elite-rule that has characterized many regimes in Africa. The report goes on to issue a message aimed at donor organizations which have "tolerated impropriety." It states that "everyone avowedly deplores the situation and wishes it were otherwise. But it will not be so until accountability is instituted."

Over the years, there has been no lack of individuals and institutions giving development advice to the countries of Sub-Saharan Africa, perhaps the foremost of which was the World Bank. It is not exaggerating to say that this report, in no small degree, stands as an indictment of many of the policies of the past of both donors and recipient countries. As to where we go from here, the report stresses a number of proposals that are usually grouped under the rubric of "structural adjustment". Up until the present, this has normally been applied to changes in macro-economic policy. Is it now possible that it will be extended to the realm of politics, especially the quality of political leadership? Is this the proper role for the Bank? Also, is structural adjustment helping the economies on the macro level while hampering the development of the poorest sectors of the population, i.e., those least able to help themselves? And how does structural adjustment help these countries to chart their own economic course?

These questions are being debated by donors and recipients alike and are especially important for the Congress, as the new agreement for the International Development Association (IDA), the Bank's soft-loan window, calls for U.S. contributions of over $1 billion per year for three years, at least 40% of which is intended for African development.

HOLD FOR RELEASE

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BANK NEWS RELEASE NO. 90/S26

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WORLD BANK PRESIDENT PLEDGES SUPPORT FOR REFORMS IN EASTERN EUROPE

WARSAW, February 22, 1990 -- World Bank President Barber B. Conable today pledged the Bank's support for the reforms sweeping across Eastern Europe. "I have come here to volunteer the World Bank's skills to be a constructive, cooperative partner--to be a coordinating leader--with the governments of East and West Europe, with the Bank's shareholders, and with the full array of international organizations," Mr. Conable declared. "We must combine our efforts to foster freedom and growth in this part of the world."

"Events are moving so fast that they demand forceful and swift responses by agencies like the World Bank," Mr. Conable said. "I assure you that we will be swift, and we will be flexible."

Mr. Conable announced that he had come to Warsaw to sign two loans totaling $360 million--the first loans by the World Bank to Poland. The loans support Poland's efforts to modernize the country's manufacturing and agricultural-processing industries, and boost exports to countries with convertible currencies. "I anticipate that the Bank will lend over $5 billion to our current Eastern European borrowers over the next three years--up to $2.5 billion for Poland," Mr. Conable said.

At the same time, Mr. Conable pointed out that assistance to Eastern Europe "should be additional so as not to come at the expense of assistance to other--and poorer--parts of the Third World. We cannot ignore the need to turn around Africa's catastrophic decline and to bring hope and better lives to Asia's hundreds of millions of desperately poor people. We cannot ignore the special problems of the heavily indebted countries in Latin America and elsewhere."

The World Bank President further announced that the World Bank will open a resident mission in Warsaw within three months; strengthen its program of policy advice, technical work, research and training in Poland; and expand

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financial assistance to Eastern Europe. He also said that the Bank's affiliates for the private sector, the International Finance Corporation and the Multilateral Investment Guarantee Agency, are expanding their work in Eastern Europe.

But ultimately, the peoples and governments of Eastern Europe "must shoulder the major burden of reform and economic modernization," Mr. Conable said. Three fundamental challenges--economic transformation, meeting the social needs of the people, and environmental protection--will require a sustained, long-term effort, he added.

"Choice already exists in the political sphere...[but] choice must be dramatically extended in economic life as well," Mr. Conable said. He declared that World Bank staff will seek ways to provide financial and technical assistance to help Poland deal with unemployment and other social costs of the transformation. On the environment, he said that the World Bank is making a major commitment to its European borrowers by financing the cleaning of rivers and coastal waters in Yugoslavia, working with Hungary on a national environmental strategy, and working with donors in Western Europe to clean up Mediterranean waters.

Finally, Mr. Conable called on the international community to work together to build networks of effective support for Eastern Europe. "Through these networks, we all can learn from emerging experience and combine our efforts efficiently," he said.

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RECORD IDA FUNDING SET FOR 1990-93

WASHINGTON, December 14, 1989--Negotiations were completed today among 31 IDA donors and Switzerland to provide SDR 11.68 billion (about US$15 billion) to the International Development Association (IDA) for lending to the world's poorest nations. The funds will cover operations in the three years from July 1, 1990 to June 30, 1993. In addition, the repayments of funds loaned in IDA's early years are now sufficient to support an estimated SDR 1.6 billion in new commitments in the same period, bringing the total resources available to SDR 13.3 billion (about US$17 billion). [1]

IDA is the concessional lending affiliate of the World Bank Group. The negotiations, which were conducted by Mr. Ernest Stern, Senior Vice President for Finance for the World Bank and IDA, and concluded today, are for the ninth replenishment of IDA's resources. The newly agreed IDA donor funding compares to that of SDR 10.5 billion (about US$12.4 billion) for the current three year period that ends on June 30, 1990, an increase of over 11 percent. Together with the recently completed Lome Agreement of the EEC, this will assure a substantial increase in concessional funds for the poorest countries.

Barber B. Conable, President of the World Bank Group, said: "The world's poor needed record funding for IDA. This is a major international initiative to raise the quality of life of the hundreds of millions of people who are currently trapped in absolute poverty." Over 50 low-income countries are currently eligible to receive IDA resources; these countries represent more than 2.5 billion people who potentially stand to benefit from IDA credits.

Mr. Stern explained that it was agreed by donors that in coming years IDA will further increase its focus on anti-poverty initiatives, it will strengthen its assistance to countries pursuing economic policy reforms and it will place more emphasis on critical environmental issues.

IDA provides credits for 35 to 40 years to borrowing countries. Such credits are currently at zero percent interest with a 0.75 percent service charge and a 10 year grace period prior to the start of principal repayments. The vast majority of the people in IDA borrowing countries have annual incomes of less than US$400. Countries with per capita incomes of US$970 or less (in 1987 dollars) will be eligible for IDA credits, but the great demand for these

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1 Under IDA8, SDR 1.1 billion in repayments are available for commitment, bringing total IDA8 resources to SDR 11.6 billion or US$14.5 billion.

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funds from the poorest nations will mean that, in effect, the effective cut-off will remain at US$580 per capita. Donors emphasized, however, that borrowing countries should not view IDA credits as entitlements and must strive to strengthen their economic performance to secure full IDA support, the chairman of the IDA negotiations noted.

Donors identified three program areas as deserving higher priority: poverty reduction, which is central to all of IDA's operations, is to be given even stronger emphasis in IDA lending allocations; support for sound macroeconomic and sectoral policies and programs, including further emphasis on institutional strengthening; environmental programs are to be further expanded and strengthened in providing for environmental protection and improvement.

In view of the urgent requirements for additional concessional funds in the low income countries of Asia and Africa, the IDA donors agreed that scarce IDA resources should be allocated based on universally applicable criteria. The share of IDA9 resources going to Sub-Saharan Africa should continue to be between 45 to 50 percent, provided this continues to be warranted by performance.

Lending for investment projects will remain the mainstay of IDA's work, representing about 75 percent of all outlays, the donors agreed. Thus, lending for quick-disbursing adjustment programs will continue to account for about 25 to 30 percent of IDA's commitments.

Mr. Stern noted that it was agreed that economic policy performance remains a critical criterion for donors in the decisions that IDA takes on individual country lending allocations. "There was broad agreement," Mr. Stern added, "that the definition of performance should include three main components: sound economic management; efforts towards growth with equity, and poverty reduction; and efforts towards long-term sustainable development."

Mr. Stern said the replenishment level of SDR 11.68 billion had been achieved through special efforts on the part of many donors. Nine countries made such efforts through share increases or special contributions -- Austria, Finland, France, Ireland, Italy, Japan, Korea, Spain and Turkey. Japan's special contribution of US$302 million was critical to reaching the overall agreement. Switzerland, although not a member of IDA, agreed to increase its support in IDA9 by close to 40 percent.

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CONTRIBUTIONS TO IDA REPLENISHMENTS
(SDR MILLION)

	IDA9		
	BASIC	SUPPLEMENTARY	TOTAL
United States a/	2524		2524
Japan	2184	239.8	2424
Germany, Federal Republic	1284	58.0	1342
France	888		888
United Kingdom	782		782
	7662	297.8	7960
OTHER b/	3656	62.8	3719
TOTAL	11318	360.6	11679

	IDA8		
	BASIC	SUPPLEMENTARY	TOTAL
United States c/	2421		2421
Japan	1811	379	2190
Germany, Federal Republic	1114	42	1156
France	707		707
United Kingdom	649	13	662
	6703	433	7136
OTHER b/	2983	321	3304
TOTAL	9686	754	10440

	BASIC SHARES IN THE REPLENISHMENT (%)	
	IDA8	IDA9
United States	25.00	21.61
Japan	18.70	18.70
Germany, Federal Republic	11.50	11.00
France	7.30	7.60
United Kingdom	6.70	6.70
	69.20	65.61
OTHER b/	30.80	34.39
TOTAL	100.00	100.00

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a/ -- Equivalent to U.S. $ 3180 million.
b/ -- Including Switzerland.
c/ -- Equivalent to U.S. $ 2875 million.

December 14, 1989

WOMEN IN PAKISTAN--A World Bank Country Study, 1989

ABSTRACT

A major obstacle to Pakistan's transformation into a dynamic, middle-income economy is underinvestment in its people, particularly women. Development is held back -- and the gains of growth are not widely shared -- if half the population cannot participate effectively either as contributors or as beneficiaries. Increasing opportunities for women will be essential to improve economic performance, promote equity, and slow Pakistan's rapid population growth.

The role of women in Pakistan is complex: in many social contexts, women are accorded esteem and importance; but on most counts, the status of women in Pakistan is among the lowest in the world, including the rest of South Asia. Using standard socio-economic indicators, this report documents women's status and shows that the gap between Pakistan and other developing countries in this respect has increased over time. It examines the interactions between human resource development, women's welfare and productivity, and economic development. It presents a three-part strategy to address these complex social and economic interactions and offers recommendations to improve opportunities for women that are tailored to Pakistan's fiscal and administrative constraints.

* The report suggests ways to increase the participation of women as providers and beneficiaries in education, family planning and health services. This greater involvement is essential for faster progress in the social sectors -- and for slower population growth. Within the family, women are the lead managers of human resources and, in Pakistan's segregated society, are the preferred service providers for three-quarters of the population (women and children). Women's education is especially crucial: to improve the education and health of all the family; to slow population growth; and to increase economic productivity.

* The report recommends several approaches to improve women's access to extension, credit, new technology, inputs, markets and formal sector employment. This would enable women to raise their productivity, and hence their contribution to economic development and family welfare, in several ways. First, the more women are seen to be economically productive, the more families will invest in female education and health care, and the more women in the future will be able to increase their productivity. Second, women's income is especially important for poor families. Third, contrary to conventional notions and most official statistics, women already contribute considerably to the rural and urban economies. Nonetheless, their productivity is depressed well below potential levels, because they lack access to productive inputs and services. Because of their "invisibility", women are still often excluded from development programs that could improve their productivity in agriculture or small-scale enterprises. Moreover, their participation in the formal labor force is also very constrained.

* The report makes several other suggestions to open up opportunities for women. It recommends removing the overt legal and regulatory discrimination against them that now reinforces a limited view of their potential. It notes that women's organizations can serve as useful channels for service delivery and sources of group support. Finally, it emphasizes that political leadership and the mass media can play a vital role in improving women's opportunities and hence their contribution to development.

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PUBLIC SECTOR PAY AND EMPLOYMENT REFORM
A Review of World Bank Experience

Barbara Nunberg
World Bank Discussion Papers
Policy, Planning, Research Division

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SUMMARY AND CONCLUSIONS

In the wake of the severe economic crises of recent years, many developing countries have begun to confront the difficult task of making their public sectors more productive. The need to reform public pay and employment policies has come to be seen as an important element in meeting this challenge. National economic adjustment strategies, often with support from the International Monetary Bank and the World Bank, have increasingly focused on these issues. Attention to public pay and employment stems in part from the pressure placed by fiscal constraints on the wage bill, which in many countries constitutes a major share of public expenditures. Concern has also been prompted by the growing recognition that conditions of pay and employment may be key inhibitors of government performance. Indeed, overstaffed bureaucracies afflicted by eroding salary scales, pervasive demoralization, corruption, moonlighting, and chronic absenteeism are often unable to carry out the essential economic policy and management tasks that are a key part of emergency economic recovery programs.

In response to these conditions, the Bank's involvement in public pay and employment reform has grown rapidly. The character and extent of Bank interventions have varied and Bank policy objectives have not always been consistent, however. Also, diverse types of lending instruments and analytic techniques have been utilized. Bank activities in this area have generally been ad hoc and have preceded the formulation of systematic policy guidance. Moreover, the rapid expansion of Bank work on pay and employment has not allowed time for considered analysis of the potential effectiveness of the various approaches taken. This has been exacerbated by an insufficient exchange of experience by Bank staff working in this area.

This paper offers an interim review of the Bank's experience with public sector pay and employment reform. Its aim is to establish what has been done and what has been learned to date. The review has limited objectives: It seeks to inventory and analyze Bank operational work in selected countries and to provide a brief guide to Bank research and policy work on this subject. The review covers the period between 1981 and February 1987. The paper tries to draw attention to issues that have emerged in the early phases of these activities and make some tentative suggestions about directions for future Bank work rather than draw definitive conclusions about the impact of these efforts. The review covers only the Bank's experience with pay and employment policy issues in central governments (generally with particular reference to the civil service). For the most part, this focus excludes reforms undertaken on the level of individual state enterprises or through wholesale reforms of state enterprise sectors. Pay and employment issues that have been addressed on an individual sectoral level (e.g. in an individual ministry of agriculture) are also excluded from the survey.

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Between July 1981 and February 1987, public employment and pay issues in central governments figured prominently in 45 Bank lending operations in 24 countries. West Africa accounted for more than one-third of these operations; Latin America and the Caribbean had slightly more than one-fourth; and the rest were distributed fairly evenly among East Asia, South Asia, EMENA, and East Africa.

Despite a heterogenous sample of countries and cases examined, four principal types of problems were identified as characteristic of the group as a whole: excessive public sector wage bills; surplus numbers of civil servants; erosion of public service salaries; and, wage compression. The principal instruments used by the Bank to address these problems were structural adjustment loans, technical assistance projects, and country economic and sector work. A variety of operational approaches were utilized. The most sweeping approach has been to call for reduction of the wage bill through salary restraint. Freezing wages is usually at best a temporary solution and tends to reinforce inequities or wage compression within salary structures. Employment reforms which aimed at cutting numbers of civil servants included: efforts to eliminate phantom workers or ghosts; elimination of officially sanctioned posts; retrenchment of temporary workers; enforcement of retirement rules; a freeze of initial recruitment and/or prevention of guaranteed entry into the civil service of university graduates; and voluntary retirement of surplus workers. The most difficult political step taken by governments is the actual dismissal of civil servants. The political impact of this action is sometimes mitigated by public education programs or competency testing. Although the Bank has, in some cases, encouraged civil servant reduction, such as the design of severance benefits or redeployment and retraining schemes. These factors may significantly influence the outcome of reforms.

Where low public sector salaries and wage compression posed a problem in attracting qualified staff to central government, the Bank sometimes recommend selective upward wage adjustments, with varying degrees of success. Other mechanisms for attracting higher level personnel were also explored. These included senior executive services, the use of local consultants, secondment from public enterprises, and compensation through non-wage allowance and benefits systems.

Some of the operational techniques financed by the Bank to carry out the above reforms included improvements in the data collection capacity of personnel management systems, civil service censuses, functional reviews of whole governments or selected ministries, diagnostic studies of various aspects of pay and employment issues in the civil service.

The institutional arrangements for pay and employment reform have varied, but in general, reform efforts located in more autonomous institutions with greater access to higher levels of government have a better chance of succeeding.

Much of the Bank's work on public pay and employment reform has been carried out through country and economic sector work in the form of Country Economic Memoranda (CEM). Country Economic and Sector Work may be either the precursor to Bank lending in this area, or it may constitute policy dialogue which becomes the main mechanism for Bank-country relations on this issue. The Bank has also financed research on public pay and employment. This research has focused predominantly on Africa and has provided an analytic framework for dealing with the economic aspects of pay and employment reform. This paper suggests that future research should attempt to: expand the data base through in-depth studies of pay and employment problems in specific countries; undertake comprehensive studies of government service incentive systems, including analysis of salary structures, career paths, non-wage allowance and pension systems, and relevant tax provisions; review severance scheme experiences; study the political and social consequences of pay and employment reform, and review case studies of employment and pay experiences in individual sectors and public enterprises.

The paper raises a number of issues for consideration and offers conclusions based on its findings, including the following:

- Political factors are crucial to the success of pay and employment reforms. Systematic analysis of the politics of the reform process, largely absent from Bank sector work, needs to be incorporated into CESW and in direct preparation of Bank projects.

- Governments must feel full "ownership" of reforms, and thus a style must be struck which allows for the appropriate mix of Bank leverage and country autonomy in design of these programs.

- Bank pay and employment operations have tended to take a short term perspective, ignoring issues of redeployment, retraining and pension and severance obligations. The Bank should take a more comprehensive approach that considers all stages of the reform process and makes more specific provision for implementation over the medium term.

- Conflicting objectives relating to goals of fiscal soundness, bureaucratic efficiency of developmental strategies need to be clarified from the outset of Bank operations and should be discussed and coordinated with the IMF to ensure program coherence.

- Bank operations are being carried out in the absence of adequate information about key pay and employment issues. Bank sponsored research and CESW should be expanded to examine such aspects as non-wage allowance systems, labor market absorptive capacity and supplementary benefit schemes such as social security programs, to name a few.

- No single lending instrument could be identified as most suitable for bringing about desired changes in pay and employment systems. Indeed, flexibility in operational approach and style is required. Although SALs have been found effective for stimulating reform, one-shot conditionality is probably less appropriate than serial conditionality supported by an institutional infrastructure provided either through specific SAL components, companion technical assistance projects or medium-term sectoral support projects with institutional development components.

- Given the staff intensive character of pay and employment operations, appropriate arrangements for supervision and staff time allocation need to be devised.

- Given the complex and multi-disciplinary nature of pay and employment operations, specialized training for Bank staff and/or recruitment of personnel with the appropriate skills may be required.

- Although the Bank has taken a lead in the area of public sector pay and employment reform, the experience of outside institutions and of individual developed and developing countries themselves needs to be examined more thoroughly.

CONGRESSIONAL RESEARCH SERVICE--ISSUE BRIEF

Multilateral Development Banks: Issues for the 101st Congress

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SUMMARY

In 1989, Congress enacted several laws affecting U.S. participation in the multilateral development banks (MDBs.) It passed legislation (P.L. 101-240) authorizing a $9.17 billion U.S. subscription over four years to Inter-American Development Bank (IDB) capital stock (2.5% of it paid-in and the rest callable), a new $82 million contribution (all paid-in) over 4 years to IDB concessional resources, and a $150 million contribution (all paid-in) to the Interest Subsidy Account of the International Monetary Fund's (IMF) Extended Structural Adjustment Facility (ESAF). Congress also appropriated $1.637 billion for U.S. contributions to the international agencies in FY1990, most but not all the funds the Administration had requested. This included $314 million to cover payment arrearages, which congressional and Administration leaders had agreed in 1987 to defer until FY1990. Congress took a number of major initiatives, in its 1989 legislation, to deal with Third World debt, environment, and poverty issues as they relate to the MDBs.

In 1990, Congress may consider several new bills concerning the international agencies. Prominent among them is legislation that would authorize U.S. participation in and a $3.18 billion payment (all paid-in, over 3 years) to the ninth replenishment of the International Development Association (IDA 9). The Administration is also considering whether to recommend U.S. membership in the proposed new European Bank for Reconstruction and Development (EBRD) and whether to support a new quota increase in the IMF. Indications on these are expected later in the year. For FY1991, the Administration is requesting that Congress appropriate $1.727 billion to pay for scheduled or overdue U.S. contributions to MDBs.

This issue brief looks at four issues affecting U.S. policy toward the MDBs.

1. How much does the United States spend for MDB aid compared to bilateral foreign assistance?

2. Have the MDBs lessened their emphasis on poverty alleviation in the Third World?

3. Do MDB development projects have adequate environmental standards?

4. Should the MDBs and the IMF play an expanded role in the Third World debt crisis?

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ISSUE DEFINITION

In 1988, Congress approved legislation authorizing U.S. participation in the World Bank's General Capital Increase and the new replenishment of the African Development Fund. It also enacted several directives governing U.S. policy on several multilateral development bank (MDB) issues. Among other things, Congress specified that future U.S. contributions might be constrained if the World Bank fails to adopt policies on Third World debt reduction which are acceptable to Congress. In 1989, Congress approved legislation (P.L. 101-240) authorizing a $150 million U.S. contribution to the IMF's Extended Structural Adjustment Facility (ESAF) and a $9.52 billion U.S. subscription (over 4 years, 2.5% of it paid-in) to the Inter-American Development Bank. Congress also appropriated $1.626 billion to fund U.S. contributions to the international agencies in FY1990. In mid-December 1989, the United States and the other donor countries agreed on terms for a new replenishment (the ninth since its inception) of the International Development Association (IDA), World Bank's concessional loan facility. The IDA 9 legislation will come before Congress in 1990. Under the plan, the United States would provide 21.61% of the $14.8 billion replenishment. In dollar terms, the U.S. contribution to IDA would go up by about 10% (to $1.06 billion annually), but its share in IDA funding would decline from the 23% level established in the last replenishment. A possible quota increase in the IMF is also being discussed by the United States and other IMF stockholders and the United States is also considering membership in the proposed new European Bank for Reconstruction and Development (EBRD). Any agreements will also be submitted to Congress in 1990.

BACKGROUND AND ANALYSIS

The United States is a member of four multilateral development banks (MDBs): the World Bank, African Development Bank (AFDB), Asian Development Bank (ADB), and Inter-American Development Bank (IDB). The World Bank -- which consists of three facilities: the International Bank for Reconstruction and Development (IBRD); the International Development Association (IDA), its concessional loan subsidiary; and the International Finance Corporation (IFC), its private sector loan subsidiary -- is the largest, providing over 75% of the funds the MDBs lend each year.

The MDBs have two kinds of loan programs. They lend about 76% of their funds on market terms, using money borrowed at commercial rates in world capital markets. These borrowings are backed by the capital subscriptions of their member countries. Part of these subscriptions (generally 5% or less) is contributed as paid-in capital. The rest is callable capital -- pledges subject to call if the MDBs need funds as a last resort to repay their creditors. The MDBs lend about 24% of their funds on highly concessional terms, mainly to the world's poorest countries, using money contributed by their member country governments.

The United States is the largest single stockholder in all but one (the AFDF, where it is a fractional percent behind Japan) of the MDBs and it has considerable influence on their activities. Decisions about MDB lending and policy are made by majority vote of their boards of executive directors, however, and (except for IDB

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concessional loans) no one country has a veto over MDB decisions. Because of the size of its voting share, however, the United States must agree to participate before any IDA replenishment or IDB capital increases can go into effect. (For further information, see CRS Report 86-769 F, The World Bank: Eighteen Questions and Answers.)

How Much Does the United States Spend for MDB Aid Compared to Bilateral Aid?

Congress does not decide in a vacuum how much the United States should contribute to the MDBs. These decisions are made within the context of funding allocations for foreign assistance, other international affairs programs (budget account 150), and ultimately total Federal spending. In FY1989, outlays for foreign assistance accounted for about one-half of 1% of the Federal budget. There are sharp debates each year about the size of the aid budget and the relative shares for bilateral and multilateral development aid, foreign policy-based (ESF) aid, and military aid. Of the total appropriated in FY1989 for foreign aid, bilateral economic aid accounted for about 44%, military aid for 38%, food aid for 8%, and multilateral aid (mainly MDBs) for 10%. The amount appropriated for MDBs has stayed about the same since 1980, while the total amount of U.S. foreign aid has almost doubled. Figure 1 (appendix) shows how budget authority for U.S. foreign aid has been allocated since 1980. Table 1 (appendix) shows actual appropriations. For a discussion of the foreign aid budget, see CRS Issue Brief IB89014, Foreign Aid: Budget, Policy, and Reform.

In 1989, the House voted 280-125 to pass H.R. 2494. This was the first instance since 1980 in which the regular legislative process was used and an open record vote was taken on MDB authorizing legislation. Between 1980 and 1989, MDB authorization legislation was enacted by reference or inclusion in omnibus appropriations or budget legislation where no separate vote was required.

In large measure, the debate about MDBs is a debate about the amount the United States should contribute to IDA. In FY1988 and FY1989, 76% of the money appropriated for MDBs went to IDA. Congress also cut the Administration's overall funding request for MDBs substantially both years, and the bulk of the cut was borne by the other MDB programs. As of 1989, the total arrearages due to such cuts totalled $414 million, of which all but $100 million is being sought in the FY1990 appropriations request. The MDB appropriation request for FY1990 was 26% larger than the FY1989 appropriation in part because it sought appropriation of most of the arrearages cut in prior years.

There have been major debates about the relative importance of concessional aid for the MDB program. Some believe the debate about IDA has distracted attention from the key elements of the MDB program: its market-rate lending to middle-income countries; and its role in stimulating international development and trade. The IDA is an important humanitarian program, they argue, but it should not be allowed to undercut support or funding for the MDB market-rate loan operation. In terms of U.S. global economic interests, they say, the World Bank's market-rate loan program is much more important, as it is now the main source of development

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finance for the world's major debtor countries and the other advanced countries of Latin America and East Asia. The supporters of the IDA argue that the size of the IDA appropriation reflects the program's intrinsic importance, for it is seen as a key vehicle for fighting poverty in Africa and other regions of high concern. In addition, they argue, IDA is a bulwark for the World Bank's market-rate loan operation. Without IDA, the poorer countries would have few reasons to support the basic rules of the international financial system and there would be new pressure for the creation of an easy money aid mechanism in the United Nations.

What Emphasis Do The MDBs Put on Poverty Alleviation?

There has been concern in recent years that, as the MDBs put increased emphasis on debt questions and economic reform, they may be giving less attention to poverty alleviation. Several congressional committees and a number of private organizations have expressed concern about this issue.

By the traditional measures -- the share of aid lent to the poorest countries, the proportion lent to certain "poverty-oriented" sectors of economic activity, and the share targeted specifically to help needy people -- the MDBs seem to be putting considerable emphasis on poverty alleviation programs. Data for the regional banks are not available. Data on the World Bank indicate, however, that it has been lending a larger share of its resources to poor countries and for "poverty-oriented" projects in recent years than was the case during the late 1970s. In 1983, the Bank adopted a system that requires the staff to specify, in its official country plans, what steps should be taken -- through loans, policy advice, or research -- to promote poverty alleviation in individual countries. (See references in **For Additional Reading**.)

Many observers are concerned, however, that the traditional measures may not fully reflect the MDBs overall impact on poverty. Some argue that MDB-supported economic adjustment programs may have actually worsened the economic situation of the poor. They say these programs force countries to reduce their spending on programs that provide basic services and support to the needy. Also, they say, the policy changes (currency devaluations, for example, or the end of government controls on market prices and distribution) associated with the reform program may throw the burden of the adjustment process onto the poor and other marginal groups with insufficient political or social "clout" to protect their interest. The MDBs put more stress, these analysts argue, on Third World debt, adjustment, environment, and growth issues and less stress on poverty alleviation issues in their loan programs in recent years.

Other analysts argue that the MDBs have not lessened their emphasis on poverty alleviation and that new methods are being used to protect the poor during periods of economic adjustment. The MDBs have done a creditable job, they say, of balancing the policy requirements inherent in their adjustment, poverty, growth, debt, and environment programs. In any case, they argue, adjustment is inevitable. Given the changes which have occurred in the world economy, countries may only chose *how* (not *whether*) they will adjust. Inaction can be more hurtful than action

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in this regard. These analysts argue, in terms of the actual effects of the programs, that the poor have not generally borne the burden of the adjustment process. In many cases, they say, poor people have benefitted over the long term from the economic changes. There continues to be considerable debate, however, about ways the MDBs could improve their programs and how their impact on the very poorest people (who often live on the margin of the economy, with few assets) can be enhanced.

Congress has taken several steps in recent years to encourage the MDBs to give more attention to poverty issues. The 1987 MDB authorization legislation (H.R. 3750) directed the U.S. EDs to push for more MDB activities that help the poor (particularly the rural poor). It required them to propose that the MDBs create offices to consult with private voluntary organizations and other grassroots organizations in the borrower countries about poverty issues. It also required the EDs to seek the adoption of guidelines by the MDBs designed to assess and minimize any negative effects that structural adjustment lending might have on the poor. In 1988, Congress noted that there is little solid information about the social and physical well-being of the poorest people in most developing countries. It directed the Administration to urge the World Bank to help countries develop appropriate statistical measures for assessing and disseminating data concerning the physical, social, and income status of the poor. In 1989, legislation was enacted (H.R. 3148, subsequently incorporated into H.R. 2494) which would require the United States to propose that poverty alleviation be given a central role in the MDBs' operational plans, program, and dialogue with each borrower country.

Do the MDBs Have Adequate Environmental Standards?

In recent years, many analysts have become concerned that the multilateral development banks might not be giving sufficient attention to the environmental impact of their development operations. Critics charge, as the Sierra Club stated in the title of its major report on the subject, that the MDBs are "bankrolling disasters" that sometimes cause major environmental damage to the borrower countries' environment.

Although critics have expressed concern about all the MDBs, the main focus of contention has centered on the World Bank. Despite World Bank policy statements and operational guidelines that stress the importance of environmental protection, Bank spokesmen acknowledge that these were often ignored in the past. Critics argue that the Bank's environmental staff was too small to monitor the overall lending operations.

In 1987, in the course of a major reorganization of its operational structure, the World Bank substantially expanded the size of its environmental staff and sought to make environmental considerations a more regular part of its loan decision process. In addition to a larger and better organized environmental unit to oversee Bank lending operations, the Bank created an environmental unit in the technical office advising each regional vice president and an environmental research and policy department in the part of the Bank responsible for policy and research. World Bank leaders have spoken, in recent years, about the need for stronger action on

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environmental issues. World Bank President Conable told a meeting in Manila in February 1989, for example, that the Bank wants to help governments pursue a goal of "zero net pollution" in Bank-funded projects. Conable also told a World Resources Institute meeting in June 1989 that more than 100 projects with significant environment components had been approved by the Bank's executive board to date and environmental assessment reports for more than 70 countries were scheduled to be done by August.

The U.S. Treasury Department says the regional MDBs have also become more attuned to environmental issues. In addition to highlighting such issues in their publications and reports, the regional banks have sponsored conferences with representatives from their borrower countries to discuss environmental concerns. There seems to be general agreement, nevertheless, that the regional banks have made less progress incorporating environmental factors into their analytical processes.

Critics worry that -- despite the World Bank's reorganization -- environmental protection remains only a secondary value at the Bank. They suggest that the Bank may have put more energy recently into public statements affirming its environmental concerns than into the actual implementation of those concerns. They complain, in particular, that the Bank has not been willing to show outsiders its operational guidelines or the terms of reference for the Bank's environmental staff participation in the internal loan review process.

Supporters argue that the World Bank has created a good base, through its reorganization and the increase in the environmental staff, for further progress on environmental issues. It is too soon to make a judgment, they say, about the Bank's openness to environmental concerns. Most of the projects currently coming up for approval were first proposed several years ago, before the new Bank environmental procedures were established. As new proposals begin to work their way through the loan review system and as the new procedures become more established, they say, environmental factors may play an increased role in the Bank deliberative process.

Two questions have been points of controversy. First, what standards should the MDBs use in judging the possible trade-offs in developing countries between the costs of environmental degradation and the benefits of economic growth? Second, how open should the MDBs' decisionmaking process be and how much information about their internal operations should they be required to make available to the public?

On the first point, critics argue that the United States is not doing enough to press the MDBs to adopt firm environmental standards. Legislation has been proposed (S. 1045), for example, that would amend the National Environmental Policy Act (NEPA), directing the Council on Environmental Quality (CEQ) to identify criteria for assessing the environmental impact of MDB projects and requiring the U.S. representatives at the MDBs to obtain for each pending project (at least 120 days before a scheduled vote) an environmental impact assessment which is compatible with the CEQ standards. Supporters of the bill believe it will make the MDBs adopt sound environmental standards and secure the public release of important information. Some argue that the United States should oppose future loans, if the multilateral agencies refuse to adopt environmental standards which it finds acceptable. Opponents of the bill argue that unilateral action of this sort

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might actually hinder the process of developing an international consensus on the issue. Different countries have different views about the relative balance which should be struck between growth and environmental preservation. The controversy surrounding any U.S. effort to impose its own standards on the MDBs and on their Third World borrowers would obscure the basic issue of the need for better MDB environmental standards.

On the second point, critics say the multilateral banks have been too secretive and too unwilling to share information with the public about their policies and operations. Some Members of Congress and some private organizations maintain that adequate oversight of MDB operations is not possible unless environmental groups and other public interest organizations can see the MDBs' plans and files before lending decisions are made. The MDBs argue that there are substantial legal, operational, political, and organizational reasons why they cannot give private citizens access to MDB files. In 1988, the House and Senate conferees directed the Secretary of the Treasury (in report language that does not change current law) to provide the public with access to internal MDB operating documents, starting one year after enactment of the FY1989 appropriation, if the MDBs did not undertake to make the data publicly available by that time. U.S. law specifies that criminal or administrative penalties shall be levied upon any individual who discloses classified third-party information of this sort to unauthorized individuals. (For additional information, see CRS Report 89-89F, Access to World Bank Information.)

Congress has had a significant impact in this area. In 1987, for example, Congress required the Treasury Department to push the MDBs to strengthen their procedures and to expand the size of their environmental staff. It also directed the Treasury to encourage the MDBs to begin making policy-based loans for natural resources management and environmental protection. Congress enacted a number of major injunctions affecting the MDBs and the environment. It also required AID to establish (in consultation with Treasury) an "early warning system" to assess the possible environmental effect of prospective MDB projects and to inform Congress and the public regularly of their findings.

In the FY1988 appropriation act Congress directed Treasury to encourage the MDBs to involve health and environment officials from the recipient countries and local private voluntary organizations in the early stages of the project review process. It required Treasury to study and report on a proposed "debt for conservation" swap proposal. It also directed the Administration to submit a plan to Congress whereby U.S. bilateral and multilateral aid policy would be aimed at addressing Third World conservation needs. In 1988, Congress also approved legislation that directs Treasury to promote the adoption of guidelines in the MDBs giving greater attention in their loan programs to energy conservation and renewable energy, to the "greenhouse" effect (the rise in global temperatures due to increased carbon dioxide production), and the protection of biological diversity in MDB agriculture projects.

In 1989, Congress again took a number of steps aimed at improving the MDB's treatment of environmental issues. The House and Senate Appropriations Committees both directed, in their reports or in their legislation (H.R. 2939), that the Treasury Department urge the MDBs to put more emphasis on renewable energy resources, conservation, and greater end use efficiency in their borrower countries. Similarly, they encouraged Treasury to put more stress in the MDBs on the reducing

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emissions of "greenhouse gases" in developing countries, including more forestry lending to the countries that produce most of those emissions. The House committee directed the Treasury to press the MDBs (particularly the regional banks) to expand the size of their environmental staff and to further strengthen their environmental programs. It also urged Treasury to consult with the MDBs and other MDB member countries regarding adoption of procedures allowing broader public access to information on MDB projects and more consultation (during the regular loan assessment process) with local non-governmental organizations and community organizations in developing countries.

Congress took additional steps in the environment area in its 1989 MDB authorization legislation. Among other things, it directed the Secretary of the Treasury (in H.R. 2494) to instruct the U.S. representatives at the MDBs to press the banks for increased environmental lending. It required that they be urged to loan expanded sums to countries that take appropriate steps to protect their endangered tropical forests, in order to help them buy down their external debts at discounted prices and to thus help reduce the financial pressures that encourage over-exploitation of forests. It also prohibited the U.S. representatives at the MDBs from voting for any MDB loan (beginning two years after the date of enactment of the legislation) unless an assessment of the environmental impact of the proposed project is available to the executive director and the general public at least 120 days prior to the vote on the loan. Circulation of the assessment to the public may be waived, if the Secretary of the Treasury reports to Congress that such disclosure would jeopardize the confidential relationship between the borrower and the MDB in question. Such a report to Congress shall include, however, a comprehensive summary of the information in question. The new law directs the Treasury Department to seek the adoption of environmental impact review systems in the MDBs that meet standards approved by the U.N. Environmental Programme and procedures that give broader public access to MDB environmental assessments. It says that U.S. Government employees may be loaned to the MDBs at no charge to help the MDBs strengthen their environmental programs.

In 1990, the United States and the other IDA donor ccuntries agreed, during their IDA 9 replenishment negotiations, that countries which borrow from the IDA in the future will need to file environmental assessments for all projects with potentially significant environmental effects. Some borrower countries are reportedly not happy with this proposal. It is not clear at this point how the new arrangement would work, what kinds of projects would be covered and what form the environmental assessment would take, or whether projects funded through the World Bank's non-concessional windows (the IBRD, IFC, and MIGA) will be similarly affected.

Should the MDBs and IMF Play an Expanded Role in the Third World Debt Crisis?

Many developing countries have found themselves with serious problems in recent years. For various reasons -- economic mismanagement on their own part, new shifts in world economic conditions (particularly higher interest rates and higher oil prices), and declining world markets for their national exports -- many developing

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countries have been unable to both service their foreign debts and purchase abroad the goods and services they need for development. In many cases, to continue servicing their debts, countries have been forced to cut their growth programs, reduce spending on basic services, and to depress their national economies. The pressures within their political systems for some type of debt relief or default have been substantial. Many analysts fear, however, that default might have a long-term negative impact on the debtor countries' developmental prospects by reducing their access to external capital and seriously complicating their trade relations. The United States and the other creditor countries also face a dilemma. If the debtor countries default or substantially reduce their debt payments, the financial stability of the commercial banking institutions which hold most of that debt may be threatened. On the other hand, if the debtor countries continue to cut their imports (as they use their available foreign exchange to service their debts) the exporter industries in the developed countries will lose important markets.

The main focus of attention in the Third World debt crisis centers on the middle-income countries. There the commercial banks have the greatest exposure and (many fear) default would put the world economy at risk. Many of the low-income countries are also deeply in debt and for some of them the burden of carrying their debt (compared to their income levels and the size of their economies) is worse than that for the larger debtors. The big debtors owe so much, though, that the threat of default gives them leverage on their creditors in debt negotiations. The low-income countries do not owe enough to get similar bargaining advantages. Their living standards are also lower, giving them less room for coping with their problems through austerity; their economies are less flexible and more tied to the production of a few basic goods; and their prospects for new export earnings are problematical.

The Third World debt crisis became evident in 1982, when Mexico announced its inability to continue servicing its debts. Between 1982 and 1985, the international community sought to use the International Monetary Fund as the principal vehicle for coping with the problem. In many cases, however, the IMF approach -- which often emphasized austerity and a short-term resolution of the borrower's international payments problems -- was found unsatisfactory in many situations.

In September 1985, then-U.S. Treasury Secretary Baker told the annual meeting of the World Bank and IMF that the multilateral banks should take the lead in coping with the debt crisis through programs which emphasized growth and a medium-term approach to the adjustment problem. The plan proposed by Secretary Baker had three elements: a $9 billion increase in World Bank and IDB lending (over their previously planned levels of aid) in the next three years to 15 key debtor countries, an anticipated $20 billion net increase in private bank lending, and action by the debtor countries to reform their economic policies and adjust to current international economic realities. (See CRS Issue Briefs 86106, The "Baker Plan:" A Remedy for the International Debt Crisis?; and 87177, The International Debt Problem: Congressional Proposals.)

The Baker plan's record of implementation is mixed. The World Bank expanded its lending to Third World debtor countries. The World Bank and IMF also expanded their level of loan and policy coordination. (See CRS Report 86-179 E, The Mexican Debt Accords and Their Financial Implications: An Overview.) The IDB,

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on the other hand, resisted the suggestion that it initiate a new program of policy-based lending. Moreover, commercial banks reduced their exposure in the Third World rather than expanding their lending as anticipated by the Baker plan. Although many developing countries undertook programs of economic and financial reform, many found there were limits to the amount of austerity their people would accept. They also encountered problems expanding their exports (to get money to service their debts) in the face of other countries' needs to trim their own trade deficits.

In the omnibus trade bill enacted in early 1988, (P.L. 100-418), the Congress directed the Secretary of the Treasury to initiate discussions with other member countries and with other countries and with the World Bank and IMF about the possible establishment of a new World Bank/IMF debt facility. In the World Bank general capital increase legislation enacted in late 1988 (H.R. 4645, P.L. 100-461), Congress also directed the Administration to press the World Bank to adopt and implement voluntary market-based procedures for reducing the debt burden and promoting sustainable economic development in Third World countries. In addition Congress directed the Administration to urge the World Bank to undertake programs of policy-based lending which are designed to facilitate such reductions of Third World debt. The law requires that the Administration report in March of 1989, 1991, and 1993 on the World Bank's performance in this area. The House Banking Committee is required by the law to assess the Administration report in March of 1989, 1991, and 1993 on the World Bank's performance in this area. The House Banking Committee is required by the law to assess the Administration's report and to make formal recommendations to the Appropriations Committee, in light of the reports and its finding, about whether Congress should approve any further U.S. contributions to the World Bank capital increase.

By early 1989, it was evident to many that the Baker Plan was not working as well as expected. On Mar. 10, 1989, Treasury Secretary Brady told an international conference sponsored by the Bretton Woods Committee and the Brookings Institution that the United States believed that debt forgiveness through market-based procedures should play a key role in future debt management plans. The Brady Plan envisioned that, overall, perhaps 20% of the commercial lenders' Third World debt might be written off through procedures facilitated by the World Bank and IMF.

The Interim Committee of the World Bank and IMF endorsed the Brady Plan in April 1989. On June 1, the executive board of the World Bank adopted formal debt and debt-service reduction guidelines specifying the World Bank's role in implementing the Brady Plan. Under these terms, the World Bank will set aside (on a case-by case basis) up to 25% of its adjustment lending (or 10% of its total lending) to a country, over a 3-year period, for programs to reduce debt principal. An amount equal to 15% of the Bank's anticipated lending to a country during a 3-year period might also be lent to finance debt-service reduction programs in qualifying countries. To qualify, countries must have sound medium-term adjustment policies in place, including steps to encourage savings, foreign direct investment, return of flight capital, and debt-equity swaps. The debt reduction funds would be disbursed over a multi-year period in phase with the debtor country's implementation of the policy reforms.

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The World Bank has set aside $100 million from its earnings to fund a debt reduction facility designed to help low-income IDA countries reduce their commercial debt burden. Eighteen countries (all but one in Africa) are potential beneficiaries of the new IDA debt facility. The World Bank has also set aside $91 million from its IDA reflows to help some of the poorest IDA borrower countries convert old IBRD market-rate loans to IDA terms.

On June 13, the World Bank approved a $1.5 billion loan package for Mexico, the first under the new guidelines, under which up to $375 million would be available for debt reduction purposes. On June 15, a $755 million loan was also approved, for Venezuela, under which $188 million could be used for debt reduction schemes approved by the Bank. In both cases, the loans by the Bank were approved even though the debtor country and its commercial creditors had not yet reached agreement on new debt management plans. Critics argue that -- by announcing its loan plans in advance -- the Bank may have diminished its leverage and increased the share of their exposure that the two countries' commercial creditors might receive in any future market-based debt reduction scheme. Supporters say that -- as a practical matter -- the Bank has to take a firm position before it can exert leadership and that any arrangements must be approved later by its executive board.

Congressional committees have been critical of the World Bank's debt policies. In June, the House Banking Committee recommended that no funds be provided the IBRD in 1990 because of inadequacies in this area. The Committee included language in H.R. 2494, subsequently enacted into law, directing the U.S. bank regulatory agencies to require increased loan loss reserves for all U.S. commercial lenders who have lent funds to highly-indebted developing countries.

The House and Senate also discussed the World Bank's role in the debt crisis during their consideration of the FY1990 foreign aid appropriations bill (H.R. 3743). The House Appropriations Committee voted not to include any funds for the IBRD or for IDB ordinary capital in its version of the bill, on the grounds that it made no sense to provide public money through MDBs for possible lending to debtor countries when the commercial banks had not yet agreed (as the Brady Plan suggested they should) to forgive a significant portion of the debt owed them by those MDB borrower countries. The Senate Appropriations Committee voted, on the other hand, to provide full funding for IDB ordinary capital and $50 million of the $90 million requested for World Bank IBRD paid-in capital. It also agreed to authorize the Administration to subscribe to the full $2.24 billion in callable capital (a non-appropriated and contingent guarantee). The Senate panel indicated, however, that it was also concerned that the World Bank was not doing enough to get commercial banks to forgive their Third World loans and that money contributed to the multilateral agencies might be used indirectly to help "bail out" commercial lenders.

The World Bank's role in the international debt crisis was an issue in the subsequent House-Senate conference deliberations. In the end, the conferees agreed, for technical budgetary reasons, to approve the $50 million for the IBRD contained in the Senate bill. They also decided, however, not to authorize the Administration to subscribe any IBRD callable capital in FY1990. They indicated that they would be watching the World Bank's activities in the coming months and that Congress would be given an opportunity, during its consideration of a supplemental appropriation bill in the Spring, to decide whether a U.S. subscription to the

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proposed IBRD callable capital should be approved, which would have allowed the Administration to subscribe the proposed $2.24 billion in IBRD callable capital. The conferees agreed they would give further attention to the role the World Bank was playing in the Third World debt crisis. The Administration has since requested (in the same FY1990 supplemental appropriations request containing the request for post-Noriega Panama aid) that Congress approve the proposed IBRD callable capital.

Strictly speaking, the Brady Plan is relevant only to countries with significant amounts of commercial debt. For most low-income countries, however, the bulk of their foreign debt is owed to official, rather than commercial creditors. The creditor countries have been discussing various means of affording those countries debt relief. (See African Debt: The Official Response and Potential Alternative Strategies. CRS Report 89-228 F, April 7, 1989.) In June 1989, prior to the Paris economic summit, President Bush announced plans -- initiated earlier by Congress in the FY1989 foreign aid appropriation act -- for the forgiveness of $1 billion in debt owed the United States by 16 African nations.

LEGISLATION

P.L. 101-167, H.R. 3743

Foreign Operations, Export Financing, and Related Programs Appropriations Bill, 1990. Includes funds for U.S. contributions to the MDBs and ESAF. Reported July 19 (H.Rept. 101-165) and approved (329-69) July 21. Reported to Senate (S.Rept. 101-131) Sept 14. Passed Senate (89-11) Sept 26. Conference report filed in House (H.Rept. 101-344), with amendment, Nov. 11. House agreed to it Nov. 14 and Senate agreed to it, with an amendment of its own, Nov. 15. House concurred with Senate amendment Nov. 16 and Senate with House amendment Nov. 17. President vetoed H.R. 2939 Nov. 19 (H.Doc. 101-113). The House and Senate passed substitute bill, H.R. 3743, Nov. 20. Signed into law Nov. 21, 1989.

P.L. 101-240, H.R. 2494

Export-Import Bank and IDB authorizing legislation. Reported to House Oct. 6, 1989, by Committee on Banking, Finance, and Urban Affairs (H.Rept. 101-271) as vehicle as well for proposed IDB and IMF authorizations and related legislation. Passed House Oct. 18 (280-125) and referred to Senate Committee on Foreign Relations. A similar bill (S. 1704) containing only the Eximbank authorizations was passed by the Senate. The House bill was referred to the Senate Foreign Relations Committee on Oct. 31. Discussions ensued between the House and Senate Banking and the Senate Foreign Relations Committees over terms of a substitute measure. On Nov. 22, the Senate made the agreed changes in H.R. 2494 and approved the legislation. The House agreed to the Senate amendments the same day. Signed into law Dec. 19, 1989.

H.R. 1706 (Porter)

The Tropical Forest Preservation Act. Requires U.S. Government to encourage stronger MDB action and more lending to encourage preservation of tropical forests, including compensatory lending (to countries taking appropriate preservation steps) to help countries buy down their debt at discount. Included in H.R. 2494 by Committee on Banking, Finance, and Urban Affairs.

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H.R. 2495 (Fauntroy)
To authorize a $150 million U.S. contribution to the Interest Subsidy Account of the IMF's Enhanced Structural Adjustment Facility. Included by Committee on Banking, Finance, and Urban Affairs in H.R. 2494.

H.R. 2496 (Fauntroy)
To authorized a U.S. subscription of $9.17 billion (2.5% paid-in and the rest callable) for IDB ordinary capital and $82 million for IDB concessional loan resources. Included by Committee on Banking, Finance, and Urban Affairs in H.R. 2494.

H.R. 3148 (Bereuter)
Requires the U.S. representatives at the UDBs to advocate policy and procedural changes giving poverty alleviation more priority in MDB operations. Requires reports on the strategies used and results achieved in giving the poor a broader role in economic life in MDB borrowers countries. Included by Committee on Banking, Finance, and Urban Affairs in H.R. 2494.

CONGRESSIONAL HEARINGS, REPORTS, AND DOCUMENTS

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----- Foreign Operations, Export Financing, and Related Programs Appropriations for 1990. Hearings, 101st Congress, 1st session. Apr. 17, 1989. U.S. Govt. Print. Off., 1989. Part 5.

U.S. Congress. House. Committee on Banking, Finance, and Urban Affairs. Subcommittee on International Development Institutions and Finance. The proposed general capital increase for the World Bank. Hearings, 100th Congress, 2d session. May 4, 11, 18, and 24, 1988. Washington, U.S. Govt. Print. Off., 1988.

----- General capital increase for the World Bank. Hearings, 100th Congress, 2d session. June 15, 1988. Washington, U.S. Govt. Print. Off., 1988.

----- Third World debt reports and the Brady plan. Hearings, 101th Congress, 1st session. Mar. 16, 1989. Washington, U.S. Govt. Print. Off., 1989.

----- Third World debt: Public reaction to the Brady plan. Hearings, 101th Congress, 1st session. Apr. 15, 1989. Washington, U.S. Govt. Print. Off., 1989.

----- IMF enhanced structural adjustment facility and the seventh IDB replenishment. Hearings. 101th Congress, 1st session. May 24, 1989. Washington, U.S. Govt. Print. Off., 1989.

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----- Seventh replenishment of the IDB. Hearings. 101th Congress, 1st session. June 6, 1989. Washington, U.S. Govt. Print. Off.. 1989.

U.S. Congress. Senate. Committee on Appropriations. Subcommittee on Foreign Operations. Foreign assistance and related programs appropriations, fiscal year 1988, H.R. 3186. Hearings, 100th Congress, 1st session. Feb. 24 and 26, 1987. Washington, U.S. Govt. Print. Off., 1987. Part I.

FOR ADDITIONAL READING

Sanford, Jonathan. The World Bank and poverty. American journal of economics and sociology, 47:3 (July 1988): 257-275, and 48:2 (April 1989): 151-164.

----- U.S. policy toward the multilateral development banks: The role of Congress. The George Washington journal of international law and economics, 22:1 (1988): 1-115.

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Figure 1. U.S. Foreign Aid, FY1980-FY1990
(millions of current U.S. dollars)

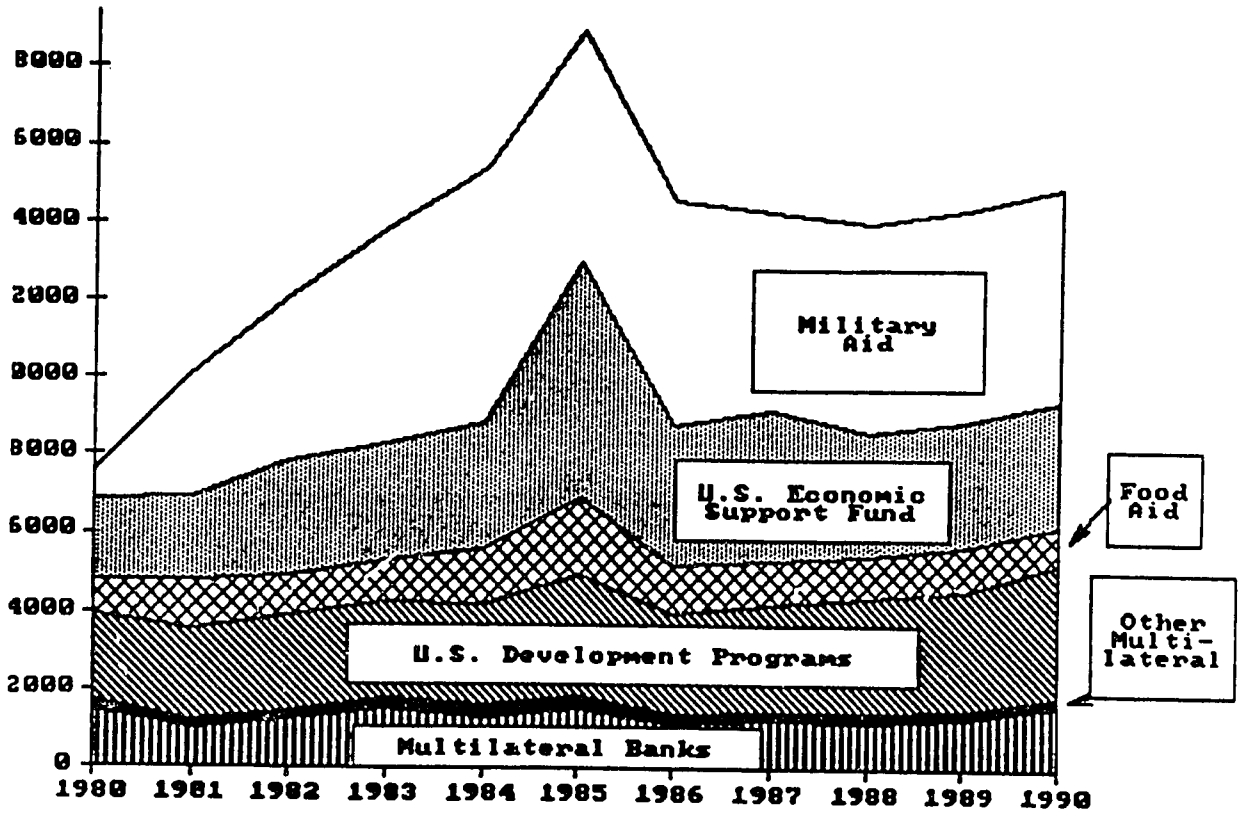

Table 1. Appropriations for MDBs
($ billions of paid-in contributions)

	FY89	FY90	FY91 Request	FY91 House	FY91 Senate	FY91 Final
WORLD BANK GROUP						
IBRD	.050	.050	.111			
IDA	.995	.965	1.064			
IFC	.005	.075	.040			
MIGA	---	---	---			
IMF ESAF	---	.140	---			
REGIONAL DEVELOPMENT BANKS						
African Dev. Bnk	.007	.011	.010			
African Dev. Fnd	.105	.105	.105			
Asian Dev. Bnk	---	---	---			
Asian Dev. Fnd	.152	.178	.302			
Inter-Amer. Dev. Bnk						
Ordinary Cap.	---	.032	.057			
FSO	---	.064	.021			
IIC	---	---	.025			
TOTAL, ALL MDBS	1.315	1.628	1.737			

SELECT COMMITTEE ON HUNGER--U.S. HOUSE OF REPRESENTATIVES
Report by the Congressional Research Service
October, 1989

SATELLITE TECHNOLOGY AND WORLD FOOD SECURITY

SUMMARY

Congress and the public have evidenced increasing concern about widespread hunger and poverty in the world and the deterioration of the Earth's environment. There is a growing awareness about the links between such phenomena as the persistence of hunger and poverty, the loss of natural resources and long-run environmental impacts of global warming.

World food security, defined as the ability of the Earth to feed growing populations, requires attention to both agriculture and the environment in a global setting. Agriculture and the environment can be monitored from the unique vantage point of Earth-orbiting satellites. Remote sensing technologies can increase our capacity to identify and solve these interrelated problems and thus contribute to enhancing global food security.

Remote sensing data gathered by satellites are being used in combination with ground and statistical data to assess agricultural and environmental conditions. Weather and land remote sensing satellites developed by NASA are being used by NOAA, USDA, AID, and international organizations like FAO and WMO to predict and respond to droughts, floods, and locust infestations in the United States and Africa. Remote sensing is also contributing to efforts to better manage natural resources. Foreign satellites systems are also being used separately or in coordination with U.S. systems.

Realizing the potential of satellite technologies to contribute to world food security will depend upon how a number of important issues are resolved. The most critical are whether current satellite capabilities will be continued; whether future development of more comprehensive satellite systems and development of data applications will occur; whether user agencies will have the capacity to take advantage of remote sensing data; whether the interagency and international cooperation and coordination critical to the comprehensive monitoring for understanding earth systems can be achieved; and whether developing countries with severe food security and environmental problems will be able to build the capacity to benefit from satellite technology and applications.

Remote sensing is an important tool. The ability to forecast drought in Africa did not prevent starvation in Ethiopia. However, satellite monitoring of deforestation in Brazil has contributed to the Brazilian Government's changes in policy to attempt to reduce burning of the forests. Ultimately, food security and environmental problems are political issues that can only be solved by governments. Obtaining data to clarify the problem is a vital first step, however.

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Introduction

Congress and the general public have evidenced increasing concern about widespread hunger and poverty in the world and deterioration of the Earth's environment. There is growing awareness about the links between such phenomena as the persistence of hunger and poverty throughout the world, the loss of natural resources, and global warming.[1]

World food security, which can be defined broadly as the ability of the Earth to feed adequately its growing number of people, requires attention to both agriculture and the environment in a global setting. Both agricultural and environmental conditions can be monitored from the unique vantage point of Earth orbiting satellites. Many have suggested that the use of remote sensing technologies in monitoring agricultural and environmental conditions will increase our capacity to solve the interrelated problems of hunger, poverty, and environmental deterioration and contribute to enhancing global food security. Public concern about global climate change and other environmental impacts of human activities has been translated into plans and proposals for expanding satellite monitoring activities at the national and international levels.

Recent measurements of changes in the Earth's atmosphere that are attributed to human causes have heightened the awareness that natural systems may be altered by activities occurring in distant regions. Understanding the functions of Earth's natural systems, the kinds of changes taking place in them, identifying the causes of these changes, and understanding their impacts on practical concerns, such as agricultural production, have become increasingly urgent.

The essential beginning point for such understanding is the gathering of data on current natural systems. Human ability to do such data collection has been powerfully augmented by the increasing sophistication of satellite systems. Proposals for more comprehensive coverage of the Earth by satellite monitoring are under development, as discussed in this report.

It is clear that applications of satellite technology can greatly extend our ability to detect and understand changes in the natural resource base, vegetative cover, soil conditions, and other conditions critical to world food security. The question remains, however, whether this ability will be exercised, and to be successful, several types of activities must be integrated. The appropriate satellite technology must be in place on a continuous basis. This means technology that makes use of the most advanced kind of sensors to detect changes on the Earth, and the data collected, must provide continuous coverage over time, in order to allow trend detection. A data analysis and management capability must exist in order to make satellite and ground-based data meaningful. Data analysis will need to be tailored to meet the needs of users, or user agencies. These applications of data—defining what is to be measured—must be planned and designed by the user agencies, which means that

[1] The report of the World Commission on Environment and Development, the Brundtland report, is among the most recent discussions of the interrelatedness of environmental, poverty, and food problems. World Commission on Environment and Development. Our Common Future. Oxford, Oxford University Press, 1987.

appropriate technical expertise must be available in the user agencies.

This report describes the extent to which U.S. Government agencies, foreign nations, and international organizations use satellite technologies in their programs for monitoring and making assessments of agricultural and environmental conditions.[2] Such programs can contribute to world food security by improving information about world supply and demand for food or by providing the basis for responding to food emergencies caused by drought, floods, or famine. Some U.S. and international agencies use remote sensing data in programs to improve the management of natural resources or to devise long term development plans. Whether in monitoring, resource management programs, or development planning, satellite remote sensing data must always be combined with ground-based, aerial and statistical data. The report concludes with a discussion of issues raised in considering the role of satellite technology in contributing to world food security.

[2] We omit discussion of U.S. and European military and intelligence satellites.

THE ATLANTIC COUNCIL of the United States
Occasional Paper

"BULDING AN INTERNATIONAL INVESTMENT ACCORD"

by Dr. Donald L. Guertin
and
Dr. John M. Kline

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EXECUTIVE SUMMARY

Foreign direct investment issues are beginning to crowd onto public policy agendas recently dominated by foreign trade controversies and financial crises. Policymakers face growing apprehension over restrictions on foreign investors in Europe after 1992, and questions regarding such devices as debt-to-equity swaps and trade-related investment measures in the developing countries.

As foreign direct investment now totals well over eight hundred billion dollars, such policy attention is desirable. A key question arises as to the nature of policy action: should there be an increasingly open international investment climate or should protectionist actions be taken?

Given the increasing globalization of the world's economy, the extent of U.S. direct investment abroad, and the benefits of such investment to all nations, this paper recommends action to foster an increasingly open investment climate.

This paper argues that there is a growing need for such an accord and identifies the body of existing principles from which it can be constructed. The Organization for Economic Cooperation and Development (OECD) offers the principal prospect for achieving early progress. Included in its membership are countries that are both home and host to about 75 percent of the world's foreign direct investment. Ironically, it is also in these OECD nations where new threats of investor discrimination are perhaps the highest. For example, there is increasing concern about European direct foreign investment in the U.S., but such concerns are sometimes voiced without an awareness that the U.S. holds an equivalent or even larger foreign direct investment position in Europe.

The authors specifically propose that the OECD strengthen its existing investment agreement, "The OECD Declaration on International Investment and Multinational Enterprises," by building on a number of principles and agreements already accepted by OECD countries. These principles and agreements cover right of establishment (first entry into a country), national treatment, expropriation, transfer of funds, and third-party dispute settlement between an investing company and a host government.

Such a strengthened agreement would lay a foundation for further OECD cooperation on international direct investment and could also provide a basis for OECD cooperation with non-OECD governments for

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a World Bank agreement on international investment, which might be developed by the year 2000.

Although current capital shortages have tempered the viral criticism of foreign investors often heard in the 1970s, the current lull in the policy debate masks growing discriminatory pressures and restrictions in the United States, Europe, and other regions. We should use the relatively positive current environment to make progress now in anticipation of the pendulum swing to even less harmonious times. The international community can no longer afford the instability of a two-legged structure that covers only trade and monetary issues while ignoring the important component of international investment relations. Now is the time to build an international investment accord.

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NEWS

INSTITUTE FOR INTERNATIONAL ECONOMICS

Contact:
Linda Griffin Kean

News Release January 11, 1990

STRICT EMBARGO: January 29, 1990, 10:00 a.m., E.S.T.

News Conference: January 29, 1990, 10:00 a.m., E.S.T.

Place: 11 Dupont Circle, N.W.--Sixth Floor

SUBSTANTIAL POLICY REFORM IS OCCURRING IN LATIN AMERICA, ACCORDING TO NEW STUDY BY INSTITUTE FOR INTERNATIONAL ECONOMICS

Washington, January 29--For the past few years, "Washington"--notably the International Monetary Fund, the World Bank, and the US government--has been urging the Latin American debtor nations to make fundamental changes in their economic policies. A comprehensive, country-by-country analysis of the reform effort to date is presented in *The Progress of Policy Reform in Latin America*, released today by the Institute for International Economics. John Williamson, the author of the study, concludes that the reforms are much more extensive than is generally recognized. This provides a ray of hope for the future from a region where most of the current economic news continues to be grim.

The reform programs in Latin America seek to emulate the macroeconomic prudence, outward orientation, and domestic liberalization that were so successful in the industrial countries during the early postwar era and more recently in the developing nations of East Asia. Latin America is in essence attempting to make the transition from statist authoritarianism

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to free-market democracy that Spain and Portugal achieved successfully in the last two decades, and that Eastern Europe is now trying to launch.

Results of this new economic realism are still spotty. The best outcomes have been achieved in Chile and Costa Rica: both started the reform process early, both have undertaken very broad-ranging reforms, and both have now experienced four years of solid economic growth. Colombia, with a very effective macroeconomic stabilization program but rather little liberalization, also has a good record. Other countries that have made substantial reform efforts--most notably Mexico but also Bolivia, Jamaica, and Uruguay--have arrested their decline but still not recovered robust growth, although the outlook in Mexico is hopeful if the debt problem is resolved satisfactorily. In contrast, countries like Peru that have moved in the opposite direction have fared disastrously.

The main message of the study to Latin America is that the countries need to sustain, reinforce, and complete the process of policy reform along the lines that are already emerging. Countries like Brazil, Peru, and the Dominican Republic that have not yet embarked on serious policy reform should initiate the process promptly. Those like Mexico, Bolivia, and Jamaica that have succeeded in stabilizing and liberalizing need to ask whether their exchange rate is sufficiently competitive; to seek debt reconstruction within the context of the Brady Plan; and above all to stay the course. If they succeed in the historic

task of making the transition to free-market democracies, they will be in a far better position to address adequately the region's appalling problems of poverty and income inequality as well as concerns about environmental degradation.

Because policy reform takes time to produce increased growth, the process needs external help from the industrial countries through its critical early years. Some have called for a new "Marshall Plan," but this suggests an indiscriminate regionwide program, which could actually reduce the incentives to adopt policy reforms. The need is, rather, for a definitive settlement of the debt problem for countries that implement and sustain determined reform programs. Such settlements would offer a visible early benefit of reform to help sustain domestic political support, as well as encourage lagging countries to initiate reform.

The Brady Plan provides for just such a selective approach. The study offers several suggestions for strengthening the Brady Plan: increased levels of financing, more flexible use of IMF and World Bank funds, tax incentives to banks to participate in debt restructuring, and the extension of debt relief on public export credits. Stabilization loans may also be needed to stop hyperinflation, and lending by the multilateral institutions must be large enough to underwrite continued growth.

The study is based on a conference held at the Institute for International Economics in November 1989. Papers on eight Latin American countries (Argentina, Bolivia, Brazil, Chile, Colombia,

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Mexico, Peru, and Venezuela) and two groups of small countries (in the Caribbean and Central America) assessed the progress made in each country in each of ten areas:

- the restoration of fiscal discipline
- reordering of public expenditure priorities away from indiscriminate subsidies, defense, and administration and toward education, health, and infrastructure
- tax reform, to broaden the tax base and cut marginal tax rates
- financial liberalization
- establishment and maintenance of a competitive exchange rate
- trade liberalization
- removal of obstacles to foreign direct investment
- privatization
- deregulation
- the establishment of secure property rights.

In synthesizing the findings of the country papers, Williamson examines the extent to which a consensus seems to exist on the desirability of each of the 10 objectives. He concludes that there is very wide support for reforms needed to underwrite macroeconomic stabilization and open the economy, namely, fiscal discipline, a competitive exchange rate, and trade liberalization. However, those bearing on redefinition of the development model--like the reordering of public expenditure

priorities, financial liberalization, privatization, deregulation, and property rights--remain more controversial.

A series of nine tables provides details of the policy steps that have been taken by the 10 major debtor countries of the region (the eight countries listed above plus Jamaica and Costa Rica). Table 10 (attached) summarizes those tables, giving an overview of which countries have acted in which areas. Table 11 (also attached) relates policy reform to subsequent economic performance in terms of restored growth.

The proceedings of the conference that provided the background for the study will be published by the Institute in March. A table of contents of the volume is appended.

About the Author

John Williamson, a Senior Fellow at the Institute for International Economics since 1981, was professor of economics at Pontifícia Universidade Católica do Rio de Janeiro (1978-81), the University of Warwick (1970-77), the Massachusetts Institute of Technology (1980, 1967), the University of York (1963-68), and Princeton University (1962-63); Advisor to the International Monetary Fund (1972-74); and Economic Consultant to the UK Treasury (1968-70). He is the author of numerous studies on international monetary and Third World debt issues, including Voluntary Approaches to Debt Relief (1988), Targets and Indicators: A Blueprint for the International Coordination of Economic Policy (1987), Capital Flight and Third World Debt (1987), and The Exchange Rate System (1985).

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TABLE 10 Latin America: summary of policy reform in the 1980s

Country	Fiscal discipline	Public spending priorities	Tax reform	Financial liberal-ization	Competitive exchange rate	Trade liberal-ization	Foreign direct investment	Priva-tization	Deregu-lation
Bolivia	++	++	++	++	+	++	+	0	++
Chile	+	0	+	++	++	++	+	++[a]	+
Peru	–	–	0	–	–	–	–	–	0
Argentina	+	0	0[a]	0	+	0[a]	+	+[a]	+[a]
Brazil	0	–	+	0	+	0	–	+	–
Mexico	++	0	++	0	+	++	++	++	+
Colombia	++	0	+	+	++	+	0[a]	+	0
Venezuela	0	0	0[a]	+	+	++	+	+[a]	+
Jamaica	+	0	++	+	+	++	+	+	+
Costa Rica	++	0	++	0	++	+	+	+	+

++ substantial reform
\+ some reform (or no need to reform)
0 no significant change (or mixed changes)
– retrogression
a. More action expected shortly.
Sources: Country papers in Williamson (1990) and personal communications with authors.

TABLE 11 Latin America: policy reform and economic performance

Policy reform	Growth	Stagnation	Decline
Yes	Chile (1974–84) Costa Rica (1983–87)	Bolivia (1985) Mexico (1983–88) Jamaica (1983–86) Uruguay (1974–86)	Trinidad and Tobago (1987)
Partial	Colombia (1983–84)[a] Barbados	Guatemala (1986)[a]	
No		Brazil Dominican Republic Honduras	Peru Nicaragua
Recent	Paraguay	Venezuela El Salvador Ecuador	Argentina Guyana

Note: Years in parentheses denote period of principal reforms.
a. Major reforms in macroeconomic policy only.
Source: See table 10 and text for rows, table 12 and text for column classification.

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Latin American Adjustment: How Much Has Happened?

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Despite Tough Talk, Big Cuts Unlikely

Bush's 1991 budget opens debate on deficit; both sides implicitly agree to do little

The release of President Bush's fiscal 1991 budget Jan. 29 launches a new season of budget partisanship, with Democrats and Republicans loudly blaming each other for failing to cope seriously with the federal deficit. But if recent history is a guide, both sides are on a course that will yield an even higher deficit before the fiscal year is over.

Beneath the highly public finger-pointing, the two sides have become locked in a sort of invisible handshake. In a bipartisan compact of political convenience, dating to the Reagan years, both the Republican president and the Democratic-controlled Congress have managed to claim that the deficit is being slashed without taking the painful steps necessary to do more than whittle at the edges.

"There is a kind of implicit agreement between the president and the Congress that we're not going to tackle the tough budget questions," says Rep. Lee H. Hamilton, D-Ind., chairman of the Joint Economic Committee. "They're just too hard substantively and politically, and there's not enormous pressure to do so from the electorate."

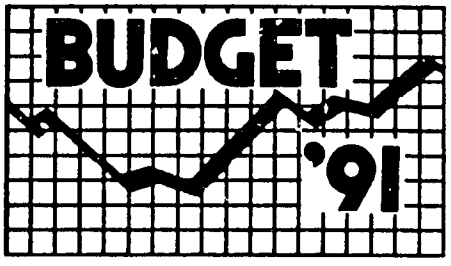
In each of the past four years under the Gramm-Rudman deficit-reduction law, the president and Congress have claimed compliance with the statute's steadily declining annual deficit limits. Yet, in all but one year, the deficit has actually risen if the growing Social Security surpluses are not included. Even counting them, the deficit remained stuck at about $150 billion a year from 1987 through 1989.

Smoke and mirrors have filled much of the gulf between the politicians' rhetoric and budget reality; 1990, an election year, is not expected to be any different. Indeed, hopes for a new direction were dashed in 1989 when plans for a major bipartisan budget agreement in the fall collapsed in a fight over Bush's proposal to cut capital gains taxes.

By Jackie Calmes

R. MICHAEL JENKINS

Budget director Richard G. Darman shows off the 1991 budget.



Instead, the deadlock continues over what most observers consider the ingredients for real, long-term deficit reduction. As long as Bush refuses to budge from his no-new-taxes stance, Democrats refuse to put Social Security benefits and other costly entitlements on the table. And each side bows to the other for fear of political retribution.

This year, a tax-and-spending compromise appears more unlikely than ever. On the tax side, the emphasis is on cuts — for capital gains, Social Security payroll taxes and Individual Retirement Accounts. For savings, many legislators are counting on a "peace dividend," probably exaggerating the windfall of defense cuts ahead thanks to the declining Soviet threat. *(Taxes, p. 221)*

Lawmakers already have begun denouncing Bush for using optimistic economic forecasts and bookkeeping gimmicks to keep his $1.2 trillion budget within the $64 billion Gramm-Rudman deficit target. But based on past experience, they are likely to adopt the same economic assumptions and gimmicks — along with a few more of their own.

"Both sides are certainly engaging in as much deception, as much budget hanky-panky as they can," said Bill Beeman, vice president for the Committee for Economic Development, a coalition of corporate and academic leaders allied to oppose continuing budget deficits. "It's not restricted to either side."

"Today's bipartisanship," conservative columnist George Will recently wrote, "is an amiable conspiracy to cook the books, run up the debt and give people a dollar of government while charging them 75 cents for it — and get re-elected."

OMB vs. CBO Estimates

The numbers game began even before the release of the White House budget.

To get to the $64 billion deficit goal for fiscal 1991, which begins Oct. 1, the administration's Office of Management and Budget (OMB) is expected to project a 1990 deficit of about $100 billion as the starting point, thus requiring roughly $36 billion in reductions.

But the necessary cuts would be more than twice as great if budget-writers had to use the estimates of the Congressional Budget Office (CBO),

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which forecast Jan. 24 that the 1990 deficit would be $138 billion. The difference, CBO Director Robert D. Reischauer told the Senate Budget Committee that day, is due primarily to his agency's less sanguine view of economic trends.

CBO's projections, which are in line with the Blue Chip consensus forecasts of leading private economists, have the economy growing this year just 1.8 percent, measured from the fourth quarter of 1989 to the same quarter of 1990. The administration is expected to predict a 2.6 percent expansion for the gross national product, the total value of the nation's goods and services.

Both CBO and OMB expect inflation to continue at 4.1 percent. But while OMB is expected to forecast short-term interest rates averaging 6.7 percent, CBO's projection is 6.9 percent. Higher interest rates increase the government's borrowing costs.

CBO's less optimistic projections typically have been closer to the mark, but in effect they are merely advisory. Under Gramm-Rudman, OMB is the arbiter for judging compliance with the law's deficit targets and thus determining whether automatic, across-the-board cuts must be invoked.

OMB Director Richard G. Darman, in a Jan. 21 appearance on ABC-TV's "This Week with David Brinkley," dismissed CBO's estimate, saying it "has no real meaning."

But Beeman called it "a realistic forecast" that is more widely used than OMB's in the private sector. At the Senate Budget hearing, Chairman Jim Sasser, D-Tenn., called CBO's $138 billion projection "the true deficit," and Sen. Ernest F. Hollings, D-S.C., said Reischauer's testimony marked "one of the few moments of truth we'll ever experience here this year in the budget process."

Sasser said, "It's become obvious to all concerned that the Office of Management and Budget consistently understates the deficits by resorting to the most optimistic economic assumptions it can credibly — and now sometimes even incredibly — employ."

Yet for all the OMB-bashing, Congress likely will make the latest assumptions its own once it turns to drafting the 1991 budget resolution. The Gramm-Rudman law does not require Congress to do so, but politics has dictated that course.

Hamilton, in an 82-page critique of budget policy issued Dec. 28, described the annual routine:

"The sitting administration has every incentive to claim, as they have in every recent year, that the economy will grow rapidly and that interest rates will fall. It demonstates their confidence in their stewardship of the economy — and it also reduces the policy pain they must impose to meet the deficit-reduction targets in their budget.

"Of course, we in the Congress need not accept these optimistic assumptions for our own planning," Hamilton noted. "We could use CBO's more realistic assumptions. And furthermore, it is in our interest to decry the optimism of the administration's forecast. But it is also in our interest to accept that forecast, because it minimizes the degree of pain that we must impose.

"They provide the smoke, and we provide the mirrors," he concluded.

For the past 10 fiscal years the actual deficit ended up exceeding the estimates used in Congress' annual budgets — by an average of $40.2 billion, CBO found. Overly optimistic economic forecasting accounted for 43 percent of the error, the budget office reported; technical mistakes and policy changes, such as unanticipated appropriations, accounted for the rest.

On Jan. 25, House Budget Committee Chairman Leon E. Panetta, D-Calif., proposed requiring Congress to use CBO data, as part of a broader bill to repeal Gramm-Rudman and replace it with what Panetta called a pay-as-you-go process designed to shave the deficits. *(Story, this page)*

Hamilton, in his report, called for an independent, bipartisan commission to do the forecasting for both Congress and the White House. "More realistic assumptions," he wrote, "would put the deficit beyond the reach of the accounting gimmicks and would require real policy changes."

Nibbling at the Budget Pie

As it is, low-balling the deficit allows the president and Congress to keep nibbling at the budget and still hit the deficit targets without resolving their tax-and-spending standoff.

At the same time, they have effectively removed much of the budget pie from the bargaining table in recent years, leaving a shrinking yet important slice to absorb most of the actual cuts. *(Box, p. 220)*

The Deficit: New Rules?

Widespread disdain for the budget process has prompted the chairmen of the House and Senate Budget committees to propose separate plans to scrap the Gramm-Rudman deficit-reduction law.

In his proposal, Sen. Jim Sasser, D-Tenn., also responded to newer concerns about Sen. Daniel Patrick Moynihan's politically attractive call to cut Social Security payroll taxes. Moynihan, D-N.Y., says his idea, which has dominated fiscal debate since it was unveiled in December, would unmask the true deficit by cutting the Social Security surplus by $62 billion over two years. But the idea's bipartisan appeal is countered by worries about higher deficits and the nation's already small savings pool.

Sasser said Jan. 25 that his bill would cut the payroll tax by $17 billion a year for seven years but only if the deficit is first pared by $30 billion in unspecified reductions. By 1997, he said, the budget would run a surplus and Social Security would return to a pay-as-you-go operation.

The same day, Rep. Leon E. Panetta, D-Calif., described a plan to cut $30 billion a year from the deficit through 1993, and $20 billion yearly thereafter until the budget is balanced. It would require spending increases or lower taxes to be offset by spending cuts or tax hikes.

Both Sasser's and Panetta's plans would remove Social Security surpluses from calculations of the deficit. That would raise the 1991 deficit by an estimated $74 billion, to $212 billion, according to the Congressional Budget Office. Gramm-Rudman calls for a balanced budget, counting Social Security surpluses, in 1993. But every previous year's target has been breached, and few experts think the final target will be met.

The Democrats propose to drop the across-the-board cuts that are Gramm-Rudman's sanctions for non-compliance. Panetta's bill also would close loopholes that have allowed Congress and the president to use fiscal gimmicks to meet the law's targets.

—Jackie Calmes

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More than three-quarters of the budget is consumed by just three categories — $300 billion for defense, much of it obligated by law or contract; popular entitlements such as Social Security and Medicare, and the mandatory interest on the nation's $3 trillion debt.

Less than a quarter of a year's spending is subject to domestic and defense appropriations over which Congress and the president have easy discretion. Some of the rest, such as Social Security and Medicare, can be cut, but only by changing the laws to limit eligibility or benefits.

In recent years, much of the fiscal bite has been taken from the 16 percent slice for domestic discretionary programs — a catchall category that includes spending for drug-fighting and law enforcement, science, housing, the environment, education, health, transportation and public works.

This year, however, attention has turned to defense. Democrats especially are vowing to tap the so-called peace dividend to restore some domestic cuts or reduce the deficit. While some defense cuts are likely — Bush's 1991 proposal for a 2 percent real reduction, after inflation, is just the starting point — military spending already has been on a steady decline for five straight years. *(Chart, this page)*

Much of the defense budget is committed to weapons contracts made during the Reagan buildup and to personnel, and cuts generally only translate into savings after several years. Moreover, Democrats and Republicans alike have resisted cuts in weapons systems and military bases that mean jobs back home.

"There is no peace dividend," said Stanley E. Collender, a budget expert at Price Waterhouse. "There is not going to be a pot of money that's suddenly available. It's only going to create a lot of frustration when that becomes common knowledge."

The Peace Dividend: Already Five Years Old?

Military spending more than doubled from 1980 through 1985. Beginning late in 1985 with the fiscal 1986 budget, Congress applied the brakes. Although the defense budget received a nominal increase in most years since then, it actually decreased when adjusted for inflation.

(In billions of dollars, by fiscal year)

1985	$ 294.7	——
1986	289.1	-4.4 %
1987	287.4	-3.6
1988	292.0	-1.9
1989	299.6	-0.9
1990 est.	301.6	-2.2

SOURCES: Fiscal 1990 Budget (Historical Tables); Congressional Budget Office

Laying Blame

The budget gamesmanship that dominated the 1980s, and continues into this decade, prompts a search for scapegoats. The president blames Congress; Congress blames the White House. Voters blame both, while they, too, come in for a share.

"It's hardly surprising that you have this bipartisan budget complicity," Collender said. "Congress and the White House are doing exactly what the voters are asking for. They want the deficit cut, but they don't want spending cut or taxes increased."

A *New York Times* poll in January found that 62 percent of respondents wanted to spend any defense savings on programs such as drug-fighting and housing. Ten percent wanted their taxes cut. Just 21 percent would apply the savings to the deficit.

"You've got to change the rewards up here," Hollings said. "We get rewarded by getting re-elected."

But after years of both parties claiming the deficit is coming down, and now talk about tax cuts and peace dividends, "how can you blame the voters?" asked Carol G. Cox, president of the Committee for a Responsible Federal Budget.

Indeed, most budget experts split their criticism between the executive and legislative branches, and between the parties. But as the nation's leader, Bush — and Ronald Reagan before him — is singled out most often.

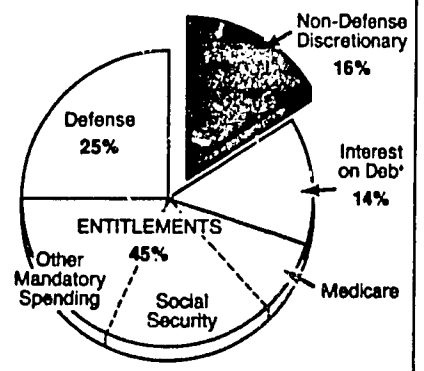
"Congress certainly shares the blame because it's been very happy to jump on those quick-fix deals," said Robert Fulton, former chief counsel for the Senate Budget Committee. "But the president has got to share the heat, and probably take more of it than anyone else. Only he can put together the necessary compromises."

That is especially true for popular presidents, the critics note, yet both Reagan and Bush contributed to the impasse by ruling out taxes as a deficit-cutting option.

"I'm disappointed Bush isn't taking advantage of this tremendous amount of popularity that he has," said House Ways and Means Committee Chairman Dan Rostenkowski, D-Ill. "He is the eighth president I've served with. I've seen the advantage of a presidency in its first year. We could have accomplished a great deal more if he'd recognized that revenues have to be part of the equation."

Hamilton, who also calls for tax increases in combination with spending cuts, said that "if you talk individually with members of Congress, a very solid majority of them would support that kind of package." But the leadership, both in the White House and Congress, has to go first, he said. "I don't think anything is likely to change unless one of two things happens," Hamilton said, drawing an oft-heard conclusion. "Either you have an economic crisis, or else you get genuine political leadership to deal with the problems that everyone knows are out there." ■

Slicing the Budget Pie



Most of the budget has been off the bargaining table in recent years. Most actual cuts have come from the 16 percent available for domestic discretionary spending.

SOURCE: Congressional Budget Office

BARBARA SASSA-DANIELS

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Rostenkowski's Deficit Plan Enlivens Budget Debate

President Bush welcomes the Democrat's gesture, but the White House rejects the details

A high-risk, half-trillion-dollar plan offered by House Ways and Means Chairman Dan Rostenkowski to solve the budget deficit may prove more a personal broadside than a practical blueprint, but it gave new life to the budget debate the week of March 12.

The plan, first published in *The Washington Post* March 11, drew wide media attention and general approval as political beau geste.

But the details — deep cuts in defense, a one-year domestic-spending freeze, a higher top tax rate and higher excise taxes — were too hazardous politically to gain more than a wary response on Capitol Hill, where few enjoy the Illinois Democrat's electoral security. Rostenkowski is unopposed this year and, in fact, may never face the voters in his district again. *(Story, p. 820)*

Yet the story of the Ways and Means chairman's proposal had strong legs, thanks largely to the White House.

"I don't want to appear totally inflexible," said President Bush on March 13 in response to a reporter's question. "We're prepared to negotiate, absolutely."

At the same time, Bush declined to endorse any part of the proposal and specifically disavowed its key components: tax increases and a year's freeze in Social Security benefits.

The administration also made clear it would resist Rostenkowski's proposed repeal of the Gramm-Rudman anti-deficit law.

When asked whether his more positive remarks meant he would reconsider these issues, Bush said: "No, it doesn't. The answer is no." *(Text, p. 861)*

Nevertheless, Rostenkowski and Bush have been friends since Bush served on Ways and Means as a GOP congressman more than two decades ago. So Bush's kind words for Rostenkowski's effort, combined with his refusal to dismiss the Illinois Democrat's plan, created an air of anticipation.

By Ronald D. Elving

PAUL CONKLIN

Rep. Dan Rostenkowski, D-Ill.

News reporters, encouraged by remarks from White House budget director Richard G. Darman and others, suggested the proposal could dislodge the years-old impasse over deficit reduction and at least provide a climate for compromise.

But Darman also said the next move was up to the Democratic leadership, including the chairmen of the House and Senate Budget committees. *(Story, p. 821)*

The Democrats generally took the opposite view, saying Bush needed first to commit himself to Rostenkowski's sense of balance between spending cuts and taxes.

"The president is the key and indispensable participant in any effort to decrease the deficit, and that includes taxes," said Speaker Thomas S. Foley, D-Wash.

While Bush had not dismissed the Rostenkowski plan outright, Foley said, that "had to do with friendship. That doesn't speak of any substantive change on the part of the president to consider new taxes."

Sympathetic Reaction

Other veteran congressional leaders seemed more willing to focus on the plan's possibilities. The deficit battles of the past decade seemed to have instilled sympathy for anyone willing to tackle the behemoth head-on.

Few know the pain of the tax and Social Security issues as well as Pete V. Domenici, R-N.M., who was chairman of the Senate Budget Committee when the critical fiscal decisions of the Reagan years were made.

Domenici said the budget process was moving "toward budget gridlock or worse," and he praised Rostenkowski for "courageously offering his view of a way out. I don't agree with all his proposals," added Domenici, "but maybe it will get serious negotiations started."

Rep. Bill Frenzel, R-Minn., a mainstay of both the House Budget and Ways and Means committees, said Rostenkowski's plan might be "the stimulus for what could be a reasonable compromise."

But while many Republicans liked the proposed domestic-spending restraint, Rostenkowski's Social Security freeze and his tax-increase package were all but orphans in either party. Remarks from congressional leaders were salutes more than counterproposals for negotiation.

"Danny is showing real leadership, and for that my hat is off to him," said Senate Finance Committee Chairman Lloyd Bentsen, D-Texas. He added that he wondered whether Bush was "prepared to roll up his sleeves and get down to work with congressional leaders."

Senate Republican leader Bob Dole of Kansas seemed at least to extend an olive branch. Rostenkowski's proposal "could be the wake-up call we've been waiting for," said Dole. "We'll see who answers it."

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Other Republicans were less generous, particularly about Rostenkowski's rejection of all tax-cut proposals — including reductions in the Social Security tax, a lower rate on capital gains (income from profits on the sale of assets) and bigger tax incentives for personal savings.

Sen. Phil Gramm, R-Texas, called the plan an "affirmation of the basic Democratic agenda: raise taxes, continue the growth of Democratic programs and if necessary cut Social Security to do it."

Serious Taxes

The plan was developed for Rostenkowski by Ways and Means staff using estimates of cost savings and revenue increases calculated by the Congressional Budget Office (CBO).

In recent years, the committee staff has typically been tasked with piecing together small revenue packages as contributions toward marginal deficit reduction. Here, the assignment was to eliminate the deficit in five years.

The plan they produced begins with CBO baseline estimates of a deficit that would be $161 billion in fiscal 1991 and $648 billion over five years. The baseline assumes a continuation of current spending, adjusted for inflation and demographic changes.

These amounts are reduced dramatically by spending freezes and cuts totaling $254.5 billion over five years and revenue increases of $195.2 billion over the same period. If this much were achieved, the national debt would grow more slowly and the Treasury would save another $61.9 billion in interest.

If such a deficit-reduction total of $511.6 billion were achieved, the annual budget would show a surplus of $2 billion in fiscal 1994 and $34 billion in fiscal 1995, according to Ways and Means staff and the CBO.

The plan's most eye-catching feature, given Bush's adamant resistance to high-profile taxes, is a package of tax increases totaling $29 billion in fiscal 1991 and $195.2 billion over five years.

The largest, and the one that would affect the most taxpayers, would be a 15-cent rise in the motor fuel tax. Rostenkowski has pressed for such an increase for many years. It is traditionally opposed by the oil and automobile industries, as well as by state governments that depend on gas taxes themselves. *(1989 Weekly Report p. 24)*

Fuel tax increases are also opposed by legislators from Western states, and rural areas generally, whose constituents tend to drive greater dis-

'Do the Responsible Thing'

"I've had a reputation as a gut politician, a total political animal from the city of Chicago. But I'm also trying . . . to do the responsible thing."

—Rep. Dan Rostenkowski, D-Ill.

When he uttered those words five years ago, Ways and Means Chairman Rostenkowski was embarking on a legislative odyssey that would culminate in the Tax Reform Act of 1986.

It proved a trying trip. But the chairman's new tax-and-cut plan indicates that he is ready to go again.

Although conceived by others, the 1986 act owed its successful birth in large part to Rostenkowski's midwifery. The old-style ward politician has since taken great pride in the "good government" tax overhaul.

As self-appointed keeper of the flame, Rostenkowski has held three days of hearings this year to monitor the act's effects, extol its virtues and urge its preservation. In speeches across the country, he cites the tax act as a parable of the possible. Comprehensive tax overhaul was supposed to be impossible, he says. But it happened.

"The story of America is a tale of turning incredibly ambitious dreams into reality," Rostenkowski wrote in introducing his new deficit-cutting plan March 11.

The plan itself is replete with proposals Rostenkowski himself has opposed over the years, including a freeze on domestic spending and on Social Security cost-of-living increases. It also relies on proposals on which Rostenkowski has long been silent, including tax increases on cigarettes, wine and beer.

Far from hiding these inconsistencies, aides to the chairman tout them. This is the point, they say. Everyone has to give.

"I plead guilty [to] the binge of playing happy politics," Rostenkowski said in a speech March 15. "But it's time we took a good look at ourselves."

In recent months, Rostenkowski's nostalgia for the events of the 99th Congress has at times suggested a man rehearsing a retirement speech.

Rostenkowski was elected to Congress at age 30. He is now serving his 32nd year and his fifth term as Ways and Means chairman. He finished his last campaign with more than $1 million cash in hand, and as a pre-1980 veteran he can convert that money to private use — so long as he retires before 1993.

Moreover, the chairmanship he holds has increasingly seemed a source of grief. In 1989, Rostenkowski was unable to stop a rush to repeal the "Section 89" rules for non-discriminatory employee health plans passed as part of the 1986 overhaul.

He also was unable to stop or modify a drive to repeal the surtax that financed the 1988 extension of Medicare to cover catastrophic illness.

And, most embarrassing of all, he was unable to scuttle a reduction in the capital gains tax, strongly backed by Bush, when it was before his committee or when it came to the floor of the House.

In the years since the tax overhaul, rumors of impending retirement have spread. One reason is Rostenkowski's public and private musings about his pay — a fraction of what lobbyists are paid to talk to him. He has been an outspoken supporter of a congressional pay raise and was one of a handful of members who voted for a 51 percent increase that was rejected in February 1989. *(1989 Weekly Report p. 261)*

Now 62, Rostenkowski could exit shortly before his 65th birthday and enjoy a second career in the private sector, one that would no doubt remunerate him highly. No one has filed to challenge Rostenkowski's reelection this year. But in 1991 his district will be redrawn. When asked, he denies that he plans to retire.

Yet his willingness to go public with something so spiky as this deficit reduction plan convinces many of his colleagues he plans to do just that.

Before he goes, he seems to want to throw one more long pass — even if there is no one deep enough downfield to catch it.

—Ronald D. Elving

tances. Others object to fuel taxes because they are levied without regard to income.

To answer this last criticism, Rostenkowski has proposed increasing the Earned Income Tax Credit (EITC) — a refundable credit for low-income households — by an amount equal to 20 percent of the gas tax revenue. Even with this offset, CBO estimates that a 15-cent tax increase would raise $12 billion in its first year and nearly $58 billion over five years.

Rostenkowski would also double the excise tax on beer, wine and cigarettes, adding $4.2 billion in fiscal 1991 and $21.2 billion over five years.

Rostenkowski would raise another $3.2 billion in unspecified "environmental taxes," which might include taxes on chemicals linked to acid rain.

Rostenkowski's Proposal

(In billions of dollars; by fiscal year)

[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]	1991-1995
CBO Baseline Deficit	**161**	**124**	**132**	**121**	**110**	**648**
Freeze defense, plus 3% decline	−10.0	−20.0	−30.0	−40.0	−50.0	−150.0
Freeze non-defense programs, 1 year	−3.0	−4.9	−5.7	−6.2	−6.6	−26.4
Freeze Medicare provider rates, 1 year	−2.4	−3.6	−4.0	−4.5	−4.9	−19.4
Freeze COLAs, 1 year (except means-tested programs)	−9.0	−12.3	−12.5	−12.5	−12.4	−58.7
Eliminate tax bubble	−4.2	−8.2	−9.3	−10.6	−12.0	−44.3
Suspend tax indexing, 1 year (except earned income tax credit)	−5.4	−10.2	−10.8	−11.4	−12.0	−49.8
Gas tax	−12.0	−11.5	−11.3	−11.5	−11.6	−57.9
Cigarette, beer, wine taxes	−4.2	−4.3	−4.3	−4.2	−4.2	−21.2
Pollution taxes	−3.2	−4.7	−4.7	−4.7	−4.7	−22.0
Interest savings	−1.6	−5.7	−11.2	−17.8	−25.6	−61.9
Total deficit reduction	**−55.0**	**−85.4**	**−103.8**	**−123.4**	**−144.0**	**−511.6**
Resulting deficit	**106**	**39**	**28**	**(2)***	**(34)***	**137**

*Surplus

SOURCE House Ways and Means Committee

Getting More Excise

The fuel and other excise tax increases together would raise $19.4 billion in the first year, a considerable increase over the $34.4 billion total for all excise taxes the federal government levied in 1989. In 1962, all federal excise taxes together were just $12.5 billion. Yet that amount supplied about 12.6 percent of all federal revenues, according to the CBO. In 1989, excise taxes represented less than 3.5 percent of federal revenues.

The revenue in Rostenkowski's plan would rely heavily on changing two features of the 1986 Tax Reform Act, which the Ways and Means chairman considers his proudest achievement. Although Rostenkowski supported neither feature during the writing of that bill, he has since defended both as necessary parts of the compromise that made enactment possible.

One is the indexing of the tax brackets contained in the 1986 act. The income levels that trigger higher rates are now raised each year so that higher incomes attributable to inflation alone will not force taxpayers into a higher bracket.

Rostenkowski would forgo indexing for one year (except for taxpayers who qualified for the EITC). This seemingly minor change would raise $5.4 billion in fiscal 1991. Thereafter, indexing would resume. But the increment gained by skipping a year would continue to have an effect, resulting in nearly $50 billion in additional income over five years.

The second change would eliminate the so-called "bubble" or rate inversion for upper-middle- and high-income households. The bubble was created in the 1986 act to swell revenue while preserving the nominal top income tax rate of 28 percent. *(1989 Weekly Report p. 2366)*

A surtax of 5 percent raises the marginal rate to 33 percent for taxpayers earning above certain amounts ($44,900 for individuals, $74,850 for joint filers). This is because, beyond these income levels, the benefits of the personal exemption and the 15 percent rate are phased out. As income rises further and the phase-out is complete, the marginal rate (the rate paid on the entire taxable amount) returns to 28 percent.

Rostenkowski proposes to leave the surtax in place, creating a new top rate of 33 percent that would begin where the surtax does now and remain in effect for all income thereafter. That would yield $4.2 billion in 1991 and $44.3 billion over five years. But it is likely to generate controversy beyond its dollar value.

Both Foley and Senate Majority Leader George J. Mitchell, D-Maine, have supported eliminating the bubble. But efforts to do so failed both in Ways and Means and on the House floor in September 1989. Although eliminating the bubble would have affected less than 1 percent of all taxpayers, Republicans successfully characterized it as a general tax increase.

Cutting Spending

The largest savings would come from a sharp downward trajectory for defense spending. Rostenkowski would freeze defense spending at fiscal 1990 levels and then cut an additional 3 percent each year. That would yield $10 billion in savings in fiscal 1991, $20 billion in 1992 and a total of $150 billion through 1995.

Spending for discretionary domestic programs would be frozen at current levels for one year, saving $3 billion in the first year. Subsequent increases would then be applied to a somewhat smaller base, saving $26.4 billion over five years.

Another proposal certain to provoke debate would freeze benefits for recipients of Social Security and other retirement programs not subject to a means test. This would save $9 billion the first year. But again, the one-year freeze would slow growth in subsequent years and so produce its most dramatic savings over time. In five years, it would save $58.7 billion.

Under Rostenkowski's proposal, doctors and other providers of Medicare services would be prohibited from increasing their reimbursement rates for one year. This would benefit those who must make copayments to cover part of their Medicare-billed services.

The rate freeze in Medicare services would save a projected $2.4 billion in fiscal 1991 and $19.4 billion over five years. ■

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A PROPER PERSPECTIVE ON THE TWIN DEFICITS[1]

by Charles Wolf, Jr.

While it's true that the deficit twins -- the budget deficit and the trade deficit -- are important, the degree of concern currently being expressed about them is exaggerated. Failure to reduce, let alone eliminate, the deficits may be imprudent. It would not be a disaster.

Moreover, focusing on the deficits diverts attention from the economy's more significant longer-run problem: namely, the aggregate savings rate. Were the deficit problems to be eased while the savings rate remained low, U.S. economic prospects would be bleak. On the other hand, if the savings rate were raised by 2 or 3 percent of the GNP, the longer-term economic outlook would be sanguine whether or not the deficits remained.

To help focus on what's primary and what's secondary, it is worth recalling a few fundamentals about the deficit twins, the relation between them, and their consanguine parentage.

The trade deficit or, to be more accurate, the current account deficit, is definitionally equal to the difference between savings and investment. In an accounting sense, the amount by which investment exceeds savings is exactly equal to the amount by which imports of goods and services exceeds exports.

In the past decade, the aggregate U.S. savings rate has declined by about 3 or 4 percent (from about 16 or 17 percent of the GNP to about 13 percent)[2], while aggregate investment has remained at about the 17

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[1]Presented in testimony before the Budget Committee of the Senate of the United States, February 22, 1989, Washington, D.C.

[2]One of the standard, but seriously misleading, practices in the sometimes polemical writing on this matter is to calculate the U.S. savings rate as *net* savings expressed as a fraction of *gross* national product, thereby shrinking the rate by 9 or 10 percent. This practice is both bad accounting and bad economics: bad accounting because depreciation charges should not be left out of the numerator if they are included in the denominator; bad economics because a relatively large proportion of U.S. plant modernization, as well as the technological advancement embodied in new equipment, is accomplished through capital consumption allowances and depreciation charges, which are non-taxable.

percent figure. This 3 or 4 percent difference has been reflected in the current account deficit. To reduce or eliminate the current account deficit implies either a reduction in investment, or an increase in savings, or a combination of the two.

While the precise determinants of the savings rate, as well as its accurate measurement, are both imperfectly understood and controversial, the government budget is clearly one of the important influences on aggregate savings. This follows from the accounting identity that gross savings represent the difference between gross national product and the *sum* of private consumption spending and government spending on goods and services. Thus, at a given GNP level, gross savings are reduced by either higher consumption or higher government spending. Government purchases of goods and services reduce aggregate savings *whether the government spending is financed by taxes or by borrowing*. The variable that matters is the *magnitude* of government spending: how it is financed is of secondary importance in its effect on savings. To the extent that taxes reduce savings, and government borrowing reduces private consumption spending (the so-called "Ricardian effect"), the size of the federal budget deficit is of secondary importance, while the size of government spending is of primary importance in its effect on savings.

Of course, there are good reasons for wanting to see the federal budget deficit reduced: for example, to keep interest rates down, to damp inflationary expectations, to restore fiscal policy as a credible instrument for countering recessions, and, finally, to convey -- internationally as well as domestically -- the image of a responsible government that lives within its means. While acknowledging that point, it's worth adding a few heterodoxical words to clarify, as well as extenuate, the effects of the federal budget deficit.

First, from the standpoint of the effects of budget deficits on credit markets and the international accounts, what matters is the consolidated budgets of the states as well as the federal government, not the federal budget alone. Because the states have amassed a

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business expenses. Those who are guilty of this practice include many people who should know better, and some who do.

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substantial aggregate budget surplus in recent years, the consolidated deficit shrinks by 50 to 60 billion dollars. Thus, the consolidated budget deficit that results for the current year is $100 billion, or about 2 percent of the U.S. GNP -- a figure not out of line with comparable figures in Japan, West Germany, or the United Kingdom.

Second, the federal budget deficit exercises a braking effect on the otherwise strong political pressures in a pluralistic democracy for government spending to rise. In general, there is a small negative, but statistically significant, relationship between the size of the federal deficit in one year and the increase in federal spending in the succeeding year, net of inflation and net of debt service.

Finally, as Robert Eisner has demonstrated, there's a substantial component of capital formation in federal government spending. Eisner has estimated this component at between $100 billion and $250 billion? annually -- the higher figure depends on whether military procurement and military R&D are included. It is not inappropriate to finance genuine and productive public infrastructure by government borrowing, because the this infrastructure contributes to improved functioning of the economy and to widening the tax base, provided the capital expenditures have been wisely selected in the first place.

Turning to the other twin, there are encouraging signs that the trade deficit is already diminishing under the impact of two powerful market forces: the lowered exchange value of the dollar, and the discipline imposed on U.S. producers by having to compete for market share with foreign imports in the U.S., and with foreign products in world export markets. As a result, the trade deficit in 1988 is likely to be about $137 billion -- more than $30 below the $170 billion deficit of 1987. The 1988 figure will probably decrease further in 1989 by another $20 billion or $30 billion.

As the U.S. trade deficit declines, the adjustment problem this will create for the rest of the world will probably be considerably greater than that for the U.S. economy. It is too easy for our friends in Western Europe and East Asia to forget that, for the U.S. trade deficit to diminish, the trade surpluses of other countries -- especially Japan, West Germany, and the Asian NICs -- will have to

decline; or they and other countries will have to experience trade deficits; or some combination of the two will have to occur. One finds much more criticism these days from European and Asian governments concerning the need for the U.S. to "do something about its trade deficit", than recognition of what this implies for their own economies![3] And these implications remain whether the U.S. trade deficit is reduced by actions that affect the U.S. budget deficit, the U.S. savings rate, or U.S. investment.

This prospect could be adversely affected by one development that has generally been overlooked. The attractiveness of U.S. assets, including real property, to foreign investors may propel a continued strong desire by foreigners to invest in the United States, in the process raising the dollar's value and impeding the downward adjustment of the U.S. trade deficit. It is worth bearing in mind that capital flows can *generate* a trade deficit, rather than being generated by it.

In sum, neither deficit warrants alarm. The federal budget and the trade accounts are less significant indicators of the economy's health than are the maintenance of sustained real economic growth, high employment, and low inflation.

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[3]For example, by the end of the 1990s, Japan should become a "mature" creditor nation--earning more from its prior foreign investments than it is paying out in new investments, implying that it will be importing more than it is exporting.

THE FINANCIAL TIMES, Jan. 2, 1990

OUTLOOK 90

Sometimes, there really is a wolf

Lawrence Summers looks at prospects for the US economy in the coming year and beyond

The current US recovery has now celebrated its seventh birthday, having survived unprecedented currency gyrations, one and a half stock market crashes, and budget and trade deficits which led many observers to predict its early demise.

Just as at the end of the 1960s, sustained growth has led people to believe it can continue indefinitely. The majority of American forecasters do not expect a recession to begin within the next year, and a number do not expect a recession to begin even by 1992. The increasingly optimistic tide of opinion extends beyond the near-term outlook to relative serenity about the budget and trade deficits and America's competitive prospects.

The optimists could be right, as they have been in the recent past. But the American economic performance faces dangers over all horizons. In the short term, as sector after sector turns weak, there is about an even chance that the recovery will not see its eighth birthday. In the longer run, the twin deficit problems could mean a very hard landing at any time, and structural deterioration in America's competitive position continues. After a decade of debt-financed growth, the outlook for the US economy is much bleaker than those who naively extrapolate the past several years of growth expect.

The consensus view is that the economy will grow at an annual rate of between 1.5 per cent and 2 per cent from the fourth quarter of 1989 to the fourth quarter of 1990.

Justifying even the relatively low consensus growth rate by adding up the components of demand is difficult. For the first time since 1982, all sectors of the economy might weaken simultaneously:

- Rapid increases in export demand which propelled the economy during 1987 and 1988 are just about exhausted, as the full effects of the dollar's 1985-87 depreciation have now worked through, and the currency's recent strength (in real terms, the dollar is now up nearly 25 per cent from its 1987 low against the yen) is likely to eliminate foreign trade as a source of increased demand in 1990.
- Business investment probably declined during the fourth quarter of 1989. It is not likely to show much strength, and may even decline, in the first half of 1990. Corporate cash flow and profit measures continue to drop sharply, and the declines that have already taken place will affect investment with a lag. Office equipment investment, which accounted for the lion's share of investment growth during the 1980s, has slowed to the point where lay-offs have become commonplace on Boston's Route 128.
- Government spending will not drive the economy forward. State and local governments around the country, particularly in the north-east, are in financial trouble and are cutting spending. Federal spending is not slated to increase and could fall if weapons programmes are slashed in anticipation of sharp reductions in future defence budgets.
- The consensus view expects consumer demand to drive the economy in the first half of 1990. It is true that consumer confidence remains high by historical standards. However, consumer confidence declined in November and surveys suggest that consumer willingness to take on debt has declined sharply in recent months.

More importantly, awareness of the weakness in the real estate market is spreading slowly. In recent weeks dozens of stories have appeared predicting declines in the nominal price of houses in much of the country. These predictions will be self-fulfilling as potential buyers hang back, anticipating further declines. Turnover in real estate markets has already fallen sharply, and the number of vacant units seeking tenants is at a record high.

Given widespread reliance on home-equity loans, it is difficult to believe that falling housing prices and a growing backlog of unsold homes will not impair consumer confidence and spending over the next year.

The Federal Reserve's strategy has been to try to fine tune the economy so that fears of a slowdown keep inflation in check but no slowdown actually takes place. But the Fed's game is a dangerous one. Increasingly long lags between money and output, brought on by financial deregulation and the increasing importance of international trade, make the task of fine tuning the economy even more difficult today than it has been in the past.

There is a possibility, if not a probability, that past monetary policies have been insufficiently accommodative to avoid a mild recession in 1990. A crucial question for the future is whether the Fed is more likely to err on the side of inflation or recession over the next year. This depends on how inflation evolves, and on how fragile the financial system proves to be.

On inflation, the risks do not look serious at the moment. With the exception of gold, which is artificially buoyed by political developments, commodity prices are very soft. In spite of relatively low unemployment, wage costs appear to be under control.

For now, it appears that the Fed has room to loosen monetary policy, but it will have to be very careful. If its commitment to attack inflation is seen to weaken, long bond rates could rise significantly, the dollar could fall, and wage demands could escalate.

The risks associated with increased corporate leverage and weakness in the junk bond market are probably overstated. Most bank debt in connection with leveraged buy-outs is senior and so will be safe – even if highly leveraged firms cannot meet all their interest obligations.

Greedy investors who bought questionable issues in 1987 and 1988 will suffer expensive losses; but the systemic risks are relatively small. Unlike the case of traditional bankrupt firms, many firms that are having trouble servicing their debts are fully viable as operating businesses. Bankruptcy in these cases is much more likely to involve the restructuring of paper claims than it is to disrupt real economic activity. It is unlikely to call forth a monetary policy response.

Real estate is a different story. Significant declines in house prices would increase financial fragility, and put the Fed in a difficult position since actions to inflate might not reduce and might even increase long-term mortgage interest rates.

The most likely outcome for next year is very slow growth. But it is important to recall that most forecasters miss most recessions. The consensus slow growth forecast could prove too optimistic in many more ways than that it could prove too pessimistic. Monetary policy is on hold for the moment. However, if growth slows further, it will turn expansionary – but probably not quickly enough to avert a mild recession.

Nevertheless, any recession that does take place is not likely to be too severe. There is no current need for the sort of wrenching disinflation that took place in 1975 and 1982.

Layered on top of these cyclical developments is the continuing risk of a hard landing brought on by the problem of the twin deficits (on the federal budget and the current account of the balance of payments.) The US current account deficit is likely to start rising again in 1990, given the recent strength of the dollar. International borrowing has been used to finance consumption rather than investment. The share of total consumption in GNP is at record levels, and net plant and equipment spending during the 1980s has been far weaker than in any previous decade – in spite of heavy borrowing from abroad.

No fundamental change in fiscal policy or in private saving that might solve the over-consumption problem is in the offing. In a more than $5 trillion ($5,000 bn) economy, budgetary fiddling over $10bn or $200bn makes very little difference. Any peace dividend from the ending of the Cold War is already massively oversubscribed.

The reality is that unless a crisis forces big policy changes, the US national saving rate will remain under 5 per cent for the next 5 years. This is less than two thirds of the saving rate the US maintained during the 1970s and less than half the savings rate of the average OECD nation.

The crucial question then becomes how long can the US finance its current low level of investment by borrowing from abroad, and by selling off domestic assets, rather than from domestic saving.

The strength of the dollar this year was caused by foreign investors' perception that US assets looked very cheap. Given that the US share of world stock market value has nearly halved in the 1980s, there is merit in this view. As long as it continues to be widespread, the US will be able to postpone adjustment by financing its current account deficit indefinitely.

The problem is that no dollar asset is cheap if the dollar is going to fall sharply within the coming year. As America's foreign debt increases and economic frictions with its traditional allies begin to supplant traditional national security concerns, it becomes increasingly easy to construct hard landing scenarios where foreign investment in the US dries up.

Combine a recession which reduces US interest rates and equity values and reduces confidence in US financial institutions with some unfavourable trade deficit news (and the lurch towards protection that would surely follow declines in the manufacturing sector). Factor in widespread support for politicians vowing to restrict efforts to make Americans "tenants in their own country." Add in tension between the US and Japan which leads the Japanese not to intervene or use administrative guidance to force financial institutions to stabilise the dollar. Finally, let progress towards eastern European integration continue rapidly so that there are substantial investment opportunities in Europe, and let Indonesia, Thailand and possibly even the Soviet Union emerge as strong magnets for Japanese capital investment.

Under such a scenario, foreign investment in US financial instruments could easily dry up, as the view that the US will never come near to balancing its trade without a substantial reduction in the dollar took hold. The Fed would then have very little room to manoeuvre, because actions to attract capital would reduce the liquidity of struggling financial institutions, and actions to provide liquidity would only fan the flames of dollar decline. Interest rates would soar, investment would collapse, and a period of stagflation would ensue. Eventually, a sharply reduced exchange rate would spur enough investment demand to spur the economy forward, but the wait would be acutely painful – not only for the real economy but also for holders of US stocks and bonds.

As the history of the last seven years demonstrates, the risk of crying wolf about the American economy is a real one. Its resilience may continue – neither recession nor hard landing is certain – but American optimism lacks the solid foundation in recent developments that is now so easily found in both Asia and Europe. In the end, the wolf ate the boy. It would be a mistake to bet too strongly on the American economy in general or the dollar in particular over the next few years.

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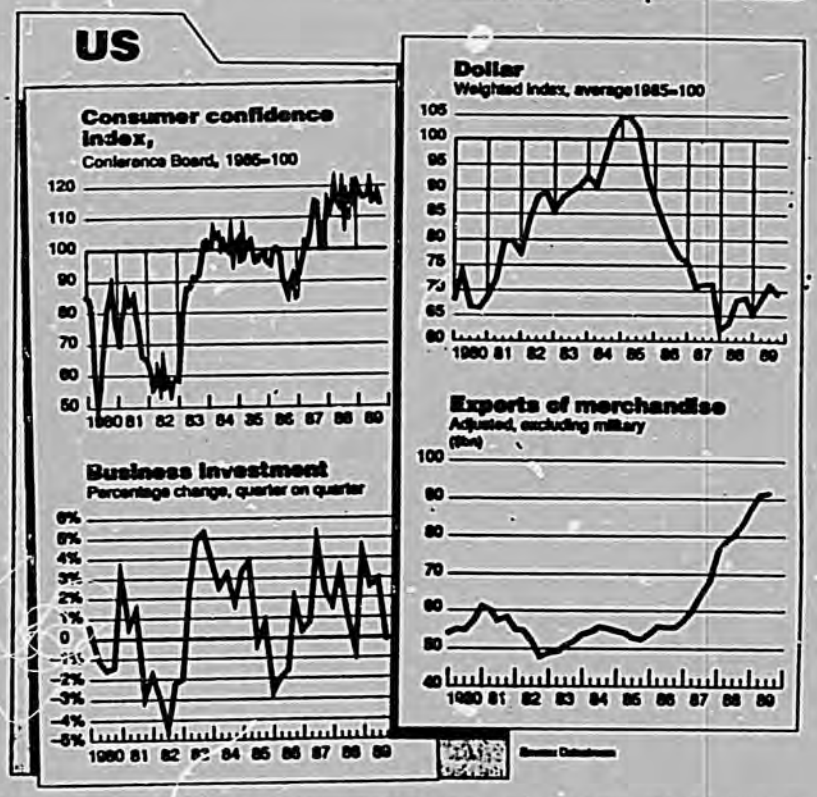
US ECONOMIC FORECAST

	1989	1990
GDP (% change)	3.0	1.5%
Merchandise trade deficit	$112bn	$90-100bn
Treasury bill rates	7.94%	7-7.5%
Yield on 30-year Govt bonds	7.88%	7.5-8.0%

1989 interest rates are end-year; 1990 are annual average



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THE NEW YORK TIMES, TUESDAY, DECEMBER 19, 1989

The 'Peace Dividend': A Rubber Check

By Jim Sasser

WASHINGTON

In what is being billed by the Administration as a victory for "deficit reduction," the Pentagon is settling for a fiscal 1991 budget of $282 billion.

This nod toward fiscal responsibility follows Administration announcements that it is contemplating dramatic Pentagon reductions in response to the relaxation of world tensions: $180 billion in cuts over four years; cuts of up to 200,000 from the nation's 2.1 million troops; a cut of some 23,000 jobs from the 500,000-strong procurement bureaucracy.

On the basis of those promised economies, we are seriously debating the question of what to do with the "peace dividend." But how can we speak of a peace dividend with a military budget of $282 billion? The peace dividend, as currently constituted, is a rubber check.

The $282 billion defense budget for fiscal 1991 actually represents an increase of some $6 billion from 1989. It would save only about $4.7 billion from current inflation-adjusted spending levels — a mere fraction of the $40 billion to $60 billion we'll need to hit next year's deficit target under Gramm-Rudman.

Worse still, the purported $180 billion "cut" actually takes, as its starting point, the Administration's "wish list" budget, which would have raised Pentagon spending by some $300 billion above a true freeze level between now and 1994.

Bush's 'cuts' would add $20 billion.

Defense Secretary Dick Cheney has apparently concluded that even a $20 billion increase over the next five years is more austerity than the Pentagon can absorb. But it is clear that the Secretary's worst case scenario — the deepest "cuts" he's currently considering — would produce a "peace dividend" that is actually a $20 billion debit.

To put all of that as simply as possible, the Pentagon gets $287 billion in the budget just passed for fiscal 1990. Under the exercise in "austerity" proposed by the Secretary, the Pentagon would get more than $290 billion annually through the mid-90's.

The Secretary's proposal appears to have been driven wholly by the desire to offer some public acknowledgment that the world has indeed changed. But it is a grudging acknowledgment at best.

It assumes continuation of virtually all of the Pentagon's priorities and programs, and it eschews entirely a fundamental re-evaluation of our military establishment in light of our changing security needs. Such a reappraisal has to be the beginning point.

Fully half of our $287 billion military budget is devoted to defending Western Europe against the now remote threat of a Warsaw Pact invasion.

Earlier this month, the Pentagon acknowledged that its estimate of a two-week mobilization period for a full-scale Soviet invasion seriously overstated the threat: 33 to 44 days is a far more likely projection. That profoundly exaggerated threat assessment was inflating our defense budget long before the Iron Curtain began to rise and the potential for hostilities in Europe began to decline.

After we make adjustments for "the common European home," which now appears to be under construction, the entire frame of reference for America's defense expenditures changes radically.

If we add to all this the potential for completing treaties to slash strategic nuclear arms and conventional forces in Europe, we should be aiming for a military budget that returns to the post-Vietnam Nixon-Ford era average: somewhere in the range of $215 billion in constant 1990 dollars.

That is a legitimate target, once we cast a critical eye on all our military assumptions, from our entire force structure to the weapons systems now in the pipeline: from the $35 billion advanced tactical aircraft to the $45 billion advanced tactical fighter to the $70 billion B-2 bomber.

Our allies and our former adversaries have already begun to respond decisively. West Germany is talking about reducing its ground forces by 20 percent. Hungary has unofficially asked that Soviet troops be removed from within its borders, and Czechoslovakia seems to be following suit.

Those countries, and many others in both the East and the West, are poised to advance into a world in which the strength of nations will be measured in economic output. We should prepare to do the same. □

Jim Sasser, Democrat of Tennessee, is chairman of the Senate Budget Committee.

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BY GERALD MARTINEAU — THE WASHINGTON POST

THE WASHINGTON POST, Dec. 7, 1989

William J. Crowe Jr.

It's Too Early to Spend the Defense Savings

As the stunning events in Eastern Europe continue to unfold, it is becoming clear that the wolves are circling the U.S. defense budget. Some stalk these dollars from altruistic motives, such as shifting more to child care, health programs and other social agenda items. Others, however, see the diminution of the Warsaw Pact threat as their best chance to realize their dream of emasculating the "wicked" Pentagon.

Both these groups are wrong. The daily headlines may be exciting, but they don't excuse rashness or misplaced logic. It is incumbent on the administration to seize the lead and to inject some good sense into the argument. This is the time to "walk, not run, to the exit" in realigning American defenses and to ensure that the outcome is shaped by a solid strategic rationale, rather than by non-security issues.

While it is appropriate to modify our defense posture as the Warsaw Pact threat diminishes, the future is still plagued by uncertainty. The free world applauds the encouraging trend toward pluralism in the East, but tearing down one system (or one wall) doesn't tell you what will follow it. We were happy when Nicaragua's dictatorship was crushed by popular forces in 1979. We're not so happy with what replaced it.

In the same fashion, we have to be cautious in making assumptions about America's defensive needs in the 1990s and beyond. No matter how appealing the prospects of a world with no Soviet threat, it isn't here yet. The reality is that the Kremlin will maintain what it considers a prudent mix of conventional and nuclear forces for the foreseeable future. More significant, the Kremlin will not dismantle its impressive mobilization system, which can call up the Soviets' vast pool of military experience in a crisis.

It is not a comforting thought, but the fact remains that there are still serious challenges ahead in Eastern Europe. Poland, East Germany, Czechoslovakia and Hungary will all be seeking economic and political structures that both accommodate the last 40 years of their history and reach out to the West. We will see turmoil, confusion and struggle as fledgling political parties emerge and vie for ascendancy. New wealth, new poverty and new frustrations will be generated. It's impossible to tell at this juncture what form the new governments will take or how stable they will be.

Regional rivalries and instabilities in the subcontinent, the Persian Gulf, the eastern Mediterranean and in Latin America show no sign of abating and may very well intensify. International terrorism and drug trafficking are increasing. Complicating the picture is the proliferation of sophisticated weapons throughout the Third World. Nevertheless, we will still expect our president to be able to control regional perturbations that threaten American interests.

Put simply, the necessity to protect our interests in an uncertain world will not disappear, and there will still be a need for armed options. In transforming our military posture, it makes good sense to proceed deliberately rather than in a precipitate fashion, keeping a close watch for signs of instability in the U.S.S.R. and Eastern Europe.

If our forces are to be smaller and more streamlined, it is imperative that they be tailored to the new international realities and threats. Only then will we get the best return on our investment. We heard a lot of criticism about not spending "smart" when we expand the military; it is even more difficult to act wisely when drawing down. This means that we must develop a new strategic rationale for our forces—a concept that will then be used to guide the reductions. It will not be easy.

History suggests that the infighting will be fierce throughout the government. The usual device for keeping political pressure manageable has been to cut all organizations and weapons procurements equally, while eliminating none of them. Specific dollar goals are set up, and the comptrollers are brought in to run the railroad. The result, more often than not, has been a reduced version of today's force, which is both inadequate to carry out yesterday's strategy and inappropriate for tomorrow's mission. The stakes in this game are too high to leave the decisions to people in green eyeshades.

Forces and services that are cut must be related to more than just budgets. As the size of our active forces goes down, increasing attention should be given to our reserve units and the mobilization system. Additionally, to get the most of our investment, the emphasis must shift to the flexible and rapidly deployable forces and equipment (including the necessary air and sealift).

At the same time, we should take care to preserve our alliances. That does not mean that we cannot remove troops from Europe or Asia. We can and should draw down. It does argue for the future emphasis to be on those global functions, such as the strategic deterrent, space and providing for regional contingencies, which we do well and which our allies cannot perform.

There is a vital role for Congress in this restructuring process. Too often in the past, congressional debate on defense has centered on "pork," with decisions being made with local districts rather than global realities in mind. But the process of downsizing America's defense will be much too important for "business as usual." The specifics of the administration's new strategy will be the subject of heated debate, as they should be. But the tough conceptual bullets have to be bitten by Congress, as well, if we are to make the transition efficiently

To say that we want to spend less on defense is not enough. As America's defense posture is reshaped, we should also insist that both the administration and Congress first agree on a realistic timetable and a thoughtful strategic rationale to guide the cuts.

The writer, a retired admiral, was chairman of the Joint Chiefs of Staff from Oct. 1, 1985 until Sept. 30, 1989.

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New Decade, New World, New Strategy

By David Boren

WASHINGTON

Americans well understand what the historic changes in the Soviet bloc are doing to the Soviet Union's influence in the world. But do we understand the impact of this on America's influence? Unless we are prepared to develop and implement a new American strategy in international politics, we could well see our own influence decline in parallel with the Soviet Union's.

The U.S., which has relied with minor adjustments in the past 45 years upon the foreign policy concepts and institutions put in place by the Truman Administration, must be prepared to embrace a new vision of its role in the world in the 1990's.

We must recognize that, as our allies become less concerned about the extreme Soviet military threat, they will feel less need for the shield of American military protection and become less willing to follow our lead in the international arena.

Economically, the allies no longer need the U.S. the way they did in 1950, when we had two-thirds of the world's assets and nine of the 10 largest banks in the world. Today, we have none of the 10 largest banks. Our share of world assets is now half of what it was in 1950, and by the year 2000 our per capita income is projected to fall significantly short of Japan's and that of several Western European nations.

Lastly, the need to gain access to the U.S. market, which in the past has induced friendly actions on the part of other nations, will no longer be more important than access to European or Japanese markets.

The fact that we now face new and difficult challenges should in no way blunt our joy or enthusiasm for the changes taking place. Nevertheless, the challenges offer us many new opportunities. These must be seized quickly, for they may not come again.

First, we have an opportunity to rebuild our own economy. In "The Rise and Fall of Great Powers," Prof. Paul Kennedy warned that the U.S. faced possible economic decline because of what he called "imperial overstretch." He defined this as the attempt to meet the same military and international obligations as we were meeting at the close of World War II with a much smaller proportion of the world's economic assets. We now have a chance to avoid that scenario.

Without a sea change in our thinking, U.S. influence will decline.

Of course, we cannot and must not unilaterally disarm in the face of short-term uncertainties about the course of Soviet behavior. It is likely, however, that we will be able to move prudently toward significant reductions in military spending.

These savings can and must be used intelligently to reduce budget deficits at home, provide tax incentives for increased savings and investment, rebuild the decaying infrastructure, improve education and develop human resources. To be strong abroad, we must concentrate on a new domestic agenda. We cannot be a world leader if we allow an underclass to develop at home, plagued with the waste of human talent that comes from school drop-out rates that are tragically high and explosive increases in drug addiction.

Second, we should view the improved prospects for economic development in Eastern Europe and other parts of the world as more than an opportunity to provide humanitarian assistance. We should also see them as a chance to regain a portion of our lost share of world markets.

Accordingly, a large share of future aid should be granted in the form of "Buy American" credits, especially to encourage consumption of the basic capital goods that lead to long-term economic relationships. Granting such credits on a massive scale is in our national interest. West Germany and Japan are already taking that approach.

Third, we should increase dramatically student exchange programs at the undergraduate college level with the Soviet Union, Eastern Europe and key nations in Latin America. This action would help build lasting bonds of friendship and make it more difficult to reverse recent advances toward freedom. It is no coincidence, for example, that those who have experienced American values as exchange students are in the forefront of the reform movement in China.

Finally, we must improve the ability of Americans to deal with the new international environment. The study of foreign languages and international studies in schools and universities must be markedly increased. The Peace Corps should be increased tenfold in the next decade, both to raise the international sensitivities of the next generation and to build strong ties with nations that we have neglected because of our past focus on large bloc and superpower relationships.

America can hardly be said to be in decline when hundreds of millions of people around the world take great risks to embrace our ideals. The words and ideas of Thomas Jefferson are on the lips of people from Managua to Prague, and the raising of the Statue of Liberty in Tiananmen Square symbolizes that the 20th century has been the "American century."

To be strong abroad, we must rebuild at home.

What we do in the last decade of this century will largely determine our role in the next. We must never forget that those who mill around at the crossroads of history do so at their own peril. □

David Boren, Democrat of Oklahoma, is chairman of the Senate Select Committee on Intelligence.

February 20, 1990

Testimony of Alan Greenspan Chairman, Federal Reserve Board

Mr. Chairman and Members of the Committee, I appreciate the opportunity to testify today on the Federal Reserve's semiannual Monetary Policy Report to the Congress. My prepared remarks discuss our monetary policy actions and plans in the context not only of the current and projected state of the economy, but also against the background of our longer-term objectives and strategy for achieving them. The final section of the testimony addresses some issues for monetary policy raised by the increasingly international character of financial markets.

Economic and Monetary Policy Developments in 1989

Last year marked the seventh year of the longest peacetime expansion of the U.S. economy on record. Some 2½ million jobs were created, and the civilian unemployment rate held steady at 5¼ percent. Inflation was held to a rate no faster than that in recent years, but unfortunately no progress was made in 1989 toward price stability. Thus, while we can look back with satisfaction at the economic progress made last year, there is still important work to be done.

About a year ago, Federal Reserve policy was in the final phase of a period of gradual tightening, designed to inhibit a buildup of inflation pressures. Interest rates moved higher through the winter, but started down when signs of more restrained aggregate demand and of reduced potential for higher inflation began to appear. As midyear approached, a marked strengthening of the dollar on foreign exchange markets further diminished the threat of accelerating inflation. New economic data suggested that the balance of risks had shifted toward the possibility of an undue weakening in economic activity. With M2 and M3 below the lower bounds of their annual ranges in the spring, the Federal Reserve in June embarked on a series of measured easing steps that continued through late last year. Across the maturity spectrum, interest rates declined further, to levels about 1½ percentage points below March peaks. Reductions in inflation expectations and reports of a softer economy evidently contributed to the drop in rates in longer-term markets.

The decrease in short-term rates lifted M2 to around the middle of its annual range in the latter part of the year. Efforts under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) to close insolvent thrift institutions and strengthen undercapitalized thrifts led to a cutback of the industry's assets and funding needs. This behavior held down M3 growth in the second half of the year, and that aggregate ended the year around the lower end of its annual range. The restructuring of the thrift industry did not, however, seem to appreciably affect the overall cost and availability of residential mortgage credit, as other suppliers of this credit stepped into the breach. In the aggregate, the debt of nonfinancial sectors slowed somewhat, along with spending, to a rate just below the midpoint of its annual range.

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So far this year, the federal funds rate has remained around 8¼ percent, but rates on Treasury securities and longer-term private instruments have reversed some of their earlier declines. Investors have reacted to stronger-than-expected economic data, a runup in energy prices, and increasingly attractive investment opportunities abroad, especially in Europe.

The Ultimate Objectives and Medium-Term Strategy of Monetary Policy

Monetary policy was conducted again last year with an eye on long-run policy goals, and economic developments in 1989 were consistent with the Federal Reserve's medium-term strategy for reaching them. The ultimate objective of economic policy is to foster the maximum sustainable rate of economic growth. This outcome depends on market mechanisms that provide incentives for economic progress by encouraging creativity, innovation, saving, and investment. Markets perform these tasks most effectively when individuals can reasonably believe that by forgoing consumption or leisure in the present they can reap adequate rewards in the future. Inflation insidiously undermines such confidence. It raises doubts in people's minds about the future real value of their nominal savings and earnings, and it distorts decision-making. Faced with inflation, investors are more likely to divert their attention to protecting the near-term purchasing power of their wealth. Modern-day examples of economies stunted by rapid inflation are instructive. In countries with high rates of inflation, people tend to put their savings in foreign currencies and commodities rather than in the financial investments and claims on productive assets that can best foster domestic growth. By ensuring stable prices, monetary policy can play its most important role in promoting economic progress.

The strategy of the Federal Open Market Committee (FOMC) for moving toward this goal remains the same—to restrain growth in money and aggregate demand in coming years enough to establish a clear downward tilt to the trend of inflation and inflation expectations, while avoiding a recession. Approaching price stability may involve a period of expansion in activity at a rate below the growth in the economy's potential, thereby relieving pressures on resources. Once some slack develops, real output growth can pick up to around its potential growth rate, even as inflation continues to trend down. Later, as price stability is approached, real output growth can move still higher, until full resource utilization is restored.

While these are the general principles, no one can be certain what path for the economy would, in practice, accompany the gradual approach to price stability. One key element that would minimize the costs associated with the transition would be a conviction of participants in the economy that the anti-inflation policy is credible, that is, likely to be effective and unlikely to be reversed.

Stability of the general price level will yield important long-run benefits. Nominal interest rates will be reduced with the disappearance of expectations of inflation, and real interest rates likely will be lower as well, as less uncertainty about the future behavior of overall prices induces a greater willingness to save. Higher saving and capital accumulation will enhance productivity, and the trend growth in real GNP will be greater than would be possible if the recent inflation rate continued.

If past patterns of monetary behavior persist, maintaining price stability will require an average rate of M2 growth over time approximately equal to the trend growth in output. During the transition, the decline of market interest rates in response to the moderation in inflation would boost the public's demand for M2 relative to nominal spending, lowering M2 velocity. M2 growth over several years accordingly may show little deceleration, and it could actually speed up from time to time, as interest rates decline in fits and starts. Hence, the FOMC would not expect to lower its M2 range mechanically each and every year in the transition to price stability.

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This qualitative description of our medium-term strategy is easy to state, but actually implementing it will be difficult. Unexpected developments no doubt will require flexible policy responses. Any such adjustments will not imply a retreat from the medium-term strategy or from ultimate policy goals. Rather, they will be mid-course corrections that attempt to keep the economy and prices on track. The easing of reserve pressures starting last June is a case in point. Successive FOMC decisions to ease operating policy were intended to forestall an economic downturn, the chances of which seemed to be increasing as the balance of risks shifted away from greater inflation. The FOMC was in no way abandoning its long-run goal of price stability. Instead, it sought financial conditions that would support the moderate economic expansion judged to be consistent with progress toward stable prices. In the event, output growth was sustained last year, although in the fourth quarter a major strike at Boeing combined with the first round of production cuts in the auto industry accentuated the underlying slowdown. On the inflation side, price increases in the second half were appreciably lower than those in the first. Although the CPI for January, as expected, showed a sizable jump in energy and food prices in the wake of December's cold snap, a reversal is apparently underway.

Monetary Policy and the Economic Outlook for 1990

Against this background, the Federal Reserve Governors and the Presidents of Reserve Banks foresee continued moderate economic expansion over 1990, consistent with conditions that will foster progress toward price stability over time. At its meeting earlier this month, the FOMC selected ranges for growth in money and debt it believes will promote this outcome.

My testimony last July indicated the very preliminary nature of the tentative ranges chosen for 1990, given the uncertain outlook for the economy, financial conditions, and appropriate growth of money and debt. With the economic situation not materially different from what was anticipated at that time, the FOMC reaffirmed the tentative 3 to 7 percent growth range for M2 in 1990 that it set last July. This range, which is the same as that used in 1989, is expected by most FOMC members to produce somewhat slower growth in nominal GNP this year. The declines in short-term interest rates through late last year can be expected to continue to boost the public's demands for liquid balances in M2, at least for a while longer. M2 growth over 1990 thus may be faster than in recent years, and M2 velocity could well decline over the four quarters of the year, absent a pronounced firming in short-term market interest rates.

In contrast with M2, the range for M3 has been reduced from its tentative range set last July. The new M3 range of 2½ to 6½ percent is intended to embody the same degree of restraint as the M2 range, but it was lowered to reflect the continued decline in thrift assets and funding needs now anticipated to accompany the ongoing restructuring of the thrift industry. This asset runoff began in earnest in the second half of last year, so its magnitude was not incorporated into the tentative M3 range for 1990 set last July. The bulk of the mortgage and real estate assets that thrifts will shed are expected to be acquired by the Resolution Trust Corporation and diversified investors other than depository institutions. Such assets thus will no longer be financed by monetary instruments included in M3. In addition, commercial banks are likely to be more cautious in their lending activities, reducing their need to issue wholesale managed liabilities included in M3. These influences should retard the growth of M3 relative to M2 again this year.

The debt of domestic nonfinancial sectors is expected to decelerate along with nominal GNP for a fourth straight year, and the Committee chose to lower the monitoring range for this aggregate to 5 to 9 percent for 1990. Merger and acquisition activity has retreated from the feverish pace of recent years, reflecting some well-publicized

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difficulties of restructured firms and more caution on the part of creditors. All other things equal, less restructuring activity and greater use of equity finance imply reduced corporate borrowing. An ebbing of growth in household debt also seems probable.

Over the last decade, money and debt aggregates have become less reliable guides for the Federal Reserve in conducting policy. The velocities of the aggregates have ranged widely from one quarter or one year to the next, in response to interest rate movements and special factors. In the coming year, the effects of the contraction of the thrift industry on the velocity of M3, and to a lesser extent on that of M2, are especially difficult to predict. While recognizing that the growth rates of the broader monetary aggregates over long periods are still good indicators of trends in inflation, the FOMC will continue to take an array of factors into account in guiding operating policy. Information about emerging patterns of inflationary pressure, business activity, and conditions in domestic and international financial markets again will need to supplement monetary data in providing the background for decisions about the appropriate operating stance.

The Committee's best judgment is that money and debt growth within these annual ranges will be compatible with a moderation in the expansion of nominal GNP. Most FOMC members and other Reserve Bank presidents foresee real GNP growing 1¾ to 2 percent over the year as a whole. Such a rate would be around last year's moderate pace, excluding the rebound in agricultural output from the 1988 drought. A slight easing of pressures on resources probably is in store. Inflation pressures should remain contained, even though the decline in the dollar's value over the past half-year likely will reverse some of the beneficial effects on domestic inflation stemming from the dollar's earlier appreciation. The CPI this year is projected to increase 4 to 4½ percent, as compared with last year's 4½ percent.

Risks to the Economic Outlook

Experience has shown such macroeconomic forecasts to be subject to a variety of risks. Assessing the balance of risks between production shortfalls and inflation pressures in the current outlook is complicated by several cross-currents in the domestic and international economic and financial situation.

One risk is that the weakness in economic activity evident around year-end may tend to cumulate, causing members' forecasts about production and employment this year to be overly optimistic. However, available indicators of near-term economic performance suggest that the weakest point may have passed. The inventory correction in the auto industry—a rapid one involving a sharp reduction in motor vehicle assemblies in January coupled with better motor vehicle sales—seems to be largely behind us. Industrial activity outside of motor vehicles appears to be holding up. Production of business equipment, where evidence has accumulated of some stability—if not an increase—in orders for capital goods, is likely to support manufacturing output in coming months. Housing starts were depressed in December by severely cold weather in much of the country. But starts bounced back strongly in January, in line with the large gain in construction employment last month. From these and similar data, one can infer the beginnings of a modest firming in economic activity. While we cannot be certain that we are as yet out of the recessionary woods, such evidence warrants at least guarded optimism.

There are, however, other undercurrents that continue to signal caution. One that could disturb the sustainability of the current economic expansion has been the recent substantial deterioration in profit margins. A continuation of this trend could seriously undercut the still expanding capital goods market. However, if current signs of an upturn in economic activity broaden, profit margins can be expected to stabilize.

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A more deep-seated concern with respect to the longer-run viability of the expansion is the increase in debt leverage. Although the trends of income and cash flow may have turned the corner, the structure of the economy's financial balance sheet weighs increasingly heavily on the dynamics of economic expansion. In recent years, business debt burdens have been enlarged through corporate restructurings, and as a consequence interest costs as a percent of cash flow have risen markedly. Responding to certain well-publicized debt-servicing problems, creditors have become more selective in committing funds for these purposes. Within the banking industry, credit standards have been tightened for merger and LBO loans, as well as for some other business customers. Credit for construction projects reportedly has become less available because of FIRREA-imposed limits and heightened concerns about overbuilding in a number of real estate markets.

Among households, too, debt-servicing burdens have risen to historic highs relative to income, and delinquency rates have moved up of late. Suppliers of consumer and mortgage credit appear to have tightened lending terms a little. Real estate values have softened in some locales, although prices have maintained an uptrend in terms of the national averages, especially for single-family residences. These and other financial forces merit careful monitoring. While welcome from a supervisory perspective, more cautious lending does have the potential for damping aggregate demand.

It is difficult to assess how serious a threat increased leverage is to the current levels of economic activity. Clearly, should the economy fall into a recession, excess debt service costs would intensify the problems of adjustment. But it is unlikely that in current circumstances strains coming from the economy's financial balance sheet can themselves precipitate a downturn. As I indicated earlier, we expect nonfinancial debt growth to continue to slow from its frenetic pace of the mid-1980s. This should lessen the strain and hopefully the threat to the economy.

International Financial Markets and Monetary Policy

Among other concerns, recent events have highlighted the complex interactions between developments in the U.S. economy and financial markets and those in the other major industrial countries. Specifically, the parallel movements in long-term interest rates here and abroad over the early weeks of 1990 have raised questions: To what extent is the U.S. economy subject to influences from abroad? To what extent, as a consequence, have we lost control over our economic destiny? The simple answer to these questions is that the U.S. economy is influenced from abroad to a substantially greater degree than, say, two or three decades ago, but U.S. monetary policy is, nonetheless, able to carry out its responsibilities effectively.

The post-war period has seen markedly closer ties among the world's economies. Markets for goods have become increasingly, and irreversibly, integrated as a result of the downsizing of economic output and the consequent expansion of international trade. The past decade, in particular, also has witnessed the growing integration of financial markets around the world. Advancing technology has fostered the unbundling and transfer of risk and engendered a proliferation of new financial products. Cross border financial flows have accordingly accelerated at a pace in excess of global trade gains. This globalization of financial markets has meant that events in one market or in one country can affect within minutes developments in markets throughout the world.

More integrated and open financial markets have enabled all countries to reap the benefits of enhanced competition and improved allocation of capital. Our businesses can raise funds almost anywhere in the world. Our savers can choose from a lengthening menu of investments as they seek the highest possible return on their funds. Our financial institutions enjoy wider opportunities to compete.

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In such an environment, a change in the expected rate of return on financial assets abroad naturally can affect the actions of borrowers or lenders in the United States. In response, exchange rates, asset prices, and rates of return all may adjust to new values.

Strengthened linkages among world financial markets affect all markets and all investors. Just as U.S. markets are influenced by developments in markets abroad, foreign markets are influenced by events here. These channels of influence do not depend on whether a country is experiencing a deficit or a surplus in its current account. In today's financial markets, the net flows associated with current account surpluses and deficits are only the tip of the iceberg. What are more important are the huge stocks of financial claims—more than $1.5 trillion held in the United States by foreigners and more than $26 trillion of dollar-denominated claims on U.S. borrowers held by U.S. residents. This is in addition to the vast quantities of assets held in foreign currencies abroad. It is these holdings that can respond to changes in actual and expected rates of return.

In recent years we have seen several instances in which rates of return have changed essentially simultaneously around the world. For example, stock prices moved together in October 1987 and 1989, and in 1990 bond yields have risen markedly in many industrial countries.

However, we must be cautious in interpreting such events, and in drawing implications for the United States. Frequently, such movements occur in response to a common worldwide influence. Currently, the world economy is adjusting to the implications of changes in Eastern Europe, where there are tremendous new opportunities to invest and promote reconstruction and growth. Those opportunities, while contributing to the increase in interest rates in the United States, also open up new markets for our exports.

Moreover, despite globalization, financial markets do not necessarily move together—they also respond to more localized influences. Over 1989, for example, bond yields in West Germany and Japan rose about a percentage point, while those in the United States fell by a similar amount. The contrast between 1989 and 1990 illustrates the complexity of relationships among financial markets. Interactions can show through in movements in exchange rates as well as interest rates, and changes in the relative prices of assets depend on a variety of factors, including economic developments and inflation expectations in various countries as well as monetary and fiscal policies here and abroad.

The importance of foreign economic policies for domestic economic conditions has given rise in recent years to a formalized process of policy coordination among the major industrial countries. The purpose of such coordination is to help policymakers achieve better performance in their national economies. It begins with improved communication among authorities about economic developments within each country. It includes systematic analysis of the likely impact of these developments on the economies of the partner countries and on variables such as exchange rates that are inherently jointly determined in international markets. Within such a framework, it is possible to consider alternative choices for economic policies and to account explicitly for the impacts of likely policy measures in one country on the other economies.

The influence of economic policies abroad and other foreign developments on the U.S. economy is profound, and the Federal Reserve must carefully take them into account when considering its monetary policy. But these influences do not fundamentally constrain our ability to meet our most important monetary policy objectives.

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Developments within U.S. financial markets remain the strongest influence on the asset prices and interest rates determined by those markets and, through them, on the U.S. economy. Exchange rates absorb much of the impact of developments in foreign asset markets, permitting U.S. interest rates to reflect primarily domestic economic conditions. Exchange rates influence the prices of products that do, or can, enter into international trade. Such factors can bring about changes in the composition of production between purely domestic goods and services and those entering international trade, and they can affect aggregate price movements for a time.

However, the overall pace of spending and output in the United States depends on the demands upon all sectors of the U.S. economy taken together. And our inflation rate, over time, depends on the strength of those demands relative to our ability to supply them out of domestic production. Because the Federal Reserve is able to affect short-term interest rates in U.S. financial markets, it is able to influence the pace of economic activity in the short-run and inflationary pressures longer-term. To be sure, monetary policy must currently balance more factors than in previous decades. But our goals are still achievable.

Monetary policy is only one tool, however, and it cannot be used successfully to meet multiple objectives. The Federal Reserve, for example, can address itself to either domestic prices or exchange rates but cannot be expected to achieve objectives for both simultaneously. Monetary policy alone is not readily capable of addressing today's large current account deficit, which is symptomatic of underlying imbalances among saving, spending, and production within the U.S. economy. Continued progress in reducing the federal deficit is a more appropriate instrument to raise domestic saving and free additional resources for productive investment. The long-term health of our economy requires the balanced use of monetary and fiscal policy in order to reach all of the nation's policy objectives.

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The Wall Street Journal

L FRIDAY, FEBRUARY 23, 1990

U.S. Markets and Foreign Interest Rates

By NICHOLAS SARGEN

U.S. financial markets have been riled this year, and especially this week, by nervousness about interest-rate hikes abroad. Overseas markets have long been influenced by U.S. developments, but now the tables have turned.

The question increasingly being asked is whether U.S. interest rates are hostage to the unprecedented surge in rates abroad. The one-and-one-quarter percentage point rise in West German bond yields in recent weeks has lifted them above U.S. yields for the first time in 14 years. At the same time, a comparable increase has lowered the spread between Japanese and U.S. yields to its narrowest level in more than a decade.

Selloff in the Bond Market

Nervousness about these rate hikes has been one of the principal factors behind the selloff in the U.S. bond market this year. And some observers are worried that the higher interest rates in Japan and Germany will prevent U.S. yields from falling even if the U.S. economy turns soft.

Economic theory provides a useful framework for examining this issue. We are now, of course, in a world of floating exchange rates. This means that U.S. interest rates will not be influenced by rates abroad if those rates reflect changes in *inflationary expectations*. In that event, the exchange rate will adjust over time to offset changes in inflation rate differentials. However, U.S. rates will still be affected by changes in the *real* interest rate. Internationally mobile capital will flow in ways that will tend to equilibrate real returns across world markets.

Thus, the effect on U.S. rates depends on whether the higher rates in Germany and Japan reflect primarily inflation pressures or economic forces in the real sector. Until recently, inflation-rate differentials were the dominant force influencing the spread between U.S. and overseas interest rates. When the U.S. inflation rate was rising relative to rates overseas, for example, the dollar was weak. And when inflation rates converged in 1989, the dollar strengthened while U.S./foreign-yield spreads shrank.

While this tempts analysts to read an inflation signal into the rise in U.S. and world interest rates, the current situation is more complex. Inflation fears have contributed to some of the rise, but they are not the whole story. Real yields have also risen significantly for the first time since the early 1980s, as a result of internal developments in Japan and Germany.

The rise in Japanese yields primarily reflects a more aggressive stance in monetary policy. The Japanese authorities are seeking to bolster the yen and to combat "asset price" speculation in land and stocks. Inflation as measured by wholesale and consumer prices remains relatively low, however, and market participants were caught off guard by the monetary tightening. The official discount rate (ODR) was increased at the end of the year, and a further ODR increase has been priced into the markets because the yen remains under pressure and the elections are now past. In the midst of a 3% drop in the Tokyo stock market Wednesday, a Bank of Japan spokesman indicated there would be no post-election increase in the rate. A restrictive monetary policy stance should keep Japanese inflation under control this year, with consumer prices widely expected to increase on average by about 2%.

Inflation fears are not the whole story. Real yields have also risen significantly for reasons internal to Japan and Germany.

In comparison, the surge in West German yields reflects increased political and economic uncertainty and a heightened demand for capital. Bondholders are concerned that quick economic and monetary unification with East Germany could prove inflationary, especially if economic restructuring is financed through money creation. The increase in money supply resulting from currency unification, however, is relatively small. Assuming a generous conversion rate of 2.4 East German marks per one West German mark, the outstanding money supply in East Germany of approximately 180 East German marks represents only 3% of West German banking liabilities. Consequently, the more important issue is whether, for political or economic reasons, the Bundesbank will feel compelled to boost money supply growth in West German marks. Such fears were heightened recently when the Bundesbank acquiesced to the West German government's desire for quick monetary union.

Even if these fears prove to be exaggerated, though, real yields are likely to rise. The need to develop infrastructure in East Germany will require additional public spending. But to offset this, monetary authorities will seek to limit inflation pressures by boosting short-term interest rates. The policy mix will tilt toward greater fiscal expansion and monetary restraint.

The heightened demand for capital will also require increased funding from the private sector. With German industry operating at close to full capacity, additional resource demands increasingly must be satisfied through imports, resulting in a reduction in West Germany's massive trade surplus. This resource transfer, in turn, will be accompanied by international capital flows. In this respect, West Germany will serve as a conduit for the Eastern bloc. Indeed, during the fourth quarter of 1989, we estimate that foreign investors made net purchases of a record $24 billion in German stocks, bonds and direct investments. This is approximately the same volume of foreign funds estimated to have come into the U.S. in the same period.

For the U.S., the principal implication is that it will face greater competition for funds than it has in the past. The U.S. bond market can still rally in 1990 if, as we expect, U.S. inflation declines. But heightened competition for global savings will raise the real interest rate, implying a higher floor for U.S. yields than before.

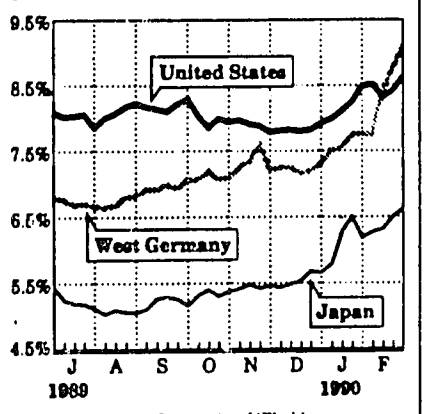
Diminished U.S. Importance

From a longer-term perspective, we can also expect the U.S.'s importance in the world economy to continue to diminish gradually as Europe and the Pacific rim assume a greater role. Consequently, interest rate developments abroad may affect our financial markets more often.

Finally, some observers undoubtedly will draw a different conclusion—namely, that the U.S. is paying the price for large fiscal and current account deficits in the 1980s. However, the U.S. alone benefited from falling interest rates last year. And the largest recent interest-rate increases have come in countries with large current account surpluses. This experience confirms that interest rates are most closely tied not to deficits, but to inflation rates and real-sector developments.

The Global Rate Rise

Yield to maturity on benchmark 10-year government bonds; in percent



Source: Datastream International/Worldview

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EDITORIAL/OPINION

Interest Rates in Global Dance

By ROBERT SOLOMON

In recent weeks, long-term interest rates in the United States have risen by half a percentage point or more despite indications that the economy is slowing. The Federal Reserve has not altered its policy and the federal funds rate remains at about 8.25%, where it has been for some time. The rise of long yields shows up, therefore, as a steepening of the yield curve.

If the United States were a closed economy, we might look for an explanation in terms of heightened expectations of inflation. Long-term interest rates are certainly sensitive to expected inflation. Market participants may indeed have such expectations, but it is hard to find a justification for such a change in expected price movements. The spurt in the producer price index in December appears to reflect temporary factors. Most indicators suggest that the inflation rate has been stable recently and the slowdown in the real economy is likely to put downward rather than upward pressure on the price level.

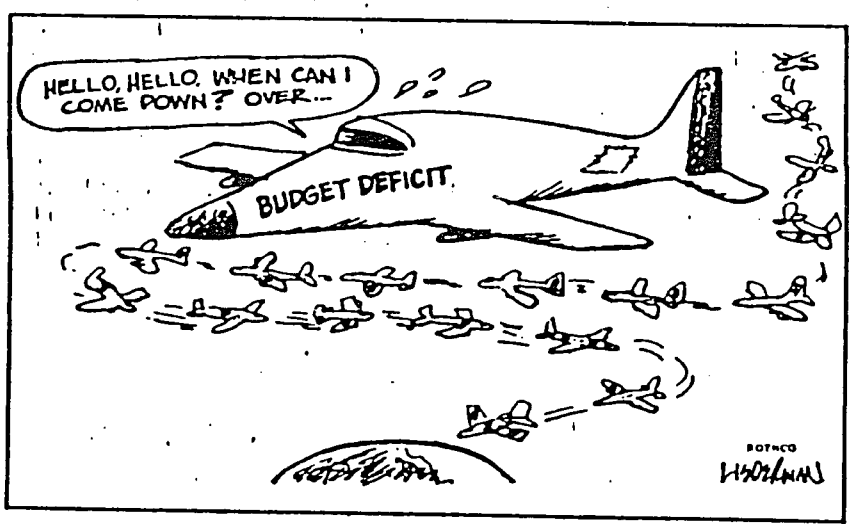
In any event the United States is not a closed economy. Everyone is aware of the important role of foreign capital — notably but by no means exclusively, Japanese capital — in U.S. financial markets. We have become accustomed to the presence of such foreign capital, even if some forms of it stimulate controversy and even Japan-bashing. The conventional wisdom has been that foreign investors — typified by Japanese insurance companies and pension funds — respond to financial conditions in American markets in making their decisions about whether and how much to invest.

Now something new has happened. Instead of foreign investors responding to what is happening in our markets, we are witnessing a reaction of investors, foreign and American, to what is happening in financial markets abroad.

Both Europe and Japan are in the midst of an economic boom, while the American economy is slowing down. Interest rates, both long and short-term, have been rising in Germany and Japan as their inflation rates have crept up and their central banks have applied a series of restrictive measures.

The result is that the differential in interest rates between the United States, on the one hand, and Europe and Japan, on the other, has narrowed significantly. Throughout most of the past decade, American rates have been well above those in Germany and Japan. There have been two reasons for this. One is that inflation has been higher in the United States. The other is that, during much of that time, exchange-rate expectations tended to keep U.S. interest rates higher; that is, the dollar was usually expected to decline relative to the German mark and the Japanese yen. In the face of such expectations, American interest rates had to be above those abroad, to compensate investors for the capital loss they would incur when the expected decline of the dollar actually occurred.

Now, as German and Japanese interest rates rise for reasons stemming from developments in their own economies, they are pulling American interest rates along in the same direction. For one thing, Japanese and German investors are finding that securities at home have more attractive yields and therefore they have less incentive to put funds in the United States. For another, American investors are being attracted by the higher yields abroad.



Some observers have said that this upward movement in U.S. interest rates in sympathy with rates abroad is happening because of American dependence on foreign capital to finance our budget and current-account deficits. That is misleading. Even if the United States eliminated its twin deficits, the rise of interest rates in Germany and Japan would be attracting both American and foreign funds out of American markets and toward those in the countries with rising yields.

We have to face the fact that the world we now live in is one of high capital mobility. Funds move readily from market to market in response to current and expected yields. Those yields are determined by interest rates and expected changes in exchange rates. While the Federal Reserve can influence, even determine, short-term rates, long-term yields have a life of their own.

These new circumstances have profound implications for policies. One is that a more flexible fiscal policy will be needed at times to offset movements of long-term interest rates that are not welcome from the viewpoint of the health of the domestic economy. Another implication is that such capital mobility strengthens the case for the international coordination of economic policies.

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U.S AND JAPAN: COOPERATION IN WORLD ECONOMIC LEADERSHIP

I am pleased to have the opportunity to return to the Japan Society to discuss U.S.-Japan relations. During the past few years I have been witness to the emergence of this relationship as central to the development of international economic policy.

Today U.S.-Japanese relations are often characterized in narrow and emotional terms. Commentary tends to focus on the extreme developments that involve provocative writings, sensational acquisitons, or the threat of retaliatory measures. Yet through all of this, the economic relationship between the U.S. and Japanese governments has remained a comprehensive one. Real progress in the areas that divide us must be built upon those very broad foundations that have sustained our relationship during this period.

At the heart of our relationship is the multilateral policy coordination process. It is through this framework that the bulk of macroeconomic adjustments will take place and the large external imbalances that presently plague us are reduced. In addition, the U.S. and Japan have built a record of cooperation in tackling specific economic and financial issues of common concern, such as the strengthened debt strategy, financial market liberalization, and more recently support for economic reforms in Eastern Europe. Finally, on a bilateral basis we are addressing for the first time structural problems in our economic relations through the Structural Impediments Initiative (SII) talks.

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These are the foundations for our economic relationship. Certainly U.S.-Japanese relations have evolved as Japan has emerged as a major world economic power and the U.S. has increasingly become part of an interdependent world economy. We have admired much of Japan's economic success while at the same time we have been frustrated by a system that seems to operate contrary to many of our basic principles of fairness and openness.

The U.S. will continue to push hard for those reforms of the Japanese system that we think are essential for opening markets, reducing government intervention and regulation, and ultimately providing a model for economic leadership to other nations. Our challenge is to avoid the pitfalls of narrow thinking and emotional reactions by building on those foundations we have put in place.

ECONOMIC POLICY COORDINATION

As the two largest economies in the free world, the U.S. and Japan share a special responsibility for fostering sustainable growth with low inflation and for working to reduce the large and persistent external imbalances between us and around the rest of the world. This involves much more than exchange rate issues; it touches the full breadth of our economic policies and trade and financial relationships with Europe, the NIEs, and the developing nations.

The focus for these efforts is the international economic policy coordination process. By the mid 1980s the emergence of major structural imbalances in the world economy had made it necessary to pursue more consistent and compatible economic policies among the major industrial economies. In 1986 and 1987, the U.S., with the help and cooperation of its allies, developed a multilateral process for coordinating economic policies among the Group of Seven industrial nations. Its purpose has been to achieve sustained growth with low inflation, to reduce external imbalances and to cooperate more closely to improve the stability of exchange rates.

In the United States, we have just completed the seventh consecutive year of steady growth, the longest peacetime expansion in U.S. post-war history. Meanwhile Japan, with an inflation rate of 2.5 percent, had the highest growth rate in the G-7 at 5.7 percent for 1989. This development reflected Japanese efforts to strengthen domestic demand in order to reduce its external imbalances within the framework of the coordination process. It is clear now that through our current policy coordination efforts substantial improvements have been made in the functioning of the world monetary system. World financial markets have followed these efforts closely and appear to understand and, by-and-large, to approve of the results.

Though the coordination efforts are a multilateral arrangement, without the close U.S.-Japan bilateral relationship the G-7's cooperative efforts would not have yielded such impressive results. Japan was an active supporter from the outset in U.S. efforts to promote economic policy coordination at the time of the 1985 Plaza Agreement, through the 1987 Louvre Agreement and up to the present time. Statements and commitments by U.S. and Japanese leaders served notice that the two largest market economies in the world were serious in their intention to advance the coordination process. A close day to day working relationship in exchange markets has also helped contribute to greater stability in exchange rates.

Policy coordination must be maintained with an eye to promoting continued economic growth and external adjustment, and strengthened to improve further the functioning of the monetary system. Japan's active support and cooperation are vital for this purpose. The U.S. welcomes Japan's forthcoming move to the number two position in the IMF as a recognition of Japan's growing role in the world economy and its willingness to accept greater responsibilities for global leadership.

COOPERATION ON SPECIFIC ISSUES OF COMMON CONCERN

Outside the policy coordination process, the U.S. and Japan have cooperated in dealing with a number of specific international issues of common concern. This cooperation has facilitated both the formulation and the execution of policies but has also revealed areas in which we believe the Japanese need to provide even greater leadership.

INTERNATIONAL DEBT STRATEGY:

The United States and Japan share a common interest in addressing the debt problems of developing countries. U.S. and Japanese commercial banks together account for more than one-third of the total commercial bank debt in the major debtor countries, and Japan is now the second largest financial contributor, after the U.S., to the international financial institutions.

The strengthend debt strategy, which Secretary Brady launched last spring, incorporates Japanese ideas and has been strongly endorsed by the Government of Japan. As a surplus country, Japan has recognized its special capability and responsibility to provide additional financing in support of the strategy. Japan has pledged $10 billion to back debtor countries implementing strong adjustment policies, with specific commitments so far in Mexico, the Philippines and Costa Rica. Timely disbursement of Japanese support will be important to facilitate completion of future financing packages.

I appreciate Japan's strong support for the strengthend debt strategy. But a true leadership role in the debt strategy entails more than just providing financing. It requires a willingness to maintain open markets for a broad range of exports from debtor nations -- including manufactured goods. Recycling surpluses is one thing, but reducing those surpluses by opening markets can provide a more enduring benefit for developing countries, without increasing their debt in the process.

FINANCIAL MARKETS:

The development of open international financial markets represents another area of international cooperation between the U.S. and Japan. One of my first assignments at the Treasury Department in 1984 was the Yen/Dollar negotiations. These were the first truly comprehensive efforts to open an entire sector of the Japanese economy. The original goals included the internationalization of the yen, foreign firm access to Japanese capital markets, and liberalization of the Japanese market.

The impact of the Yen/Dollar discussions in opening and liberalizing the Japanese financial markets marked a major shift in attitude by Japanese officials toward Japan's role in the international financial system. There is no doubt that a more international outlook is now firmly in place in Tokyo. The benefits of deregulation are now recognized -- after a very difficult beginning. In recogonition of changing U.S., Japanese and world financial market relationships, in 1988 we broadened our Yen/Dollar agenda and assigned responsibility to a new "U.S.-Japan Working Group on Financial Markets."

Despite significant progress, we do not believe that the financial liberalization process in Japan is complete. The changes adopted to date have yet to transform Japan's financial system into a truly market-based one. Foreign firms remain frustrated by the old problems and practices that continue to protect traditional Japanese financial interests while denying the benefits of free markets to Japanese consumers on the one hand and foreign firms on the other.

This is extremely disappointing in light of Japan's immense financial and economic power. It is also not fair, given that Japanese financial institutions have benefited so much from operating in the open financial markets of other countries. Many American observers today, for example, point to the growing concentration of Japanese interests in the American banking industry, while noting the inability of American banks to develop a similar base of banking assets in Japan. Naturally this produces ever louder complaints about the effective subsidy enjoyed by Japanese banks through continuing deposit interest rate regulation.

The U.S. Adminstration is coming under increasing pressure to resort to legislative solutions as the perception grows that unfair practices in Japan's financial markets not only benefit Japanese financial institutions but also have an effect on other areas such as trade and direct investment. New congressional legislative proposals call for an annual review by the Treasury of national treatment in financial markets and provide for sanctions if national treatment is not provided in foreign markets.

We believe that to avoid these pitfalls the major issues of market liberalization and access in Japan must now be addressed through a more rapid timetable for fundamental deregulation. At the November 1989 Financial Markets Group meeting, Japan committed itself to accelerating the pace of our talks. Experts met in January and we hope the next full meeting will take place in May.

The broadening of our financial market dialogue with Japan incorporates issues of mutual interest outside our two economies. The list would include the EC's integration of its financial markets as part of the 1992 proposals. However, the ability of Japan to join the U.S. in exercising effective influence and in demonstrating leadership in this area of financial market liberalization depends upon further fundamental Japanese deregulation.

EASTERN EUROPE:

Recently the U.S. and Japan have worked with other industrial nations to begin creating the mechanisms for integrating the nations of Eastern Europe into the international economy. Of course, the major European countries will have a primary role in this whole effort. Yet the emergence of Eastern Europe from a long period of economic stagnation and political repression carries worldwide implications and is not a matter of concern only to its European neighbors. It is in the economic and security interests of both the U.S. and Japan to encourage the implementation of pluralistic political systems and market-oriented economic reforms in these countries.

One of the first challenges in Eastern Europe has been to encourage an economic reform program for Poland, in order to halt that country's serious inflation and budgetary problems and to lay the groundwork for radical structural reforms. The U.S. took the lead internationally in assembling a $1 billion Stabilization Fund for the purpose of supporting a new Polish foreign exchange regime. Japan was a key supporter of the Stabilization Fund, offering a loan in the amount of $150 million.

The U.S. and Japan are also working together to ensure that the proposed European Bank for Reconstruction and Development provides adequate support for market-oriented economic reforms for the countries of Eastern Europe. Japan has also joined the U.S. in supporting the work of the IMF and the World Bank in Eastern Europe, thus ensuring that these countries receive adequate support from the international financial institutions.

To date Japan has tended to follow our lead in Europe and has faced domestic criticisms for extending its involvement to a region of the world where it has relatively minor direct interests. But leadership has responsibilities, and Eastern Europe represents another area where Japan must look beyond parochial concerns and participate in the important process of restructuring both the political and economic landscape.

SII -- A COMPREHENSIVE BILATERAL APPROACH

Treasury's successful formula for the Yen/Dollar Talks inspired us to apply the same framework and philosophy in the U.S.-Japan bilateral trade area, and more recently to structural impediments to external payments imbalances.

As a general rule for negotiations, we should concentrate our efforts on understanding how a particular market or sector works in practice. Only then can we identify and remove the underlying barriers to trade and investment across whole sectors. The heart of the problem is that, in Japan as elsewhere, enormous structural adjustments are needed across many economic, political and social levels.

That is why this concept was adopted in the Structural Impediments Initiative. Treasury proposed the SII as a unique approach to identify and remove structural impediments to the adjustment of payments imbalances. To our knowledge, this marks the first time two major economic powers have engaged in complex bilateral discussions aimed at reducing broad structural economic problems. This is important for the economic policy coordination process in general, because relative growth rates and exchange rate realignment have not been enough to promote full adjustment.

The first step in the SII has involved a well-documented, comprehensive study of the intricacies of the Japanese economic system. It is now being followed by high-level discussions on appropriate actions to address these problems. The U.S. is critically examining Japanese structural problems such as their saving/investment pattern, distribution system, exclusionary business practices, Keiretsu relationships and foreign direct investment, and land use policies.

The SII process recognizes that U.S. structural changes are also required to attack our external deficit. Not only must we be more aggressive investors and marketers and generally more knowledgeable about Japan, but we also need to improve certain structural inadequacies in our own economy, including our weak savings performance. The Japanese have raised these issues during the SII talks, in addition to other matters such as the short-term U.S. corporate outlook and deficiencies in the education and training of the U.S. workforce.

With the election process now complete in Japan, we look forward to near-term progress in the SII talks. We hope that both sides will approach these talks with a serious willingness to address the difficult, fundamental decisions called for and will follow through with concrete actions.

It is important to keep in mind that the success of SII will not only affect our bilateral trade relations. Our efforts in the SII are aimed at facilitating the adjustment of payments imbalances and ensuring that structural impediments do not undermine the development of a more integrated global economy. This should be particularly important to Japan as it increasingly invests directly in foreign markets.

To date, such impediments have made it difficult for foreign firms to access the Japanese markets directly. We would all benefit from the economic efficiency encouraged by open markets and the removal of barriers to trade and foreign direct investment. We would all lose if the failure to remove these impediments leads to more, rather than less, protection.

OUTLOOK AND CONCLUSIONS

As I have observed the evolution of U.S.-Japanese economic relations, I have been struck by how far our relationship with Japan has developed in the past few years. In the economic policy coordination process, in specific issues of common interest, and in our current bilateral SII talks, the U.S. and Japan have forged a strong foundation for economic partnership and leadership.

There are many voices today calling for extreme measures -- from Ishihara's The Japan That Can Say No to those U.S. experts who advocate a stifling regime of managed trade. We must reject and avoid these distractions and concentrate anew on building upon those foundations we have struggled to create.

Japan has increasingly recognized the benefits of its status as an economic power and come to understand the need for it to demonstrate a stronger leadership role in the international economic system. At the same time, leadership will only be complete when other major industrial countries and developing nations accept Japan's economic system as a model. Here there are many who still criticize the vestiges of economic insularity in Japan. I would contend that the U.S.-Japan economic partnership will become most effective when the evolution of Japan's economic system allows its leadership to be accepted as widely as Japan's unquestioned post-war economic success.

The Wall Street Journal

WEDNESDAY, MARCH 21, 1990

U.S. Industry's Lead Gets Bigger

By William J. Baumol

A flood of books and articles tells us that the U.S. economy has lost its leadership, or is about to. The productivity growth rate has fallen drastically since the 1950s and 1960s, and is well below those of a score of other economies. It is implied that, as a result, U.S. companies can no longer compete in manufactured products, so labor is driven increasingly into (low-paying) service jobs. American workers are condemned to earning a living by doing each other's laundry.

Careful review of the evidence shows that all of this is a melange of half-truths, and that the basic implication is false.

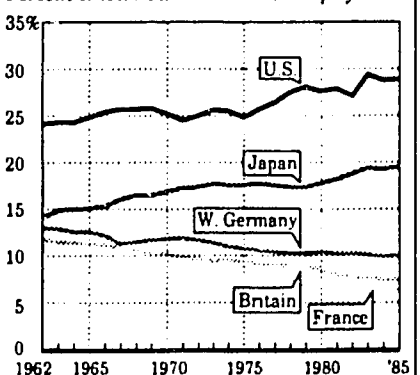
It is true that in the 1970s the U.S. productivity growth rate fell some 60% from the golden age of the 1950s and 1960s. But there is good reason to believe that it was the rapid growth of this earlier period that was abnormal, not the subsequent return toward historical productivity growth rates. The rapid growth of the '50s and '60s throughout the industrialized world was, arguably, a recovery from war and depression, using an untapped accumulation of innovation and savings. And once the recovery was complete, productivity growth slowed everywhere in the world: Japan's productivity growth rate has fallen by just about the same 60% since the late 1960s as the U.S. rate.

Learning American Techniques

Moreover, the evidence indicates that the absolute productivity level of U.S. labor in general, and in manufacturing in particular, continues to be the highest in the world. True, other countries are learning American techniques and are consequently pulling closer to the U.S. That, in fact, is why their productivity can grow faster than America's.

Where the Blue Collars Are, 1962-1985

Percent of total OECD industrial employment



Source: Organization for Economic Cooperation and Development

Most striking of all, in terms of absolute output, America's manufacturing ascendancy continues to increase, not fall. The 24 member-countries of the Organization for Economic Cooperation and Development include the bulk of the free-market industrial economies of the world. The U.S. share of OECD industrial output has grown, to 39% of the total in 1986 from 36% in 1973—hardly what one would expect of a country in the throes of deindustrialization.

If anything, U.S. labor is moving into services less rapidly than its trading partners. Only one of 19 major economies, New Zealand's, has seen slower relative growth of its service sector.

Not only is U.S. domination of manufacturing output increasing, but so is U.S. domination of manufacturing employment. The remarkably steady rise of Japan's share of OECD industrial employment (to nearly 20% of the total in 1985 from about 15% in 1962) is nearly paralleled by the U.S. record: To about 28% in 1985 from some 24% of the total in 1962, about a 17% increase. (See chart.)

In contrast to the U.S. and Japanese performance, the shares of OECD industrial employment in Britain, France and Germany all fell—by about 30% in Britain, 20% in Germany and 10% in France over the period 1962-1981.

So who's flipping all those hamburgers? The years from 1962 to 1985 were years of rapid population growth in the U.S., far more so than in Britain, France and Germany (whose populations all remained nearly stationary). Consequently, and despite the growing U.S. share of OECD manufacturing employment, much of America's swelling labor force was obliged to seek employment outside of industrial fields.

U.S. service employment has therefore grown rapidly, while the employment in industry, as a share of the total U.S. labor force, has declined. But that is not because other countries are taking away U.S. manufacturing sales and leaving America with services. Of 19 industrial countries for which data are available (including Japan and West Germany) *every one* has witnessed an increase in the share of the labor force employed in services.

If anything, U.S. labor is moving into services less rapidly than its trading partners. Only one economy of the 19—New Zealand's—has seen slower growth of its service sector relative to its industrial sector than the U.S. While the U.S. service industry ratio grew 10% over the 15 years from 1965 to 1980, West Germany's rose 19% and Japan's went up 31%.

If every industrial nation is becoming a service economy, it cannot be because some are winning away the manufacturing markets in which the others used to sell their industrial outputs. So what's going on? 1) Manufacturing and agricultural productivity have for more than a century been growing far more rapidly than productivity in such services as teaching, law, real estate and insurance; and 2) there have been virtually no long-run trends in unemployment rates in industrial countries.

Rapidly rising productivity has meant that jobs in manufacturing and farming have expanded more slowly than population. With unemployment rates not rising, it follows that new entrants to the labor force have had to find their jobs in the only remaining economic sector—the services. But this implies that countries have become service economies not because their productivity performance in manufacturing has been so poor. On the contrary, it has resulted from the outstanding productivity achievements of both industrial and agricultural sectors. Here, too, there is nothing disturbing about the U.S. record.

Tragic Failures

In all this we must not deny that a number of important U.S. industries have lost their competitive edge—consumer electronics, automobiles and steel among them. Each of these failures is a tragedy, particularly for older workers whose jobs disappear and who cannot easily migrate into more prosperous arenas.

But the decline and rise of particular industries, with all their very real human costs, have always been the hallmark of technological progress accompanied by international competition. And even industries once given up as lost can sometimes rise from the dead, as the steel minimills of the U.S. have done. Their productivity levels and prosperity put them in the vanguard of world manufacturing—like so many other American industries.

Mr. Baumol, a professor of economics at Princeton and New York University, is co-author of "Productivity and American Leadership: The Long View" (MIT, 1989).

Secretary Baker

Current
Policy
No. 1254

Diplomacy for the Environment

United States Department of State
Bureau of Public Affairs
Washington, D.C.

Following is an address by Secretary Baker before the National Governors Association, February 26, 1990, Washington, D.C.

I'm pleased to have this opportunity to talk to you today about the environment. It is a subject that is important to me personally and also very important for the 50 states, the territories, and for our foreign policy.

A little history may be in order. In 1852, Chief Seattle responded to a request of the U.S. Government to purchase some tribal lands for the arriving pioneers. The chief replied: "The Earth does not belong to man, man belongs to the Earth. All things are connected like the blood that unites us all: man did not weave the web of life, he is merely a strand in it." And the chief warned, "Whatever he does to the web, he does to himself."

The settlers kept moving West—my great-grandfather among them. These independent, hard-working, and courageous people helped to make our great nation what it is today. Even for those of us whose ancestors did not take part in the westward saga, the pioneers still epitomize the essence of the American spirit.

Yet, by century's close, it had already become evident to many Americans—from the developed East and the developing West alike—that America's bounty was not inexhaustible. It had become apparent that we needed to take responsibility for protecting and replenishing our natural resources so that future generations could enjoy them.

In 1908 at the White House, President Theodore Roosevelt convened a conference on the conservation of natural resources—the first of its kind not only in the United States, but in the world. It was known as the Conference of Governors. And it is fair to say that the conference was the single greatest stimulus to the creation of a responsible national environmental policy for the United States.

Now, as we plan ahead for the next century, we must remember the lessons of the 19th and the 20th centuries.

From America's native peoples, we have learned that we cannot take nature for granted. We must cherish it and respect its God-given dignity.

From our forefathers, we have learned that nature is not a cornucopia of unending supply. We must give back to the Earth if we are to continue to draw from it.

From the history of the conservation movement in the United States, we have learned that state and federal governments, business and labor, national organizations, and individual citizens must work together if we are to craft effective environmental policies.

Finally, we know from our own experience in this interdependent world that we must "think local and act global." We cannot serve America's environmental interests effectively unless we address worldwide environmental concerns. That is where foreign policy enters the picture. And that's what I'd like to talk about today.

The Environment and U.S. Foreign Policy

The foreign policy objectives of the United States are grounded in our basic values. We seek to encourage democracy, foster prosperity through economic liberty, ensure security, and improve effective international cooperation that addresses our common interests. What is not well-

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known, however, is that our environmental concerns have a major role to play in the achievement of each of these objectives: democracy, prosperity, security, cooperation, the environment—they are all interconnected. That is why the President and I are committed to ensuring that environmental issues are fully integrated into our diplomatic efforts. This is the greening of our foreign policy.

Democracy and the Environment

So first, I would like to discuss how our efforts to consolidate democracy are linked to our environmental efforts. Democracies—dependent as they are on an informed citizenry, an open society, and accountability in government—afford the greatest scope for responsible environmental action. The conservation movement is one of the greatest success stories for grassroots democracy in the United States. When we defend and promote democratic and environmental values, we express the essence of what we believe is essential for all nations to make progress—developed and developing nations alike.

Let me give you a vivid example of how democrats and environmentalists make common cause. In Eastern Europe, environmental concerns were championed by democratic opposition groups long before the people power revolutions of last fall. In fact, environmental issues helped galvanize the push for democracy. It was an international environmental conference in Sofia, Bulgaria, which helped to spark the popular revolution. "The Ecoglasnost Association," formed in anticipation of that conference, is now one of Bulgaria's largest grassroots organizations and democratic opposition groups. So in Bulgaria, Ecoglasnost gave the term "Green Revolution" a whole new meaning.

The environment is clearly one of those points of mutual advantage between East and West that the President and I are pledged to seek as we try to leave the cold war behind. To help the East Europeans help themselves in the crucial area of environment, we are offering our whole experience in dealing with these issues. We are offering to the emerging democracies grants and concessional loans; joint projects, training and technology; as well as guidance in drafting laws and regulations.

For instance, we have proposed a joint U.S.-Czechoslovak study to determine the most cost-effective way to deal with Czechoslovakia's serious air pollution problems. We are providing clean-coal technology to Poland, in part to arrest the tragic defacement of Krakow's historic architectural treasures—treasures literally being eaten away, day by day. For the region as a whole, we have promoted participation in the Budapest Regional Environmental Center, first announced by President Bush last July. With the Soviet Union, Foreign Minister Shevardnadze has agreed to my request to add to our meetings a fifth major agenda item on transnational concerns. Environment is the most prominent issue in these ongoing discussions.

The sum total of all these projects will reinforce the trends toward democracy in the East—that is, governments responsible to the people and the concerns of the people.

That brings us to our second major objective: promoting prosperity and economic liberty. Just as political freedom and economic liberty go hand in hand, so, too, do sustained growth and a healthy environment. Strong economies provide the material means with which to protect the environment. These relationships are symbiotic. They are expressed by the concept called "sustainable development."

Sustainable development, to put it simply, is a way to fulfill the requirements of the present without compromising the future. When policies of sustainable development are followed, our economic and our environmental objectives are both achieved. In fact, America's entire approach to bilateral and multilateral assistance is based on the concept of sustainable development.

Providing market-based incentives, eliminating structural impediments, and ending international trade practices that distort global markets—all will generate an economic dynamism that benefits the developed and developing world alike.

Bilateral and Multilateral Efforts

Let me cite a few examples of how we are making the concept of sustain-able development work through our bilateral assistance efforts. In Rwanda, we are sponsoring a project linking the economic benefits of tourism with the conservation of two unique, species-rich protected areas. In other developing countries around the world, we are fostering biodiversity. By so doing, we can increase the availability of natural products for commercial purposes. Life-saving pharmaceuticals and other marketable goods such as food and dyes can result. An ongoing AID [Agency for International Development] project in Indonesia focuses on the management and conservation of exotic native fruits, which may prove marketable. This project also promotes the management practices needed to stem the wanton destruction of tropical forests.

Innovative efforts, such as debt-for-nature swaps, are also important. These, like all other debt reduction efforts, must involve basic structural reform if they are to succeed. Debt swaps are not the panacea for debt reduction, nor can they single-handedly solve environmental problems, but debt swaps can help with both.

On the multilateral level, the development banks can play a key role in promoting environmentally sustainable growth. We will continue to encourage the multilateral development banks to strengthen their policies, staff, and training. We hope other donor countries will join our efforts to integrate environmental assessments into all operations of the development banks.

I know that there are dramatic calls by some for the establishment of new financial institutions or mechanisms to

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provide environmental assistance. But before we spend our scarce resources on creating new bureaucracies, it makes good sense to make maximum use of the multilateral tools already in existence and to reinforce existing institutions.

Similarly, before we dedicate additional resources toward international environmental efforts, we will need to know how much is required. Substantial funding for environmental projects is already available. We fully recognize, however, that developing countries may need some additional aid in order to meet the incremental costs associated with fulfilling their international environmental obligations.

Our third key objective is ensuring global security. Solid democracies and sound economies cannot grow in unsafe surroundings. We have long worked in partnership with friendly nations to protect ourselves against traditional security threats from hostile governments. But in today's world, traditional concepts of threats to the security of our citizens need to be updated and extended to include the new transnational dangers—environmental degradation among them.

Environmental Threats Are Everyone's Concern

Environmental threats respect no border. They threaten human lives and violate the territorial integrity of states from both within and without. Chernobyl—a classic example of the ills of the stagnant Brezhnev era—showed how lives can be needlessly endangered when governments fail to act quickly and responsibly to protect their own citizens and the people of neighboring countries.

Not surprisingly, the drug cartels that threaten the health of the world community also damage the environment. As I pointed out at the UN Special Session on Narcotics last week, traffickers in the Andes are destroying vast tracts of forest for their drug labs and are dumping millions of gallons of precursor chemicals into rivers.

Forty years ago, we and our NATO partners pledged to "safeguard the common heritage and civilization" of Europe against our common enemies. As the President pointed out, Europe's environment is the common heritage of all Europeans, and we all must work to protect it. As we have seen, defending Europe's environment from the threat of pollution is just another way for the West to help the peoples of the East realize their dream of a Europe whole and free.

Our fourth objective is enhancing effective international cooperation that addresses our common interests. As we have seen, many of today's problems—environmental problems especially—have worldwide consequences. They demand global solutions. All nations share responsibility for the protection of the international community.

No nation alone, however great, can dictate fully the course of human events nor fully protect its natural resources. And no nation, however small, is without the power to act for the health of the global community. All countries must act responsibly and work together.

I am glad to say that more than ever before, nations all over the world are working together on global environmental problems. Let me give you two examples. One is global climate change. Just a few weeks ago, the President addressed the Intergovernmental Panel on Climate Change. He was the first head of state to speak before the panel. And his presence demonstrated the seriousness with which our government regards this question as well as our dedication to finding appropriate scientific, economic, and environmental solutions. The President reiterated our policy toward climate change. We call it the "no regrets" policy, and we encourage other nations to adopt a similar approach.

Just what do we mean by "no regrets"? We mean that while we are pursuing the serious scientific research that is critical to any responsible approach, we're also hedging our bets in an economically sound way. We mean that the United States is making a major financial commitment to analyze these scientific issues, increasing our funding for the U.S. Global Change Research Program to over $1 billion. And we mean that we are prepared to take actions that are fully justified in their own right and which have the added advantage of coping with greenhouse gases. They're precisely the policies we will never have cause to regret. Specifically:

- We are committed to phasing out chlorofluorocarbons (CFCs) by the year 2000 to protect the ozone layer. CFCs also contribute significantly to the "greenhouse" effect.

- Next, the President has launched a major reforestation initiative called "America the Beautiful." Under this multiyear program, our citizens will plant 1 billion trees each year in partnership with the government and busines. The trees will provide habitats for wildlife, stem soil erosion, provide recreational facilities, offer employment, and generate forest products. At the same time, the trees will help absorb carbon dioxide, a major "greenhouse" gas.

- Finally, we are dedicated to a program of energy conservation and energy efficiency. This contributes to efficient use of scarce energy supplies, reduces our dependence on foreign energy sources, and saves us all money —citizens, government, and industry alike. Moreover, decreasing the use of the fossil fuels will reduce "greenhouse" gas emissions.

If the results of international scientific research demonstrate that climatic conditions will not change in a significant way, we will have "no regrets" for these actions because they provided other benefits. If, on the other hand, the findings of our research turn out to be more troublesome, we will have taken prudent steps toward solving the problem in a cost-effective way. We urge other nations to join us in our "no regrets" efforts.

A final example of global cooperation involves a denizen of the animal family—a party animal. Some might say he is a partisan creature, but

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he has bipartisan virtues. Sadly, he is listed among the severely endangered species. Even the Democrats among us agree that if we let our old friend the elephant pass from the earth, we will all be diminished. Therefore, last summer the United States led the way in banning the international trade in ivory. Now, a global effort is underway. Most other nations have joined us. And although some trading in ivory continues, I believe we can all work together to develop an enforcement system that saves the African elephant.

Conclusion

The environmental efforts that I have described here today are illustrative of the many ways the Bush Administration is acting to protect the environment nationally and internationally. This morning, I have not even begun to touch upon our no-net-loss of wetlands policy, our opening of formal discussions with Canada on acid rain, or our driftnet resolution that was adopted unanimously by the United Nations. Nor have I touched upon another major environmental initiative of this Administration: crafting a revised Clean Air Act with incentives for our private sector to find creative, market-driven solutions to enhance air quality. And I am very hopeful that we will soon be able to sign the Basel convention, which controls exports of hazardous wastes.

The United States is doing all of these things because it serves our national interest to do them. We are also doing them because they are fundamentally the right thing to do. The great early pioneers of American conservation recognized these truths, and they found effective ways to act upon them. Their views didn't always prevail with the officials of their era, and they certainly didn't always agree with one another. Controversies that raged around the Governor's Conference back in 1908 continue down to this day. Indeed, environmental issues have never been simple; they never will be. Environmental problems are complex and sometimes slow to develop. And sometimes, we are even slower to recognize them.

Yet despite the intense debates, despite all the uncertainties, despite the sheer complexities involved, there remains before us, as before all peoples, the unquestioned responsibility to act. Emerson, the 19th century American essayist and poet, put it this way: "We do not inherit the Earth from our ancestors, we borrow it from our children."

This is a sacred debt that must be honored. The splendor of nature enfolds and unites all of humankind. Now, together, the earth's peoples must work, so that this precious web of life shall embrace, in beauty and in peace, all the generations to come. ■

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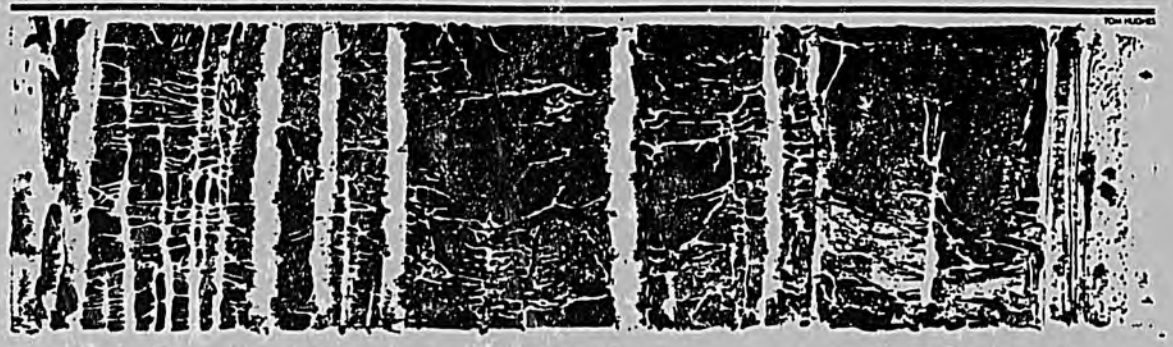

TOM HUGHES

Six Steps Toward Environmental Security

By James Gustave Speth

IF 1989 was a year of impressive public speech about the global environment, 1990 will test whether political leaders here and abroad are prepared to back up their words with action.

The communiqué that emerged from the Group of Seven summit in Paris last July – the so-called "Green Summit" – was powerful and even eloquent. At the end of the meeting, President Bush called for "decisive action to preserve the Earth." The reconvening of the G-7 heads of state in Texas this summer is one of 10 major events already scheduled for 1990 at which President Bush and other leaders will be judged by what they do and not by what they say (see box).

These opportunities come not a moment too soon, for a new kind of international security threat is advancing on us. The world's geopolitical systems may be faring better, but its ecological systems are in trouble.

The buildup of carbon dioxide and other "greenhouse" gases in the atmosphere threatens far-reaching climate change. One class of these gases – chlorofluorocarbons – is also depleting the Earth's ozone layer, which shields us from the sun's ultraviolet radiation. Over large areas of the globe, urban air pollution is assaulting the countryside hundreds of miles away, damaging aquatic life, forest, and crops.

In the developing world, pressures on natural resources intensify daily. Hundreds of millions of people living in poverty destroy the environmental resources on which their future depends because they have no alternative means of support. The deserts expand while the forests, with their wealth of life forms, retreat. An acre of tropical forest disappears every second; a plant or animal species dies out every 15 minutes.

Given the projected doubling of world population and fivefold increase in world economic activity in the lifetime of today's children, the natural world hasn't got much of a chance under our usual ways of doing business.

Against this backdrop, what the world community does in the 1990s is critical. Environmental deterioration will continue. But the 1990s can also be an exciting period in which nations redeploy some of the skill, talent, and resources being liberated along with Eastern Europe to deal with massive environmental problems. If that happens, we can leave a legacy of hope to the new century, a gift of a planet that is on the mend.

Addressing today's environmental challenges will require action along six fronts that lie outside traditional environmental policy. We can gauge political leadership in the 1990s by whether it promotes six broad transitions – the necessary "megatrends" of global environmental protection:

1. **A demographic transition** toward stable populations before the world's population doubles again. Population size and growth rates contribute to virtually every environmental challenge societies face today. Just try to imagine a world of 10 billion people, twice today's population; then consider that some recent projections put global population at 14 billion in the next century.

A stabilization strategy should be directed at three goals: alleviating poverty, improving the status of women, and reducing both mortality and fertility rates. Specifically, we need to sharply increase access to family planning information and services, reduce the death rate by making basic sanitary services and health care widely available, and expand the educational and employment opportunities open to women.

2. **A technological transition** away from the resource-intensive, pollution-prone technologies of the 20th century to a new generation of environmentally benign technologies. Nowhere is this technological transformation more needed than in the energy sector, given the tremendous problems caused by today's extravagant fossil-fuel use. Economical technologies are available today – in transportation, housing, manufacturing, and other sectors – to achieve dramatic increases in energy efficiency and sharp reductions in fossil-fuel pollution.

3. **An economic transition** to a world economy based on reliance on nature's "income" and not depletion of its "capital." In market economies like ours, this transition requires making the market mechanism work for environmental protection, not against it. Today around the world, inappropriate subsidies encourage deforestation, excessive pesticide use, energy consumption, and water wastage. These subsidies should be eliminated, and national income accounts should reflect natural-resource deterioration as another form of capital depreciation. This transition requires honest prices – prices that include the full environmental costs of production, use, and disposal. This revolution in pricing can accompany the shifting of a fair share of the tax burden away from activities that should be encouraged, such as earning income, and onto activities that should be discouraged, such as generating pollution and waste.

4. **A social transition** to a more equitable sharing of environmental and economic benefits. In much of the world, the greatest destroyer of the environment is poverty. The third world desperately needs major new financial resources dedicated to sustainable development. Here there are two complementary needs: to increase sharply both official development assistance and private investment in developing countries, and to improve the way funds are spent.

A lasting transition out of poverty – essential both to meet basic human needs and to relieve a deteriorating resource base – won't happen in the third world if the US and other industrial countries don't strengthen their development assistance, relieve the burden of international debt, and take other major initiatives.

5. **A transition in information and awareness** that involves major gains in understanding natural systems and human effects on them, in monitoring and assessing environmental conditions and trends, and in providing indicators and measures that can help both policymakers and the public grasp important trends and gauge progress. Scientific research is needed to reduce uncertainties on global warming and other major planetary changes. Consciousness of environmental problems and the necessary directions of change must be communicated to a wider public.

6. **An institutional transition** to stronger national and international institutions that can promote the overall transition to global sustainability. The United Nations and other institutions must be able to reach a broad array of new international agreements. New arrangements are also needed to integrate environmental objectives into such other fields as trade and debt policy, agriculture, energy, transportation, foreign policy, and development policy and assistance.

For world political leaders, the challenge is to devise a system of shared international responsibility. The goal of diplomacy must shift from conflict management to common endeavor. Without this shift, the next great international crisis is likely to be environmental. Equally significant, though, will be the activity of citizen groups, nongovernmental organizations, and communities.

No one nation can solve the problem of environmental degradation. But its size and importance guarantee that the US will have a vast impact – for good or ill – on whether the world meets the environmental challenges of the 1990s. President Bush ran for office as an environmentalist and could justly claim that title if he rises to the occasion offered by the events now scheduled for 1990 and promotes the large-scale transformations that are essential to "preserve the Earth."

■ *James Gustave Speth is president of the World Resources Institute, a Washington policy-research center.*

President Bush and the Global Environment

1. President Bush's State of the of the Union Address	January, Washington
2. Meeting of the 60-nation Inter-Governmental Panel on Climate Change (IPCC) (meets again in Stockholm in late summer)	February, Washington
3. National Transportation Strategy from the Department of Transportation	Winter, Washington
4. National Energy Strategy from the Department of Energy (interim report; final in December)	April, Washington
5. Earth Day Celebration	April, Washington
6. High-level International Conference on Global Warming, at the White House	Spring, Washington
7. Treaty Negotiations on Ozone Layer Protection	June, London
8. G-7 Summit Meeting	July, Houston
9. Second World Climate Conference	November, Geneva
10. First Negotiating Session for Global Climate Change Convention	late 1990, location unknown

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How To Fight Global Warming

By Elliot L. Richardson

WASHINGTON

Environmentalists and politicians can argue the costs and benefits of international action on global warming from now until doomsday, and they probably will. But nothing will get done without an institutional mechanism to develop, institute and enforce regulations across national boundaries.

The need for a mechanism emerged clearly from this week's meeting of the Intergovernmental Panel on Climate Change, a group sponsored by the United Nations. President Bush's speech at the conference, in which he called for more research on the "uncertainty" of global warming, may have disappointed some. But that misses the larger point.

Little can be accomplished in the absence of multilateral institutions that will eventually carry out whatever remedial environmental actions the world community can agree upon. In short, we need an international treaty, modeled perhaps on the Law of the Sea Treaty, to coordinate and enforce international action on the environment.

Of course, many scientific questions need to be answered. We need to know the costs and benefits of various means of stopping the buildup of greenhouse gases. We need to discuss regulatory standards and cost-effective enforcement measures. Eventually, however, we will have to act.

The world cannot afford to rely on independent action by individual countries. The results are bound to be highly uneven. One nation could cut back on its carbon dioxide emissions; one could stop the destruction of its own forests, still another could do nothing. The least responsible transnational corporations will seek out and encourage the most permissive regulatory environments.

For maximum impact as well as equitable burden-sharing, there will have to be universal standards universally accepted. Deliberation about the political palatability and enforcement of these standards should be concurrent with, not subsequent to deliberation about science and regulation.

Take, for instance, the question of whether to strengthen organizations like the United Nations Environmental Program or the International Maritime Organization, combine them or build a new one — a global Environmental Protection Agency — from scratch. Or take the question of what powers should be granted to the chosen institutions. Should these institutions be limited to formulating recommendations or should they also have the power to promulgate and enforce regulations?

Political considerations must also be discussed. Will there be a single governing body with universal representation? What kind of voting arrangement will govern its decisions — a one-nation, one-vote system like the United Nations General Assembly, a weighted system like the World Bank or Intelsat or something in between? Dispute-resolution mechanisms must be put in place.

Whether the international institution is given power to enforce rather than merely recommend regulations obviously affects representational and decision-making issues. In fact, the more power the organization will be expected to exercise and the more money it will be authorized to spend, the fiercer will be the battles.

The arena in which these battles are fought will be an international conference of some 160 sovereign states to be held in Brazil in 1992. These states will vastly differ in their contributions to environmental degradation. Their delegates will represent every race, culture, ideology, geographical circumstance and state of economic development on earth.

Given the scope and complexity of this conference's task, a thorough preparatory process is indispensable. The U.N. took four years to lay the groundwork for the Law of the Sea Conference, and the conference spent nine more years, with twice a year meetings, to produce a treaty.

The U.S. has not yet taken a prominent role in laying the groundwork for an environmental treaty. Our leadership in such effort nevertheless can make a critical difference. It is in our own interest and in that of the entire world community to take the initiative.

Our responsibility, our economic stake and our breadth of regulatory experience are unequalled. It is not too late.

Elliot L. Richardson headed the U.S. delegation to the Law of the Sea Conference from 1977 to 1980.

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International Environment: Overview of Major Issues

SUMMARY

The international nature of many environmental problems has become a major focus of attention in recent years. Scientific data indicate that transboundary movement of pollutants poses an increasing threat to global ecosystems, thus making all nations potentially subject to negative economic, social, and health impacts from environmental degradation originating beyond their borders. Many issues are interconnected (e.g., tropical deforestation may exacerbate global warming and species loss), and some proposed solutions may compound other problems (e.g., controlling sulfur emissions may increase carbon dioxide emissions). Moreover, continuing high levels of population growth intensify most of these problems.

The July 1989 Economic Summit in Paris of the heads of state from the seven major industrial nations ("G-7") and the President of the Commission of the European Communities placed strong emphasis on environmental issues, which are the focus of one-third of the final Declaration. A brief summary of the environmental provisions this Declaration is provided below, followed by individual issue summaries. The issues described are chosen because of the level of attention and concern given them currently by the scientific community and policymakers. Issues included are: global climate change, depletion of stratospheric ozone, acid rain, international waste transport, marine pollution, tropical deforestation, loss of biological diversity, environmentally sustainable development, and preservation of the Antarctic.

Congress has enacted environmental protection legislation to address both domestic and international concerns in several of these issue areas. Increasingly, it has been searching for ways to address more comprehensively the international implications of environmental degradation, both through unilateral action and through promotion of international action. Actions in the 100th Congress included ratification of two international environmental protection protocols as well as consideration of proposals to amend existing environmental protection and foreign assistance statutes. In the 101st Congress, numerous bills have been introduced that refine or build on earlier proposals.

CONGRESSIONAL RESEARCH SERVICE--ISSUE BRIEF
By Mary Tiemann and Susan R. Fletcher

ENVIRONMENTAL DEFENSE FUND

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January 9, 1990

Mr. E. Patrick Coady
Executive Director
World Bank
1818 H Street, N.W.
Washington, D.C. 20433

Dear Mr. Coady,

We are writing to express our serious concerns about the proposed World Bank $167 million loan to Brazil for the Rondonia Natural Resources Management Project. We recognize that the Bank is proposing a new and important kind of project, a project which is being justified by the Bank on the basis of its environmental and social benefits. We commend the Bank for its objectives in the project: learning from difficult past experiences, promoting sustainable development in the Amazon forest, using new approaches to land planning and providing crucial services to local populations.

However, based on consultation with NGOs and local community representatives in the region and our own analysis, we conclude that the project contains serious flaws in its design and proposed implementation. Since the project is intended to be a model for the implementation of agro-ecological zoning in fragile tropical forest regions, it is critical that the Bank address the factors detailed below, which are likely to seriously undermine its effectiveness. We are concerned that flaws in project design will discredit what is in theory a very promising approach to environmentally sustainable development in tropical regions.

This project is of unique concern because it would finance the continuation of the Polonoroeste program. In 1987, World Bank President Conable in his public speech announcing Bank environmental reforms characterized Polonoroeste as a "sobering example of an environmentally sound effort which went wrong. The Bank misread the human, institutional and physical realities of the jungle and the frontier....Protective measures to shelter fragile land and tribal people were included; they were not, however, carefully timed or adequately monitored." Problems arising in the first Polonoroeste project, which the current project proposes to help address, include a) the highest rate of deforestation in the Brazilian Amazon; b) land concentration, unsustainable land use, particularly widespread cattle ranching, and failure of agricultural

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colonization; c) continuing invasions by cattle ranchers, land speculators, loggers, miners and agricultural colonists into natural protected areas and Amerindian reserves; d) more than 250,000 cases of malaria; e) tragic, widespread rural violence directly related to the above mentioned phenomena.

The Rondonia Natural Resources Management Project will have little effect in addressing these problems if it is not substantially changed to include prompt execution of still pending measures required in the 1981 Polonoroeste loan agreement, increased involvement of local peoples and NGOs, and stronger legal grounds for key policy reforms. Past experience in other Bank Brazil projects in the 1980s indicates that the project's prospects for success are slight without explicit, specific requirements for the accomplishment of carefully timed and monitored measures, linked to loan disbursements. This is essential to ensure protection of Amerindian and natural reserves as well as the other land use zones in the project's agro-ecological plan.

Negotiations for this project are scheduled to begin on January 15, 1990, and we understand it is scheduled be submitted to the Executive Board for approval in late February. For the reasons enumerated below, we urge you to ask Bank management to address a number of critical issues that now are not adequately addressed in the project before it is submitted to the Board for approval. In this letter we have summarized these issues; they are discussed in more detail in the accompanying memorandum and attachments.

We strongly urge you to ensure that the issues listed below are resolved and that appropriate measures to address them are included in the final appraisal report distributed to the Directors prior to the Board presentation. In particular, we believe that some measures are of such critical priority that they must be addressed and resolved before negotiations commence. We note that these measures are long overdue and would require mainly an exercise of political and administrative will rather than the commitment of new resources:

Issues to be Resolved as a Pre-Condition of Negotiations

1. The Bank should insist that the Brazilian authorities legally regularize the Amerindian Reserves and protected natural areas whose legal regularization and protection were a condition of the 1981-1983 Polonoroeste loans. Most of these areas are still not regularized, in addition to suffering from government tolerated encroachments of cattle ranchers, agricultural colonists, land speculators and miners. Of 17 indigenous areas in Rondonia, ten still await regularization; and five of these areas await in addition demarcation. All were known to the Bank and the government at least since 1983, and these actions have been pending since then. Four natural areas--the Guapore and Jaru Biological Reserves, the Pacaas Novas National Park and the Cunia Ecological Station--were to have been fully established under the first Polonoroeste loans, and still lack legal regularization and complete demarcation.

Currently, the Bank's proposed project does not require compliance with minimal legal and administrative conditions of the former loans; how can it expect the provisions of the new loan to be respected?

2. NGOs, local unions, indigenous and community groups in Rondonia maintain that contrary to Bank claims, there has been little or no substantive consultation with, and participation of groups representing the target populations and putative beneficiaries of the project: Amerindian and rubber tapper populations, and agricultural colonists. There is even less provision for participation and consultation in the current implementation plans.

Before any negotiations the Bank must ensure that indigenous, environmental and landless peasants' NGOs are given full access to information on the project, participate in its planning, and that the implementation is designed to maintain and incorporate this consultation and participation. More than most Bank loans, this project is being justified on its prospective environmental and social benefits to these peoples; their active involvement and participation as the constituency for the project is indispensable for its success.

3. Critical legal and policy uncertainties concerning the criteria under which land titling and land reform can take place must be resolved before negotiations: a) the National Institute for Colonization and Agrarian Reform (INCRA) has not modified the statutes that maintain deforestation as a basis for land titling; b) the Brazilian Congress has not yet enacted constitutionally required implementing legislation defining "productive property," a key criterion for both land reform and potentially, land titling; c) the Bank should obtain a legal opinion on the implications of these constitutional issues for the project; d) the project does not analyze nor address the need for land redistribution in agro-ecological zones 1 and 2.

<u>Measures to be Agreed on in the Negotiations and Included in the Loan Agreement:</u>

4. It should be agreed that disbursements for the loan will be linked to a schedule, to be submitted to the Bank for inclusion in the loan agreement, to physically establish the integrity of the 17 Amerindian reserves and 4 protected natural areas that should have been established under the first Polonoroeste project. Of particular concern is the situation in the Guapore Biological Reserve, whose establishment was a specific condition of the 1981 Polonoroeste loan, and which has yet to be fully regularized legally let alone physically protected from illegal logging, land speculation, illegal colonization and mining encroachments occurring along roads into the reserve and via two illegal airstrips.

5. It should be agreed that disbursements for the loan will be linked to a schedule, to be submitted to the Bank for inclusion in the loan agreement,

to physically establish the physical integrity of the other agro-ecological zones, particularly zone 4, designated for extractive activities. Currently, the project lacks specific measures and timetables to commit the Brazilian authorities to ensure the integrity of the proposed agro-ecological zones. For example, areas designated as extractive production reserves are suffering from ongoing road construction, government endorsed land claims, illegal logging, land speculation and forest clearing.

Measures to be Incorporated into the Board Presentation:

6. Although the project acknowledges that access to credit for smallholder agriculturalists is absolutely essential for its success, its agricultural credit component is gravely flawed and inadequate. It should be reformulated to include economic analysis of smallholder cultivation of perennial crops in zones 1 and 2, identifying current and potential constraints. Based on this analysis, it should include effective measures and conditions to ensure the success of such credit. Such measures would include viable, tested credit programs, acceptable to small farmers, for the main perennial crops grown in Rondonia, coffee and cacao, and credit to ensure financial support for the subsistence needs of smallholder families in the interim years before perennial crops are fully established.

7. The project should incorporate the recommendations of the Special Study of the Operations Evaluation Department on "The Bank's Role in Environmental Issues in Brazil," which has yet to be completed. The project design does not fully reflect the lessons to be learned from past Bank problems in project implementation and design in Brazil.

8. Greater attention needs to be given in the project to addressing the environmental and health problems caused by gold mining along the Madeira River and its tributaries. This is the fastest growing economic activity in the state, and there is little analysis of its impacts in the project area, nor are there effective measures proposed to address its impacts.

Bank projects in Brazil in the 1980s have suffered from a failure to link disbursements to concrete evidence of timely fulfillment of specific project objectives. It is disturbing that the design of the current project is less rigorous and specific in this regard that the original 1981 Polonoroeste loan.

Despite its laudable intentions, the current project design is destined to ensure repetition of the same mistakes of other environmentally problematic Bank projects in Brazil. We appeal to you in your capacity as the final locus of responsibility in the World Bank, to ensure that negotiations for this loan are postponed and the project and proposed negotiating points revised to address the issues outlined in this letter and the accompanying memorandum. We also request that you take steps to postpone the currently proposed dates for Board consideration. Representatives of the Washington based signatories

to this letter are available to meet with you at your earliest convenience.

Sincerely,

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SCIENTIFIC AMERICAN April 1990 Volume 262 Number 4

Deforestation in the Tropics

Government policies that encourage exploitation—in particular excessive logging and clearing for ranches and farms—are largely to blame for the accelerating destruction of tropical forests

by Robert Repetto

Tropical forests are disappearing at the rate of tens of thousands of square miles per year. The deforestation is laying waste a valuable natural resource throughout much of the developing world and is driving countless plant and animal species to extinction, and it may well have significant effects on world climate.

Among the agents of the devastation are inefficient commercial logging operations and the conversion of forested areas to cattle ranching and agriculture. Data collected by numerous investigators and evaluated by my colleagues and me at the World Resources Institute indicate that both the logging and the conversion are largely the result of government policies. Many of those policies are driven by the severe economic pressures afflicting debt-burdened underdeveloped countries. Those pressures in turn are exacerbated by certain practices of developed countries and their national and international financial institutions. Hence the causes as well as the effects of tropical-forest degradation should elicit worldwide concern.

The destruction of tropical forests is a more serious problem than it was thought to be only a decade ago, judging by recent estimates based on remote sensing from satellites and on careful field surveys [*see bottom illustration on page 40*]. In India, for example, studies by the National Remote Sensing Centre lead to an estimated deforestation rate for the early 1980's of 1.5 million hectares (3.7 million acres) per year, some 10 times an earlier estimate by the Food and Agriculture Organization; the satellite imagery showed that large areas legally designated as forestland were already in fact virtually treeless.

Deforestation at this rate poses extreme risks to natural systems. The consequent release of carbon dioxide to the atmosphere is estimated to account for from 15 to 30 percent of annual global carbon dioxide emissions, and so it contributes substantially to the buildup of greenhouse gases. Moreover, the loss of tropical forests is rapidly eliminating the habitat of large numbers of plant and animal species. About half of the world's species inhabit tropical forests; in 10 biologically rich and severely threatened regions that account for 3.5 percent of the remaining tropical-forest area, 7 percent of all plant species will probably go extinct by the end of the century, if current trends continue.

A sense of crisis is emerging in the tropics as governments recognize that the rapid deforestation represents a

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RAIN-FOREST LUMBER MILL is in the Brazilian state of Pará, where, as in many other developing countries, excessive logging is a major cause of deforestation. Often inefficient milling operations have been subsidized by governments in an effort to provide local employment.

waste of valuable resources and a severe economic loss. In some cases governments have taken action. In Thailand commercial logging was recently banned, over the protests of influential concession holders, when surveys showed that forest cover there had declined from 29 to 19 percent of the land area between 1985 and 1988 and after landslides from deforested hillsides cost 40,000 people their homes. In the Philippines, where undisturbed forests containing one valuable family of tall trees, the dipterocarps, have shrunk from 16 million hectares in 1960 to less than a million hectares left standing in remote hill regions, logging has been suspended in most provinces; as a result, mills in the Philippines are closing or are importing logs from Sabah and Sarawak, two states in Malaysia.

Mills in the once rich Indonesian production centers of Sumatra and Kalimantan are also experiencing shortages of accessible high-quality timber and are importing logs from Sabah, Sarawak and the Indonesian province of Irian Jaya. Government officials have begun to realize that Indonesia's ambitious plans for developing its timber industry could be thwarted by a lack of timber. Even Sabah and Sarawak, currently the major sources of logs in Asia, are harvesting almost twice the sustained yield of their forests, which are being depleted rapidly.

In the Ivory Coast, where forest cover has decreased by 75 percent since 1960, an estimated 200 million cubic meters of commercial timber has simply been burned to clear the land for agriculture, incurring a loss of perhaps $5 billion. In Ghana, where 80 percent of the forests have disappeared, the forest department estimates that only 15 percent of the timber was harvested before the land was cleared. In Brazil, where little timber is extracted before forestland is cleared by burning, the resulting loss in commercial timber approximates $2.5 billion annually.

Burning valuable timber in the course of clearing forests is only one obvious kind of wastage. The loggers themselves destroy enormous quantities of timber through careless use of equipment and inefficient logging practices. If loggers extract 10 percent of the timber in an area, selecting mature trees of the most valuable species, they typically destroy at least half of the remaining stock, including immature trees of the valued species as well as harvestable stocks of somewhat less desirable varieties. Loggers often keep reentering partially harvested areas to extract more timber before stands have recovered, inflicting heavy damage on residual trees each time and making regeneration impossible. In Ghana and the Ivory Coast, some stands have been reentered as often as three times in 10 or 15 years as concessionaires obtained sales contracts for logs of lesser-known species

According to a recent study commissioned by the International Tropical Timber Organization, not even one tenth of 1 percent of remaining tropical forests are being actively managed for sustained productivity. Moreover, in most countries, forests designated for logging are left virtually unprotected from encroachment by settlers and shifting cultivators after a timber harvest and are thus exposed to burning and clearing. Surveys in the Amazon make it clear that deforestation is particularly rapid where roads for logging or other purposes have opened up a region.

The biological degradation of tropical forests carries a high and escalating price tag. The timber cost alone

has been unexpectedly high, because tropical-timber prices have bucked the general downward trend of commodity prices and many previously uncommercial species now find ready markets. Countries where loggers have been allowed to extract as few as two or three trees per hectare, destroying the rest as uncommercial, now regret their shortsightedness. The upward trend in tropical-timber prices is likely to continue as supplies are depleted in Asia, Central America and West Africa over the next decade; the timber in the Amazon Basin, which is now being recklessly burned, will become increasingly valuable.

Potential revenues from timber sales are by no means the only economic losses in deforested countries. Probably 70 percent of the wood harvested in tropical countries is used locally, mainly for fuel. As forests recede, severe fuelwood shortages loom. Other forest resources become unavailable to local residents, including animals killed for meat, fruits, oils, nuts, sweeteners, resins, tannins, fibers, construction materials and a wide range of medicinal compounds. In Indonesia the value of exported nontimber forest products had climbed to $123 million by 1986.

Recent studies have shown that the capitalized value of the income derived from such nontimber forest products—readily renewable resources that can be extracted sustainably—may greatly exceed that of the timber harvest. Moreover, the incomes so derived are the livelihoods of local residents, whereas the profits from timber operations are typically captured by distant elites or foreign corporations. Logging operations have sparked some violent protests by villagers in Sarawak and in the Philippines and other countries.

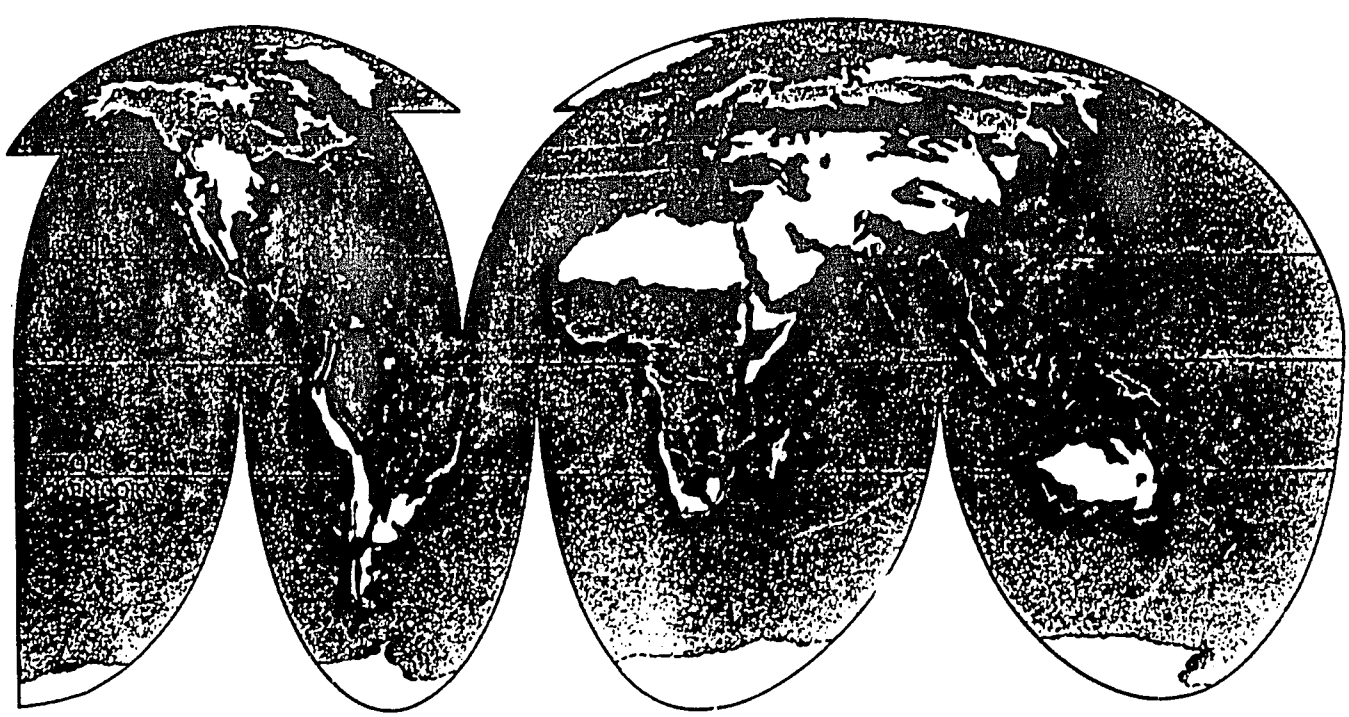
Quite aside from the loss of timber, deforestation often has a severe environmental impact on soil, water quality and even local climate. Shallow, easily leached soils are damaged by heavy equipment, and when they are exposed to heavy tropical rains, they can quickly erode or at least lose any remaining nutrients. Studies in Ghana showed that elimination of savanna forest raised soil-erosion rates from less than a ton to more than 100 tons per hectare per year, with a consequent nutrient loss 40 percent higher than what is being supplied by the application of chemical fertilizer. Riverine fisheries have been damaged by the increased sedimentation that results from erosion or by deforestation in floodplains that provide critical seasonal habitats for fish. Large-scale deforestation interrupts moisture recycling, thus reducing rainfall, raising soil temperatures and perhaps promoting long-term ecological changes.

Logging is often the first step in deforestation: it may be followed by complete clearing of trees and a deliberate shift to land uses—typically cattle ranching and inappropriate modes of agriculture—that not only are unsound environmentally but also result in direct economic loss. For example, studies in the rapidly deforesting Brazilian state of Acre show that because pastures quickly lose productivity and can carry few cattle, the present per-hectare revenue from the collection of wild rubber and Brazil nuts is four times as high as the revenue from cattle ranching.

All in all, both experience and analysis reinforce the argument that deforestation has not been a path to economic development; in most tropical countries it has instead been a costly drain on increasingly valuable resources. Moreover, deforestation is not inevitable. It is largely the consequence of poor stewardship, inappropriate policies and inattention to significant social and economic problems whose true locus is outside the forest sector.

To begin with, in the developing countries most governments—which are the proprietors of at least 80 percent of the mature closed-canopy tropical forest—have not put an adequate value on that resource. As proprietors, they could capture the entire resource value of the forests' timber, except for the cost of the labor and capital committed to managing and harvesting it, by charging high enough royalties and taxes or by selling harvesting rights to the highest bidders. Instead, with very few exceptions, governments have allowed most of these resource rents to flow to timber concessionaires and speculators, who are often linked to foreign enterprises.

In the Philippines, for example, if the government had been able to collect the full resource value of the roughly three million cubic meters of timber



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harvested in 1987, its timber revenues would have exceeded $250 million—more than six times what was actually collected. Low royalties and taxes, combined with widespread log smuggling and tax evasion, left much of the excess profits in the hands of timber-concession holders, mill owners and timber traders. The Asian Development Bank has estimated that total profits averaged at least $4,500 per hectare harvested.

Governments have created such windfalls as these by keeping royalties and fees charged to timber-concession holders low, reducing export taxes on processed timber to stimulate domestic industry and granting income-tax holidays to logging companies. Moreover, governments have failed even to enforce the modest official charges effectively. (Between 1979 and 1984 in Indonesia, 125 million hectares were harvested, but taxes and royalties were collected on only 86 million.) As a consequence, few tropical countries have limited timber exploiters to a normal rate of profit and thereby captured the value of the forest resource for the public treasury [*see illustration on page 41*].

The resulting bonanza atmosphere has sparked timber booms throughout the tropics, drawing both domestic and foreign entrepreneurs—many with little forestry experience—into the search for quick fortunes. Under their pressure, governments have awarded timber concessions that cover areas far greater than they can effectively supervise or manage and that sometimes extend beyond designated production forests into protected areas and national parks. In the Ivory Coast concessions were let for two thirds of the nation's production forests in just seven years. Of 755 politically favored concessionaires, only 51 actually log their holdings themselves; most of them merely sell their cutting rights, profiting as middlemen. In Indonesia, Thailand and the Philippines, the areas under concession exceed the total area of production forest.

The opportunity for private gain has attracted politicians as well as businessmen. In Thailand, Sarawak, Sabah, the Philippines and other places, cabinet ministers, senators and other senior politicians are involved in the timber industry. In the Philippines, for example, Senator Juan Ponce Enrile, the principal opposition leader, holds extensive timber concessions he acquired under the Marcos regime. In Indonesia most of the 544 concession holders are retired military or government officials who can bring pressure in Djakarta to halt investigations into violations of forestry regulations. Effective supervision by forestry-department personnel, often low-ranking officials, is virtually impossible.

While they sacrifice enormous sums in potential forest revenues, governments in the tropics are failing to invest enough in stewardship and management of the forest. In Indonesia nearly half of all trained foresters work in Djakarta, hundreds of miles by sea from the forests; those who do get out into the field find themselves dependent on concession holders for shelter and transportation. A study in Ghana found that 66 percent of all government posts for professional foresters, 54 percent of the posts for junior professionals and 43 percent of the technical-grade positions were vacant. Gabon has enough forestry personnel, but there is no way for them to do their job in the field: the departmental budget was reduced by 75 percent between 1984 and 1988. All of this means that although in many countries forestry codes and concession agreements are worded to ensure sustained productivity over at least several cycles, almost nowhere are forests being managed to achieve that goal.

Ineffective government supervision is compounded by the perverse incentives established for timber companies by the terms of concession agreements, which actually discourage any possible interest loggers might have in management for sustained yield. Even though intervals of 25 to 35 years are prescribed between successive harvests in selective-cutting systems—and longer intervals in monocyclic systems (when all salable timber is extracted at once)—most agreements run for 20 years or less, some for less than five years. Concession holders are given little reason to care whether or not productivity is maintained for future harvests.

Again, relatively undifferentiated fees are often levied, based simply on the volume of wood extracted. This encourages "high-grading," a practice in which loggers take out only logs having the highest value and do so over large areas and at minimum cost. Because trees whose standing value is less than the royalty rate can be destroyed with impunity, extensive damage is often inflicted on residual stands. In Sabah, Indonesia and the Philippines, from 45 to 75 percent of residual trees are destroyed or seriously damaged during harvesting operations. Royalties based not on what is extracted but on the size of the concession and on the total salable timber it contains would encourage more complete utilization of the timber within a smaller harvesting area; ad valorem royalties (based on the value of extracted logs) would also encourage fuller utilization.

Distorted incentives also reduce the efficiency of wood-processing industries. Many countries seek to increase both employment and the value added to forest products domestically by encouraging processing rather than the exporting of logs. They must provide strong incentives to local mills to overcome high rates of protection against the importation of processed wood in Japan and Europe. Extreme measures, such as bans on log exports or export quotas based on the volume of logs processed domestically, have created inefficient local industries, which are sometimes set up only to preserve valuable log-export rights.

In the Ivory Coast such quotas have created a large processing industry requiring 30 percent more logs than efficient mills would consume to produce the same output. This inefficiency is supported by the sale of rights—worth as much as $15 per cubic meter on the open market—to export high-value logs. In Zaire concessionaires must process 70 percent of their harvest domestically. The requirement has increased timber cutting, because profitable export of prized species supports inefficient sawmilling, which dumps low-value output domestically at prices about 30 percent below production costs.

Such extreme protection can create powerful local industries able to resist regulation. Indonesia has successfully captured between 70 and 80 percent of the world's hardwood plywood market by banning log exports and providing generous industrial incen-

COOL CONIFEROUS FOREST

TEMPERATE MIXED FOREST

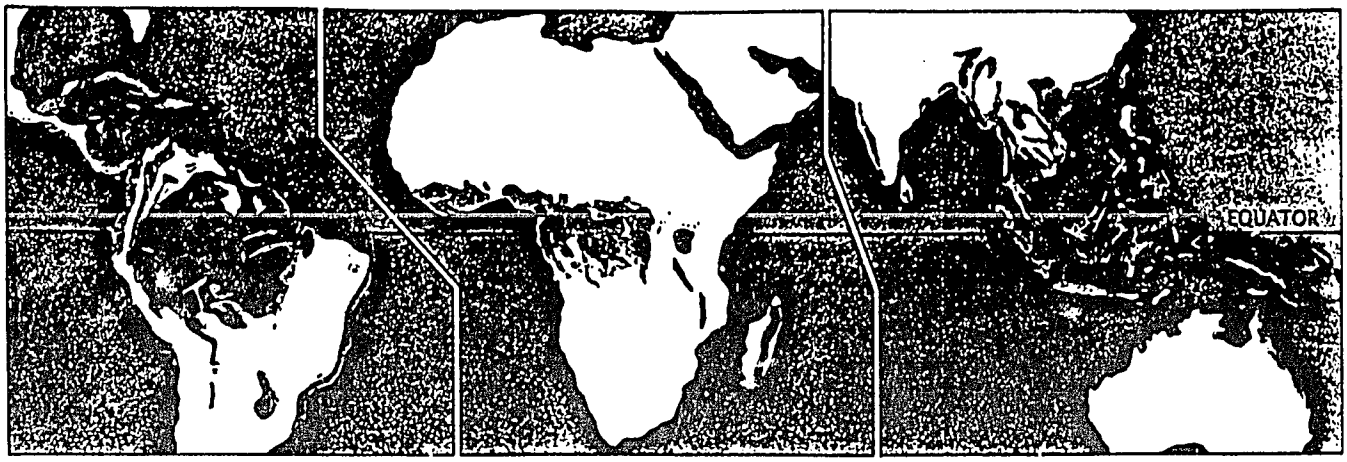
WARM TEMPERATE MOIST FOREST

TROPICAL MOIST EVERGREEN FOREST

TROPICAL MOIST DECIDUOUS FOREST

DRY FOREST

WORLD'S FORESTS can be grouped into six main vegetation zones. The tropical forests dealt with in this article are moist evergreen forests, moist deciduous forests and some dry forests.



TROPICAL RAIN FORESTS once extended over the entire area shown in color. Now the rain forests have disappeared from the yellow areas; their current extent is shown in green. The map is based on one published by the Smithsonian Institution.

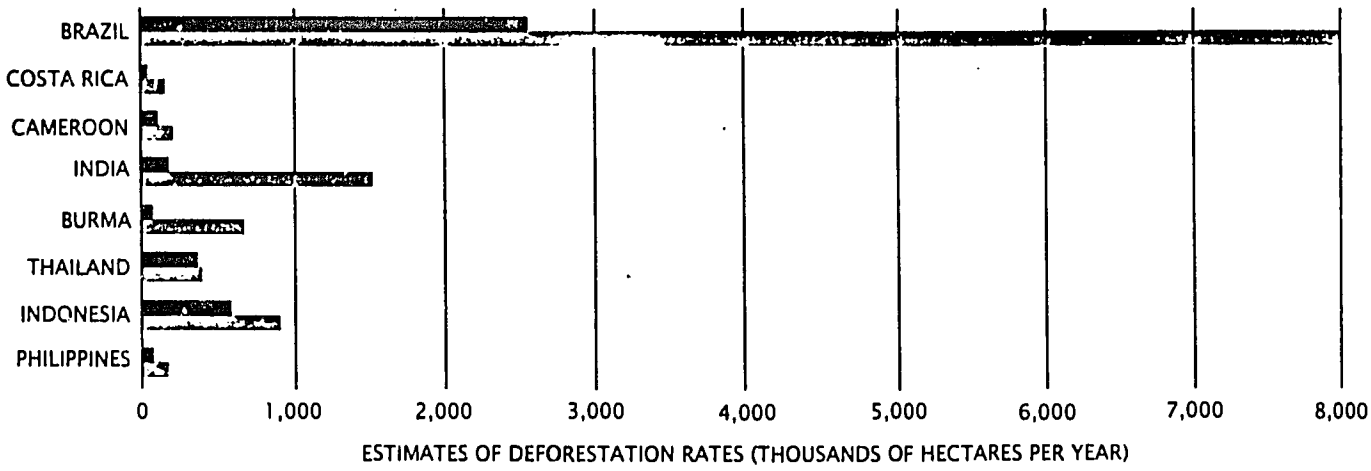
tives. The rapidly expanding but inefficient processing industry now consumes 35 million cubic meters of logs annually, more than previous peak exports, and current plans call for doubling capacity during the 1990's.

Countries sheltering inefficient processing industries can incur heavy economic and fiscal losses. In the Philippines each log exported as plywood is worth from $100 to $110 less per cubic meter than it would be if exported without processing or as sawed timber; the government sacrifices more than $20 million annually in forgone export taxes to encourage these plywood exports.

Industrialized countries have contributed to—and profited from—these forest-policy problems in the tropics. European and U.S. companies have held interests in logging and processing enterprises, especially in tropical Africa and Latin America, but Japanese business now heavily outweighs its rivals in the tropical-timber trade. Japan is the largest importer, accounting for 29 percent of the tropical-timber trade in 1986, roughly the same share as the European Economic Community. Imports (which, unlike those of the EEC, are mostly of unprocessed logs) were 30 percent higher in 1987, mainly because of a construction boom in Japan, where most tropical-hardwood imports are processed into construction plywood, primarily as disposable forms for molding concrete.

Large Japanese trading companies are involved in all stages of exploitation, as partners and financiers of logging concessionaires, as exporters and importers, and as processors and distributors. As log supplies were successively depleted, Japanese firms have shifted their attention from the Philippines to Indonesia, then to Sabah and Sarawak, and now they are interested in Amazonian forests. François Nectoux and Yoichi Kuroda find that the Japanese have shown little interest in sustained management of their holdings; their highly leveraged operations have harvested as much as possible as fast as possible in order to pay off financing charges. Moreover, Japanese firms have participated in the bribery, smuggling and tax evasion that make tropical timber cheap to import and at the same time deprive exporting countries of much of the value of their resource.

Inadequate forest policy and management are often abetted by misguided agricultural policy. Many countries actively encourage the conversion of tropical forests to other uses. Rules of land tenure in many states, such as Sabah, allow private parties to obtain title to forested land by showing evidence of "improving" it—by clearing away the trees, for example. In the Philippines, Brazil and elsewhere, recognized rights of occupancy or possession are awarded on the basis of the area of land cleared.



RATES OF DEFORESTATION appear to be increasing. Here estimates made by the Food and Agriculture Organization in the early 1980's (*gray*) are compared with more recent estimates (*color*) based on satellite imagery and field surveys.

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Such provisions often become a mechanism for privatizing land from the public forest estate. Those who obtain ownership soon sell out to larger capitalists, who consolidate the land to establish private ranches and accumulate speculative holdings.

In many cases such activities would be uneconomic without heavy government subsidies. In the Brazilian Amazon, road-building projects financed by the federal government and multinational development banks have fueled land speculation. More than 600 cattle ranches, averaging more than 20,000 hectares each, have been supported by subsidized long-term loans, tax credits covering most of the investment costs, tax holidays and write-offs. The ranches proved to be uneconomic, typically losing more than half of their invested capital within 15 years.

Indeed, surveys showed that meat output averaged only 9 percent of what was projected and that many ranches were reorganized and resold repeatedly, having served only as tax shelters. (In that respect, they were unquestionably productive, generating returns of up to 250 percent of their owners' actual equity input.) Although the Brazilian government has suspended incentives for new cattle ranches in Amazonian forests, supports continue for existing ranches, covering 12 million hectares, that have already cost the treasury more than $2.5 billion in lost revenue.

More general agricultural policies contribute indirectly to deforestation. In Latin America and the Philippines the aggregation of the better agricultural land into large, generally underutilized estates pushes the growing rural population into forested frontiers and upper watersheds. The extreme concentration of landholdings is supported by very low agricultural taxes that make farms and ranches attractive investments for people in upper-income brackets, for whom it costs almost nothing to keep extensive holdings that generate relatively little income.

Subsidized rural-credit programs also promote land concentration: ceilings on interest rates inevitably lead banks to ration credit in favor of large landholders who have ample collateral and secure titles. Particularly in inflationary settings in which land provides security, large landholders with access to virtually free credit can easily buy out small farmers who cannot finance investments to raise agricultural productivity. Many of the recent migrants into Rondônia and Acre in Brazilian Amazonia are small farmers and farm laborers who have been displaced from Paraná by large-scale mechanized cultivation.

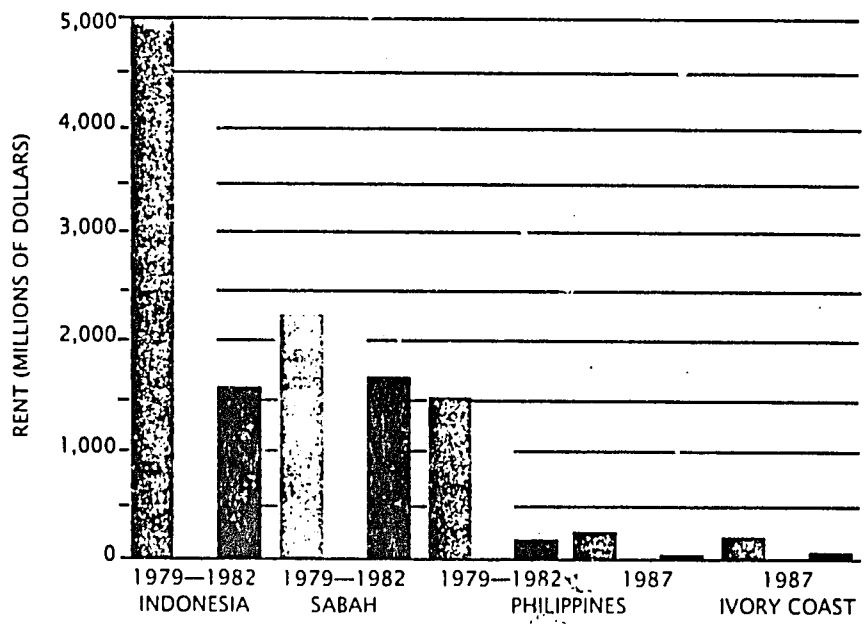
In many countries, deforestation has provided a temporary escape valve—a respite from development pressures that can be dealt with effectively only at a more fundamental level. In the Philippines, population growth rates in the forested uplands are even higher than the high national average of 2.5 percent per year, resulting in high rates of deforestation and soil erosion. Yet the government has been reluctant to address population control directly or to attack highly skewed patterns of landholding in the lowlands.

The Indonesian government's ambitious "transmigration" program, which has so far resettled about a million families from crowded Java to the outer islands—80 percent of them to sites cleared in primary or secondary forest—was largely an attempt to provide employment and livelihoods. At a cost of $10,000 per household (in a country that invests only $125 per capita annually), transmigration could obviously not compensate for slow employment growth on Java itself, and it has been sharply curtailed in recent budget cuts necessitated by lower petroleum prices.

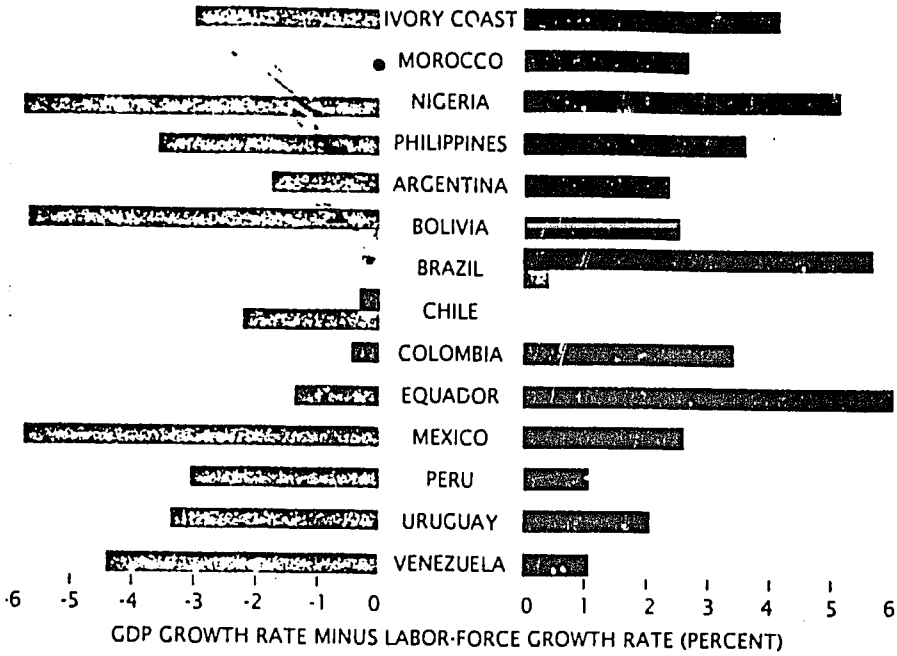
Indeed, rapid deforestation in the tropics during the 1980's has generally been linked to the exceptionally difficult economic conditions most tropical countries face. Indonesia's drive to export timber products is a conscious effort to offset its lower petroleum earnings and protect its development program from further cutbacks. Many of the most heavily debt-burdened countries are coincidentally those with most of the remaining tropical forests. The 1980's were the first period in 40 years when economic growth in those countries failed to outpace the increase in the labor force [*see illustration on next page*]. Employment in the organized urban sector stagnated and declined; real wages plummeted in the informal urban labor market. Instead of the usual rural-to-urban migration, there was a pileup in agriculture.

In Brazil, for example, the agricultural labor force grew by 4 percent a year between 1981 and 1984, compared with a growth rate of only .6 percent between 1971 and 1976; agricultural wages fell almost 40 percent in real terms between 1981 and 1985. With no alternative, given the concentration of agricultural land in large holdings and the absence of jobs, rural households migrated to the frontier in increasing numbers. A more favorable economic climate could reduce the pressures of unemployment, poverty and population growth on the remaining tropical forests.

Is there hope for improvement?



TROPICAL COUNTRIES have generally failed to collect (in royalties, export taxes and other fees) the full resource value of timber taken from their forests. The dark-colored bars show, for four-year periods or for single years, the "potential rent": what might have been collected if harvested logs had been disposed of (exported as logs, sawed or further processed) to yield the highest possible net return. The light-colored bars show the "actual rent" that could have been collected given the actual disposal of the harvest. What the governments did in fact collect is shown in black.



GOVERNMENT POLICIES that promote deforestation are often motivated by economic pressures. One such pressure is illustrated. From 1965 to 1980 (*black bars*), economic growth (measured by gross domestic product) generally outpaced the growth of labor forces, but from 1980 to 1986 (*colored bars*), labor forces grew faster than most economies, generating unemployment and reducing government revenues.

There are, in fact, signs of a new approach to forest policy reflecting increasing awareness of the national and global significance of tropical forests.

Many countries are taking steps to capture resource rents at full value. The government of the Philippines has imposed partial bans on logging, cracked down on illegal logging and raised timber royalties. It plans to increase timber taxes further and is considering assigning harvesting rights on the basis of competitive bids. The Ivory Coast also expects to move to competitive bidding. Indonesia has raised timber taxes substantially. Ghana, with World Bank assistance, has doubled timber royalties to an average of 12 percent of export value and plans a further 50 percent increase by 1992.

A number of governments are now strengthening their forest-management capability with the help of development-assistance agencies. The World Bank and the Asian Development Bank now have loans for forest-management improvement in the pipeline for a dozen countries. Most of these loans support forest-policy reform as well as institutional strengthening. Under the aegis of the Tropical Forestry Action Plan, sponsored by the World Resources Institute, the World Bank, the U.N. Development Program and the Food and Agriculture Organization, more than 50 countries are preparing national action plans to conserve and manage their forests.

International interest in tropical forests has bloomed, accompanied for the first time by a willingness to contribute to their maintenance. Several voluntary organizations in developed countries have raised money for debt-for-nature swaps: a bit of the external debt of a tropical country is bought up at a discount and then exchanged for a local-currency fund (usually to be managed by a local voluntary agency) that will finance forest-conservation programs. Some business groups have also taken an active interest. Associations of tropical-timber traders in the Netherlands and the U.K. have proposed that all importing countries levy a surcharge on tropical-timber imports to create a fund for forest conservation.

There remains a great deal more that the world outside the tropics might do. Inappropriate consumption of tropical hardwoods (for disposable concrete molds, for example) contributes to deforestation. Some businesses in industrialized countries are still taking part in forest destruction. Barclays Bank was recently found to be the majority owner, through its Brazilian subsidiary, of two huge Amazonian cattle ranches that have burned half a million acres of forest to create pasture. (The *Sunday Times* of London reported that the bank's chairman, on learning of this involvement, declared, "Being personally an extremely keen gardener and botanist...I was extremely cross.")

Development-assistance agencies are still financing activities that are destructive to tropical forests. The African Development Bank has recently agreed to a project that will run a road through one of the Ivory Coast's few remaining tracts of rain-forest and mangrove habitat. Another of its projects would develop sawmilling capacity affecting more than 800,000 hectares of virgin forest in the Congo, even though the country has no forest-management capability and the area in question is the home of Pygmy communities. Such projects should be supplanted by others designed to improve forest management and step up the pace of reforestation.

The potential scope of international cooperation to halt the destruction of tropical forests is large. The Tropical Forest Action Plan provides one useful framework. The Montreal Protocol for protection of the ozone layer and a proposed convention to mitigate global climate change could also be powerful mechanisms for international cooperation. Fees levied on chlorofluorocarbons and taxes on fossil-fuel and other greenhouse gases in industrialized countries would help to reduce emissions and also provide funds needed to implement national programs formulated under the Tropical Forest Action Plan. Programs in which debt reduction is linked to improved resource management and conservation could be expanded substantially.

New forms of international cooperation would reflect the world's growing awareness that the disappearing tropical forests are not only national treasures but also essential elements of the biosphere on which everyone, everywhere, depends.

FURTHER READING

THE PRIMARY SOURCE: TROPICAL FORESTS AND OUR FUTURE. Norman Myers. W. W. Norton & Co., Inc., 1984.

THE FOREST FOR THE TREES? GOVERNMENT POLICIES AND THE MISUSE OF FOREST RESOURCES. Robert Repetto. World Resources Institute, 1988.

PUBLIC POLICIES AND THE MISUSE OF FOREST RESOURCES. Robert Repetto and Malcolm Gillis. World Resources Institute, 1988.

TIMBER FROM THE SOUTH SEAS: AN ANALYSIS OF JAPAN'S TROPICAL ENVIRONMENTAL IMPACT. François Nectoux and Yoichi Kuroda. Gland, Switzerland, World Wildlife Fund International, 1989.

"AGRICULTUAL POLICIES IN INDUSTRIAL COUNTRIES AND THEIR ENVIRONMENTAL IMACTS: APPLICABILITY TO AND COMPARISONS WITH DEVELOPING NATIONS"

The World Bank
Environment Working Paper No. 25
Policy, Planning, and Research Staff

ABSTRACT

For developing countries agricultural output growth between 1965 and 1986 has been an impressive 3.3 percent per annum. There is mounting evidence, however, that some of the growth is developing and industrial countries alike has occurred at the expense of long-term resource degradation. The question which this paper addresses concerns the types of environmental and resource-related agricultural policy adjustments that could properly address the costs of resource degradation and increase long-term prospects for sustainable development. The paper reflects experiences in both industrial and developing nations. Where possible, lessons and insights of relevance to policy-making in developing countries are sought.

Conceptually, agricultural production will be most efficient when the costs borne by producers include external costs. Policies should try to reduce the divergence between the private and social costs of resource use. In actuality, there are large differences between conceptually pure policies and actual ones. A natural resource accounting framework which recognizes the difference between the income generation and the depreciation of resource stocks and which more accurately measures time, sustainable income would enable policy successes and failures to be judged more reliably.

One important lesson that has emerged from industrial countries is that agricultural and environmental policies should be "integrated". It may be costly to determine specific linkages in precise quantitative terms, but the qualitative impacts can be thought through, at low cost. Applicability of integrated policy-making to developing countries is therefore possible and is to be encouraged.

The paper reviews conceptual possibilities for internalizing externalities and where possible provides specific examples or experiences. It discusses the Polluter-Pays-Principle, taxes/subsidies as well as regulations and the associated enforcement issues. In general terms, a contribution of both the incentives' and the regulatory approach are needed. In developing countries one will have to rely more on incentives than in industrial nations, since the capacity to enforce regulations there is more limited.

Other possible issues of relevance for environmentally sound agricultural development are also discussed, including income/tax reform, research priorities, land tenure security and its possible effects on long-term investment, possible ways of enhancing environmental quality, and the limits of extension work when environmental and financial objectives diverge.

The paper concludes that improvements are possible particularly in the following areas: (a) the development of policies which internalize external costs; (b) the preparation of natural resource accounts and other information which enable decision makers to appreciate the environmental costs of the policy options under consideration; (c) identification of the opportunity costs and impacts on economic growth of different resource pricing policies; (d) improving the enforcement of regulations and reducing corruption; (e) phasing out input subsidies and introducing policies and

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introducing policies and property right arrangements which reflect the marginal cost of resource use; and (f) making income taxation policies neutral to the environment. The paper also encourages research, particularly on the physical impacts of projects and policies as well as their economic valuation.

Population Crisis Committee

PRESS RELEASE

Population Crisis Committee ■ 1120 19th Street, N.W. ■ Suite 550 ■ Washington D.C. 20036

HOLD FOR RELEASE
UNTIL MONDAY, FEBRUARY 26, 1990 - A.M.

Contact: Kathleen Mazzocco
(202) 659-1833

THE 1990s:

THE CRUCIAL DECADE FOR POPULATION STABILIZATION

Price Tag: $10.5 Billion a Year

WASHINGTON, D.C. -- The world's nations can prevent a doubling of global population only if good birth control is universally available by the end of this decade, says "Report on World Progress Toward Population Stabilization," a new study by the Population Crisis Committee (PCC).

The report establishes for the first time a country-by-country plan for early population stabilization, including a price tag -- $10.5 billion a year by the year 2000. Currently, $3.2 billion a year is spent for family planning in developing countries, where virtually all current population growth is occurring.

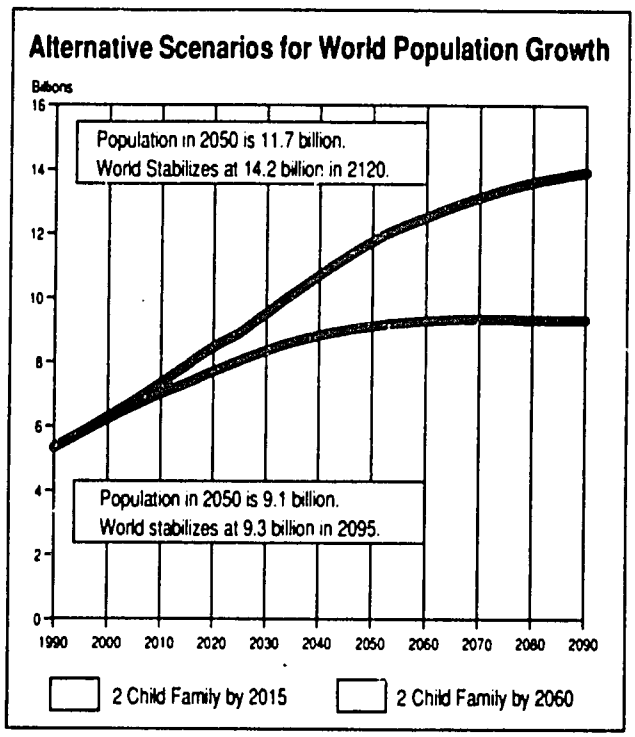
"To stop population growth, worldwide birth control use must grow from about 50 to 75 percent of couples, and average family size must decrease from about four to two children," says Sharon L. Camp, Ph.D., Vice President of PCC and the report's senior author. "This can happen only

-- over --

once all couples have access to affordable contraception. The longer we wait, the bigger the stable world population will be."

The plan also estimates the financial contribution governments, private philanthropists, multilateral organizations and consumers will have to make as a share of the $10.5 billion price tag.

The world's population is now 5.3 billion. Recent U.N. projections show world population almost tripling to 14 billion before stabilizing unless birth rates decline much more sharply over this decade. However, if birth control becomes universal by the year 2000, world population growth can be stopped at close to 9 billion, says the report. The difference in the two numbers is almost equal to the current world population.



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"This is a preventable disaster. We have what it would take -- the financial resources and the know-how -- to solve this problem, and to do so in our children's lifetime," says Dr. Camp. "But we have to act immediately. We cannot dither away another decade."

Universal access to birth control is necessary to increase contraceptive use to about 75 percent of fertile couples. It is that 75 percent rate of contraceptive use by the year 2000 that will produce a two-child family average worldwide, or "replacement level" fertility about 15 years later in 2015. Replacement level fertility by the year 2015 would result in a world population of about 9 billion in 2050, growing very slowly to a stable population of about 9.3 billion in 2095.

Some 29 countries out of 125 studied are firmly on the path to population stabilization. Some of these countries are: the United States, Canada, South Korea, Singapore, Taiwan, Japan, New Zealand, Australia and the countries of Eastern and Western Europe. They contain almost 18 percent of the world's population and fertility is at replacement level or lower. The United States' population is still growing (even without immigration), but very slowly. Italy's population is stable. East and West Germany's populations are declining.

Twelve countries -- Costa Rica, Colombia, Chile, Brazil, Argentina, Uruguay, Poland, Israel, Turkey, China, Thailand and Sri Lanka -- with almost 29 percent of the world's population, are rated "Good," with current contraceptive use between 61 and 75 percent. Women have on average 2.6 children. Together the governments and consumers (including donors) in these countries need to spend a hefty $3.7 billion annually by the year 2000 to achieve early population stabilization. But some can be expected to exceed the 75 percent contraceptive use target.

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Twenty-one countries, including Mexico, Ireland, Romania, Tunisia, Zimbabwe, the Philippines, Indonesia and Vietnam, with almost 12 percent of the world's population, are rated "Fair," with contraceptive use between 43 and 60 percent. Women have on average 3.9 children. These countries, which are well within range of the report's year 2000 target, need to boost spending to $1.5 billion annually by the end of the decade.

The 62 countries in these three categories, representing 58 percent of the world's 1990 population, have excellent prospects for reaching population stabilization targets.

Eighteen additional countries, including Guatemala, the Soviet Union, India, Nepal, Bangladesh, Egypt, Jordan, Kenya and Botswana, with more than 27 percent of the world's population, are rated "Poor." Although half have national population policies and subsidized family planning programs, major new initiatives will be needed to reach 75 percent contraceptive use by the end of this decade. Contraceptive prevalence is now between 15 and 42 percent. Women have on average 4.3 children. Expenditures in these countries must reach $4 billion annually by the year 2000, and a significant share of the money will need to come from foreign aid donors.

In 45 countries, including Haiti, Senegal, Angola, the Ivory Coast, Nigeria, Zaire, Rwanda, Tanzania, Libya, Afghanistan, Pakistan, Saudi Arabia, North and South Yemen and Myanmar (Burma), with 14 percent of the world's population, contraceptive use is rated by the study "Very Poor," at 14 percent or lower. Women have an average of 6.4 children. Populations in these countries are doubling in 24 years. By the year 2000, $2.1 billion would be needed to raise contraceptive use high enough to reduce fertility to an average of just over two

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children per woman by 2015. Some of the countries in this category will almost certainly fall short of the report's targets.

The total price tag for family planning services in developing countries in the year 2000 is estimated at $10.5 billion in constant U.S. dollars. This figure assumes that it costs an average of $16 to provide family planning for one couple for one year in developing country settings.

The actual number of couples in developing countries who are using birth control today is 360 million. In the year 2000, that number needs to increase to 660 million -- 75 percent of all fertile-age couples in developing countries in the year 2000 - to achieve eventual world population stabilization .

Currently expenditures for family planning in developing countries are about $3.2 billion. The money comes from these sources:

- Developing country governments -- $2 billion or 63 percent

- Developing country consumers -- $550 million or 17 percent

- Foreign donors -- $659 million or 20 percent.

The report calls for a radical shift in the way the financial burden for worldwide family planning is divided. To mount the level of effort needed for early population stabilization, the report says at least half of the global budget must come from the wealthy industrialized nations.

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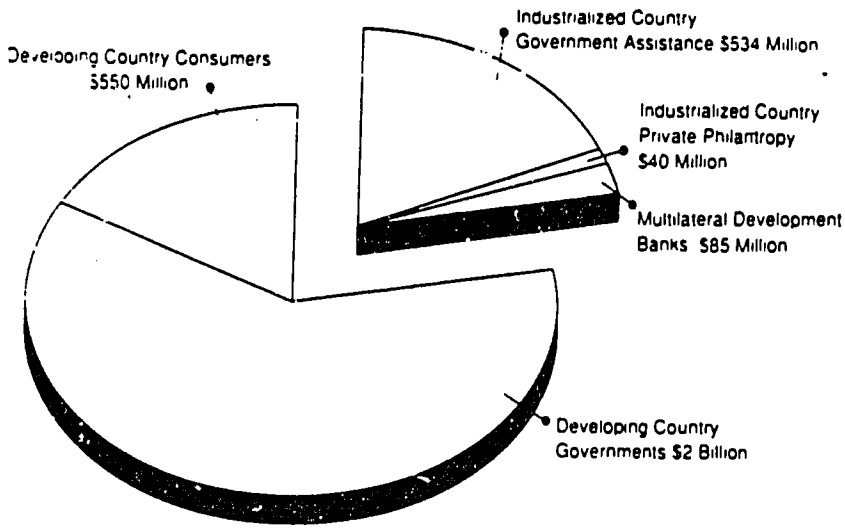
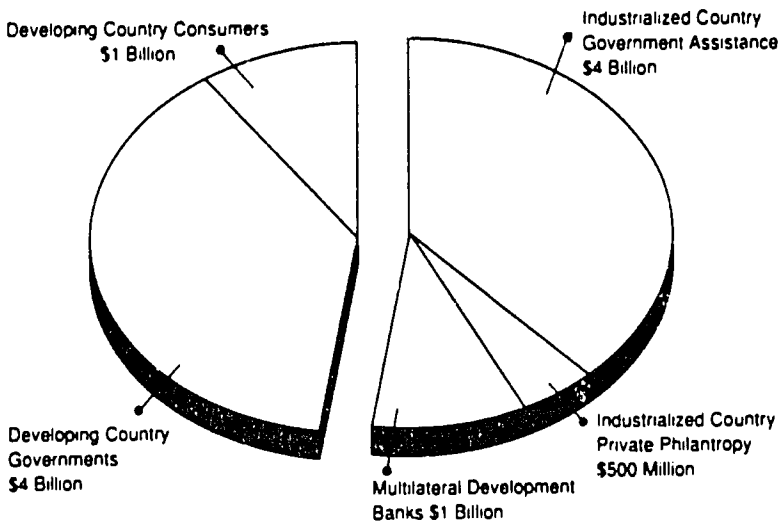
Current Family Planning Expenditures (in $U.S.)



Estimated Total Expenditures – $3.2 Billion

Year 2000 Target for Family Planning Expenditures (in constant $U.S.)



Projected Total Expenditures – $10.5 Billion

The study recommends that the $10.5 billion budget for family planning and related services for the year 2000 be divided in the following way:

Industrialized Country Governments -- should raise contributions from today's $534 million to $4 billion. This would require a doubling of all foreign

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aid (as occurred between 1977 and 1987) with four percent allocated to population and family planning.

The U.S. government share should be $1.2 billion, up from $227 million spent on international family planning programs today. This figure is based on the relative wealth of the U.S. compared with other industrialized countries.

Developing Country Governments -- should invest $4 billion compared to today's $2 billion Since much of the latter figure is spent by just two countries, India and China, most developing countries will need to more than double their budgets.

Multilateral Development Banks -- should raise their spending from today's $85 million a year to $1 billion, or about three and a half percent of their current development loan flows.

Private philanthropists -- should spend $500 million compared to today's $40 million.

Consumers -- can be expected to spend, if services are universally available, $1 billion compared to today's $550 million.

"Universal family planning is a bargain compared to the costs of delaying world population stabilization -- greater environmental damage, stagnant Third World economies, political instability and intolerable amounts of human suffering," says Dr. Camp.

* * *

International Narcotics Control Update

United States Department of State
Bureau of Public Affairs
Washington, D.C.

Public
Information
Series

Revised January 1990

Recent international efforts have resulted in the two most dramatic developments in the global war on drugs: the elimination of Jose Rodriguez Gacha, leader of Colombia's notorious Medellin cocaine cartel; and the apprehension and arraignment on narcotics charges of deposed Panamanian leader Manuel Noriega.

Gacha died in a gun battle with Colombian police, who had been cooperating with U.S. drug agents. Noriega turned himself over to U.S. authorities after American forces acted to capture him and help restore democratic government in Panama. His arrest was aided by the cooperation of the new civilian government of Guillermo Endara and the Vatican through its Papal Nunciature, where Noriega had sought refuge in Panama City.

President Bush said Noriega's apprehension "should send a clear signal that the United States is serious in its determination that those charged with promoting the distribution of drugs cannot escape the scrutiny of justice." The President and other U.S. officials praised President Endara and the Vatican for their efforts to ensure the accused trafficker's arrest. The new government signed an agreement with the United States, pledging cooperation on money laundering, drug investigations, and steps to eliminate trafficking.

Also, President Bush agreed to attend a summit meeting with counterparts from Andean countries in Cartagena, Colombia, on February 15, 1990. Secretary of State James A. Baker, III, has declared that "there is no foreign policy issue short of war or peace which has a more direct bearing on the well-being of the American people."

© AP/Wide World Photos

Narco-terrorists blew up the offices of the *El Espectador* newspaper in Bogota, Colombia, after the newspaper identified narco-traffickers on its front pages.

International Control Efforts

1909 — International Conference on Narcotic Drugs leads to signing of 1912 International Opium Convention.

1920 — League of Nations creates Advisory Committee on Traffic in Opium and Other Dangerous Drugs.

1931 — Convention for Limiting the Manufacture and Regulating the Distribution of Narcotic Drugs.

1946 — Protocol transfers drug control functions to the UN Commission on Narcotic Drugs.

1988 — UN Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances.

"The drug pirates and profiteers attack the central nervous system and vital organs of democracy; the administration of justice; the integrity of government; the right of free speech. Ultimately, the illegal narcotics trade robs dignity and freedom not only from the individual but from entire nations."

Secretary Baker

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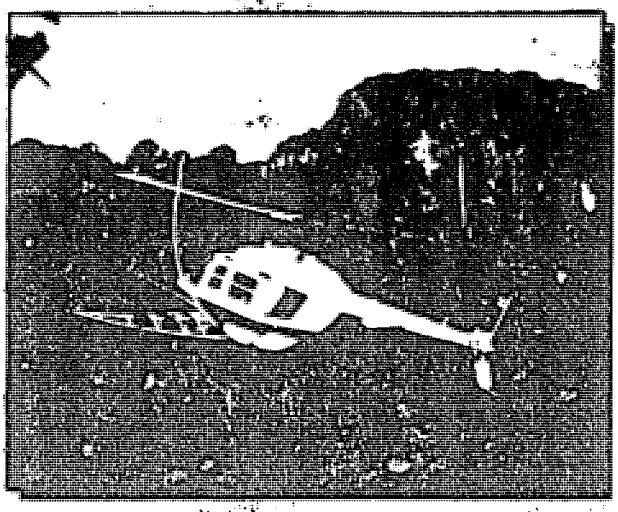
Countries with Major Bilateral Control Programs



Through cooperative agreements, the Department of State helps maintain a fleet of 150 aircraft used in regional counternarcotics programs around the world.

The United States has bilateral narcotics control programs with the following countries:

- The Bahamas
- Bolivia
- Brazil
- Colombia
- Ecuador
- Jamaica
- Mexico
- Pakistan
- Peru
- Thailand
- Venezuela

Production and Use

Illicit drugs are produced primarily in the developing world and used mainly by consumers in more affluent nations. Increasingly, however, producing and trafficking countries are confronting growing drug use problems of their own. In the past, governments have pointed fingers of blame at one another—the consumers blamed the producers, while producer nations claimed that the problem rested with citizens of the developed world who use illicit drugs.

The illegal narcotics problem has assumed such global proportions that virtually no nation is immune. Leaders of nations on both sides of the equator and from across the ideological spectrum have declared an all-out war on drugs. Rhetoric and blame are being replaced by cooperative efforts aimed at breaking the vicious cycle of drug production and consumption.

The Soviet Union, which long denied the existence of a drug problem within its borders, is now engaging in major official and unofficial programs to curb drug use. The Government of Colombia—where most of the world's cocaine is processed—has declared war on drug dealers. Speaking at the UN General Assembly's 1989 session, Colombian President Virgilio Barco called Colombia's drug lords "international fugitives." "They do not have a home," said President Barco. "Colombia is not their homeland."

President Bush's policy confronts drug consumers, producers, and traffickers alike. He told a meeting of U.S. drug enforcement officials in April 1989: "Let's face it: Americans cannot blame the Andean nations for our voracious appetite for drugs." Rather than blaming other countries, the United States wants to work with them to eliminate both supply and demand for illicit narcotics for, in the words of Colombia's President Barco, "the only law that drug traffickers do not violate is the law of supply and demand."

As the lead federal agency responsible for America's international narcotics control efforts, the Department of State is implementing key elements of the 1989 national drug control strategy, in which the Administration outlines a broad list of international priorities that include:

- Disrupting and dismantling drug-trafficking organizations;
- Reducing the cocaine supply by giving law enforcement, military, and economic assistance to Peru, Bolivia, and Colombia to isolate coca-producing regions, block delivery of chemicals used in processing, and dismantle drug-running networks;
- Reducing heroin supply by convincing other countries to pressure opium growers to cut heroin processing and distribution;
- Reducing marijuana supply through strengthened foreign law enforcement and eradication; and
- U.S. encouragement for European Community and other multilateral efforts aimed at source country and transit country production and distribution and at European consumption.

Other international objectives include:

- Making antidrug efforts a priority in U.S. bilateral relations with virtually every other country;
- U.S. ratification of the UN Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances and urging other nations to ratify the UN convention;
- Strictly enforcing existing U.S. laws that make foreign aid contingent on the recipient countries' compliance with antinarcotics efforts; and
- Strengthening domestic and international efforts against the "laundering" of drug money.

Enforcing U.S. International Narcotics Policy

Effective enforcement of international narcotics control programs involves interdiction, criminal penalties against traffickers, and eradication. As U.S. health and education officials seek to curb drug use at home, the State Department's first priority is to apply pressure against drug smugglers and traffickers through cooperation with other countries.

In August 1988, 30 countries joined in a month-long cocaine-control project under the auspices of the International Drug Enforcement Conference. Thirty countries (from Europe and North, Central, and South America) participated in a cooperative, coordinated, multinational law-enforcement operation to improve capabilities to seize cocaine and cash, track down fugitives, and crack down on the "laundering" (or disguising) of drug money. The United States committed National Guard units in four states to work side by side with the U.S. Customs Service inspecting cargo.

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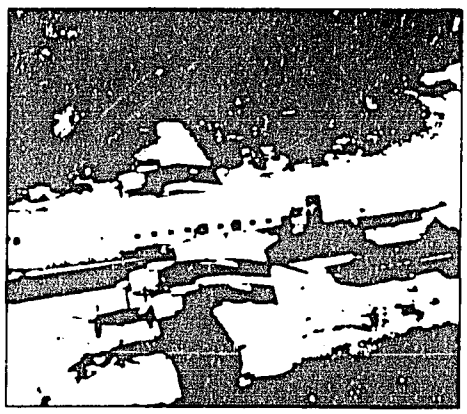
The U.S. Government needs the help and cooperation of other countries to win the war against drugs. At left, authorities burn opium at a rural processing facility in Thailand, one of the major producers of the crop.

Narco-traffickers load cocaine onto a DC-7 cargo plane (below) at an isolated dirt airstrip in Colombia. Such shipments often are bound for lucrative markets in the United States. Colombian President Virgilio Barco has called his country's drug lords "international fugitives."



Currently, in South and Central America, the Department of State and the Drug Enforcement Administration work with law enforcement officials in a cooperative effort called "Operation Snowcap" that targets illegal laboratories, processing facilities, and airstrips for destruction. Most Snowcap activity is in Bolivia and Peru. Since this operation began in 1987, results have included the destruction of cocaine laboratories and the seizure of thousands of pounds of cocaine.

International Cooperation

The United States cannot assume all the responsibility for the war against drugs, nor can it expect to win the war without support from other countries. A cornerstone of U.S. international drug policy is encouraging other countries to help combat drug trafficking while the U.S. addresses drug-use problems at home.

Since most cocaine comes to the United States through the Caribbean, Central America, and Mexico, the U.S. Government is strengthening antidrug programs in those transit areas. Joint Information Coordination Centers have been established in the Caribbean area to develop and disseminate information that will result in more arrests. Twenty-six Caribbean countries have improved their ability to communicate with one another and with U.S. law enforcement agencies through INTERPOL (an international police coordination network). In Latin America, the U.S. Government supports law enforcement activities through training and technical assistance. Nine of the 11 countries with which the United States has major narcotics control programs are in the Caribbean and Latin America.

U.S. officials aim to achieve international consensus on the drug threat. During the July 1989 economic summit of industrialized nations, Secretary Baker urged Canada, France, Italy, Japan, the United Kingdom, and West Germany to take more aggressive actions against the laundering of drug money. The seven summit partners created a financial action task force, which met during the fall of 1989 and is to make recommendations by April 1990. A new U.S. financial crimes center will collect, analyze, and disseminate information to law enforcement agencies to help combat money laundering.

During the September 1989 meeting in Wyoming with Soviet Foreign Minister Eduard Shevardnadze, Secretary Baker discussed implementation of a U.S.-U.S.S.R. agreement calling for cooperation in combating illegal narcotics that has been in effect since January 1989. In meetings with other world leaders, such as Pakistani Prime Minister Benazir Bhutto, Secretary Baker offered U.S. support to reduce drug production and trafficking.

An important milestone was reached on December 19, 1988, when an international conference in Vienna adopted the UN Convention Against Illicit Traffic in

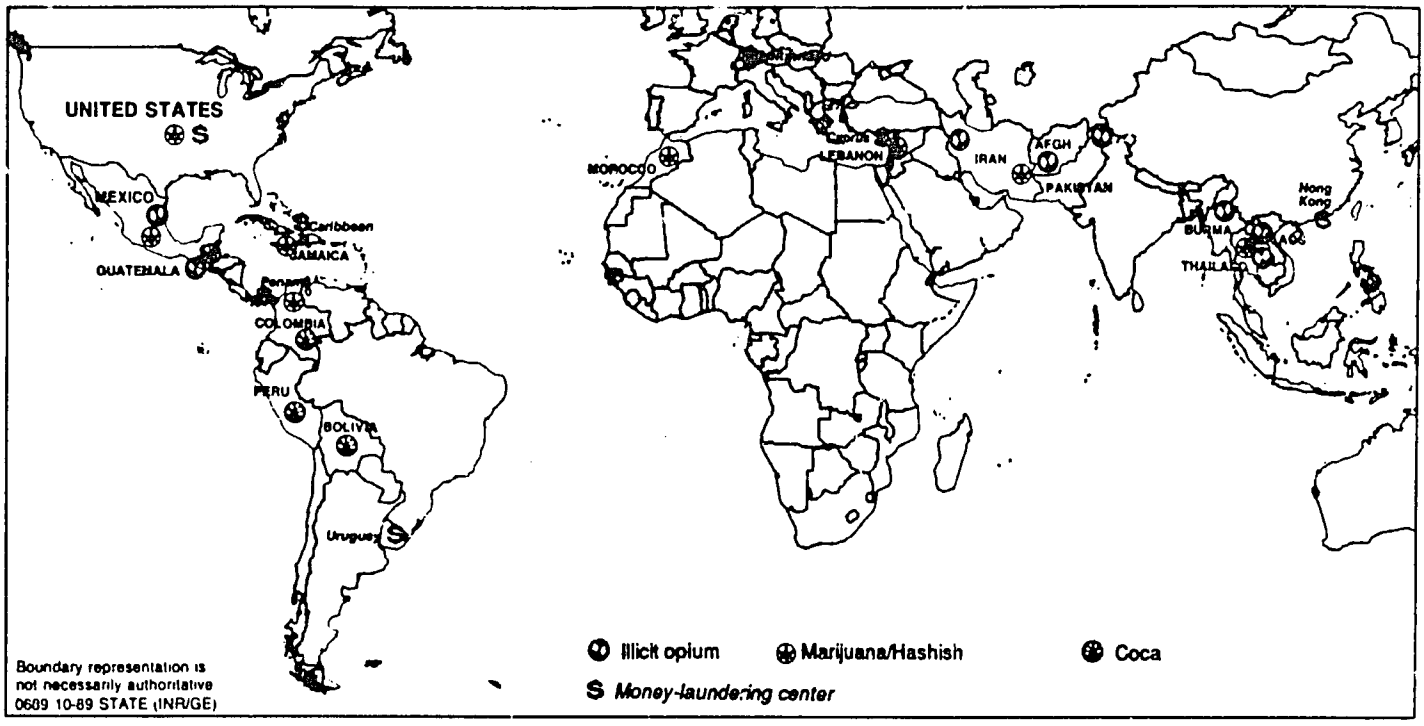
The Narco-Rich and the Drug Economy

The international drug economy runs on cash—lots of it. Worldwide drug profits were estimated to be as high as $240 billion in 1987. Drug trafficking is profitable because illegal narcotic crops are cheap to cultivate and process, while their street value is high.

Although typical drug trafficking operations have several layers of intermediaries, most of the gains go to a rich, small elite that has come to wield impressive economic and political power. Some members are believed to have a personal worth that exceeds their country's national debt. They buy land and other assets for investment purposes and control numerous domestic businesses. They also bribe and intimidate local politicians, judges, and police, who in turn allow illegal activities to continue in an ever-widening circle of corruption.

Although some traffickers have engaged in token philanthropic projects, the vast amount of their profits do not stay in the countries where narcotics are produced. They are usually transferred abroad and transformed into a more manageable form to conceal their illicit origin. "Laundering" schemes include electronic funds transfers, depositing funds in international tax shelters, or setting up dummy "shell" corporations. Such capital flight rarely benefits the developing countries where most drugs originate.

Major Cultivation Areas and Money-Laundering Centers, 1989



Narcotic Drugs and Psychotropic Substances. Signatories are required to provide assistance in the investigation and prosecution of narcotics cases by other signatories. International cooperation in the war on drugs becomes obligatory; 67 countries have signed the convention, including the United States.

U.S. officials also work with UN agencies and other international organizations on drug-related issues. The UN Fund for Drug Abuse Control, located in Vienna, is a key multilateral organization in the global struggle against drugs.

Environmental Destruction

The global war on drugs is also an element of another key U.S. foreign policy objective—the preservation of the world's environmental resources.

Growing drug crops often involves the use of "slash and burn" techniques that destroy forests, cause erosion, and eventually deplete soil resources. Coca leaves are processed with strong chemicals such as kerosene and sulfuric acid, which pollute the water supply, and cause other environmental damage. The result is a loss of valuable natural resources in many developing countries.

Fragile ecosystems in South America, Southeast Asia, and other drug-growing areas can survive only when narcotics crops and drug trafficking are eliminated.

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IMMEDIATE RELEASE March 9, 1990

CHENEY EXPANDS DEFENSE ROLE IN NATIONAL DRUG STRATEGY

Secretary Dick Cheney today unveiled a set of tightly drawn plans to expand the Defense Department's role in implementing the President's National Drug Control Strategy.

The plans were developed by the commanders-in-chief of the Unified and Specified commands, who had been directed by Cheney late last year to submit plans to reduce the flow of drugs into the United States in their particular areas of responsibility.

"President Bush gave the Defense Department a clear set of marching orders when he issued his National Drug Control Strategy," Cheney explained. "These plans carry out those orders. We will act swiftly, methodically, and in accordance with our nation's laws and traditions.

"We will work hard to stop the delivery of drugs on the way to the United States and at our borders and points of entry. Deploying appropriate elements of the armed forces with the primary mission to cut off the flow of drugs should, over time, help reduce the flow of drugs into the country. We will work closely with the law enforcement agencies that have the primary mission of stopping the drugs."

The Fiscal Year 1991 Defense budget request includes $1.2 billion to fund the Department's counter drug activities. For Fiscal Year 1990, the Department will obligate $450 million for the Defense role in the counter drug effort, compared to $300 million for Fiscal Year 1989.

The Department's role in the counter drug effort stems from the Secretary's counter-narcotics guidance and the Fiscal Year 1989 Defense Authorization Act, which designated Defense as the single lead agency of the federal government for the detection and monitoring of aerial and maritime transit of illegal drugs into the United States. So that all federal agencies can share drug intelligence and operations information and work together to interdict drugs, the Act assigned to the Department the task of integrating into an effective communications network all of the federal command, control, communications and technical intelligence assets dedicated to counternarcotics. It also required the Department to coordinate the increased use of the National Guard in the counter drug effort.

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The plans were submitted by the commanders of the North American Aerospace Defense Command, Forces Command, and the U.S. Atlantic, Pacific, and Southern commands.

The North American Aerospace Defense Command (NORAD), charged with defending the air sovereignty of the North American continent, has expanded its mission to include detection and monitoring of air and sea traffic suspected of carrying illegal drugs into the United States. It will employ a network of 44 ground radars, which are designed to warn of high altitude penetrations of U.S. airspace.

Coverage of low-flying aircraft will be accomplished with the use of 16 land-based aerostats, tethered balloons with radar, a network which will be completed at the end of Fiscal Year 1992. Until the system is complete, NORAD will deploy mobile ground radars in strategic areas to help close known gaps.

The line of aerostats will stretch from the Southwest border throughout the Bahamas and into Puerto Rico. The system will consist of six aerostats along the Southwest land border, five along the Gulf Coast, one in the Florida Keys, three in the Bahamas, and one in Puerto Rico.

NORAD also plans to strengthen its patrol of the Southern border and coasts by calling on E-3 AWACS aircraft. It can call on any number of its 50 interceptor alert aircraft, which are positioned at 25 locations across the United States. These aircraft can assist the U.S. Customs Service and U.S. Coast Guard with tracking missions when required.

The NORAD Command Center, located in the Cheyenne Mountain Complex, is the central collection point for information about possible air and space attacks against North America. Working with its four sector operations control centers, NORAD will track suspicious aircraft anywhere in North America and notify the appropriate law enforcement Command, Control, Communications and Intelligence Center, which will initiate joint communications with other agencies.

The Forces Command (CINCFOR), headquartered at Fort McPherson, Ga., will coordinate all Department of Defense operational support to counter drug activities on the ground in the continental United States. CINCFOR will use Army, Marine Corps and Air Force elements in the ground operations and will ensure unity of effort at the state level by coordinating with the National Guard.

CINCFOR will offer a wide range of training to federal, state and local law enforcement agencies. Training and assistance will be provided in the areas of intelligence analysis, transportation of law enforcement agents, detection and monitoring, use of ground sensors, photo reconnaissance, and engineering support activities.

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CINCFOR activated Joint Task Force 6 at Fort Bliss, Tx., in November 1989 as a planning and coordinating headquarters to provide counter drug support from the Defense Department to federal, state and local law enforcement agencies along the Southwest border.

The Marine Corps, in joint training exercises initiated with the Border Patrol late last year in the Tucson and El Paso areas, provided instruction in scouting and patrolling, camouflage and concealment, land navigation/map reading, and selection and manning of observation posts. In return, the Border Patrol conducts classes in tracking techniques.

While the initial focus of CINCFOR's effort will be on the Southwest border, planning and coordination will begin among other Army Headquarters and regional law enforcement agencies. Each Headquarters will work with regional law enforcement agencies to determine support requirements, after which procedures will be set up to handle requests for support.

National Guard units, although not a part of CINCFOR's command since they normally operate under the command and control of the individual states and territories, plan to perform such activities as cargo searches at land border entry points and seaports, aerial and radar surveillance of borders and select air corridors, transportation support, loan of equipment, training, ground reconnaissance of border and isolated air strips, and communications support. Based on experience to date, the National Guard on a typical day will call on more than 700 Guard volunteers from 20 states to perform 40 counter drug missions.

The U. S. Atlantic Command (USCINCLANT) has developed a plan to track and interdict the flow of drugs in international waters and airspace prior to its entry into U.S. territory. It has conducted counter drug operations for several years in the Atlantic and Caribbean and will continue to use four or five Naval ships daily expressly for that purpose. It will also significantly increase E-3 AWACS flights to extend radar coverage in the Caribbean.

U. S. Navy and Coast Guard forces have been jointly operating in the Caribbean since 1981. These patrols continue today, the largest joint Navy-Coast Guard operation since the Vietnam Conflict.

The U.S. Atlantic and Pacific commands each plan to use more than eight classes of aircraft and six classes of ships for counter drug operations. The aircraft include E-2 Hawkeyes, P-3 Orions, Seahawks, SeaSprites, Broncos, Vikings, F4 Phantoms, and F-14 Tomcats. Ships include destroyers, frigates, guided missile frigates, guided missile destroyers, aircraft carriers, patrol hydrofoils, and a variety of amphibious and logistic support ships.

The U.S. Atlantic Command established Joint Task Force 4 in Key West, Florida, in April 1989. The Task Force coordinates, with appropriate law enforcement officials, counter drug operations to detect and monitor aircraft and vessels suspected of smuggling illegal drugs into the United States through the Atlantic and Caribbean.

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Due to the vast size of the Pacific Ocean and the number of vessels that cross it, much of the **U.S. Pacific Command** (USCINCPAC) counter drug effort will be in the areas of intelligence cueing and data collection to sort out drug trafficking vessels. USCINCPAC has, accordingly, diverted significant intelligence manpower to fully dedicated counter drug functions.

USCINCPAC anticipates a dramatic increase in its detection and monitoring efforts this fiscal year. Dedicated counter drug ship days, for example, are expected to increase by 146 percent over Fiscal Year 1989. Defense Department aircraft will fly over 2600 dedicated counter drug hours in the Pacific during this fiscal year, an increase in flying hours of 24 percent.

USCINCPAC will use military dog teams, when requested, to assist law enforcement agencies in the detection of illegal drugs at air and sea ports of entry. These dog teams may be used to detect illegal drugs in aircraft, vessels, air and sea cargo containers and air parcel cargo, but they will not be used to detect illegal drugs on people.

USCINCPAC also plans to focus on marijuana eradication in Hawaii. Active duty Defense Department personnel and National Guard troops will be used for eradication efforts on federal land in Hawaii and, if requested, on state property if there is no direct participation of Defense personnel in a search, seizure, arrest, or other such activity during eradication efforts.

The U.S. Pacific Command established Joint Task Force 5 in Alameda, California, in February 1989. The Task Force is now coordinating counter drug operations to detect and monitor aircraft and surface vessels suspected of smuggling illegal drugs into the United States through the Pacific. It also coordinates with federal law enforcement agencies in USCINC-PAC's area of responsibility to ensure that all detection and monitoring ships, aircraft and equipment interact effectively and that duplication is prevented.

The U. S. Southern Command (USCINCSO) has developed a plan to provide support and development of host country capabilities. It will provide training and operational support, materiel, advice, and technological and maintenance support to cooperating nations' counter drug organizations and to U.S. law enforcement agencies as requested. Defense personnel will not participate in actual field operations.

Cocaine and the precursor chemicals required to process it are frequently carried on vast river networks in South America. A combination of Navy, Marine Corps and Coast Guard trainers as requested will assist in the development of host nation capabilities to patrol, identify, and intercept precursor chemicals and cocaine shipments.

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To improve the capabilities of U.S. law enforcement agencies to detect and monitor drug traffickers, USCINCSO will rely on a Caribbean basin radar network that consists of a series of early warning radars, some already in place and operational. The radar sites are planned throughout Central America, South America, and the Caribbean. Regional operation centers are located in Key West, Fla., and the Republic of Panama.

USCINCSO will support counter drug operations with data collected from radars and from deployed air and sea surveillance platforms. E-3 AWACS aircraft will be employed to establish a data base of radar information and to react to individual suspect tracks. This information will be shared with the Atlantic Command and other nations in an effort to track suspected aircraft and to assist legal authorities in the apprehension of the aircraft, crew, and illegal cargo.

The Defense Department's counter drug effort is part of an interagency strategy coordinated by the Director of National Drug Control Policy. All U.S. government counter drug activities abroad, including those of the Defense Department, are coordinated through the interagency process.

No Defense Department personnel or resources dedicated to the counter drug effort are employed in a national territory of another country without the consent of that country.

(end)

STATEMENT OF SEN. JOSEPH R. BIDEN, JR.
"RECENT DEVELOPMENTS IN THE ANDEAN NATIONS"
MARCH 27, 1990

TODAY THE COMMITTEE AND THE CAUCUS COMPLETE A SERIES OF THREE JOINT HEARINGS REGARDING U.S. DRUG POLICY AND THE ANDEAN NATIONS. THESE HEARINGS, IN MY VIEW, HAVE BEEN A USEFUL FORUM FOR DISCUSSING SOME OF THE NEWEST IDEAS REGARDING WHAT WE CAN DO IN THIS COUNTRY TO HELP REDUCE THE FLOW OF COCAINE COMING FROM SOUTH AMERICA.

TODAY'S HEARING LOOKS AT TWO VERY RECENT DEVLOPMENTS IN THE REGION -- DEVELOPMENTS THAT ARE UNRELATED, BUT BOTH ILLUSTRATE THE COMPLEX BALANCE BETWEEN DRUG POLICY AND ECONOMIC POLICY THAT MUST SHAPE ANY U.S. "ANDEAN PLAN."

THE FIRST OF THESE DEVELOPMENTS IS AS DRAMATIC AS IT IS SUDDEN. WE WILL HEAR TODAY SOME STARTLING NEWS: CONFIRMATION OF PREVIOUSLY SKETCHY REPORTS THAT THE VALUE OF COCA CROPS HAS PLUMMETED OVER THE PAST FEW MONTHS IN AT LEAST ONE COCA-PRODUCING COUNTRY, BOLIVIA.

AS MR. SAMUEL DORIA MEDINA -- THE TOP ECONOMIC ADVISER TO THE PRESIDENT OF BOLIVIA -- WILL TELL US, A 100-POUND BAG OF COCA LEAF THAT EARNED ITS GROWER ABOUT $65 A YEAR AGO, IS NOW SELLING FOR ONLY $5 OR $10 TODAY.

> FARMERS, WHO WERE MAKING ABOUT 100% PROFIT ON THEIR COCA CROPS, ARE NOW SELLING THEIR CROPS FOR MASSIVE LOSSES.

WHAT ACCOUNTS FOR THE SUDDEN AND RADICAL SHIFT? IT APPEARS THAT THE WAR ON THE TRAFFICKERS IN COLOMBIA HAS BEEN SO SUCCESSFUL THAT THE DISORGANIZED AND DISCOURAGED CARTELS ARE ONLY ABLE TO PAY A FRACTION OF WHAT THEY ONCE PAID FOR THE COCA LEAF.

WHATEVER IS RESPONSIBLE FOR THE CHANGE, OUR RESPONSE TO IT SHOULD BE AS SWIFT AND AS DRAMATIC AS THE CHANGE.

THE DROP IN COCA PRICES PROVIDES US WITH THE BEST CHANCE IN TEN YEARS TO WEAN THE ANDEAN NATIONS AWAY FROM THEIR ECONOMIC DEPENDENCY ON COCA PRODUCTION. IF WE ACT NOW, WITH VERY LITTLE MONEY, WE STAND A BETTER CHANCE OF MOVING FARMERS OUT OF THE BUSINESS OF GROWING COCA, AND INTO OTHER CROPS AND REGIONAL INDUSTRIES.

ODDLY, INSTEAD OF CLAIMING SUCCESS FOR COLOMBIA'S WAR ON THE CARTELS AND SEEKING TO CAPITALIZE ON IT, THE ADMINISTRATION HAS RESPONDED CAUTIOUSLY AND SLOWLY TO THESE NEW DEVELOPMENTS. I WOULD HAVE THOUGHT THAT THE ADMINISTRATION WOULD BE PROUD OF ITS ACHIEVEMENTS, AND SEIZE THE MOMENT. INSTEAD, THE

ADMINISTRATION STANDS BY ITS INITIAL PLAN TO WAIT UNTIL 1991 TO SEND NEW ECONOMIC AID FOR CROP SUBSTITUTION AND DEVELOPMENT.

I SAY THAT WE MUST ACT NOW, WHILE THE OPPORTUNITY EXISTS. THAT IS WHY, A FEW WEEKS AGO -- WHEN THE FIRST SKETCHY REPORTS OF A PRICE DROP EMERGED -- I ADVANCED THE IDEA OF SENDING $125 MILLION IN EMERGENCY ECONOMIC AID TO THE ANDEAN NATIONS -- TO MAKE PROGRESS NOW, WHILE THE OPPORTUNITY EXISTS.

MY PROPOSAL GAINED THE IMMEDIATE ENDORSEMENT OF THE NEW YORK TIMES, AND I AM PLEASED TO ANNOUNCE TODAY IT IS BEING COSPONSORED BY SEVERAL OF MY COLLEAGUES. WITH TODAY'S CONFIRMATION OF A DRAMATIC PRICE DROP IN BOLIVIA, WE HOPE TO GAIN ADDED SUPPORT FOR OUR EFFORT.

IT IS MY HOPE THAT WE CAN ADD THIS EMERGENCY AID PROPOSAL TO ANY URGENT SUPPLEMENTAL AID PACKAGE THAT IS PROPOSED FOR PANAMA AND NICARAGUA.

I LOOK FORWARD TO HEARING FROM OUR WITNESSES TODAY, AND LEARNING OF THE PROSPECT FOR IMMEDIATE PROGRESS TO REDUCE THE SUPPLY OF COCA -- AND ULTIMATELY COCAINE -- BEING PRODUCED IN SOUTH AMERICA.

THE SECOND ISSUE WE WILL BE HEARING ABOUT TODAY IS THE QUESTION OF COFFEE PRICES, TRADE, THE WAR ON DRUGS, AND THEIR RELATIONSHIP.

IN JANUARY, THIS COMMITTEE HEARD TESTIMONY FROM THE THE COLOMBIAN AMBASSADOR, STATING THAT THE ANDEAN NATIONS HAD LOST ALMOST $750 MILLION IN REVENUE DUE TO LAST JULY'S COLLAPSE OF THE COFFEE AGREEMENT.

LIKE MANY AMERICANS, I FOUND THIS TESTIMONY TO BE STRANGE, BECAUSE I HAD NOT NOTICED ANY DROP IN THE PRICE OF COFFEE IN THE GROCERY STORE.

AFTER SOME INVESTIGATION, OUR STAFF HAS MADE SOME INTERESTING, INITIAL FINDINGS -- AND I EMPHASIZE THAT THEY ARE INITIAL FINDINGS ONLY. THESE CONCLUSIONS ARE ILLUSTRATED BY TWO CHARTS THAT I WANT TO SHOW NOW.

THIS FIRST CHART INDICATES WHAT HAS HAPPENED TO COFFEE PRICES SINCE LAST JULY. IT SHOWS THAT THE PRICE THAT GROWERS ARE GETTING FOR THEIR COFFEE NOW IS ABOUT ONE-HALF OF WHAT IT WAS IN JULY -- DOWN FROM ABOUT $1.20 A POUND TO 65 CENTS A POUND.

BUT THE PRICE THAT U.S. ROASTERS ARE CHARGING RETAILERS HAS DROPPED ONLY ABOUT 6% OVER THIS PERIOD OF TIME -- SCARCELY MOVING AT ALL.

ACCORDING TO ONE STUDY, A ONE POUND CAN OF COFFEE COSTS TODAY PRICELY WHAT IT COST -- ABOUT $2.96 -- ONE YEAR AGO -- A TIME WHEN THE GROWERS' PRICE FOR THE COFFEE BEANS WAS DOUBLE WHAT IT IS NOW.

THIS SECOND CHART SHOWS WHAT HAS HAPPENED FROM ANOTHER PERSPECTIVE. LAST JULY, ABOUT 36% OF THE PRICE OF A POUND OF COFFEE WAS ATTRIBUTABLE TO WHAT THE GROWERS' MADE. TODAY, THE GROWERS' SHARE IS DOWN TO 22%.

AS A LAYMAN, I CAN ONLY DRAW ONE CONCLUSION: SOMEONE IS $750 MILLION DOLLARS RICHER THAN THEY WERE LAST YEAR.

> THAT MONEY EITHER BELONGS TO THE PEOPLE OF SOUTH AMERICA WHO ARE FIGHTING THE WAR ON DRUGS FOR US, OR TO THE PEOPLE OF THIS COUNTRY WHO BUY THE COFFEE --
>
> BUT NOT TO THE MIDDLE-MEN WHO MAY BE THREE QUARTERS OF A BILLION DOLLARS BETTER OFF THAN THEY WERE DUE TO THESE PRICE CHANGES!

HOW CAN WE ASK FARMERS IN SOUTH AMERICA TO GROW COFFEE INSTEAD OF COCA LEAVES FOR COCAINE, WHEN THE PRICE THEY ARE GETTING FOR THEIR COFFEE HAS BEEN SLASHED IN HALF OVER THE PAST YEAR?

AND HOW CAN WE TELL THE AMERICAN PEOPLE THAT THIS DISASTEROUS POLICY IS JUSTIFIED WHEN THE PRICE THEY ARE PAYING FOR COFFEE HAS BARELY DROPPED AT ALL OVER THE SAME PERIOD?

MORE OUTRAGEOUS STILL, I WOKE UP SATURDAY MORNING TO READ IN THE NEWSPAPER THIS INCREDIBLE HEADLINE:

> "A CUP OF COFFEE WILL COST MORE"

THIS IS WHAT THE NEW YORK TIMES REPORTED ON SATURDAY, BASED ON STATEMENTS BY THE NATION'S LARGEST COFFEE ROASTERS.

> THAT'S RIGHT: AMERICANS ARE GOING TO BE ASKED TO PAY MORE FOR COFFEE, WHILE OUR DRUG FIGHTING ALLIES IN COLOMBIA ARE BEING ASKED TO LIVE ON LESS FOR THEIR CROPS.

HOPEFULLY TODAY, WITH THE INSIGHTS OF MR. MURPHY FROM THE TRADE REPRESENTATIVE'S OFFICE, AND MR. BOECKLIN FROM THE COFFEE ASSOCIATION, WE CAN FIND OUT WHAT EXPLAINS THIS SITUATION, AND WHAT CAN BE DONE TO SET IT RIGHT.

IN CLOSING, I WANT TO THANK OUR WITNESSES FOR APPEARING HERE TODAY, AND ALL THE WITNESSES WHO TESTIFIED BEFORE THE COMMITTEE AND THE CAUCUS DURING THIS SERIES.

THANK-YOU.

Beyond Law Enforcement:

Narcotics and Development

"If you had to choose between getting a new helicopter and giving [coca] farmers more credit, which would you take?" "The credits," he said, without pausing.

That was Captain Omar Humberto Díaz, 26, head of the anti-narcotics police in San José del Guaviare, Colombia, in an interview with American journalist Michael Massing. Díaz, who commands a 120-man force responsible for coca eradication efforts in that region, was addressing the question of what his priorities would be, considering that the United States is experiencing serious budgetary constraints that limit its capacity to spend resources abroad.

Perhaps Captain Díaz is the exception, and not the rule, among law enforcement officials in Peru, Bolivia and Colombia — the countries which produce 98% of the coca leaves processed into the cocaine that supplies the international market. But his unhesitating response demonstrates that at least some of those responsible for carrying out law enforcement measures at the source, against coca growers, realize the limitations and/or inadequacies of current anti-drug efforts.

The Law Enforcement Approach

In September 1989, during his first prime-time television address to the nation, President Bush announced his anti-drug strategy. It seeks a solution to a problem that is considered "a serious threat to national security," and relies largely on suppression, both at home and abroad, to cope with the drug crisis.

"The international drug trade" — says the plan — "poses a serious threat to the welfare, economy and national security of the United States ... Programs are needed to deter and incapacitate international production and the trafficking organizations responsible for bringing these drugs into the United States. Other nations must be motivated to engage their resources and efforts to defeat international narcotics trafficking [1]."

The plan includes the provision of $2 billion to Colombia, Bolivia and Peru over the next five years (an average of $133 million per country per year), "to help them counter the producers, the traffickers and the smugglers". The Reagan administration's approach consisted of sanctions, including suspension of US foreign assistance for any country not considered to be co-operating fully in curbing illicit narcotics. The current approach features a "carrot" component as well: a financial reward system for countries that demonstrate that they are trying to fight drugs.

Critics within the United States have questioned the Bush administration's strategy on the basis that it still concentrates primarily on law enforcement, despite evidence accumulated during the past eight years that such efforts have minimal impact on drug use and drug trafficking, which still seem to be on the increase.

One measure of this is the number of cocaine-related emergencies/overdoses reported by DAWN (Drug Abuse Warning Network of the National Institute of Drug Abuse). While drug use among some populations, in particular teenagers, is decreasing, according to recent surveys, drug use in general appears to be increasing in the United States. In 1984, DAWN reported 7,054 emergencies involving cocaine overdoses, while in 1987 the total was 32,578, a more than four-fold increase. During 1988, the number was the highest ever reported, 42,491, an increase of 30% over the previous year's record total [2].

As for drug trafficking control, the US budget has been increasing steadily from $1.5 billion in 1981 to $5.5 billion in fiscal year 1989. But given the few successful and costly seizures to date, the current $5.5 billion cannot realistically be expected to alter the behavior of the cocaine market.

In 1987, for example, the US Air Force spent $2.6 million on six drug seizures and ten arrests. The Navy spent $27 million and the Coast Guard $13 million to capture 20 boats and seize 550 pounds of cocaine. The average cost of a pound seized by the Navy and Coast Guard combined was $54,545.45 each. At that rate, the 1989 drug program budget of $5.5 billion could be expected to finance the seizure of no more than 50 metric tons of cocaine — far below the estimated 270 tons that were exported to the United States in 1988 from Colombia alone [3].

Others have criticized the current strategy because it does not acknowledge the close link between Third World poverty and drug production. Five months before Bush announced his strategy, Bolivia's President Jaime Paz Zamora stated: "We have to fight the narcotics trade because it is evil, but we can't fight drugs by becoming poorer [4]." Subsequently, Presidents Barco of Colombia, García of Peru, and Paz of Bolivia, commenting at a meeting in Ica, Peru, on the new US program to fight drugs, said that "it is not sufficient and is not very serious", because, among other reasons, "it does not guarantee a program for the substitution

Carmen Miranda

Bolivia: coca-growing areas

of coca plantations that will help the 'campesinos' [5]."

Coca In Tradition

The coca plant has been sacred to the Indian populations of the Andes since pre-Inca times. Traditionally, coca leaves have been chewed and are still chewed by the peoples of the Andes as a mild stimulant and as sustenance while working in harsh environmental conditions, especially at high altitudes. Cocaine is only one among the 14 alkaloids contained by the coca leaf, which also contains more than 28 nutrients that supplement the Andean people's daily diet. In some cases, coca leaves may be their main source for minerals and vitamins. The presence of calories, protein, carbohydrates, fiber, calcium, phosphorus, iron, vitamin A and riboflavin, has led some scientists to argue that the coca leaf ranks higher than 50 food staples available in Latin America [6].

In Bolivia alone, there are an estimated 1.5 million coca leaf chewers, mostly among peasants and miners. In Peru, peasants with their caravans of burros, transport Andean crops to the rain forests, or coca to the highland communities, where the chewing of the leaves is widespread. In some instances, the coca leaf is used to pay for labor and services. Coca leaves are also used for a variety of medicinal purposes in Andean households, and play a vital symbolic and religious role in Andean society.

Cultivating 12,000 hectares (29,600 acres) in Bolivia and 10,000 hectares (24,700 acres) in Peru, would provide enough coca to meet the needs of the local population [7].

Increasing Demand

Over the last decade, however, coca production has experienced unprecedented expansion in the Andean countries, which can only be explained by the equally unprecedented growth in the demand for coca-derived drugs in the international marketplace.

In fact, coca has emerged in the 1980s as the single most profitable export cash crop of Peru and Bolivia. These two countries produce 60% and 30%, respectively, of the coca leaves processed into cocaine for the international market. Another 8% is produced in Colombia — which controls some 80% of the total cocaine trade — while the rest comes from Ecuador and Brazil.

Peru's production of coca leaves increased from 11,068 metric tons in 1959 (most of it for local consumption) to 50,000 in 1980, a more than four-fold increase. Estimates of coca production for Peru in 1988 range from 97,000 tons according to the 1988 US National Narcotics Intelligence Consumers Committee (NNICC) Report, to 300,000 tons from Peruvian sources [8]. In Peru, coca grows mainly in the Huallaga Valley area at elevations of 500 to 2,000 meters, that is, in the Central Huallaga and some sections of the Lower Huallaga.

In Bolivia, where coca is mostly grown in the subtropics of the departments of Cochabamba and Santa Cruz, and in the high mountain valleys of the department of La Paz, production increased from 4,800 metric tons in 1963 to 38,286 tons in 1981, an eight-fold increase. Estimates for 1988 range from a low of 57,400 tons according to US sources, to a high of 147,607 tons by the Bolivian government [9].

Available data for Colombia show that coca production in 1988 was about 22,000 metric tons [10].

Together, Peru, Bolivia, Colombia and, to a much lesser extent, Ecuador, had the capacity in 1988 to produce as much as 454 metric tons of cocaine hydrochloride, according to US estimates [11]. However, the Bolivian and Peruvian estimates of coca-leaf production mentioned above would suggest that the amount may be three times as much [12].

For the impoverished peasants of the Andes, coca production represents a short-term solution to the need for cash. Traditional patterns of land distribution, inequitable rural development

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strategies, overpopulation, environmental degradation and unfulfilled expectations of finding jobs in the urban areas, are some of the reasons forcing many of them to migrate to the rain forests in search of land. Here they fell trees to clear land for coca production in an attempt to improve their livelihoods. At the same time, traditional or new elites are amassing immense fortunes through cocaine trafficking. These trends are only helping to reinforce the inequalities that have prevailed in these countries for centuries.

In Colombia, for instance, where the top 4% of all landowners have traditionally controlled 68% of the arable land (while 66% of rural households are landless or nearly landless), official sources have estimated that the "drug barons" now own 400,000 arable hectares, or about 8% of the total [13]. Independent sources contend that the number is closer to 1 million, roughly 20% of the total [14]. It is no coincidence that the areas where the new landowners now have their haciendas are those in which the highest number of peasant massacres by paramilitary groups have occurred [15].

The illegal nature of this economic activity (which makes violence the chief means used by traffickers to regulate the cocaine business), combined with the international response to the drug trade (which has overlooked the issues of poverty and underdevelopment facing coca producers) is occurring at enormous cost to the Andean countries.

That cost is bound to continue into the future. It is inevitable that the current coca "boom" will end, either because markets for cocaine and "crack" actually decrease, or because they are replaced by other drugs — most probably chemically produced, synthetic narcotic amphetamines such as "Ice," or methamphetamines such as "Ecstasy," which can be manufactured in industrialized countries at low cost. When this happens, the peasant growers on whom the cocaine business rests will not be better off than they were before. And they will have to find new frontier areas, where they will begin a new cycle of felling trees for other cash crops or subsistence agriculture, with no better hopes for changing their condition of poverty and marginality.

Production and Environmental Degradation

Ironically, were it not for the illegality of cocaine as a commodity, and its harm to human health (although its world-wide casualties are still much lower than those of alcohol and tobacco), coca would seem to be an ideal crop for production in many areas of the Andean ecosystem and in the Amazon Basin. The coca plant begins to produce one year after cultivation; leaves can be harvested three to five times a year; the plant can survive between 15 and 20 years and maintain relatively good production levels on even poor-quality land.

Furthermore, coca cultivation and harvesting are labor intensive and provide an important source of employment for the rural population [16].

Had modern coca farmers followed the methods of their predecessors during centuries of coca cultivation, it could be argued that coca, compared with other crops, was environmentally benign. Aware of the erosion menace, pre-Inca and Inca farmers cultivated coca bushes in two-foot-deep ditches dug into stonewalled terraces. Shade trees and intercropping with yucca further prevented topsoil erosion.

But the growing demand for drugs has turned coca cultivation into a predatory activity. In Peru, for instance, coca production has been directly or indirectly responsible for the deforestation of some 703,000 hectares (1,736,410 acres) in the Amazon region [17]. Coca cultivators, who since the 1950s have been migrating from the highlands to the Ceja de Selva (Eyebrow of the Jungle), are clearing the leaves and roots of covering

Carmen Miranda

Colombia: coca-growing areas

vegetation that in normal circumstances keep the jungle's heavy rainfall from eroding the top soil on the steep slopes. Harvesting of the coca leaves, which occurs an average of four times a year, further exposes the soil to the rains, causing more erosion.

Settlement and deforestation of the Bolivian Chapare in the department of Cochabamba — where most of the Bolivian coca is grown — has increased significantly since the 1980s. The original settlement area expanded outwards as new impoverished families coming from the highlands began to form "sindicatos" (peasant unions which are de facto forms of local government in frontier areas) and to carve farms out of virgin forest. And with the collapse of Bolivia's tin industry in the early 1980s, thousands of jobless miners also moved to the Chapare to participate in the bonanza of the cocaine industry, the only sector that emerged unharmed by the economic crisis [18].

In Colombia, coca cultivation increased along with the expansion of the agricultural frontier. Fleeing La Violencia (Colombia's civil war of the 1940s and 1950s), many of today's coca growers settled in La Macarena (Colombia's most important biological reserve located in the department of Meta), where they first cultivated marijuana, the boom crop of the 1970s. Others settled in areas of the Amazon, including the departments of Guaviare, Caquetá, Vaupés and Putumayo, first clearing the forest for food crops. But much of the produce never reached markets due to the lack of roads and other basic infrastructure.

Originally, the technology for processing the leaves into coca paste and base — the two intermediate steps before cocaine hydrochloride is finally obtained — was kept out of reach of the farmers by the drug traffickers. This was done as a means of obtaining the largest share of the value added to cocaine.

The situation has changed, however. Today, most peasants involved in the coca economy in Peru, Bolivia and Colombia are not only growing the leaves but also making coca paste. One reason for this is that the chemistry of the process and the technology required are not too complex, and peasants easily mastered them [19]. Also, drug traffickers soon discovered that, in order to protect their interests, it was more convenient to have peasants manufacturing paste in small units (which are easy to construct, absorb smaller amounts of leaves and chemicals, and above all, are difficult to detect by law enforcement agents) than having the activity centralized in large refineries [20].

One way of encouraging peasants to become involved in the manufacturing process has been to keep the prices of the leaves at a barely profitable level so that growers try to increase their income by making coca paste [21]. This activity is carried out in small "kitchens" (usually called "laboratories" by the media) and uses hundreds of tons of chemicals that are contributing heavily to the environmental degradation of the rain forest regions.

Marcelo Buenaventura, a forestry engineer with the National Agrarian University of Peru, calculated in a 1987 study that coca growers dump the following annual volume of toxic waste in the Huallaga Valley's watershed: 15 million gallons of kerosene, 8 million gallons of sulphuric acid, 1.6 million gallons of acetone, 1.6 million gallons of the solvent toluene, 16,000 tons of lime and 3,200 tons of carbide [22].

Most of the paste/base is sent to real laboratories where it is further refined into cocaine hydrochloride. The drug is then exported from Colombia via Mexico into the United States (a shift from the formerly-favored Caribbean routes to Florida, as a result of US interdiction efforts), or from Bolivia or Brazil into Europe through transport networks set up through Paraguay and Argentina [23].

THE ROAD TO COCA

'We used to live up there, in the foothills of the Andean mountain range. People were poor up there, like us. We learned to write on the linings of cigarette packages, on pieces of cardboard. My father said we need not go to school. If you are interested, you learn by yourself! That's what my father used to say. Besides, there were no schools where we lived. We never saw a pill; not even for malaria. We were always settlers, firstcomers everywhere.

We then moved down the forest, and with our father we cleared a piece of land. It was hard work felling trees for agriculture, cattle and pigs; working with other "colonos" (settlers) because the forest is tough. You just cannot do it all by yourself; you gather with your fellows and do it, once and again.

We tried maize, cacao, tobacco. Sometimes the crops failed, sometimes we could not sell them. You see, here the land is not that good, and the government gives you no help. In Colombia nobody knows that you exist, and nobody cares anyway. But then coca came ...

One day, a man showed up passing out the seed. Marcos was his name. He said "plant this and you will be rich like the peasants further north" [La Macarena]. And he gave each one of us a little bundle of coca seeds. We initially said no, thank you very much, we are used to hardship. Because, you know, we have always been very .... We didn't like that sort of thing.

And he said, "Fair enough, it's up to you. I give seeds to everybody out of a strategy. I don't want quarrels in the future. So, keep it anyway."

Then, when we saw that the others were doing fine, we also decided to plant.'

Excerpts from an interview with Simeón Pérez, a Colombian coca grower in El Bajo Caguán, Caquetá. Conducted by Patricia Castaño and Adelaida Trujillo, two Colombian filmmakers.

The Classic Export Cash Crop

The 25 million Americans who use illegal drugs spend about $50 billion a year on them. For cocaine alone, an estimated 5 to 10 million consumers spend between $20 and $25 billion annually, that is, a minimum of $2,000 per year per capita [24].

By way of comparison, this drug-spending is roughly equivalent to the

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combined GNPs of Colombia ($34 billion), Peru ($14 billion) and Bolivia ($5.5 billion). Similarly, what a single American spends on cocaine a year is more than the 1988 average per capita income of Colombia ($1,400), Peru ($900) or Bolivia ($780).

The supply of cocaine appears to have increased constantly and, as a result, cocaine prices have decreased considerably. In 1980, the wholesale price of one kilo of cocaine in the United States was $55,000. In 1988, the wholesale price of cocaine at the port of entry hit an all-time low of $11,000 per kilo.

Latin American exporters, and retailers in US and European cities, receive most of the value added to a kilogram of cocaine. In 1988, an exporter could earn from $11,000 to $34,000 per kilo of cocaine, according to the 1988 US NNICC Report, while the earnings by retailers could be as much as $80,000 to $100,000 per kilo ($80 to $100 per gram) [25].

At the very beginning of the chain, in the Bolivian Chapare, a coca cultivator could sell a "carga" of leaves (45 kilograms) for $55 to $100 ($1.20 to $2.20 per kilo), while a coca paste producer could sell one kilo of his product for about $250 [26].

A Cushion for the Debt Crisis

Cocaine money plays a vital role in helping to cushion the economic crisis facing Bolivia and Peru, due to debt and structural adjustment, and in contributing to Colombia's healthier economic performance. In the cases of Bolivia and Peru, it is generally argued that hundreds of thousands of people have been able to survive the crisis because of the existence of the coca-cocaine economy [27].

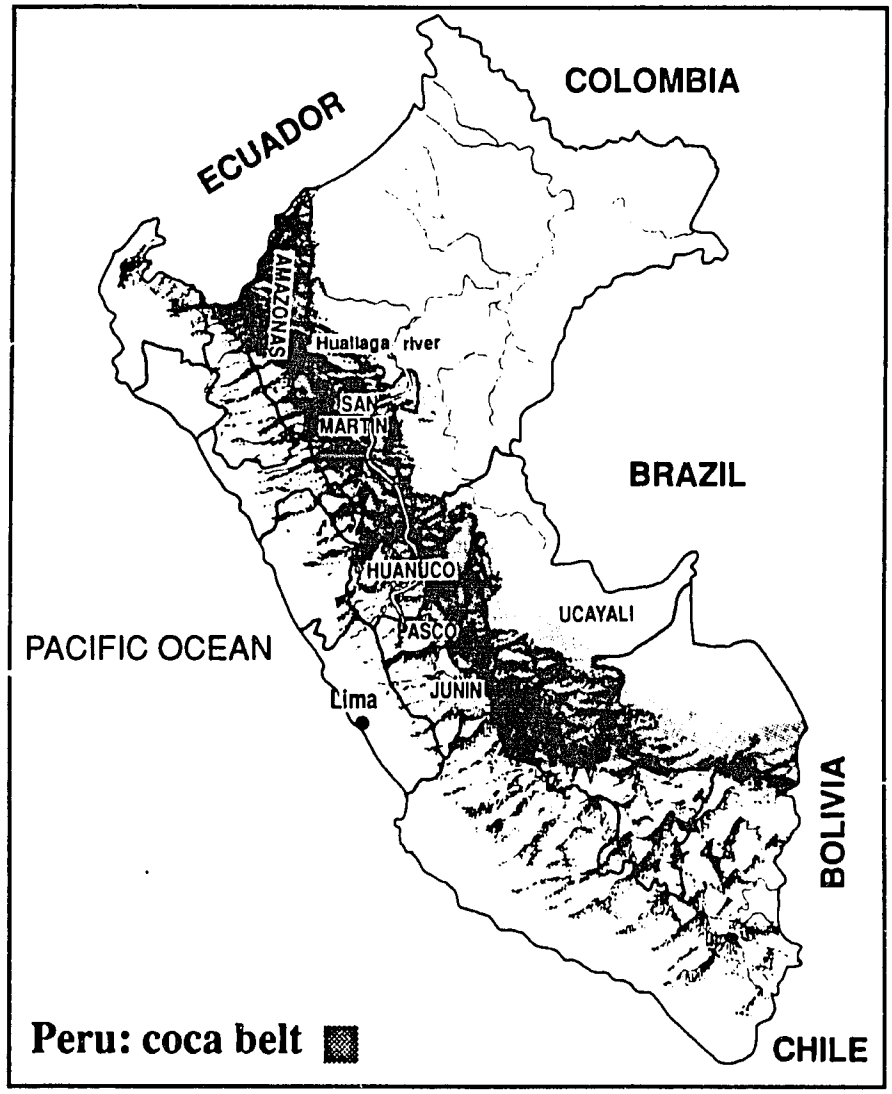
Conservative estimates by *The Economist*, London, show that in 1987, Bolivia and Peru each received $375 million from cocaine exports, while Colombia — whose narco-entrepreneurs control most of the wholesale marketing — obtained some $750 million [28]. This, of course, is only a fraction of what the drug traders pump into the international banking system or overseas investments, which gain the greatest benefits from the revenues from drugs.

A recent cover story in *Time* magazine reports that the international financial system, featuring electronic-funds networks and the secrecy laws of tax havens, is helping "drug barons" to launder as much as $100 billion a year in US proceeds. In South Florida alone, it is estimated that the money laundering industry — which helps to support the business of drug trafficking — pumps $800 million a year into the local economy [29].

In a 1988 assessment of the cocaine economy in Colombia, economist Carlos Caballero estimated that 310 metric tons of cocaine were exported from that country, generating about $7.1 billion in revenues, of which $4.06 billion were profits. Of this, as much as $1.5 billion circulated in the Colombian economy [30]. This is slightly less than what the country obtained from coffee exports — $1.6 billion — and represents 20% of the country's total export earnings of $5.5 billion.

Colombia's most important legal export cash crop — coffee — as well as its most important illegal export — cocaine — are heavily linked to the US market. Last year, US policy regarding coffee producer countries (which also include Bolivia and Peru, where coca and coffee grow literally side by side) contributed heavily to the collapse of the international coffee agreement. This triggered a 50% fall in coffee prices, which is likely to cost Colombia some $500 million in export earnings in 1989 [31]. The estimated loss is 7.5 times greater than the $65 million in military aid that the United States offered the Colombian government last year to fight the war on drugs.

The coffee sector employs some 2 million people directly, and another 1 million indirectly — in a total work force of about 10 million [32]; the cocaine business employs about 300,000 Colombians, directly or indirectly [33].



Peru: coca belt

Carmen Miranda

In Bolivia, Samuel Doria-Medina, a leading economist with the governing Movement of the Revolutionary Left (MIR), said last year that, were the coca-cocaine phenomenon to disappear, Bolivian exports — estimated to be $580 million a year — would drop by 50 percent, and the GDP — which amounts to $4.6 billion — would drop by almost $2 billion. He also said that annual per capita income could drop from $780 to $300, and some 400,000 wage earners — out of Bolivia's total work force of about 1.7 million — could be left jobless [34]. In Peru, which is currenly experiencing the worst economic crisis of this century, the coca-cocaine economy yields up to $1.5 billion a year [35]. In the Upper Huallaga basin alone, it directly supports from 200,000 to 300,000 peasants and their families — that is, from 16 to 25% of the population of the upper jungle as estimated in 1984 [36].

In total, some 1.5 million people in Peru, Bolivia and Colombia are estimated to benefit from the coca-cocaine economy as farmers, hired hands, harvesters, refiners, middlemen, transporters, buyers and also as gunmen. Many more benefit from it indirectly, with cocaine money flowing into different sectors of the formal and informal economies [37].

Constraints on Crop Substitution

A 1989 study of the coca economy in the Huallaga Valley reports that profitability of coca is 2.4 times that of cocoa, and 39.9 times that of yellow corn (maize) [38]. Another 1988 report indicates that farmers in the area can obtain up to $4,500 a year per hectare of coca, while for the most profitable legal crop, cocoa, annual earnings are US$600 [39].

The World Bank's Living Standard Measurement Survey indicates that about 31% of the poorest in Peru lived in the rural districts of the Andean mountain range (sierra) in 1985-1986. Similarly, a National Planning Institute study on Critical Poverty in Peru indicates that most of the provinces in the Trapecio Andino (33 out of 42) showed the worst indicators of poverty [40]. It is because of this poverty that peasants have migrated massively from the highlands into the rain forests to get involved in the cultivation of coca or to work as farm hands and in other activities related to the coca-cocaine industry.

A study of the coca economy in Bolivia shows similar findings. It reports that in the department of Cochabamba, coca produces the highest net income of the local economy, that is, 3.2 times more than that obtained from oranges, and more than 6.3 times the income from banana production [41].

While the average gross domestic product per capita (GDP) for the rural areas in Bolivia as a whole was $401 in 1988, in the regions of Chapare (department of Cochabamba) and Yungas (department of La Paz) — the largest coca producing areas of the country — average GDP was $566 and $509, respectively [42].

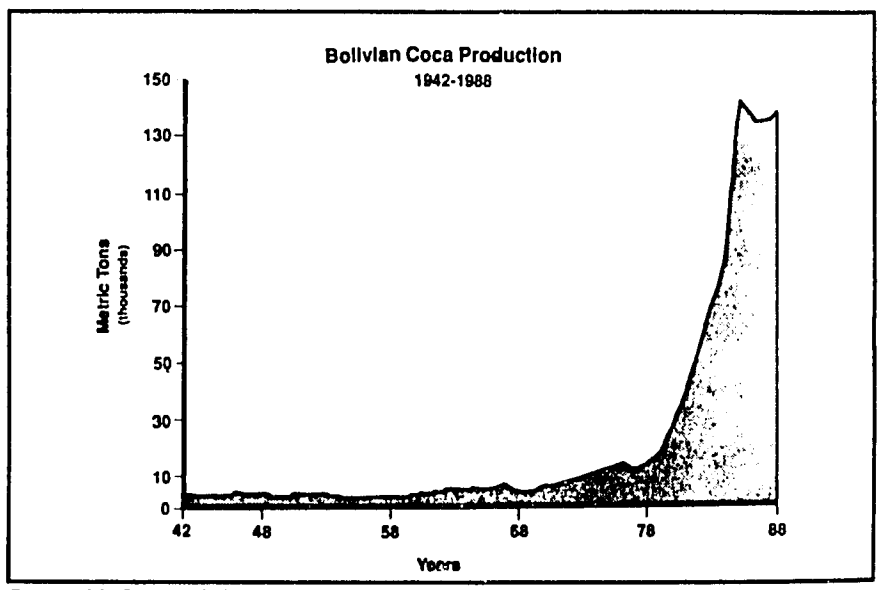
As in the case of Peru, most small-scale farmers in the Bolivian Chapare are former highlanders. Most of them have come from the neighboring mountainous Cochabamba Valley, while another significant number of smallholders have migrated from the department of Potosí, one of Bolivia's poorest regions [43].

In both Peru and Bolivia, as well as in Colombia, governments have encouraged settlement in the rain forests. National development strategies have sought to involve marginal populations by expanding the agricultural frontier and increasing the production of domestic food crops and/or cash crops for export.

At the same time, however, agricultural policies in these countries over the last several decades have been directed toward supplying the urban areas with cheap food. This has led to deteriorating terms of trade for many agricultural products and, ultimately, to lower profitability for legal agriculture [44]. Deficient marketing mechanisms and lack of appropriate infrastructure have also contributed to the failure of these development schemes.

Attempts have been made to substitute other crops for coca. In programs financed by the United Nations Fund for Drug Abuse Control (UNFDAC), eradication of coca plantations is voluntary. Sometimes, these involve commitment on the part of the growers not to increase the area devoted to narcotic crops. Various incentives are offered, including technical assistance, credit, infrastructure (irrigation systems, roads) and services (schools, health centers). Peasants are also provided with seeds to plant other crops such as coffee, citrus fruits, cocoa, and dyestuffs (annato and cochineal) [45].

Unfortunately, the great majority of crop substitution programs financed from abroad are not only driven by a law-enforcement mentality but constitute only a minimal fraction of the larger suppression effort, which focuses on forced eradication. In Bolivia and Peru, for example, the US Agency for International Development is responsible for income substitution projects in coca-growing areas where, at



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Source: MACA — SUBDESAL. Programa de Reconversión Agrícola 1988.

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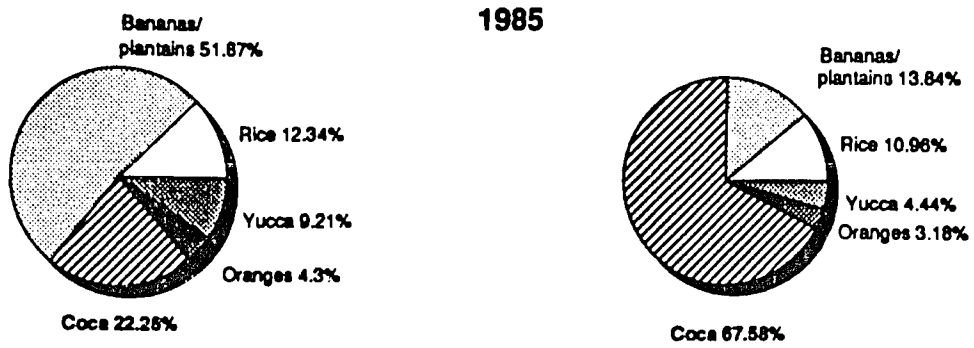
Shifting patterns of peasant land-use in tropical Cochabamba.



Source: CIDRE (Centre for Research and Regional Development). Strategy and plan of action for the development of Cochabamba's tropic, Cochabamba, Bolivia, 1988.

the same time, the US Drug Enforcement Administration (DEA) is supporting local police forces in eradication and interdiction missions.

Peasant Resistance to Substitution Programs

Substitution programs have therefore been opposed by coca farmers, who view them with suspicion because they are linked to police-led campaigns to eradicate coca by force before the substitution project bears fruit.

In Peru, the most apparent consequence of the attempts to eradicate coca has been the relationship between the Shining Path guerillas and coca farmers, which involves both protection and intimidation. This in turn has led to a conflict between police forces, in charge of coca eradication and interdiction, and the army, responsible for counter-insurgency.

Aware of peasant reliance on the Shining Path for the protection of their economic activities, the army tries not to upset those involved in coca cultivation and paste manufacturing so as not to encourage their relations with the insurgents. As a result, the police (supported by agents of the DEA in carrying out spraying trials with herbicides, in addition to eradication and interdiction missions), accuses the army of co-operating with the "narco-traffickers "[46].

In Bolivia, attempts at coca eradication have led to continuous active resistance by peasants. "There is no other crop that is so resistant to drought and pests, yields four crops a year and provides enough income to ensure the livelihood of thousands of farmers," says Prudencio Ticona, a Bolivian coca producer and union activist, dismissing eradication as a precondition for crop substitution [47].

Like most of the 36,000 growers in the Chapare region, Ticona opposes eradication — the chief policy sponsored by the United States — before any real development alternatives are offered. According to government sources, there are another 23,000 coca growers in the Yungas of La Paz, while 2,400 more are producing coca in the area of Yapacaní, in the department of Santa Cruz. However, official estimates of the total number of coca growers in Bolivia are considered to be conservative as they only account for those growers who are plot owners, thus excluding the sharecroppers [48].

Most coca producers in Bolivia are unionized and constitute a powerful political pressure group. Since July 19, 1988, when the government declared coca cultivation illegal in most areas, farmers have staged several demonstrations and other political actions including road blockades, the seizure of government offices responsible for coca policy, and hunger strikes. Many have been successful, resulting in government concessions favoring the interests of the peasants [49].

Development and Participation

On March 1, 1989, after 20 days of a hunger strike by the executive committee of the Confederación Sindical Unica de Trabajadores Campesinos Bolivianos, CSUTCB (Confederation of Bolivian Peasant Workers), an agreement was signed between the Minister of Foreign Relations, Guillermo Bedregal, and Juan de la Cruz Villca, executive secretary of the CSUTCB. The agreement guarantees peasant participation in all stages of the government's Integral Plan for Development and Crop Substitution (known by its Spanish acronym, PIDYS) [50].

Juan Lechin, a labor leader and adviser to the Bolivian coca growers, says that for the peasants, substitution is pointless "unless it means roads, services, and especially markets and fair prices for the new products [51]".

In Peru, the Interethnic Association for the Development of the Peruvian Forest (known by its Spanish acronym, AIDESEP), which groups 18 Indian organizations, has also suggested possible alternatives for sustainable development for the Indian communities living in the rain forests, and for the settlers who are growing coca in the Amazon.

AIDESEP says that if the United States [and other industrialized nations] are truly interested in solving the problem of drugs, they should purchase the coca leaves at prices higher than those offered by the local middlemen. With those resources, argues AIDESEP, Peru would not need to request foreign aid to put a comprehensive development program in place.

AIDESEP argues that the design and implementation of alternative, ecologically sound, and profitable substitution programs involving the

participation of those affected — together with adequate infrastructure, technology, and the provision of basic services for the local population — would progressively replace coca production. But achieving this objective, says AIDESEP, will require consumer countries to reduce the demand for drugs, as a decreasing price for coca is a key to cutting down illegal production [52].

In September 1989, at the United Nations General Assembly, Peruvian Foreign Minister Guillermo Larco-Cox proposed a comprehensive package that would include decriminalization of drugs, giving coca farmers an alternative way of earning a living, funding the transition by buying up the coca crop, and transforming Peru's foreign debt into resources for breaking up the drug market [53].

Independent analysts [54] have said that the financing of comprehensive development for Bolivia and Peru will require an annual expenditure of $3 billion to wean these two countries away from their dependency on coca-dollars. Compared with the social costs of cocaine and the billions that the United States spends on anti-drugs programs, they say, this amount is more than affordable. They point out that mechanisms are needed to ensure that the funds are properly administered, and that one way of doing this is by channelling resources through non-governmental organizations, and having them oversee and manage the transformation process.

Whatever solutions are proposed, chances are that none are likely to succeed unless coca producers can participate in all stages of the process, to ensure that their economic and social needs are met.

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FOOTNOTES

[1] The New York Times, September 6, 1989. [2] The National Narcotics Intelligence Consumers Committee (NNICC) Report 1988, p33. [3] H. Cruz, "The Cocaine Industry." The Wharton Econometrics Forecasting Association-WEFA, Philadelphia, PA, 1989, p9 (Unpublished). [4] The Washington Post, September 3, 1989. [5] Foreign Broadcast Information Service, Latin America Report, Inter-American Affairs, (October 11, 1989), p2. [6] E. Morales, "Political and Economic Implications of Coca Crop Substitution in Peru." Paper presented at the annual meeting of the American Anthropological Association, Washington D.C, (November 17, 1989), p1. [7] For Peru see E. Morales, op.cit., p4. For Bolivia see Ministerio de Asuntos Campesinos y Agropecuarios (MACA), Subsecretaría de Desarrollo Alternativo y Sustitución de Cultivos de Coca (SUBDESAL), Plan Integral de Desarrollo y Sustitución, PIDYS (n.d), p13.[8] Due to the illegality of this activity, it is difficult to find reliable data. Most authors agree that the US data on coca-cocaine production is very conservative. In the cases of Bolivia and Peru, both government and independent data assume not only a higher number of hectares planted in coca than US agencies, but also a higher annual yield per hectare. For Bolivia, official data assume an average annual yield of 2.4 metric tons per hectare (2.47 acres) on some 61,000 hectares (150,670 acres) as opposed to 1.4 metric tons per hectare on some 41,000 hectares (101,270 acres) of the US NNICC Report. See Ministerio de Asuntos Campesinos y Agropecuarios (MACA), Subsecretaría de Desarrollo Alternativo y Sustitución de Cultivos de Coca (SUBDESAL), Programa de Reconversión Agrícola, (1988), pp18 & 32. For Peru, national data assume an average yield of 1.5 metric tons per hectare (2.47 acres) on some 200,000 hectares (494,000 acres). See E. Alvarez, "The Economic and Political Economy of Coca Production in the Andes: Implications for Rural Development for Bolivia and Peru," The Nelson A. Rockefeller School of Government, 1988, p15. See also E. Alvarez, "Rural Poverty and Illegal Coca Economy in Peru." Paper presented at the International Symposium on Money Laundering, Coral Gables, Florida (October 26-28, 1989), p8. [9] MACA, Programa de Reconversión Agrícola, p33. [10] NNICC Report 1988, p39. [11] NNICC Report 1988, Ibid. [12] Both national and US estimates include legal (for traditional consumption) and illegal production of coca leaves (for processing into cocaine). Evidently, not all production goes to cocaine manufacturing for export. Some of it remains in the local markets for traditional uses; another portion goes to the production of coca paste which, mixed with tobacco, is locally marketed under the name of "basuco" in Colombia, "pitillo" in Bolivia, and "kete" in Peru. 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High Political Price Exacted for Any Potential Benefits

■ The current military approach to drug eradication is destabilizing and demeaning to our Latin American friends.

By PETER H. SMITH

For decades, the United States waged the Cold War in Latin America, embracing anti-Communist crusades, giving aid to reformers and undermining leftist leaders through subversion or outright intervention.

With that war fading, there is a growing vacuum at the heart of American policy toward Latin America. Enter the Bush Administration's war on drugs, which is being fought largely in other countries to cut supply at the source.

But as an anti-drug policy, Bush's war skirts a key part of the problem: American demand for drugs.

Consumer taste in drugs is notoriously volatile. During the 1980s, the drug of choice shifted from marijuana and heroin to inhaleable cocaine, then to crack. Now, drug users are discovering "ice," a synthetic.

The United States produces ever larger shares of its own marijuana and "designer drugs," apparently including a synthetic version of cocaine. A flotilla permanently based off the Colombian coast is no antidote to that.

The "drug summit" in Cartagena, Colombia, called by the Andean presidents to discuss aspects of the drug trade, was conspicuous for its absences: Mexico, the Bahamas and the neighbors of the South American participants. What happens if the drug cartels set up shop in Ecuador, Brazil or Belize?

U.S. anti-drug policy, of course, gives priority to domestic law enforcement and border interdiction. Also included are modest efforts, which the President has pledged to enhance, to reduce demand at home. International cooperation is far down on the priority list. Almost as an afterthought, the Cartagena document calls for a "world summit" in 1991. But the thrust of U.S. international anti-drug policy points most directly at Latin America.

And therein lies another problem: Latin American initiatives should flow naturally from a coherent, clearly stated Latin American policy, not from one primarily designed to exploit domestic politics within the United States. Otherwise, the initiatives might backfire.

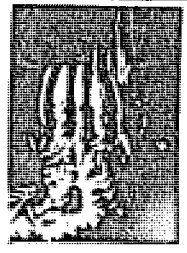
The Panama invasion has revived deep-seated suspicions among Latin Americans about U.S. motives and Washington's appetite for military intervention. Alan Garcia, the president of Peru, came close to boycotting the Cartagena meeting. Vice President Dan Quayle, Bush's choice to soothe ruffled Latin tempers after Panama, was welcomed only in Honduras and Panama, U.S. client states. Growing enthusiasm within the United States for greater use of American armed forces to combat drug traffickers heightens Latin apprehensions. (Bush's anti-drug budget proposal includes $1.2 billion for the Pentagon.)

In the meantime, the Bush Administration wants its Latin counterparts to do the dirty work. The Colombian government's use of its army and national police to wage war on that country's drug lords is an example of what Washington has in mind. Bush has extravagantly praised the action. But Peru and Bolivia, where most of the world's coca is grown, certainly aren't eager to pay the social and economic costs, not to mention lost lives, that Colombia has paid. In any case, Colombia's President Virgilio Barco Vargas did not undertake his anti-drug campaign out of deference to U.S. concerns. Rather, the Medellin cartel was threatening his country's political stability, and he decided to act.

The results have been ambiguous. Since declaring all-out war last August, the government of Virgilio Barco Vargas has cartel leaders plead to negotiate with the government. But narco-trafficking continues unabated. The volume of illicit cocaine exports from Colombia actually increased in 1989, to an estimated 350 to 450 metric tons.

There is an additional risk associated with using the Latin American military to fight drug traffickers: How would the stability of new or fragile democracies be affected? In Peru, for example, army attacks on coca farmers have driven resentful *campesinos* into the ranks of Maoist guerrillas. The lesson holds for other countries: The more intense the war against drug cartels, the more intense the polarization—and the greater the immediate threat to political stability.

The United States is not helpful here. Our economic assistance to Latin America, even as envisioned at Cartagena, is pitiful-



DRUGS: America Looks for the Way Out

■ Fifth in a series

ly small. Current allocations for the Andean countries amount to $260 million in "security assistance," $125 million in economic aid. Urging impoverished peasants to stop cultivating coca leaves—because it is "immoral," as the President said in Cartagena—without offering them an income substitute is unrealistic.

Legalizing or decriminalizing drug use in the United States does not offer easy answers. In theory, it would eliminate a major point of friction in U.S.-Latin American relations, reduce the magnitude of violence connected with drug trafficking and permit Latin American countries to better tailor their domestic policies to national needs. Presumably, the United States could use some of its law-enforcement savings for regional economic assistance. Finally, the legalized export of drugs would provide Latin America with the foreign currency it needs to service its debt and rebuild its economies. For these reasons, the idea of drug legalization should receive more serious attention than it has.

In practice, these potential benefits would come at a high political price. Latin Americans would resent a turnaround in U.S. policy that suggested their anti-drug sacrifices were all in vain, especially since so many were carried out at Washington's behest. Drug legalization in the United States would force Latin American governments to re-examine their own drug laws and policies with an eye toward repealing or radically altering them. To the extent that amnesty for some criminals would be necessary, governmental authority probably would weaken, with grave consequences for stability. As one senior Latin American policy-maker said, legalization of drugs in the United States would be "Kafkaesque."

The inadequacy of the Administration's current approach is underlined by the rise, through mostly free and fair elections, of pragmatic and thoughtful leaders in Latin America. They are friendly toward the United States; they need our understanding and help in dealing with their enormous social and economic challenges. If we want their help in solving our drug problem, we need to redefine our relationship with them. Toward that end, we should drop our shortsighted insistence that they maintain the front line of our drug war.

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The Los Angeles Times, March 16, 1990

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AGENCY FOR INTERNATIONAL DEVELOPMENT
Congressional Presentation--Fiscal Year 1991
Annex 1--Africa

FY 1991 U.S. ECONOMIC AND MILITARY ASSISTANCE - REQUEST

05:52 PM
15-Feb-90

	DA	ESF	PL 480 TITLE I	PL 480 TITLE II	NARC'S	PEACE CORPS	OTHER ECON	IMET	FMF	OTHER MILITARY	TOTAL
AFRICA											
Angola	--	--	--	--	--	--	--	--	--	--	0
Benin	1,000	--	--	1,132	--	1,718	--	100	--	--	3,950
Botswana	7,000	--	--	--	--	4,046	--	375	1,000	--	12,421
Burkina	3,000	--	--	5,574	--	--	--	100	--	--	8,674
Burundi	7,500	--	--	--	--	1,000	--	175	--	--	8,675
Cameroon	20,000	--	--	--	--	3,611	--	275	--	--	23,886
Cape Verde	3,000	--	--	1,989	--	95	--	75	--	--	5,159
Central African Republic	2,000	--	--	--	--	2,700	--	200	250	--	5,150
Chad	6,000	6,000	--	2,315	--	1,619	--	300	2,000	--	18,234
Comoros	700	--	--	--	--	599	--	75	--	--	1,374
Congo	1,000	--	2,000	--	--	--	--	50	--	--	3,050
Cote d'Ivoire	500	--	5,000	--	--	1,041	--	150	--	--	6,691
Djibouti	--	4,000	--	--	--	--	--	175	2,000	--	6,175
Equatorial Guinea	1,000	--	--	--	--	497	--	100	--	--	1,597
Ethiopia	--	--	--	11,456	--	--	--	--	--	--	11,456
Ethiopia (North)	--	--	--	--	--	--	--	--	--	--	0
Gabon	--	--	--	--	--	2,833	--	100	--	--	2,933
Gambia	6,000	--	--	2,792	--	1,269	--	100	--	--	10,161
Ghana	16,000	--	6,000	5,302	--	2,354	--	175	--	--	29,831
Guinea	15,000	--	10,000	500	--	1,378	--	150	--	--	27,028
Guinea-Bissau	4,000	--	--	531	--	1,326	--	100	--	--	5,957
Kenya	26,000	7,000	5,000	2,707	--	3,176	--	1,175	8,000	--	53,058
Lesotho	7,000	--	--	--	--	2,395	--	75	--	--	9,470
Liberia	--	6,000	--	--	--	2,410	--	500	1,000	--	9,910
Madagascar	19,000	--	5,000	2,302	--	--	--	75	500	--	26,877
Malawi	20,000	--	--	--	--	2,524	--	250	2,000	--	24,774
Mali	18,000	--	--	3,034	--	3,982	--	125	--	--	25,141
Mauritania	590	--	--	4,892	--	1,749	--	175	--	--	7,406
Mauritius	1,500	--	--	--	--	--	--	25	--	--	1,525
Mozambique	22,000	--	--	29,784	--	--	--	--	--	--	51,784
Namibia	2,000	5,800	--	--	--	--	--	100	--	--	7,900
Niger	18,000	--	--	--	--	3,456	--	275	1,250	--	22,981
Nigeria	11,000	6,000	--	--	--	--	--	100	--	--	17,100
Rwanda	9,000	--	--	--	--	652	--	100	--	--	9,752
Sao Tome	300	--	--	--	--	388	--	125	--	--	813
Senegal	19,000	5,000	5,000	--	--	2,596	--	525	1,000	--	33,121
Seychelles	--	3,300	--	--	--	285	--	100	--	--	3,685
Sierra Leone	500	--	4,000	906	--	3,366	--	100	--	--	8,872
Somalia	3,000	--	5,000	--	--	--	--	900	--	--	8,900
South Africa	25,000	13,000	--	--	--	--	--	--	--	--	38,000
Sudan	--	--	20,000	2,939	--	--	--	900	--	--	23,839
Swaziland	6,000	--	--	--	--	2,143	--	75	--	--	8,218
Tanzania	14,000	--	--	--	--	2,417	--	100	--	--	16,517
Togo	4,000	--	--	2,576	--	2,442	--	100	--	--	9,118
Uganda	20,000	--	6,000	3,000	--	--	--	175	--	--	29,175
Zaire	33,000	--	16,000	--	--	3,016	--	1,075	3,000	--	56,091
Zambia	5,000	--	5,000	--	--	--	--	--	--	--	10,000
Zimbabwe	5,000	--	--	--	--	--	--	250	--	--	5,250
S Africa Regional/SADCC	50,000	--	--	--	--	--	--	--	--	--	50,000
Africa Regional	72,910	--	--	--	--	--	--	--	4,000	--	76,910
Disaster Reserve	--	--	--	--	--	--	--	--	--	--	0
Env/Global Climate Change Resv	[3,000]	--	--	--	--	--	--	--	--	--	[3,000]
AEPRP	55,000	--	--	--	--	--	--	--	--	--	55,000
Total	560,500	56,100	94,000	83,731	--	63,083	--	10,175	26,000	--	893,589

AFRICA OVERVIEW

Introduction

The Development Fund for Africa (DFA) provides A.I.D. with the opportunity to respond more flexibly and effectively to the needs of the more than 500 million people living in sub-Saharan Africa. The DFA Action Plan was prepared in FY 1989 to map out where we intended to go and to establish milestones for measuring progress. The Action Plan is comprehensive in that it embraces the integration of all development resources (DFA), Economic Support Fund (ESF), P.L. 480 and local currencies) towards achieving a common set of strategic objectives.

The strategy laid out in the Action Plan is consistent with and fully supports overall Agency objectives: broad-based economic growth that is sustainable in economic and environmental terms; the development of human resource capacity; and the formation of pluralistic societies in which communities and individuals as well as national governments are empowered to take action in support of growth and change and in which participation in social and economic decision-making is shared by all.

In implementing the DFA Action Plan, we intend to focus our resources to contribute as effectively as we can to the process of bringing about sustainable, broad-based, and market-oriented economic growth in the spirit of pluralism -- that is, in a way which encourages Africans of all regions and all walks of life to take the initiative in applying their knowledge and talents, realize the benefits, and build nations which are self-reliant both politically and economically.

This overview reflects A.I.D.'s experiences in implementing the DFA for two years and our plans for FYs 1990-91. It opens with a brief look forward to the decade of the 1990s. For the people of sub-Saharan Africa, real social and economic progress by the year 2000 is going to require not only a continued flow of external resources but, perhaps more importantly, a significantly more efficient use of their own resources. This can only be accomplished with sustained efforts by African governments to shift the locus of responsibility and choice closer to the individual through policy and political reforms, to foster the expansion of competitive and profitable enterprises through expanded markets as well as revised policies, and to broaden the development dialogue throughout the private as well as public sector.

Africa in the 1990s

The next decade in sub-Saharan Africa will see the birth of some 270 million children. The increased likelihood that these children will survive will require success in child survival efforts and in assuring family food security. Increasingly effective family planning programs could reduce the net population growth rate from 2.9% to 2% or less.

The number of primary school-age children will increase by over 40%. Less than two-thirds of African children today begin primary school; only one of every 200 children goes beyond secondary school.

During the decade of the 1990s, the work force of Africa will grow overall by some 90 million participants. About half will probably find employment in rural areas, but a growing number of rural youths will migrate to the cities for work. Urban areas are projected to include 45% of the total sub-Saharan African population by the year 2000.

All this means that African economies, like Alice in Through the Looking Glass, must run very fast in order to stay in place. Simply maintaining current enrollment rates for primary and secondary education in Africa in the face of rapid population growth will require budgets to double by the end of the decade to $9 billion per year (in current dollars). Providing the basic course of immunization to all the children born in the decade will require $2.5 billion.

Assuming that foodgrain production in the region grows at the historical rate of less than 2% per year, foodgrain imports will have to increase to maintain current levels of consumption — from the current level of 8 - 10 million metric tons per year to 12 or 14 million tons per year by the year 2000. Assuming that grain prices remain at current levels, procurement of minimum amounts of foodgrain on the international market would mean an average bill of nearly $4 billion (current dollars).

A continuation of the Gross Domestic Product (GDP) trends of the 1980s will not generate the resources required. To keep ahead of population growth means that GDP should increase at more than 3% per year; to improve Africans' social and economic prospects calls for a rate of 4% or 5%.

Is this feasible? It might be — if resources are used more efficiently than they have been in the 1980s. This will require higher returns on investment and broader tapping of the energy and productivity of the African people.

As one means to assist African governments to manage financial resources, A.I.D. will be negotiating forgiveness of economic assistance loans -- both Development Assistance (DA) and Economic Support Fund (ESF) loans — for countries that have recognized reform programs (an International Monetary Fund (IMF) stand-by, structural adjustment facility (SAF), enhanced structural adjustment facility (ESAF) arrangement, or a World Bank adjustment program). Already 13 sub-Saharan states (Benin, Cameroon, Cote d'Ivoire, Ghana, Guinea, Kenya, Madagascar, Malawi, Mali, Niger, Nigeria, Uganda and Zaire) have been declared eligible for debt relief. This relief will total $745 million including principal outstanding and life of loan interest. Other countries which are expected to qualify for debt relief, such as Uganda and Tanzania, could bring total forgiveness of economic assistance loans approaching one billion dollars by the early 1990s.

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Various factors will affect African development in the 1990s:

- African politics are fluid, and many countries could suffer from instability in the next decade.

- The global terms of trade for Africa's traditional exports do not appear to be improving.

- Increased integration of the European Community (EC) in 1992 raises new issues for Africa. Changes in Eastern Europe may also have a large impact. Eastern Europe may provide a more attractive and accessible market than Africa. The need for capital in Eastern Europe may result in fewer resources for Africa.

- On the other hand, it is possible that more resources will be available from Asian donors.
- Growing global awareness of problems of the environment is beginning to affect donor priorities in sub-Saharan Africa. However, at this point, increased environmental awareness in Africa itself remains more a goal than a reality.

The FY 1991 Request

For FY 1991, A.I.D. is requesting $560.5 million for the Development Fund for Africa (DFA), including $50 million for the Southern Africa Regional Program that supports the efforts of the Southern Africa Development Coordination Conference (SADCC). In addition, $56.1 million in Economic Support Funds (ESF) are requested to support U.S. strategic and political interests in a limited number of countries. To the greatest extent possible, ESF resources are utilized to complement and support DFA and P.L. 480 programs. The Administration also requests $177.7 million in P.L. 480 resources, which will be programmed in close coordination with DFA funds to support our programmatic objectives.

The proposed assistance will benefit over 40 countries in Africa -- promoting broad-based economic growth, the development of human resource capacity, and greater participation of individuals and communities in the choices being made by the society. Within this FY 1991 request, 54% of bilateral DFA will be targetted to 10 major high-performing countries. Eighty percent of bilateral DFA will go to 20 high-performing countries. The African Economic Policy Reform Program (AEPRP), a performance-based fund which supports critical reforms in a small number of countries each year, will be continued in FY 1991 at a level of $55 million. The FY 1991 request to sustain support for efforts in South Africa which will strengthen multiracial resistance to apartheid, build black bargaining power, and help blacks to prepare themselves for leadership in a post-apartheid, nonracial democracy is $38 million. This will be complemented by the $50 million requested for the Southern Africa Regional Program.

Through the Southern Africa Regional Program, A.I.D. will continue to support SADCC's comprehensive program of economic assistance for the nine majority-ruled countries of southern Africa (Botswana, Lesotho,

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Swaziland, Zimbabwe, Mozambique, Tanzania, Malawi, Angola, and Zambia). The goals of this assistance are to coordinate regional development and reduce economic dependence on South Africa. With a population of over 70 million people, these nations are an important region in themselves -- whose importance will expand further as Namibia achieves independence in 1990.

Through its FY 1991 program, A.I.D. continues to place high priority on activities in the areas of health, child survival and family planning, through the DFA itself and in conjunction with other, centrally funded projects. With rapidly growing recognition of the importance of closer attention to the improved management and conservation of Africa's natural resources, A.I.D. also intends to emphasize activities to preserve and improve the African environment. Finally, the FY 1991 program will include the start of at least two new basic education activities (additional to the four planned for initiation in FY 1989 and FY 1990).

A.I.D. will continue to seek ways to improve its collaboration, individually and collectively, with U.S. and indigenous private, nongovernmental and voluntary organizations as key partners in African development. These organizations offer a major vehicle for insuring broad participation in program planning and implementation at the local level. They are vital adjuncts in the effort to decentralize decision-making -- and hence developmental benefits -- at the grass roots and to assure that decision making is a participatory process. A.I.D. also will continue to fund activities in Africa through its central programs.

Results of U.S. Assistance to Sub-Saharan Africa under the DFA

As the DFA Action Plan states, "We are making a major effort to concentrate our programs on countries with the most growth potential, and to take a broad, systemic look at the problems in individual countries". The FY 1991 budget request reflects this emphasis: A.I.D. has increasingly concentrated its resources on a smaller group of countries selected on the basis of their economic performance and potential for growth, as well as their need.

Budgetary concentration in 20 priority countries -- Senegal, Mali, the Gambia, Guinea, Guinea-Bissau, Ghana, Niger, Cameroon, Zaire, Rwanda, Burundi, Kenya, Uganda, Tanzania, Malawi, Mozambique, Botswana, Lesotho, Swaziland, and Madagascar -- has been accompanied by more focused and targeted programs within each country.

The DFA Action Plan provides directions for country programming by articulating four strategic objectives toward which A.I.D.'s efforts in Africa are to be directed:

- Improving the management of African economies by redefining and reducing the role of the public sector and increasing its efficiency;

- Strengthening competitive markets to provide a healthy environment for private sector-led growth;

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— Developing the potential for long-term increases in productivity; and

— Improving food security.

Improved country program monitoring and evaluation systems are essential both to keep programs on track and to report on progress made. The remainder of this report cites country program results that illustrate progress to date towards accomplishing A.I.D.'s objectives. These objectives are being accomplished through the integration of the full array of available resources, i.e., DFA, ESF, P.L. 480 and local currencies.

Strategic Objective One: Improved Economic Management

Since 1987, 16 of the 20 DFA priority countries have made significant progress in improving their economic management through sustained implementation of structural adjustment programs. In June 1989, the Government of Cameroon joined this group by putting into place a long-term economic restructuring program.

Macroeconomic Stability

Nearly half of the DFA priority countries (Ghana, Mali, Zaire, Burundi, Uganda, Tanzania, Mozambique, and The Gambia) made substantial progress in FY 1989 in ensuring that their fiscal, monetary, and sectoral policies are flexible enough to adjust to changing economic conditions. Donor support has been important in: (1) providing levels of financial assistance large enough to make a difference to the economy (including critical debt rescheduling and debt forgiveness); (2) conditioning this assistance to support restructuring objectives; and (3) furnishing the technical support needed to design and monitor the reforms.

** The ***Gambian*** Economic Reform Program, for example, received support from A.I.D. as well as other donors in all three areas: financial assistance, conditionality, and technical support. A.I.D.'s technical support, provided by the Harvard Institute of International Development (HIID), played a small, but crucial, role in a reform process now widely recognized to have resulted in increased per capita incomes, particularly in the rural areas (where the poorest Gambians live), increased agricultural output, and expanded trade.

As the process in The Gambia has been similar to that played out elsewhere, it may be useful to elaborate what happened.

> In mid-1985, the Government of The Gambia had come to the end of its rope: net foreign assets were negative, a parallel foreign exchange market had emerged in 1983; an attempt to raise farmgate peanut prices in 1982 bankrupted the public marketing agency when world prices fell; large food imports needed to cover the shortfalls of the 1983/84 harvest put further pressure on limited financial resources; and in mid-1984, the Government was unable to pay

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arrears to the International Monetary Fund (IMF) on a stand-by arrangement. The economic situation had deteriorated to the point that the IMF had initiated steps to have The Gambia declared ineligible for further borrowing.

When it became evident that other donors had no intention of rescuing The Gambia without the Government changing its economic policies, the Government acted. The Minister of Finance brought together a task force of senior officials and two expatriate advisors — an A.I.D.-funded HIID advisor to the Ministry of Finance and a World Bank economist. In a short time, the task force forged the design of the Economic Recovery Program: exchange rate reform, promotion of agriculture and other productive sectors; civil service and parastatal reform; monetary and fiscal policy reforms; and the reorientation of the Public Investment Program. This program was fully endorsed by The Gambia's President.

Stabilization of the foreign exchange market was the first order of business — and a key indicator to donors of the Government's commitment to reform. Arrears to the IMF were the next hurdle to be overcome. After that, donor resources flowed generously in support of the program, providing over 60% of GDP in 1986/87, 30% in 1987/88, and almost 40% in 1988/89.

The Gambia Economic Recovery Program benefited from good initial design, able political leadership, relatively favorable production and trade conditions, and outside assistance in implementation. For example, an A.I.D.-supported study on customs duty reforms in March 1989 led to a reorganization of the Customs and Excise Department which contributed to a 20% increase in customs revenues.

As a result of the economic management policies now in place, The Gambia has made considerable progress in reducing internal and external imbalances and strengthening its growth potential for the 1990s. Annual GDP growth was estimated at 4.6% for the 1988/89 period. Key reforms have been implemented, including liberalization of the trade system, reform of the exchange system, the introduction of flexibility in interest rates, the promotion of private sector activity through the provision of appropriate price and other incentives, and greater efficiency in public sector operations. These reforms have led to increases in agricultural production (in spite of adverse weather conditions and locust infestation), a decline in the rate of inflation, an improvement in The Gambia's external position (including a reduction in external payments arrears which will enable it to more easily service its debt), a significant decline in the budget deficit, and stabilization of the foreign exchange market.

Reducing Public Sector Involvement

At least six of the 20 DFA priority countries have made strides in reducing public sector involvement in areas better suited to private investment and risk-taking. A few examples demonstrate the variety of approaches taken and the breadth of problems addressed.

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** In ***Cameroon***, financial gains to the Government and to farmers resulted from A.I.D.'s support for liberalization of fertilizer import and distribution and provided a welcome spot of relief in 1988/89 for the country's stressed economy. Government outlays for fertilizer subsidies were reduced by $12.3 million. Even with this reduction in public subsidies, the cost of fertilizer to the farmers was 18% lower than the year before. Increased efficiency from private sector involvement in procurement and distribution accounted for this gain.

** Overall economic management in ***Malawi*** was significantly affected by two major FY 1989 actions supported by A.I.D.: the restructuring of ADMARC, the major public corporation engaged in the agricultural sector, and development of the private Malawian trucking industry. ADMARC divested itself of several agricultural estates and part of its interest in the National Seed Company. According to an evaluation team, these steps "visibly improved ADMARC's liquidity and management efficiency." Thanks to transport reforms, cargo imports into Malawi in Malawian-owned trucks increased by 10 percentage points between 1987 and 1988.

Public Service Delivery

Continued emphasis on efficient and equitable public service delivery is important under the DFA. It is clear that the needs in Africa for these services are enormous -- and that African governments feel a responsibility for providing them. Governments continue to play a lead role even as they attempt to tap the energies and resources of the private sector.

The case of ***Mozambique*** illustrates in concrete terms the close relationship between policy reform initiatives taken by the Government and the ability of needy people to access essential services.

** Ravaged by rural insurgency, drought, and years of economic mismanagement, Mozambique's economy had progressively deteriorated. By 1988, imports outstripped foreign exchange earnings by a factor of 4.5 to 1. Over 5.5 million people -- nearly 40% of the population -- are thought to be displaced, severely affected by war, or in refugee status. The human infrastructure has been stretched beyond its capacity to cope with the crisis.

However, since 1987 Mozambique has faithfully adhered to a tough Economic Recovery Program (ERP) for rehabilitation and structural adjustment. The exchange rate has been devalued by over 95% and is adjusted regularly to maintain a constant real value. The government has cut the number of products subject to administrative allocation from 43 at the start of the ERP to 15. Agriculture farmgate prices have been increased to levels approaching border parity. Progress has been made in promoting private agricultural production through pricing and marketing reforms while providing a safety net of food assistance to help poor consumers meet basic nutritional requirements. These measures have helped reverse

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negative growth rates and achieve 4% gains in GDP in 1987 and 1988, with a projected growth rate of 4% in 1989.

Several innovative steps have been taken with private and voluntary organization (PVO) partners to minimize the costs of food delivery to needy people while reinforcing local markets and producer incentives. With World Vision, for example, A.I.D. arranged for emergency commodities to be transferred to a sales program in a port town in exchange for the delivery of an equal quantity of maize produced in an area much closer to the end-recipients. In addition, P.L. 480 Title II section 206 commodities are used to work with the Government to better target commodities. Yellow corn provided through P.L. 480, which is less preferred, is sold at a lower price on the market to low-income people, while white corn, grown locally, is sold commercially at market rates to those who can afford it. In essence, this provides a nutritional safety net for low-income groups and provides them protection from the structural adjustment changes taking place in Mozambique.

Family Planning/Child Survival

Progress in family planning lays the groundwork for gains elsewhere. A.I.D. is assisting family planning efforts in virtually all A.I.D.-assisted countries in Africa. Gains in child survival are often seen as a prerequisite to increased acceptance of family planning. A.I.D. supports child survival efforts in 17 of the 20 DFA priority countries as well as in nine other countries.

** In 1988/89, for the first time ever, four African countries recorded declines in fertility rates. These figures in ***Botswana, Kenya, Swaziland, and Zimbabwe*** provide evidence that a public commitment to providing family planning information and services can yield results. In Botswana, the downturn in fertility rates offers hope for eventual control of that country's unemployment problem and improvements in the quality of life of the average citizen.

However, success in aggregate terms does not mean that all problems have been solved.

** Overall progress in reducing infant mortality in ***Kenya*** over the last several years has been impressive. However, an A.I.D.-financed Demographic and Health Survey showed that difficulties persist in specific regions of the country. An in-depth study of childhood mortality undertaken in July-August 1989 expanded the analytical basis for further program decisions on child survival. As a result, Mission attention has shifted somewhat to the health care financing side of the picture and to greater involvement of PVOs and nongovernmental organizations (NGO) in community-based services for both child survival and family planning.

** Recent data on child survival confirms that many factors contribute to infant mortality. There is not a direct relationship between infant mortality rates and traditional forms of interventions such as oral rehydration therapy (ORT) and immunizations. ***Malawi***, for

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example, has done well in immunizations and ORT use, but has suffered continued high infant mortality. This may be because of other problems, such as acute respiratory disease and drug resistant malaria. A.I.D. will be examining such issues in the future.

Education

Educational services absorb a large amount of public resources. Approximately 13% to 20% of government budgets are allocated to education -- compared to only 5% to 6% for health and family planning together.

A.I.D.'s involvement in primary education, until 1989, has been limited to small programs in Lesotho, Swaziland, Botswana, and Liberia and to slightly larger programs in Zimbabwe and Cameroon. As our involvement in this sector grows, it will be important to take a hard look at the lessons of experience to date.

** In ***Zimbabwe***, the major Basic Education and Skills Training project ended in 1989. The project initiated a new Bachelor of Arts in technology, supported development of an education policy research center, and upgraded curricula. It also established a computerized management system in the Ministry of Education that has improved the quality and management of education. However, the impact of the project on post-secondary technical and vocational education has been disappointing due to pay for teachers. Initiatives are now under way to improve the remuneration packages of trained staff and to stem their loss to jobs elsewhere.

Transport

A.I.D. is providing resources to improve the delivery of transportation services in six of the 20 DFA priority countries (Ghana, Guinea, Mali, Swaziland, Tanzania, and Zaire), in the southern Africa region as a whole, and in six non-priority countries.

** Landlocked ***Chad*** covers an area twice the size of Texas and has only 17 miles of paved road. Road maintenance supported by A.I.D. is critical to keeping transport (and commodity) costs low enough to allow Chadian producers to compete on international markets and to enable Chadian consumers to purchase what they need.

** By the end of 1989, A.I.D. had provided over $130 million to improve capacity and efficiency in the ***southern Africa region***'s rail and road networks. While improvements to the network continue, the following measurable improvements have resulted to date: (1) in Zambia, eight locomotives which carry cargo to ports in Tanzania and Mozambique have been rehabilitated and a computerized inventory system is being installed; (2) the Kafue-Chirundu roadway which links Zambia to Zimbabwe has been rehabilitated; (3) along the Beira rail corridor in Mozambique, 141 kilometers of track, 12 steam locomotives, and 2 diesel locomotives have been rehabilitated, and maintenance facilities and staff capabilities have been ungraded; (4) along Malawi's Northern Corridor, three ports have been

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constructed on Lake Malawi to facilitate Malawi's use of the Dar es Salaam Port in Tanzania, and reduce the use of scarce foreign exchange to meet Malawi's high unit costs of transportation; and (5) new operational and management systems are being installed in the SADCC regional transportation coordination unit to improve the flow of rail traffic throughout the region.

Lessons Learned in Improving Economic Management

Among the many lessons learned from A.I.D.'s involvement in efforts to improve economic management in sub-Saharan Africa, four stand out:

— Economic policy reform is an essential and dominant item on the development agenda in sub-Saharan Africa and will remain so in the 1990s.

— Functioning financial markets are critical to shifting economic responsibilities from the public to the private sector;

— The shape and pace of domestic economic reform in Africa is affected by international economic conditions.

— The political feasibility of reform is strongly related to "who loses" from reforms. Political leadership makes a significant difference in determining the success or failure of reform efforts.

Strategic Objective Two: Competitive Markets and a Healthy Environment for Private Sector Growth

Over the last two years, all 20 DFA priority countries received support from A.I.D. in the area of marketing and development of private sector enterprises in commerce and trade.

Since independence, many countries in Africa have relied on a high level of government interference in the market, partly in an attempt to attain a more equitable distribution of wealth. African leaders in these countries now realize that they have overextended the role of the public sector and restricted the operation of the private sector. The result has been slow economic growth, rising debt burdens, and less, rather than more, equitable markets. Sustaining equity-oriented services is difficult when growth, and therefore revenues, are stagnant. Where markets have been freed up and prices have been allowed to move, the experience has been very positive — with consumers benefiting from lower commodity prices, producers gaining from lower transaction costs on their inputs, and private traders profiting from the expanded volumes of trade and lowered costs of doing business legally.

** In ***Mozambique***, A.I.D.'s commodity import program (CIP) supports the economic recovery process and has demonstrated the potential for private sector-oriented market growth within prevailing constraints. Private importers and distributors of agricultural and transportation equipment now manage 95% of the program. The World

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Bank and the Government have been encouraged by this success to initiate an experimental "non-administrative foreign exchange allocation system" for selected private imports. The direct effects of the CIP program on markets in the capital city of Maputo are also visible as local agricultural production has expanded to meet demand.

** ***Uganda*** offers another example. In this country, soap -- formerly manufactured only by parastatal firms -- is now being manufactured and distributed privately as well. The soap is being sold below the official ceiling price and is plentiful. P.L. 480 assistance in the form of tallow and self-help measures in the Title I agreement helped foster this change.

** ***Botswana***'s experiences with employment generation in the private sector show the difficulties faced by small, resource-constrained countries. Although Botswana's GDP growth performance has been stellar -- topping 10% per year between 1980 and 1986 -- unemployment is currently 25% in urban areas and major villages. Although 20,000 people enter the labor market each year, the formal sector is providing only 7,000 to 8,000 new job opportunities. Diversification of productive enterprises into other market areas -- beyond the diamond mining which has financed growth to date -- is felt to be essential to the stability of the economy over the long term. Yet current shortages of skilled labor and entrepreneurial talent constrain the diversification of investments into new areas as well as the quality of public administration.

A dialogue -- with both the Government and various private sector organizations -- on policies for increasing private sector investment thus has been central to the A.I.D. program. It has been complemented by advisory services (provided by the International Executive Service Corps), studies, and specialized training in financial management and business planning. For example, an A.I.D.-supported Overseas Private Investment Corporation (OPIC) study resulted in negotiations with potential American investors, including a leather furniture manufacturer that could potentially employ 2,000 to 3,000 Batswana.

Lessons Learned about Competitive Markets

Three findings based on past program experience are being integrated into A.I.D.'s approach to market reform and development:

- Private entry into markets vacated by the public sector is not automatic, but must be fostered.

- Markets are interlinked. Reforms in one market engender or require reforms in other markets to be sustained.

- A healthy financial market and private financial institutions are critical for economic development and must be promoted.

A.I.D. and African country experience indicates that the movement toward free competitive markets is necessary to generate self-sustaining

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development and growth. To further assist private sector development, A.I.D. plans to emphasize financial market development by promoting the design of new commodity and stock markets and the liberalization of central bank regulations and improved banking practices.

Strategic Objective Three: Developing the Potential for Long-Term Increases in Productivity

The Environment

Activities to improve the management of Africa's natural resource base are currently under way and will be continued in all 20 DFA priority countries.

The impacts of efforts directed to the sustainable use of natural resources, by their nature, are realized gradually over extended periods of time. However, a recent assessment of three different resource conservation activities in ***Rwanda*** illustrates the relationships among the protection and preservation of biodiversity, sustainable agricultural production, and increased incomes.

** The Volcanoes National Park is the most famous of the three activities as it was the site represented in the movie Gorillas in the Mist. Over the past 10 years, tourism in Rwanda has increased dramatically to become the country's second largest source of foreign currency. A.I.D. assistance has trained local teachers and park guides. This has permitted the expansion of conservation education programs so that both tourists and local residents can learn about the unique resources in the Volcanoes National Park. Conservation education in local schools and in the community helps people to understand the importance of the forest as a watershed and the gorillas as a unique asset. The Government is now creating a network of parks and forest reserves to encourage tourists to spend more time and money in Rwanda.

The Nyungwe Forest is a new reserve being developed with A.I.D. support. One of the richest forests in Africa, it has 10 kinds of primates and 270 bird species. The plan is to retain the natural environment in a large core area and to allow limited access to a buffer zone for logging and other low-intensity uses.

Community agroforesty in Rwanda demonstrates a third approach to natural resource management. The Cooperative for American Relief Everywhere (CARE), with A.I.D. backing, responded to a government request to address fuelwood needs of both Ugandan refugees and permanent residents. The results of the project are visible everywhere. Trees dot the hillsides, line agricultural plots, and grow in gardens. In three years, three million seedlings were produced, sold, and planted. Today, 40% of the area farmers are using agroforestry practices for erosion control, 6,000 hectares of degraded hillsides have been reforested, and 1,500 nurseries have been established elsewhere in the country to replicate the experience.

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Agricultural Research

A.I.D.'s bilateral assistance to agricultural technology development in Africa is complemented by assistance provided through the International Agricultural Research Centers (IARCs) and the Strengthening African Agricultural Research/Faculties of Agriculture (SAARFA) project, a major regional agricultural research support program. Assistance programs in most of the DFA priority countries include an agricultural research or agricultural extension activity. Research programs in Uganda, Cameroon, Mali, and Niger are the largest and receive the majority of the funding.

** Rinderpest currently affects millions of cattle in Africa -- cattle normally herded far away from any source of electricity and cold chain facilities. In ***Niger***, field tests of a vero-cell adapted rinderpest vaccine (developed by Plum Island Disease Control Center in Florida and the Integrated Livestock project staff) showed remarkable stability of the vaccine after 30 days storage at the high ambient temperatures common in Niger. Heat-induced deterioration problems thus may be close to solution.

** A.I.D.'s assistance to the ***Malian*** national crop research system was the subject of a recent evaluation. The analysis found that research supported by A.I.D. and other donors had contributed to a number of farming and cropping innovations: (1) intercropping of maize and millet in rotation with cotton; (2) use of new rice and cotton varieties; (3) rapid adoption of high-yielding cowpea varieties; and (4) replacement of chemical fertilizer with locally produced rock phosphate and manure. The study estimated that the research had benefited approximately 150,000 hectares of farmland in recent years and that value added each year at the farm level was in excess of $8 million. In 1990, Mali will have a 600,000 metric ton surplus of sorghum and millet, the largest surplus ever.

Training to Improve Job Productivity

A.I.D. support for skills training covers four areas. Individual training is programmed by A.I.D. Missions in all 20 DFA priority countries and in 14 other African countries. Agricultural education is supported in Cameroon, Kenya, Lesotho, Swaziland, Uganda, and Zaire. Faculty development and other programs which strengthen university training capacity are an important focus in Botswana. Private enterprise-related training is sponsored in all countries; Botswana, Madagascar, Senegal, and Swaziland have the largest programs.

Two examples from the field are the following:

** In ***Swaziland***, an innovative program addresses job-related training needs at a number of levels. In-country training for traditional leaders is developing linkages between traditional and modern sectors. Ohio University is completing a long-term teacher training effort, which has improved the quality and quantity of trained staff in the primary education system. With A.I.D. assistance, the Swaziland Institute of Accountants is establishing basic standards for the accounting profession and offering skill-building seminars through local institutions. The in-country component has been so

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popular that it will meet project output targets in 1989, two years ahead of the scheduled completion date.

** Although nonwhites make up over 80% of the population of ***South Africa***, the percentage of nonwhites in professional jobs in that country is extraordinarily low. Since 1982, A.I.D. has supported U.S. training for almost 1,300 students from South Africa. There is evidence that, while some of those returning to South Africa have problems readjusting upon their return, the more mature and experienced graduates are moving into positions of leadership and influence in their professions.

Lessons Learned in Developing the Potential for Long-Term Productivity Gains

Evaluations of both SAARFA, the regional project which supports multicountry agricultural research efforts across the continent, and the Applied Research and Extension project in Zaire highlight an important finding concerning the linkage of natural resource management and agricultural research: the impact of good commodity research is likely to be constrained in Africa until more progress is made on adapting research objectives to Africa's natural resource endowment and policy environment.

A second observation emerging from the SAARFA evaluation also is worth noting: networking among African researchers, a strategy initiated by A.I.D. over five years ago, is beginning to lead to real benefits — speedier development and transferral of technologies, more efficient use of scarce research resources, and relevant professional training for African researchers.

For FYs 1990-91, A.I.D. programs in all 20 DFA priority countries are expected to actively support agricultural research, technology development, and skills training for a wide range of Africans. Sixteen of the 20 will focus on improving natural resource management. In addition, design of a debt-for-nature swap in Ghana has just begun.

Strategic Objective Four: Improved Food Security

Improving the Stability of Food Supplies

A.I.D.'s principal resource for making a direct, short-term impact on food security in Africa is food aid. In FYs 1988-89, about three million metric tons in food commodities were provided to 37 countries in sub-Saharan Africa for free distribution or for sale through normal market mechanisms. These food commodities are valued at $620 million.

The impact of such support can best be understood if the tonnages are translated into daily per capita consumption figures. By this measure, approximately 803 million person-days of food were provided during these two years. However, this amounted to only 0.2% of the estimated person-days of consumption.

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Clearly, improved food security in Africa has to go beyond supplying food aid to supplement commercial markets and funding externally managed feeding programs to meet crises. Local production of foodgrains overwhelms imports as a source of supply. Only increased incomes will foster greater access to, and more regular participation in, food markets (and ultimately result in larger and more stable markets).

Given present data availability, production and import figures (rather than consumption or nutrition indicators) must serve as the basis for assessing impact. Data from 1981-87 indicate that, as per capita food production has declined, foodgrain imports per capita also have declined. This implies that markets in Africa have contracted and that total supplies from internal and external sources have probably not kept pace with food needs.

On the whole, food aid figures indicate more compensatory behavior than cereal import figures: food aid imports rose on a per capita basis as production per capita fell. This finding indicates that there is an income constraint either at the national or household level, which depresses the effective demand for grain below the level of need. Without food aid, countries in sub-Saharan Africa might have had to shrink foodgrain imports even further.

Famine Preparedness

FY 1988 and FY 1989 saw relatively good agricultural conditions in most drought and famine-prone countries in Africa.

** In ***Ethiopia*** early warning systems led to early identification of severe production shortfalls in 1989 and facilitated the early mobilization of food aid to prevent mass starvation.

** In war-torn ***Mozambique***, too, food aid is an important protection against famine, but management of the food resource has been uneven. Disaster preparedness has been addressed through dialogue with the Government of Mozambique, and A.I.D. has succeeded in convincing the Government to encourage nongovernmental organizations to play an expanded role in providing disaster relief. A.I.D. will support this decision by continuing to provide grants to NGOs.

Meeting the Needs of People at Nutritional Risk

The task of identifying people at risk of food deprivation and devising cost-effective approaches for assisting them is demanding and difficult. Community-level involvement of private, nongovernmental organizations is essential when the risks are both climatic and economic and when relatively small groups of people with transitory needs are involved (e.g., farmers whose fields are flooded, children under five).

The job of providing food to people at nutritional risk is much less manageable when as much as half of the population is at risk, when that risk is chronic, and when many causes contribute to it.

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** In ***Mali***, for example, half of the urban population surveyed in 1985/86 consumed less than the recommended level of calories and protein. A rural survey also found that almost half the farm households in the most highly productive agricultural areas of Mali were net buyers of foodgrains and that their consumption levels were also low. These consumption shortages occurred in spite of the fact that overall food production in Mali was up (resulting in a large surplus this year, as noted above). Clearly the food problem in Mali is not only a matter of overall food production, but of inadequate incomes to purchase food by at-risk households. A lasting solution to this problem cannot be found just by providing targeted food aid to at-risk groups. The root cause of the problem has to be addressed through broader policies to raise incomes, such as efforts to increase non-agricultural employment opportunities. The DFA gives A.I.D. the flexibility to examine food security issues in this broader context.

Increased Agricultural Production and Utilization

Rather than targeting consumers to whom special access to food supplies is to be assured, it is possible to target farmers to either (i) produce the foods needed in the national market or (ii) produce the foods which will at least help to assure food security for the producing household. In either case, it is essential first to identify those farmers currently producing below their potential levels and second to provide them the special help they need -- inputs, extension services, marketing support, etc. This approach improves farm households' incomes or consumption and increases national food supply. It is often less successful in ensuring that the food security needs of the non-producing households are met (especially when lack of purchasing power constrains effective access to market food). It is also often not sustainable; only as long as the project mobilizes special resources can the assistance continue.

** The poor condition of the transport network in ***Zaire*** has led to several area-specific agricultural production and processing projects. The Bandundu and Shaba projects (serving a total population of 1.5 million Zairiens) focus on increasing regional maize production and marketing through free markets and improved roads, improving the efficiency of cassava processing, and, perhaps most importantly, developing the capacity of nongovernmental organizations to provide leadership and extension services on a sustained basis.

Focusing on food processing is another way of addressing this food security issue and links closely with other initiatives to increase agribusiness, nonfarm employment and incomes, and overall market efficiency.

** In ***The Gambia***, for example, a project being implemented by Catholic Relief Services (CRS) involves 30,000 farmers, 8,000 hectares in sesame production, and experimentation with sesame processing. This has helped to diversify the agricultural economy, making farmers less dependent on peanuts (currently facing falling prices in world markets). It also helped increase the variety of

foods available for consumption. While still a pilot effort, the project so far has encouraged enough production to necessitate serious exploration of the market potential for sesame seeds, oil, and paste in both domestic and export markets.

Lessons Learned about Improving Food Security

To provide food assistance effectively and efficiently means programming food aid with full awareness of its impact on market development and production incentives as well as on the nutritional status of those who receive it. How food aid is distributed can have a major impact on private sector development and reducing the role of the public sector.

Perhaps the principal lesson from A.I.D.'s recent experience in addressing food security is the close link between peoples' access to food and their full participation in the economy. Access means more than market places scattered around the country and food supplies in the market. It means people having the wherewithal to purchase the needed supplies -- and that in turn means one must have fair and competitive markets for one's labor as well as the products of one's enterprise. There is growing evidence that African leaders are allowing their citizens greater and more meaningful roles in the economy -- letting them express their desires and needs through market mechanisms, encouraging them to make fundamental choices as to how and where they want to live, and fostering the idea of private economic activity. Without such participation, it is difficult to envision a future of food security for the region.

In order to improve food security in Africa in FYs 1990-91, A.I.D.'s focus will be on: (1) expanding the impact which humanitarian (or project) food aid can have on food security; (2) extending the impact of program food aid through better integration into the overall assistance program and the use of multi-year grant programming under the Food for Progress legislation; and (3) exploring how the needs of particular at-risk groups can be met most efficiently. In addition to food assistance, A.I.D. will also provide support for agricultural production and processing efforts in 15 of the 20 DFA priority countries.

Because of progress made in raising agricultural production, U.S. food assistance for sub-Saharan Africa is not programmed to increase over the next two years. This progress, in turn, has been due at least in part to changes in economic policies, improvements in marketing, and progress in agricultural research -- broader changes that A.I.D. has been able to support because of the flexibility of the DFA. The ability to transcend narrow program categories and look at the root cause of problems in this way is one of the benefits of the DFA.

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Debt Relief Plays Key Role in Helping Sub-Saharan Africa

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Overview

By almost any measure, sub-Saharan Africa is the world's poorest region. Average per capita income in the region's 45 countries is less than $300 (excluding South Africa). Life expectancy, employment, and access to education and medical care all are much lower than other regions of the world. Africa's development problems are compounded by frequent drought, political instability and civil war, and a 3.3% population growth rate well in excess of economic growth.

Added to these problems is sub-Saharan Africa's heavy burden of foreign debt, which reached about $143 billion at the end of 1989. This is equivalent to 115% of sub-Saharan Africa's gross domestic product (GDP) and 369% of foreign exchange earnings from exports.

Most of the debt is owed to official creditors (i.e., foreign governments and international financial institutions such as the International Monetary Fund (IMF) and the World Bank). Annual scheduled debt repayments in 1989 were about $18 billion, or about 46% of the region's total earnings of foreign exchange. Rescheduling and other measures lower this ratio to about 28%. The need to service its foreign debt strains sub-Saharan Africa's foreign exchange resources and restricts imports of goods needed to support investment in economic growth.

President Bush addressed this problem with a major U.S. initiative to help sub-Saharan Africa meet its economic challenges. The President's plan, announced last July, excused African countries from repaying U.S. development assistance loans, provided they institute economic reforms. This policy encourages African countries to take the necessary steps to improve their economies. The Bush Administration recognizes the need to reduce the debt-service burden of beneficiary countries and foster long-term economic growth.

A key part of U.S. policy in sub-Saharan Africa is debt relief for countries that institute economic reform. In December 1989, the U.S. Ambassador to Ghana, Raymond Ewing (left), signed an agreement in which the United States canceled $114 million in debt owed by Ghana in exchange for economic reform. Kwesi Botchwey, Secretary of Finance and Economic Planning, signed for Ghana as Eleanor Quist, acting chief director of the ministry, observed. (U.S. Department of State photo)

Major U.S. development assistance goals in Africa are better management of economies, stronger competitive markets, higher private sector-led growth, increased long-term agricultural and industrial productivity, and improved food security. To encourage these changes, the United States provides about $1.5 billion annually in bilateral and multilateral aid to sub-Saharan Africa.

Increased trade and private investment are vital to sub-Saharan Africa's economic recovery. The United States is the largest single market for African products, providing a major source of foreign exchange needed to tackle the region's financial problems. Faster growth in Africa will lead to a larger market for U.S. exports. The United States also promotes private investment in Africa.

New U.S. Debt Plan

On July 6, 1989, President Bush announced that the U.S. Government would forgive sub-Saharan African debts resulting from certain loans from the United States. The program, which began in November 1989, is being implemented through bilateral agreements with each individual beneficiary country.

Debt forgiveness covers all outstanding eligible development assistance debt of a country. In most cases the debt will be forgiven over the course of 3 years or less. Each part of debt relief will be contingent on the country's continued eligibility for drawings or disbursements under the relevant IMF and/or World Bank programs.

To qualify for debt relief, a country must have in effect economic reforms endorsed by the World Bank or the IMF. Eligibility for debt relief will be determined on a case-by-case basis. At present 14 countries—Benin, Cameroon, Cote d'Ivoire, Ghana, Guinea, Kenya, Madagascar, Malawi, Mali, Niger, Nigeria, Tanzania, Uganda, and Zaire—either have or are in the process of beginning IMF or World Bank programs that would qualify them for relief as long as they continue these programs.

Twenty-two sub-Saharan African countries owe about $1.4 billion in such debt to the U.S. Government. The actual amount to be forgiven will depend on the number of countries that undertake the required adjustment programs.

Based on the number of countries expected to qualify initially for the program, the potential stock of debt eligible to be forgiven is initially expected to total about $600 million—the amount owed to the United States by the 14 countries listed in the table above. The total includes principal outstanding and life-of-loan interest.

These countries also will potentially save some $220 million in scheduled interest that would otherwise be due on the canceled debt, assuming that they remain in compliance with their World Bank and IMF programs. This will result in an initial annual savings of almost $40 million in debt service payments for the 14 countries. These figures could increase if other sub-Saharan African countries with outstanding U.S. debt decide to undertake World Bank or Fund-supported structural adjustment programs.

Debt Owed the United States by 14 Sub-Saharan Countries As of January 15, 1990
($ million)

	Principal Outstanding	Interest on Life of Loan	Total
Total	**583.6**	**217.7**	**852.2**[1]
Benin	22	10.4	32.4
Cameroon	31.9	12.5	73.4
Cote d'Ivoire	5	0.8	5.8
Ghana	79.7	34.3	114
Guinea	4.5	0.9	5.4
Kenya	101.3	53	174.8
Madagascar	5.8	1.4	7.2
Malawi	29	11.4	40.4
Mali	5.1	1.7	6.8
Niger	2.8	0.6	3.5
Nigeria	62.4	16.9	79.3
Tanzania	80.7	26.9	107.6
Uganda	8.8	1.6	10.4
Zaire	144.6	45.3	191.2

[1] Total includes $50.9 million in undisbursed loans that will be converted to grants.
Countries that have not signed debt agreements with the United States as of January 15, 1990 are: Cote d'Ivoire, Tanzania, and Uganda.

Source: U.S. Agency for International Development

Other Debt Owed the United States

President Bush's decision is targeted at sub-Saharan African countries that meet economic reform criteria. It does not represent a change in policy toward debts owed the U.S. Government by governments outside Africa. Other forms of U.S. debt owed by sub-Saharan African countries, such as loans extended, guaranteed, or insured by the U.S. Export-Import Bank, Foreign Military Sales credits, and loans for purchase of U.S. agricultural commodities, are not affected by the new debt forgiveness policy. However, low-income, debt-distressed African countries can reschedule U.S. official loans (other than those under the new debt policy) under the generous Paris Club[1] terms agreed to at the Toronto economic summit in June 1988.

Since October 1988, the United States has participated at the Paris Club in 15 so-called Toronto reschedulings of some $3 billion in debt obligations. Under the Toronto "menu of options" for low-income countries, creditors may choose from three options to provide debt relief on nonconcessional debt (such as U.S. Export-Import Bank loans and Foreign Military Sales credits). The United States will continue to choose the option that allows debtors to repay U.S. Government debt rescheduled in the Paris Club over 25 years with a 14-year grace period. Normal Paris Club policy allows rescheduling over a 10-year period, with 5 years grace.

African countries with outstanding commercial bank debt, such as Nigeria, also can benefit from the U.S. initiative proposed by Treasury Secretary Nicholas Brady on reducing such debt, provided they meet the conditions of eligibility.

Structural Adjustment

Structural adjustment is a difficult process, requiring basic changes in government and public thinking that involve painful economic sacrifice. These measures are necessary, however, to establish the conditions required to achieve sustainable long-term growth. Governments undertaking these efforts have to take considerable political risks, and they depend on support from the United States and other major donors to assure successful programs. More than 30 sub-Saharan African countries now have IMF- or World Bank-supported structural adjustment programs. A major goal is to reduce existing policy and physical bottlenecks to economic growth in these countries.

[1] The Paris Club is an informal group of major creditor governments, including the United States, with no charter or fixed membership, which meets on an ad hoc basis to undertake multilateral rescheduling of debt payments owed to or guaranteed by creditor government agencies. A debtor government's adherence to an IMF adjustment program is usually a precondition to a Paris Club rescheduling.

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Common elements of structural adjustment programs are:

Establishment of realistic exchange rates. Overvalued currencies reduce a country's competitiveness in world export markets and prevent local producers from competing against cheaper imported goods.

Reduction or elimination of government price controls. Price controls prevent producers from adjusting prices to respond to market conditions, encourage scarcity, and cause inefficient use of resources.

Reduced government budget deficits. Large budget deficits can contribute to excessive money supply growth and inflationary pressures. They also deprive the private sector of much-needed credit. Adjustment programs attempt to improve government budget controls and taxation policies to ensure more efficient use of government resources.

Parastatal reform. Losses from inefficient parastatals (government-owned enterprises) are a frequent contributor to budget deficits. Reform efforts include measures to privatize selected parastatals, eliminate government monopolies, or allow parastatals to price their goods and services so that costs are reflected more accurately.

Positive interest rates. Government policies frequently attempt to keep interest rates below the rate of inflation, thereby discouraging savings and investment.

Economic Assistance

In its bilateral and multilateral aid programs, the United States has advocated economic reform in recipient countries, recognizing that sustained growth can occur only when economic policies are sound. It is in the U.S. interest to assist African economic development, partly because larger markets there will be able to absorb more U.S. products. In the last few years, U.S. development assistance and economic support programs have been on an all-grant basis.

Economic and Social Indicators: Sub-Saharan Africa Compared with Other Regions

	Sub-Saharan Africa	East Asia	South Asia	Latin America
GDP growth (annual average %, 1980-87)	0.4	8.0	4.8	1.4
Population growth rate (annual average %, 1980-87)	3.2	1.5	2.3	2.2
Life expectancy (years)	51	68	57	66
Infant mortality (per 1,000 live births)	115	40	102	56
Population per physician (1984)	23,760	2,400	3,570	1,230
Daily calories per person (1986)	2,101	2,594	2,228	2,701
Primary school enrollment (% of age group, 1986)[1]	66	123	84	108

[1]Enrollment of students outside the age group can result in ratios over 100%.

Source: World Bank

U.S. bilateral aid to sub-Saharan Africa was more than $1 billion in FY 1989. All U.S. assistance is on a grant basis, except $102 million in concessional loans for food imports provided under Public Law 480. The U.S. contribution to multilateral assistance is more than $500 million annually, much of it provided in the form of concessional loans from the World Bank's International Development Association and the African Development Bank's African Development Fund.

Congress created the Development Fund for Africa (DFA) in 1987. Funding in FY 1990 is about $560 million. The DFA is used for quick responses to U.S. development goals in Africa. It is concentrated in countries committed to sound economic policies and that have reasonably good development potential. The DFA supports activities targeted in the areas of health, voluntary family planning, natural resources, and basic education. The greater flexibility afforded by this fund also permits closer cooperation with other donors and private voluntary organizations. An important element of the DFA is the African Economic Policy Reform Program. So far it has provided more than $250 million to almost 20 countries undertaking policy reform initiatives.

Private Investment

The U.S. Government encourages private local and foreign investment in Africa, which is the principal way economic growth in Africa can be achieved. Productive investment promotes economic development by increasing employment, local production, exports, and foreign exchange.

The Africa Growth Fund, established recently by the U.S. Overseas Private Investment Corporation (OPIC) and owned by major U.S. corporations, makes portfolio investments in African companies, providing money often unavailable from other sources. The Fund judges potential investment under the same criteria used in other venture capital operations but is prepared to assume greater risks to make money available to private investors.

Under OPIC's Investment Insurance and Finance programs, private American investors can obtain loans and/or insurance against the risks of inconvertibility, expropriation, and political violence, thus facilitating investment in developing African countries. OPIC, and more recently the U.S. Agency for International Development (AID), sponsor investment missions to African countries that introduce U.S. companies to profitable investment opportunities there.

USAID's Trade and Development Program facilitates rational investment decisions through its funding of project feasibility studies. An excellent example of U.S. Government promotion of profitable investment in Africa is the AID/OPIC-sponsored Export Processing Zone projects for Togo and Cameroon, which will encourage investment free from the legal restraints that discourage investment in so many African countries.

Trade

U.S. trade with sub-Saharan African countries amounted to $9.8 billion in 1988. The United States purchased more of Africa's exports than France and West Germany combined, the next two largest importers from Africa. U.S. imports of $7.7 billion in 1988 represented 37% of industrial country imports from sub-Saharan Africa, while U.S. exporters accounted for only 12% of the exports to Africa. The U.S. trade deficit with sub-Saharan Africa was $5.7 billion in 1988. Oil comprises more than half of U.S. imports from the region.

In the Uruguay Round of multilateral trade negotiations, the United States has been leading a move to dismantle barriers to trade in agricultural products, enabling Africa to capitalize on its comparative advantage in these products.

G-7 Trade with Sub-Saharan Africa ($ million)

	G-7 Exports		G-7 Imports		Trade Balance	
	1987	1988	1987	1988	1987	1988
Canada	225	285	416	533	-191	-248
France	5,725	6,078	4,138	4,334	1,587	1,744
West Germany	2,232	2,285	3,063	3,000	-831	-715
Italy	1,879	1,982	2,036	1,800	-157	182
Japan	1,806	2,237	1,094	1,668	712	569
United Kingdom	2,693	2,189	1,811	1,890	882	299
Subtotal	**14,560**	**15,056**	**12,558**	**13,225**	**2,002**	**1,831**
United States	1,853	2,057	8,496	7,736	-6,643	-5,679
Total	**16,413**	**17,113**	**21,054**	**20,961**	**-4,641**	**-3,848**

Source: International Monetary Fund, *Direction of Trade Statistics*

U.S. Export-Import Bank's Interest Rate Formula

The U.S. Export-Import Bank recently has adjusted its interest rate formula for debt reschedulings, a move expected to result in substantial interest savings on all (African and non-African) newly rescheduled debt. The new formula, which applies to all rescheduling agreements negotiated within the Paris Club after March 1, 1989, uses the interest rate on short-term U.S. Treasury bills, instead of that on medium-term Treasury bonds, as the Eximbank's base rate. Total interest savings for Africa over the life of the rescheduled obligations are estimated to be in excess of $250 million at current interest rates. ■

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Economic Reform in Africa: Is It Working?

Carol Lancaster

IN RESPONSE TO the economic crisis that has engulfed much of sub-Saharan Africa since the beginning of the 1980s, a growing number of African governments have implemented economic reform programs. These programs most always have been shaped by advice and pressure from the International Monetary Fund (IMF) and the World Bank and encouraged by developed countries. As the decade progressed, the breadth and pace of economic reform in Africa have accelerated, with nearly 30 countries now implementing reform programs. Over the same period, the objectives of these reform programs have become more ambitious. They have moved from an early emphasis on reducing unsustainable deficits in the balance of payments to promoting long-term growth through improving economic efficiency, reducing the role of the state in the economy, and encouraging an increase in private investment.

The economic reforms have proven painful for many Africans, including the poor and the middle class. They also have been politically risky for African governments, as declining standards of living have fed political discontent and led to occasional outbreaks of violence. Furthermore, the increasing engagement of international financial institutions (IFIs) in economic policy-making in Africa has generated deep resentment among many Africans who, with some justification, believe that policies affecting their lives are being decided abroad once again.

What have been the results of nearly a decade of experimentation with economic reform in sub-Saharan Africa? As yet, there are no clear-cut successes where reform programs have led to economic recovery *and* sustained growth. Recently, a dispute has arisen between the World Bank and the Economic Commission for Africa (ECA), a United Nations organization based in Addis Ababa,[1] over whether those countries implementing reforms have any economic progress at all to show for their efforts. The World Bank has argued that countries implementing reform programs have enjoyed greater economic progress in recent years than those without economic reform programs.[2] The ECA has argued that the opposite is true—those countries implementing IFI-sponsored reform programs have fared worse economically than those without such programs.[3]

Who is right? Is anyone right? These are far from academic questions. The answer affects the lives and future of most Africans. If the reform programs promoted by the IFIs and developed

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countries have made things worse in Africa, as the ECA appears to be suggesting, then clearly an urgent review of these programs is needed. If the ECA is wrong, then it is equally urgent to clear up misunderstandings and clarify real differences or uncertainties, in order to avoid slowing the momentum for reform in Africa and impairing the support, financial and moral, for such reforms from developed countries.

Background to the Economic Crisis and Reform in Africa

The manifestations of Africa's economic crisis by now are well known to anyone passingly familiar with the region. In Africa, the most rapidly accelerating population growth rates in the world—indeed, in some cases, in all of human history—have combined with slowing rates of economic growth. As a result, between 1978 and 1985, per capita incomes dropped by an average of 15 percent, reaching levels no higher than those of the 1960 independence period. In addition, in countries with fragile ecologies, particularly those of the Sahelian region, the pressure of burgeoning populations on land has led to a dramatic deterioration of the environment.

Economic decline also is manifested in the deterioration of infrastructure and services—in roads, power supplies, communications; in education and health services; in rising prices and declining qualities and quantities of goods in the market; in black markets for foreign currencies; in empty government offices as civil servants hold second and third jobs to make ends meet; and in the rising incidence of malnutrition and illiteracy.

The causes of this decline are also familiar. Economic mismanagement has been pervasive, dating back to the independence period and before. On attaining independence, African governments assigned the state a major role in promoting development. The apparatus of government was already large in the colonial period and the new leaders simply took over and extended it. Governments controlled economic activities, usually regulating prices, wages, interest rates, internal and external trade, transport, and investment. A number of governments nationalized key economic sectors and ran them as public enterprises. However, African governments often lacked the capacity to manage efficiently large and complex bureaucracies, to plan realistically, and to make decisions with a good idea of their likely economic consequences. Often, where such capacity existed, the common problem of political or personal motives driving economic policies still persisted.

Marketing boards provide an illustrative example. They were created in the colonial period to purchase cash crops from farmers, to tax them, and to reinvest the tax revenues in order to promote further production of those crops. After independence, many of the marketing boards were taken over quickly by politicians who often diverted revenues to finance political parties and who used the boards as sources of employment for political supporters. Farmers, receiving decreasing real returns from their cash crop production, lacked the incentive to produce more. Many shifted to the production of subsistence crops or illegally sold their products in the black market or across the border. As a result of government exploitation or neglect, the agricultural sector—a major source of national income and employment in much of the continent—expanded,

but at diminishing rates, during the first two decades after independence.

By the end of the 1970s, the consequences of two decades of economic mismanagement were beginning to figure not only in the declining rates of agricultural growth but in the declining volumes of exports as well. It was the extraordinarily adverse external conditions of the early 1980s, however, that turned worsening economic problems into a full-blown economic crisis for much of Africa. The recession in developed countries produced a collapse in world prices of primary products on which Africans depended for their export earnings. The availability of commercial lending to the region dried up and foreign aid inflows stagnated. Worldwide interest rates rose, increasing the cost of external debt service for the handful of African countries, including Côte d'Ivoire, Nigeria, Zaïre, and Sudan, which had been able to borrow commercially. African economies were forced to make a sharp contraction in their imports, on which their economies were heavily dependent. This contraction resulted in far fewer imported consumer goods, a shortage of spare parts and raw materials for continuing production, and a drastic reduction of imported goods and services for investment. The squeeze was economically disruptive and politically risky.

Not all African countries were affected equally by these problems. Those that suffered natural disasters such as drought, floods, and locust plagues, or chronic conflicts on top of economic mismanagement and external adversity fared far worse. Economic conditions in Angola, Mozambique, Ethiopia, and Sudan have regressed to among the worst in the world. The few countries that had managed their economies well and benefited from economic good fortune—Botswana and Mauritius, for example—enjoyed some of the healthiest growth rates in the developing world. During the 1980s, however, the rest of Africa faced increasing economic troubles.

Africans began to recognize the growing seriousness of their economic plight when their heads of state signed the *Lagos Plan of Action*,[4] discussed by the Organization of African Unity (OAU) at its meeting in Lagos in 1980. The plan described the economic problems confronting the continent and proposed several solutions, including increased aid flows and the creation of subregional and, later, continent-wide common markets to stimulate trade, investment, and industrial growth.

Also in the late 1970s, financial officials from African member states of the World Bank asked the Bank to conduct a study of their economic problems and to identify solutions. This report, *Accelerated Development in Sub-Saharan Africa*,[5] published in 1981, marked a watershed in thinking about development in Africa, both in the region and abroad. For most of the two decades since independence, Africans had attributed poverty and slow growth largely to their colonial heritage and a hostile international economic environment. There was little mention in public, at least, of their own policy failures. Additionally, many African leaders subscribed to African socialism—in essence, state-led development. Some governments, for example, that of Tanzania, were openly hostile to private investment, domestic or foreign. African demands for larger foreign aid flows often were justified not just on the basis of very real needs but also on the notion that Western industrialized countries owed

Africa reparations for exploitation, past or present. One of the objectives of the request for the World Bank study was to provide further justification for a doubling in aid flows to Africa.

The 1981 World Bank report did call for a doubling in foreign aid. Its main thrust, however, was that much of the continent's growing malaise derived from African policy failures; the policies needed to be changed if growth was to be restored. The report was well received in developed countries, where a consensus was emerging that economic policies had become one of the major impediments to development in Africa and elsewhere in the world. In contrast, the report generated considerable controversy in Africa when it was first published. However, as the 1980s wore on, African officials began to echo the analysis of the report. By the 1986 special session of the United Nations General Assembly on Africa's economic and social crisis, African leaders associated themselves with the ECA/OAU submission prepared for the meeting that affirmed the view that economic policies were in need of reform throughout much of the region.[6] In the final resolution passed by the General Assembly at the end of the special session, the need for policy reforms was linked to the need for increased external financing, if policy changes were to promote economic recovery and growth.

The evolution in thinking about economic policies and structures in Africa paralleled similar thinking in much of the world, including in socialist bloc countries. The experiment in socialism and state-led growth, so popular for much of the postwar period, appeared to be exhausted almost everywhere. Heavy state involvement in economic activities had ensured perhaps a degree of equity—at least at the level of rhetoric—in the direction of development in the Third World. However, it frequently had resulted in an enormous waste of resources, gross inefficiencies, corruption, and the development of parallel markets outside government control. Ultimately, it had slowed growth. With socialism discredited, at least for the moment, and African leaders desperate for additional external financing, there was a readiness in Africa to experiment with the economic reforms that the IFIs and Western countries required as a price for their increased financial support. But who was to advise on appropriate reforms, to coordinate external financing, and to monitor policy reform in Africa? These roles fell first of all to the IMF.

The Evolution of Economic Reform in Africa

The most immediate problem confronting an increasing number of African countries in the late 1970s and early 1980s was the unsustainable gap in their balance of payments. These were heavily import-dependent economies, relying on the production and export of a few primary products—copper, cotton, cobalt, groundnuts, fish, coffee, cocoa, tea, and petroleum—and on the import of almost everything else, including foodstuffs, consumer durables, gasoline, spare parts for transport vehicles, machinery, fertilizer, and capital equipment. The prices of African export commodities had collapsed during the early 1980s, reaching their lowest real level since the Great Depression. During much of the 1970s and early 1980s, inflation in the West had driven up the prices of most imports, leaving Africans increasingly poorer vis-à-vis the rest of the world. By the beginning of the 1980s, the gap between what most African countries wanted to import

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and what they could afford had so widened that they faced no alternative but to compress imports.

In order to ease the sharpness of that compression, the governments with access to commercial lending sought additional foreign loans. However, commercial banks were no longer flush with surplus petrodollars, and were increasingly nervous about loans to impecunious developing country governments. By 1982, they virtually ceased to make new loans to African countries. Most governments also sought additional foreign aid. Foreign aid donors, skeptical of the capacity of African governments to utilize their aid effectively, were disinclined to increase aid commitments unless an IMF stabilization program was in place. Finally, an increasing number of governments found they could no longer fully service their existing external debts without imposing a yet greater contraction of imports. Creditor governments required that governments negotiate a stabilization agreement with the IMF before they would agree to a debt rescheduling. An IMF stabilization agreement (either a standby agreement covering 12–18 months or an extended fund facility, to cover three years) became the price for debt rescheduling and additional external financing. Even the Soviets advised African governments seeking additional aid—for example, the Ghanaians in 1982—to go to the IMF first.

The IMF was empowered to make loans to member states in foreign currency at near commercial terms (commercial rates of interest and repayment over three to five years). The loans were conditioned on the borrower's implementation of policies designed to stabilize balance of payments. The requirement was to reduce the gap between export earnings and import costs to sustainable levels. IMF conditions typically included currency devaluations, reductions in government deficits (either through increased tax revenues, reduced government expenditures, or both), and restrictions on domestic credit creation. IMF loans were disbursed in tranches. Each additional disbursement was dependent on a review by the IMF of the borrowing government's fulfillment of agreed policy changes, such as reductions in budget deficits, restrictions on domestic credit creation, or an adjustment in the value of the national currency. The reviews took place roughly every six months, with further disbursements often delayed or programs canceled when performance was inadequate.

If there were a Fund "model" for successful programs, it would be the following. A government with an unsustainable balance of payments deficit would seek a loan from the IMF. The IMF and the government would agree on policies designed to restrict demand for imports and encourage increased production of export commodities. IMF loans would permit increased imports in order to increase export production. Ideally, by the time the loan was completely disbursed, the gap in the balance of payments would be closed, economic health would have returned to the borrowing country, and the loan then would be repaid. Between 1979 and 1983, 20 African governments had implemented IMF stabilization programs. An increasing number of governments adopted successive programs during the same period.

Despite successes of IMF programs in other parts of the world, for example, in Turkey and Portugal, no single program in sub-Saharan Africa actually conformed to the IMF model. There were a number of reasons for the dis-

appointing results. First, borrowing governments did not always fulfill their end of the bargain. In some cases, agreed policy reforms were never implemented. In other cases, reforms were implemented and later reversed. Second, where reforms were implemented positive effects often were overwhelmed by internal or external shocks such as drought, further drops in commodity prices, war, and other unexpected calamities. However, the deeper problem, increasingly acknowledged by the IMF and its critics by 1984, was that African economies could effectively restrict demand but could not expand quickly export production. Poor, narrowly based, and reliant on the export of primary commodities to soft world markets, African economies were rigid and slow to change. It likely would take years to implement needed reform programs and even longer to realize their benefits. Finally, although many of the economic changes advocated by the IMF were clearly necessary, by themselves they proved insufficient to bring about economic recovery or even a sustainable reduction in Africa's balance of payments. The scope of needed change was broader, the time required to implement the changes longer, and the amount of additional, concessional resources larger than what the IMF could offer.

By 1983, the Fund's management and directors had become alarmed by the increasing amount of the institution's resources being allocated to repeat lending to African governments. In country after country, one IMF loan followed another, usually financing the repayments of the first loan. A number of African governments were simply unable to repay fully their loans from the Fund. Yet, the IMF could not just stop lending in Africa; developed countries still insisted that a precondition for debt rescheduling was the implementation of an IMF program. Therefore, in 1984, the Fund began to reduce the size of its loans to African countries (although not the number of loan programs it signed annually). By 1986, it was receiving in repayments more than it was loaning in new monies to the region. In response to criticisms that the IMF should not be taking out more than it was putting into a foreign exchange-starved region, it initiated a Structural Adjustment Facility (SAF) and, a year later, an Enhanced Structural Adjustment Facility (ESAF). Both facilities would make loans to poor, debt-distressed countries in concessional terms (10 years grace, 10 years maturity, at 0.5 percent interest), effectively refinancing hard IMF loans on softer terms.

At the same time it was becoming clear that IMF stabilization programs alone were not the solution to Africa's economic crisis. In addition, the World Bank was becoming engaged increasingly in advising African governments on economic reform, in financing reform programs directly, and in coordinating developed country financing for African reform programs. The Bank offered structural and sectoral adjustment programs that conditioned loans on soft terms (10 years grace, 40 years maturity, with only a small administrative charge), with economic reforms aimed either at specific sectors or at the economy as a whole. An economic sector might be agriculture, industry, finance, or education. Sector adjustment loans support reforms designed to improve efficiency and productivity in a specific sector. Structural adjustment loans typically are tied to macroeconomic reforms aimed at affecting the performance of an entire economy. A currency devaluation, for

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instance, could affect agriculture, industry, finance, transport, and other key economic sectors. Sector adjustment loans tend to be smaller than structural adjustment loans.

The requirements of the Bank's larger, more ambitious structural adjustment loans included increases in producer prices; reduction or elimination of subsidies, price, wage, and credit controls; trade liberalization; revisions in investment regulations; privatization of state-owned enterprises; and reductions in the size of the civil service. The structural adjustment loans typically were conditioned on the existence of a stabilization program with the IMF.

Sectoral adjustment programs included loans in support of reforms in specific economic sectors: finance, education, health, agriculture, transport, or export. While World Bank loans seldom included the quantitative performance criteria typical of IMF loans and did not involve the periodic performance reviews of the Fund, the conditions of Bank loans tended to be more numerous and often more intrusive than those of the Fund.

Like the Fund, the World Bank also had a model—seldom explicitly described and often changing—of how its structural adjustment programs would bring about economic recovery and renewed growth. The Bank's model was rather different from that of the Fund. It appeared to assume the following. Borrowing governments would implement policy changes intended to improve the efficiency of government operations and to reduce government controls or engagement in the economy. With incentive prices and fewer impediments to private economic activity, existing producers, agricultural or industrial, would expand their production and investment. The increased inflow of aid loans and grants would ease import constraints on consumption, production, and investment and further speed recovery and growth. To what extent has this model been realized in sub-Saharan Africa?

By the mid-1980s, the trend in economic reform programs in Africa was for a government first to negotiate a stabilization program with the IMF, then to adopt a World Bank sectoral adjustment program (often beginning with the rehabilitation of the export sector), and eventually to implement a structural adjustment program with the Bank. By the end of 1988, three governments had only an IMF stabilization program in place. Another 22 governments were implementing World Bank sectoral or structural adjustment programs, often together with IMF programs. Four countries had begun and then suspended IMF and World Bank reform programs: Sudan, Zambia, Somalia, and Sierra Leone. (Somalia has since negotiated another agreement with the IMF.)

There is some confusion about the nature of the relationship between the IFIs and African governments undertaking reforms. Some Africans complain bitterly about what they perceive to be a neocolonialist IFI dictating policies to their governments. Officials of the IFIs, in private moments, also occasionally worry about the degree of their influence over policies in Africa. There is little doubt that the influence and engagement of these institutions in economic policy-making in Africa is unprecedented. It is a mistake, however, to assume that they are in control of economic policy-making in the region. What the IFIs typically do is to identify individual institutions in an African government that share their views on needed reforms. Not surprisingly, these usually include the ministry of finance and the central bank. The urgent need of most African gov-

ernments for foreign exchange and the willingness of the IFIs to lend it if reforms are undertaken strengthens the voice of those in government sharing the views of the IFIs. Nevertheless, support for reform within African governments is seldom unanimous and often unstable. Where political violence or economic reversals strengthen the voice of those opposed to reform, heads of government can jettison reform programs—as in Zambia or Sudan.

The cost of rejecting IFI advice can be very high for governments starved of foreign exchange. Governments unwilling to agree to economic reform programs lose access to loans from the IFIs, to additional aid flows from most developed country governments, and to the ability to reschedule their debts. Statistics on aid flows over recent years show clearly that those countries, like Ghana, with reform programs in place have enjoyed increases in their aid levels while those countries, like Zambia, without reform programs have seen their aid inflows stagnate or fall. Short-term trade financing—necessary in order to maintain a predictable flow of imports and to avoid import prices being inflated by high risk premiums—also can dry up. Loss of access to aid, on which many African governments now depend heavily, and to trade credits means a further contraction of imports; drops in consumption, production, investment, and exports; and an increased turn on the downward spiral of economic decline.

The Results of Economic Reform

The most fundamental assumption on which all the experimentation in economic reform in Africa rests is that most individuals—whatever their culture, education, or economic situation—most of the time will act to promote their own economic interests. Where opportunities exist for them to increase their incomes, they will exploit them. Structural obstacles—for example, the lack of roads or marketing facilities—may slow their response to economic incentives, but, with enough time, will seldom prove insuperable. Thus, farmers offered higher prices for their products will increase production in the short run and, where additional investment is needed or additional inputs promise to be profitable, will seek to expand inputs or make additional investment to support larger production in the long run. Similarly, established manufacturers will expand their capacity utilization in the short run to take advantage of profitable opportunities. Entrepreneurs, established and new, will invest to exploit profitable opportunities. This is the theory, in its most simplified form, of how the policy reforms supported by the IMF and World Bank are assumed to work.

Thus far, what have been the consequences of reforms in sub-Saharan Africa? Governments have made significant policy changes, particularly since the mid-1980s. The 1989 World Bank report *Africa's Economic Adjustment and Growth in the 1980s*[7] documents declines in real exchange rates, resulting from devaluations and increases in real prices for export crops and food prices. Both reflect world market conditions and are intended to encourage farmers to expand production.

The World Bank report includes statistical analyses showing that the countries implementing reform programs have enjoyed real economic progress, especially when adverse external shocks are factored out. This contrasts with those countries without reform programs or with weak reforms that have experienced little economic

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progress or further decline. According to the Bank, between 1985 and 1987, the economies of countries with strong reform programs grew an average of 3.8 percent per year, while those with weak or no reform programs grew by only 1.5 percent. Economies with strong reforms experienced an average growth in their agricultural production of 3.4 percent, in contrast to agricultural growth in those countries with weak reform programs of only 2.6 percent. Countries with strong reform programs all experienced increases in the volume of exports, the levels of real domestic investment, and per capita consumption, albeit by small amounts. In countries with weak or no reform programs, these indices all dropped.

The Economic Commission for Africa challenged the Bank's findings on a number of counts and attempted to put forth its own adjustment alternatives.[8] The ECA complained that the Bank's statistical methodologies are flawed, that key data is not provided, and that the concepts and definitions on which the Bank bases its analysis are hazy or contradictory. The ECA also challenged the Bank's claim that those countries implementing strong reform programs experienced improved economic conditions and, by implication, that the reforms actually promoted those improvements. Using World Bank data tapes, the ECA recalculated average annual growth rates between 1980 and 1987 of African countries and produced results showing that those countries with strong adjustment programs actually had the poorest growth rates, while those with no adjustment programs enjoyed the highest rates of growth.[9] The ECA, implicitly criticizing its own analysis as well as that of the Bank, concluded that "any attempt to establish a one-to-one relationship between growth trends and the adoption or non-adoption of structural adjustment programs is prone to over-simplification and fallacies."[10]

The alternative framework of adjustment proposed by the ECA shares the major goal of IFI adjustment programs: increased production through more efficient use of national resources. However, the ECA alternative differs from IFI programs in several key ways: it calls for greater participation, decentralization, and democratization in African countries—political changes well beyond the scope of what the IFIs can suggest. Moreover, it advocates sweeping economic, political, and institutional reforms by African governments, but also calls for continued reliance on the state as a major economic manager, controlling trade, prices, and other key aspects of economic activity. The most basic disagreement between the IFI and ECA approaches involves the ability of African states to manage their economies effectively.

The question remains: Who is right about the success or failure of structural adjustment in sub-Saharan Africa? The answer is that it is still too soon to make a definitive judgment. Neither the World Bank nor the ECA was wise to declare the success or bemoan the failure of the structural adjustment experiment in sub-Saharan Africa.

The period of intensive experimentation with reforms in sub-Saharan Africa is still brief, having begun really in the mid-1980s. Factors other than economic policy changes—particularly the weather—have a major impact on economic performance and remain difficult to account for, even though the World Bank tried to do so in its calculations. Finally, those countries with reforms have benefited from additional external financing that has eased

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import constraints and permitted expanded production and income. Their growth may depend heavily on the additional foreign aid as well as the impact of the reforms themselves.

Nevertheless, there is undeniable evidence that economic reforms are beginning to bear fruit in a number of countries. The case of Ghana is often cited in this regard. With one of the broadest and most sustained reform programs in place for over a half decade, Ghana has seen its economic conditions greatly improve in recent years. Growth rates have exceeded 5 percent per year, over several years, for the first time since independence. Markets today, in contrast to those of several years ago, are filled with goods. Transport vehicles, 80 percent of which were out of service at the beginning of the reform period in 1983 for want of spare parts and gasoline, are now running. Roads and railways are being repaired. Exports are up as is agricultural production. In Ghana and elsewhere, visible signs of economic recovery may result, in part, from higher levels of aid. However, it is difficult to believe that all the recovery rests on aid alone. Food producers, in particular, are seldom heavily dependent on the imports that foreign aid finances. Only a few of them use fertilizer and improved seeds. Favorable weather no doubt has been a factor in increased agricultural production. Yet, when considering sustained increases in agricultural production over several years in Ghana, weather alone cannot be the sole factor. Farmers are responding to incentives.

Economic recovery is not, however, the same as a structural adjustment success. The critical element needed to turn recovery into sustained growth is an increase in private savings and investment. As noted earlier, the World Bank model for recovery and growth in sub-Saharan Africa rests heavily on reducing the role of the state in the economy to encourage an increase in private production and investment. The Bank as well as developed country governments—the United States and the Soviet Union included—clearly have concluded that most African governments currently lack the capacity to implement efficiently a strategy of state-led growth. While the state would continue to provide key services such as security, education, health, maintenance and expansion of infrastructure, the private sector would become the critical source of sustained economic growth. For that growth to occur, private investment must rise. However, private investment does not appear to be growing significantly in sub-Saharan Africa—not even in Ghana, which comes closest to a structural adjustment success. Herein lies the key weakness in the structural adjustment experiment in sub-Saharan Africa.

Even where African governments implement bold, broad, and sustained reforms, private investors—domestic or foreign—are slow to exploit new opportunities. Decades of political instability, corruption, and economic mismanagement have weakened confidence in the economic and political future of the region and have prompted continued capital flight from Africa. What guarantee is there for investors that the government of Ghana, for example, which came to power in a coup d'état, will not be overturned by another coup tomorrow, with the new government reversing policy reforms? In other countries undertaking reforms, for example, in Guinea or Kenya, creeping corruption deters investors, despite both governments' public support of increased investment. Moreover, for the many Af-

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rican countries that are small, resource-poor, landlocked, or located in unstable regions, attracting significant private investment—even with the best reform programs—is extremely difficult. African nations not only must be more attractive to investors than they have been since independence; they also must be more appealing than their competition, which includes Korea, Singapore, Thailand, and Eastern Europe. Investment capital, even African-owned capital, is highly mobile, and normally moves to the areas where secure profit-making opportunities are greatest. It may be beyond the abilities of much of sub-Saharan Africa to create such conditions in the foreseeable future, even with the best of intentions or the most energetic of reform efforts.

The ECA report raised another major issue regarding the economic reform experiment in Africa: the social costs of structural adjustment on the poor. The World Bank report predicts that policy reforms would raise the incomes of farmers—the vast majority of Africans and the majority of the African poor—by increasing prices for their products. The ECA argues that structural adjustment programs hurt the poor. These programs typically entail reductions in government expenditures (including on education and health services or the imposition of user fees for such services), increases in the prices of staple foods and public transport, and the firing of substantial numbers of public employees. The overall consequences of these policies on the poor can be an increase in their cost of living, a loss of employment and income, and the inability to send their children to school or to a doctor when they are sick. Which argument is right?

Both are right. Farmers are receiving higher incomes in countries where farm prices have been raised. However, the urban poor, the small but growing number of rural wage laborers, and the urban middle class all have seen their standards of living eroded. Yet, the available information does not answer the bottom-line questions: Have the benefits to the poor generally outweighed the costs? How will the benefits and costs evolve in the future?

Because of growing concerns about the social costs of adjustment on the poor, concerns raised most vociferously by UNICEF, but not absent from World Bank analyses either, there have been a number of programs initiated to reduce those costs. The Bank has initiated a series of studies in individual African countries of the social costs of adjustment. Ghana, with the support of UNICEF, has created an $80 million Program of Actions to Mitigate the Social Costs of Adjustment (PAMSCAD), funded by foreign aid donors and international institutions. The program finances public works and other activities to provide increased income and employment for the poor, as well as for redeployed or fired civil servants. Although PAMSCAD cannot mitigate even a small portion of the costs of adjustment in Ghana, it is an important symbol of government concern and a source of hope for the poor. Similar programs are likely to be instituted in other countries implementing reform programs.

The debate about the social costs of adjustment often misses an important point—most African countries would have had to adjust to a deterioration in their economic position vis-à-vis the rest of the world in the absence of structural adjustment programs, a process that inevitably would carry social costs for some segments of their populations. It is simply wrong to think that adjustment could have been

avoided or the poor would have remained better off if there had been no structural adjustment programs. The prices of African exports dropped. Africans could no longer import as much as before and they could not borrow continuously from abroad in order to avoid reducing their imports. Real income of some people in these countries would have to fall. Structural adjustment programs attempt to implement an unavoidable adjustment in an orderly fashion, and they are increasingly shaped so that at the same time incentives exist for renewed growth.

Realistically, it is probably not possible for African governments or their foreign supporters to offset all the social costs of adjustment programs, nor to know where social costs of adjustment end and ongoing, chronic poverty begins. The most that can be done is to keep in mind the impact of specific policy changes on the poor when shaping adjustment programs and to attempt to offset the costs to the most vulnerable groups through as much direct intervention as can be financed. On this point, there appears to be little real dispute between the Bank and the ECA.

The World Bank–ECA Disagreement

Both World Bank and ECA officials are expert, experienced, and share virtually the same information on the extent and impact of policy reform in Africa. Nevertheless, two questions remain to be answered. Why did they argue about issues, knowing that neither side was entirely right? What, then, is the future of policy reform in Africa?

It is hard to avoid the impression that the World Bank and the ECA got involved in a battle over turf, specifically on who is to speak authoritatively on economic issues affecting Africa. The Bank has taken on an ever more prominent role in recent years in influencing discussions on African economic problems and reform programs. At the same time, the two major African international economic institutions—the ECA and the African Development Bank—have been unable to play a significant role in structural adjustment, which over the past decade has become the economic issue of the greatest prominence. Africans—government officials, international bureaucrats, intellectuals, and the general public—are visibly uneasy and often openly angry about the role of the IFIs in their governments' economic policy-making. Yet, even the most angry will admit to the frustration of not having their own alternative to Bank-supported structural adjustment programs.

With funding from the United Nations Development Program (UNDP), the ECA launched in 1988 a project to develop an African framework for structural adjustment programs. Its draft report, later published as *African Alternative Framework for Structural Adjustment Programmes*, was presented to a meeting of African ministers of finance in Malawi in March 1989.[11] The report attacked the nature and impact of IMF and World Bank adjustment programs, emphasizing the structural obstacles to economic change in Africa, and recommending a return to state-directed development. The report was criticized strongly by a number of African ministers of finance and later attacked publically by the head of the Nigerian delegation to the OAU meeting in Addis Ababa in July 1989. He declared that an African alternative to structural adjustment did not exist.[12]

At the same time of the ECA meet-

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ing in Malawi, the World Bank published its report (ironically, also funded by the UNDP), reportedly having rushed it into print without the usual internal Bank clearances. Although Bank officials claim that the timing of their report had no relationship to the ECA conference, it is hard to avoid suspecting that the Bank intended to use the report to undercut criticisms by the ECA of its structural adjustment programs. The publication of the Bank's report provoked an even greater controversy when an angry ECA rushed into print *Statistics and Policies*, a criticism of the Bank's report.[13] Later, the executive secretary of the ECA, other senior African economists, the World Bank president, and other officials met together in Washington in an attempt to iron out their differences. The communiqué issued after the meeting promised better consultations between the World Bank, the IMF, and African regional organizations in the future, but gave little hint as to whether the argument between the Bank and the ECA had been resolved or would reemerge in the future.

The dispute between the World Bank and the ECA is unfortunate and unproductive. By making premature claims about the results of structural adjustment and by attacking each other's credibility, these institutions risk undermining those African governments implementing adjustment programs and weakening their international support. On the other hand, the dispute is a useful warning of the growing African frustration about reform and the IFIs' role. It also points to a deeper problem: The Bank increasingly appears to be taking on responsibility without power about African economic policies, while Africans retain power but diminished responsibility for those same policies.

Conclusion

The future of structural adjustment in Africa is uncertain. Successful adjustment probably will take not years but decades for its positive benefits to be realized. It will require considerably more external financing to bring about those benefits, including additional aid loans, grants, and debt relief for the most heavily indebted governments. Africans, in turn, will have to recognize that foreign aid donors do not owe them additional aid for the undertaking of reforms long overdue and in their own interest. At the same time, foreign aid donors must recognize that reforms will not succeed, even in decades, if Africans cannot afford the imports to maintain existing production, to support needed rehabilitation of their economic assets, and to permit increased investment. All parties must recognize that for many of the less economically advantaged African countries, the combination of aid and reform may have to last a long time, particularly where those countries find it difficult to stimulate significant new private investments in their economies.

Still, it will take more than aid and reform to restore Africa to economic health. It will require something only Africans can provide: serious national leadership concerned about the future of their people more than the condition of their own personal fortunes or political positions. There are still too many places where that leadership is lacking.

Notes

1. The ECA was established in 1958 as a regional commission of the UN. (Others were established in Latin America and Asia.) Its mission is to "initiate and participate in measures for facilitating concerted action to relieve the economic and technological problems of Africa." (UN Doc-

ument E/CN.14/424, p. 3) ECA membership includes all independent African states. It has become an important source of research and thinking on economic issues for African countries and has had considerable influence on debates on these issues within the continent. The *Lagos Plan of Action*, discussed later in the text, was largely a product of ECA efforts.

2. International Bank for Reconstruction and Development (IBRD), *Africa's Economic Adjustment and Growth in the 1980s* (Washington, D.C.: The World Bank, March 1989).

3. ECA, *African Alternative Framework for Structural Adjustment Programmes*, E/ECA/CM.15/6/Rev.3 (Addis Ababa: ECA, 1989) and *Statistics and Policies: ECA Preliminary Observations on the World Bank Report, "Africa's Adjustment and Growth in the 1980s."*

4. Organization for African Unity, *Lagos Plan of Action for the Economic Development of Africa 1980–2000* (Geneva: International Institute for Labor Studies, 1981).

5. IBRD, *Accelerated Development in Sub-Saharan Africa: An Agenda for Action* (Washington, D.C.: World Bank, 1981).

6. OAU, *Africa's Submission to the Special Session of the United Nations General Assembly on Africa's Economic and Social Crisis*, ECM/2XV/E/ECA/ECM.1.1, March 13, 1986.

7. IBRD, *Africa's Economic Adjustment and Growth in the 1980s*.

8. ECA, *African Alternative Framework* and ECA, *Statistics and Policies*.

9. While neither the World Bank nor the ECA provided details or equations used in reaching their conclusions, the Bank now appears to be methodologically on stronger ground. For example, it attempted to factor out external shocks in its analysis and broke the period covered in the analysis into two parts—1980–1984 and 1985–1987, a more realistic approach if the effects of reforms, many of which are recent, are to be seen. However, the Bank's classification, "strong reform programs," is subjective and open to challenge. Many would challenge including Zaïre and Kenya in this category. On the other hand, the ECA based its calculations on country growth rates averaged over the period 1980–1987, and weighted country growth rates by the size of population. The long period obscures important changes in economic indicators, and population size is an irrelevant variable in relating growth to policy reform.

10. ECA, *Statistics and Policies*, p. 10.

11. ECA, *African Alternative Framework*.

12. From an address delivered by Vice Admiral Augustus Aikomu, chief of general staff and leader of the Nigerian delegation to the twenty-fifth assembly of heads of state and government of the Organization of African Unity, Addis Ababa, July 25, 1989, p. 18.

13. ECA, *Statistics and Policies*.

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Leonard H. Robinson Jr.

But Why Not More Help for Africa?

The Washington Post, Feb. 1, 1990

It is truly amazing, even breathtaking, to comprehend the speed at which European Communist states, with the Soviet Union as fulcrum, have collapsed wholesale in the past two months. A "cold war" has been nearly dissipated overnight, thanks to the ramifications of perestroika.

The United States has rushed in to capitalize on this extraordinary turn of events. Secretary of State James Baker has visited and touched the now porous Berlin Wall. Poland and Hungary received a nearly unanimous congressional commitment of $900 million in development aid for the next three years. Where did the $900 million come from? Why did it take only days to secure? As an Africanist, I want to know—so do the people of Africa.

Those of us who have toiled for decades in support of Africa's continuing development have been rudely awakened to the harsh realities of how the world really operates. The fall of Communist regimes in Eastern Europe and the concomitant and obvious reduction in the power of communism as an ideology and way of life has riveted the attention of the West and precipitated a torrent of goodwill, resources and the promise of more to come. Indeed, I fully expect that a second Marshall Plan, aimed at Eastern Europe, is already on the drawing board. But what about Africa?

The East-West struggle has been played out in parts of Africa in cruel, painful and devastating ways, Ethiopia, Somalia, Angola and Mozambique being the most succinct examples of the chess game. The cost in human lives and property has been overwhelming. Add to this Africa's longstanding environmental calamities and chronic economic stagnation, and you have to wonder why Western nations have not rushed to Africa's aid with the same degree of alacrity witnessed in Poland and Hungary. The recent excuse is Africa's limited value from a strategic perspective. If that is so, then have we been engaged in "containment" there and in other aspects of the East-West stalemate?

Since 1984, African nations have embraced a number of economic and political reforms designed to diversify their economies. They have divested themselves of state-controlled and-owned industries, they have provided incentives to farmers to produce more for human consumption and they have generally moved to privatization. Belt-tightening strategies have been introduced in most countries, often with the encouragement of the IMF and World Bank, but at the very real risk of social and political instability. The striking results in Ghana, Botswana, Nigeria and even Tanzania have been worthy of notice. African leaders and policy makers have publicly acknowledged their past transgressions regarding their policies, and they have courageously accepted their economic responsibility to put Africa back on a solid economic and political footing. So where is the help from the Western nations and their financial institutions, which previously were so avidly courting the continent?

On Jan. 10, the United States pledged to cancel debts of $735 million owed by 12 African sub-Saharan countries. Although the debt of these countries is lower than that of Latin America, unlike the latter, Africa's debt is primarily "official," or owed to governments and multilateral agencies. The issue of Latin America's debt, which totals a staggering $427 billion, is being addressed through relief for the countries of Brazil, Mexico, Argentina and others. The so-called "Brady Plan for Debt Relief" was focused almost exclusively on Latin America. No such official plan has yet been devised for Africa in spite of the fact that Africa's debt of approximately $139 billion pales in comparison to that of Latin America and the Caribbean.

Even though the United States is home to almost 35 million Americans of African descent, its foreign assistance sadly ignores this statistic. Worse still, many African Americans fail to understand or practice the notion of "motherland politics" as their Euro-American counterparts do. Centuries of slavery blotted out almost all vestiges of identification and price, and many Americans continue to view Africa through the eyes of Tarzan and Meryl Streep. But the African continent is one of the planet's richest jewels, and we are throwing it away.

The writer is president of the African Development Foundation.

In Africa, Glasnost . . .

By Teresa K. Smith

AS in Eastern Europe, economic failure and ruinous political systems have blighted Africa. African leaders may well be the next advocates of *glasnost*, taking note of a burgeoning enthusiasm for democracy across the African continent.

Applause for developments in Eastern Europe is not muted in North nor in sub-Saharan Africa. To the contrary, *novoe myshlenie* (new thinking) is spreading across Africa. Advocates of *novoe myshlenie* not only oppose single-party rule, they are leading the way with concrete measures for the achievement of pluralism. Individual Africans – much like the Lech Walesas and Vaclav Havels of Eastern Europe – are breaking the culture of silence, once characterized by turning the other way in the face of general repression, deplorable human rights abuses, and endemic corruption. But are we in the United States listening?

Africa is in the throes of an important transition period. In the face of the breakdown of former political and economic institutions, African democratic expression is taking form – through citizen dissent, non-governmental human rights organizations, centers for political pluralism, opposition political parties, and free elections. In addition, a number of states have ended one-party rule.

Let us remember in our euphoria over democratic revolution in Eastern Europe that there are similar voices on the African continent.

In Algeria, the unofficial Algerian League of Human Rights has been an active government watchdog, and that country has abandoned one-party FLN rule. Since February 1989, some 20 political parties have emerged in Algeria. Senegal, with 17 political parties, also has opted for multiparty democracy and has carried out two elections in the 1980s.

Mauritania took a step in this direction, convening elections for local mayors in 1986, which was the first democratic exercise the country has known since independence in 1960.

In post-Bourguiba Tunisia, a greater scope of political activity has been made possible. Nigeria's military government has pledged to step down following multiparty elections scheduled for 1992.

In Zimbabwe, the emergence of a new opposition party, the Zimbabwe Unity Movement, intends to stop the country's move toward a one-party state.

In Namibia, one remarkable democratic development, with which SWAPO cooperated fully, is the recent completion of an internationally supervised, free and fair referendum of self-determination as a first step toward independence. International negotiations are underway to carry out a similar process in the former Spanish colony of Western Sahara.

Just as African writers, such as Nigerian Wole Soyinka, Kenyan Ngugi wa Thiong'o, and South African Nadine Gordimer, have been outspoken in their contempt for repressive government, individuals across the continent have come together to establish centers to promote democracy. Nigeria's former head of state, Olusegun Obasanjo, established in 1988 the Africa Leadership Forum in Nigeria in order to assist potential and incumbent leaders in the critical self-analysis necessary for Africa's genuine liberation. Jacques Ntouankeu leads the Center for the Study and Research of Pluralistic Democracy in Senegal, which is tracing the move from authoritarianism to democracy in Africa. Nongovernmental human rights organizations are emerging in each region of the continent.

Finally, as in Europe and the Americas, a human rights system has been established in Africa. "The African Charter of Human and People's Rights," authored by distinguished Africans including Keba M'bye, the Senegalese jurist on the International Court of Justice, was ratified in 1986 and is now part of the African Commission (a specialized human rights agency of the Organization of African Unity), which will be the adjudicating body for human rights complaints on the continent. In sum, there is a movement toward democratic institution-building in Africa, one that has been initiated and is being carried forward by Africans themselves.

Although many analysts believe that future US aid to Africa ought to be conditioned by demonstrable democratic reforms by recipient governments, it is doubtful that future US economic support will be forthcoming. Reality has demonstrated that Western aid to Africa, as pledged at the Thirteenth Extraordinary General Assembly of the United Nations in 1986 (in which I participated as a nongovernmental representative), has not been honored. At that Assembly, a pact was made that African countries would implement severe belt-tightening measures and market-oriented reforms, and the West would provide the required capital inflows.

Yet, as much as Africans have been attempting to keep their end of the bargain, they have done so largely on their own, without much Western support. The development fund for Africa of $565 million, allocated annually by Congress, spreads very thinly among more than 40 countries and constitutes a minuscule portion of overall US foreign aid. And, as Congress now moves to allocate aid to support the struggle in Eastern Europe ($900 million to Poland and Hungary alone approved in January), it is likely that the US commitment to Africa will continue to diminish further.

Let us remember in our euphoria over democratic revolution in Eastern Europe that there are similar voices on the African continent. Let us not silence the African voices of *novoe myshlenie*. To do so would be to champion the revolution in one continent and ruin it in another.

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. . . And Perestroika

By Mwimanga S. Tembo

WITH communism – and perhaps socialism – tumbling down since the cold war ended in Eastern Europe, African countries have also arrived at a similar crossroad.

Nearly three decades ago, the majority of African countries gained independence from European colonialism. At that time of tremendous euphoria, the fashionable ideology for African countries was various shades of "African socialism." Capitalism, which to Africans was synonymous with European colonial oppression and exploitation, was seen as being evil and decadent.

After three decades of African socialism, what does the report card look like?

Through socialism, many of the black independent countries in Southern Africa were able to open the door to previously unimagined educational and other opportunities for many of their citizens. One of the most familiar statistics in Zambia, for example, is that at independence in 1964, after 70 years of British colonial rule, there were only 100 black Zambian high school graduates and only a handful of college graduates. This in a country of 3 million people who were suddenly expected to run their own mining and manufacturing industries, the army, hospitals, and government bureaucracy.

Except in highly technical fields like medicine and engineering, Zambia now has thousands of graduates. Indeed, whether it is in health, transportation, communication, or, yes, even in government and politics, African countries have generally made tremendous advances.

But in the 1980s, many African countries began reeling under serious economic crises. What has gone wrong? Has African socialism run out of gas?

African socialism worked as long as the raw materials that were being exported to the developed West continued to fetch high prices, oil prices remained low, and loans were available from Western financial institutions. But world prices for raw materials like cocoa and copper, for example, plummeted in the 1980s. As a result, major copper-exporting southern African countries like Zambia, and West African major cocoa exporters like Ghana, were in trouble. As international loans stopped, African socialism simply could not work.

The only "resource" that was being shared equally among the vast majority of the population in the late 1980s was poverty. It is as if at independence African governments chose socialism, but forgot to establish permanent and enduring economic structures and systems that would generate income for the countries continuously, even in the face of obstacles.

With rapid population growth and exploding demand for Western consumer products like cars, VCRs, TVs, luxury goods, and increasing urban food demands, African socialism as practiced during the last two decades can no longer meet these pressing sophisticated demands. African socialism for the most part therefore has died a natural death.

As African countries have tried all kinds of band-aid solutions, including harsh austerity measures imposed by the International Monetary Fund, they have come to the realization that it will take an entirely different course, and not mere rhetoric about ideology, to return to economic soundness. Whether the solution is foreign investment, mixed economies, or good old Western capitalism, one thing is clear: Most African countries now realize that they need an economic solution that will foster production to satisfy increased national consumer demands.

Western critics and observers have taken the role of social and economic kibitzers, always emphasizing that Africans were mismanaging their economies and that the solution was adopting Western free-enterprise capitalism. These critics will now probably say: "We told them."

But they should not forget that the test of true freedom for individuals or a country often is the risk of making choices that might later prove wrong.

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THE WALL STREET JOURNAL

JANUARY 31, 1990

Democracy or Disaster for Africa

By Herman Nickel

Mr. Nickel, U.S. ambassador to South Africa from 1982 to 1986, is a fellow at the U.S. Institute of Peace in Washington.

Are African leaders about to add Eastern Europe's Great Democratic Revolution to the long list of external calamities inflicted upon their hapless continent? Or will they heed the lessons the revolution holds for the economic and political governance of their countries, and face up to the self-inflicted causes of Africa's depressing decline?

The answer will be critical. Without a dramatic turnaround, sub-Saharan Africa is now headed for a Malthusian nightmare. The continent's population probably will double in the next 20 years to more than one billion, plunging per-capita incomes ever further below the subsistence level. A high percentage of Africa's people will be handicapped for life by the irreversible damage of infant malnutrition. Sub-Saharan Africa could turn into the international equivalent of the urban underclass.

So far the African response to this challenge is not encouraging. In a typical reaction, Lt. General Olusegun Obasanjo, the former head of Nigeria's military government, has complained about the diversion of aid funds to, "just a few countries of Eastern Europe, while we continue to wait for the West to honor its far more modest commitments to Africa."

But before casting themselves as victims of racist-tinged Western indifference, African leaders should ask themselves what they themselves have to do with this depressing state of affairs. Why is it that a region of 450 million people has not been able to achieve a gross national product greater than that of Belgium, with its 10 million population? Why is it that its share of world trade is down to a mere 1.5%, half of what it was in 1960?

It was not lack of aid that caused the failure of Julius Nyerere's grand experiments in African socialism. Overindulgent donor governments underwrote that flawed exercise in social engineering to a fault, with record sums of aid per capita. Only now is Tanzania beginning to recover from this disaster of unintended consequences.

No Alibi

Volatile commodity prices and changes in the terms of trade provide no alibi either. Over time, commodity price gains have exceeded the losses. To be sure, civil conflicts have inflicted staggering human and economic damage, especially those fueled by outsiders such as Cuba and South Africa. But it is also true that Botswana, Africa's one shining economic and political success story, owes its remarkable progress largely to its productive diamond mines, developed with South African investment and expertise. In neighboring Zimbabwe, the railroad system would have collapsed, with disastrous consequences for the country's greatest foreign exchange earner, the tobacco crop, if it had not been for 20 South African locomotives. African countries well beyond Pretoria's reach have done no better, and often worse, than some of the so-called frontline states.

The root of Africa's economic problems, according to a recent World Bank study, "From Crisis to Sustainable Growth," is low return on investment. Africa's investment and operating costs are typically 50% to 100% above those in the most comparable area, South Asia. "Africa," the report concludes, "is simply not competitive in an increasingly competitive world."

As in Poland, phasing out distorting controls is bitter medicine, and it deserves encouragement (as by the U.S. decision to cancel its share of the official debts of Mali and Malawi, which have adopted structural adjustment programs sponsored by the International Monetary Fund and the World Bank). But the opening up of the economic system to market forces and the opening up of the political system must go hand in hand. "Leaders," the World Bank warns, "must become more accountable to their people."

Sadly, it is this lack of accountability—and the resultant profusion of corruption, bloated bureaucracies, underperforming parastatals and abuse of power—that has become Africa's common denominator, from single party left-wing regimes to conservative President-for-Life autocracies. It also applies to the racist political system of South Africa.

The self-serving rationalizations advanced by African leaders against multiparty democracy (including a free and independent press) are becoming ever more threadbare. Supposedly, multi-party systems foster tribal politics. But as one reform-minded member of Mozambique's government puts it dismissively, "what do you think we have now?"

Equally hollow is the argument that for communally oriented Africa, socialism is the natural way of life. That is a myth, contradicted on every African street-corner, and in the rural areas of Africa, where, as everywhere else, small farmers are most productive working their own land.

Of course, there is nothing peculiarly African about the reluctance of rulers to initiate reforms that could put them out of business. The missing element in Africa is a groundswell for change from below. The patience of Africa's long-suffering masses does not seem to have run out just yet. Thus far, the December riots in Benin, where angry crowds defaced a statue of Lenin, have remained an isolated incident.

Nevertheless, there are clear signs that Eastern Europe's democratic revolution against communism is unsettling to many African leaders. Zambia's Kenneth Kaunda, whose version of African socialism has brought a potentially rich country close to ruin, hastily arranged a TV interview to protest that, unlike the regimes of Eastern Europe, he had never lost touch with the people.

In neighboring Zimbabwe, the defiant reaction to the implosion of socialism was so blinkered as to border on the bizarre. The regime of Robert Mugabe has plunged ahead with plans to transform the country into a single party state based on "Marxist-Leninist principles." Such ideological bravado is likely to guarantee that the resumption of vital foreign investment, which a new investment code was supposed to encourage, will not take place.

It is one of the absurdities of our time that because of its political mandate not to deal with South Africa, the World Bank's otherwise excellent report must treat that country like a blank spot on the map, rather like ancient maps that showed imaginary dragons inhabiting terra incognita. There is no realistic scenario for Africa's recovery that does not involve a prominent role for South Africa. South Africa remains the continent's most advanced and dynamic economy, with half of Africa's productive capacity.

Even now, such politically disparate leaders as those of Zaire, Mozambique, Congo, Ivory Coast, Gabon and Guinea-Bissau are vying to get South Africa involved in the reconstruction of their economies. President F.W. de Klerk's readiness to meet the preconditions for constitutional talks with South Africa's black majority is making it easier for the leaders of the African states to acknowledge this relationship publicly.

For these leaders appreciate that, being of Africa, South Africa is the one economic power that does not have the option to disengage. As they see the attentions of the First World shifting away from Africa, they are demonstrating a heightened awareness that Africa needs greater economic cooperation and that Africa's most advanced and powerful economy must play a key part in it.

But there are at least two preconditions that must be met before South Africa can play its full part in Africa's recovery. The first is the dismantling of apartheid. Otherwise, no true normalization of relations between South Africa and the rest of the continent is possible. Nor will there be an end to the capital outflows and a resumption of foreign investment that are so critical to the strength of the South African economy.

The second is that the South African economy must be allowed to survive the transition to non-racial democracy intact, so that it can generate the growth the country and the rest of Africa so desperately need. But which economic course a post-apartheid government will follow remains very much an open—and anxious—question.

Unfortunately, the maxim that apart-

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(Continued)

heid and capitalism, like liberation and socialism, go hand in hand, has become a syllogistic trap from which few of the old and new generation of anti-apartheid leaders have thus far been able to free themselves. For a moment, it looked as if Nelson Mandela might be an exception when he was quoted by a Soweto friend and businessman as having come around to the view that only a free market can provide employment for a rapidly growing population. But that flash of common sense caused such consternation among his "scientific socialist" comrades that Mr. Mandela had to issue a hasty disclaimer. Any change in the ANC's plans to nationalize "the mines, the banks and monopoly industries" was, he said, "inconceivable."

South Africa seems to be one of the last places on earth where the display of hammer and sickle at public rallies still evokes cheers rather than jeers. That is why the first instinctive reaction of many prominent black South Africans to the collapse of socialism in Eastern Europe was to ignore or discount it. In the first half of November, when the Berlin Wall began to crumble and the democratic revolution was taking control of the streets of Prague, Sofia and Leipzig, the weekly "New Nation," unofficial mouthpiece of the anti-apartheid Mass Democratic Movement, carried not a word about these events in its two pages of world news. In the following week it finally found a way to apply spin-control to an obviously unsettling story. NATO, it proclaimed, was now in disarray.

If Mr. Mandela's apparent views are ignored, and a post-apartheid government opts for failed socialist formulas in self-defeating effort to redistribute wealth, the disastrous consequences in South Africa would be compounded throughout the continent.

Three common and consistent imperatives thus emerge for Western policy throughout Africa.

First, there must be firm insistence on market-oriented economic policies, and, second, open markets must be matched by the kind of political accountability that comes only with democratic pluralism. Where these conditions do not exist, aid simply shores up crumbling regimes, much as it did in the communist Poland of the '70s. Even more consequentially, most foreign investors will simply look elsewhere. The third element is that Africa's economic recovery, like Eastern Europe's, hinges on creating a framework for regional cooperation, one that includes South Africa.

If the lessons of the Democratic Revolutions of 1989 are heeded in Africa, the continent's tragic decline could still be reversed. The alternative is too ghastly to contemplate.

Wall Street Journal

AL TUESDAY, JANUARY 2, 1990

A Famine in the Making in Sudan

By JOHN PRENDERGAST

A lightning coup in Sudan brought an Islamic fundamentalist military junta to power this past June. So far the new government has shown little interest in bringing the six-year-old civil war to an end. Instead, Gen. Omer Bashir and his Revolutionary Command Council have bombed rebel-held towns and attempted to starve their enemies into submission. They are executing citizens without any semblance of due process. They are enacting onerous Islamic laws in a land one-third of whose population is non-Moslem.

Preoccupied with establishing its own power, the new government is displaying a fateful indifference to a looming famine. By the middle of 1990, as many as 10 million Sudanese will be at risk of starvation because of drought, war and misguided agricultural policies.

Into this desert have confidently stepped the World Bank and the International Monetary Fund. These two multilateral institutions have a long history of collaboration in economic and development planning in Sudan, and they are now promising to do even more. But the results of their past assistance should shatter any illusions that current economic development models can lead to broad-based economic growth in African countries like Sudan.

The cornerstone of the World Bank/IMF approach to Africa has been to push for increases in the export of raw materials. The idea is that by exporting grain and cotton, a country like Sudan can grow its way out of its economic difficulties. But the mechanized grain-farming and irrigated cotton schemes that the Bank has funded benefit the wealthiest segments of society with capital to invest (traders, religious leaders, military officials and large landowners) at the price of pushing smallholders off their land by the thousands.

Food production for local consumption has fallen sharply during the last decade. The Sudanese people have come to depend on imported American wheat, whose cost is subsidized by the U.S. taxpayer. Local farmers cannot compete with the cut-rate products of American agribusiness.

Meanwhile, export earnings have fallen significantly as the costs of domestic production rise because of the environmental stress inflicted by mono-cropping. The cost of pesticides has risen to one-third the total value of the cotton crop—and climbing.

To stimulate production, higher farm-gate prices have been offered by the government to producers. But in rural Sudan, the profits from higher prices are usually absorbed by wealthy monopsonistic traders, who extend credit to the small farmers whose produce they buy. The higher prices are simply intercepted.

As Sudan's cotton production becomes more costly, the price of cotton on world markets continues to tumble. This is no fluke. The World Bank/IMF export formula has been applied to many Third World countries—and they are producing many of the same commodities.

The fall in the value of Sudan's dwindling exports has been made even steeper by repeated currency devaluations. The World Bank and the IMF urge borrower countries to devalue in order to stimulate export production and to curtail import demand. Yet despite six major devaluations, Sudan's current account deficit swelled from 6% of GDP in 1977 to 11% in 1983.

As export markets sag, attempts to reduce government expenditure have increased suffering and instability. Development and social service spending were cut in half during the adjustment period of 1978 to 1985, leading to a decline in nutritional standards and health care. Over the same period, expenditures for administration and defense more than tripled.

The World Bank/IMF analysis of the "mismanagement" of the Sudanese economy is incorrect because it fundamentally misreads what the "state" really is in a place like Sudan. State policies do not represent the general interest of the Sudanese people but the interests of a few social groups: the military, wealthy merchants, landowners and high-level bureaucrats. The World Bank and the IMF may want "development"; whoever controls the state wants merely to go on controlling it.

World Bank and IMF development strategies have further reinforced the privileges of the richest segments of Sudanese society. Those strategies have also exacerbated regional inequalities, because they concentrate so disproportionately on the east-central region of Sudan. It is resentment of the biases of development strategy that helps fuel the Sudan People's Liberation Army insurgency. The SPLA, based in the non-Moslem south, has been fighting successive Sudanese governments since 1983. For the government, in turn, the desire to defeat the SPLA far outweighs any economic agenda.

Because civil conflict is incompatible with economic growth, the U.S. and its allies ought to press the multilateral institutions to freeze all transfers to the government of Sudan until a peace agreement has been reached with the SPLA. At the same time a reconstruction fund should be created and held in escrow, not to be released until peace is achieved. The conditions for assistance from this fund should not be narrowly economic, but should stress food security at the household level, environmental protection and restoration, decentralization, broad participation in government and greatly reduced military budgets. And until the war comes to an end and a more representative government is installed, the Treasury and State Departments should actively lobby for the termination of all aid to Sudan.

Mr. Prendergast is a co-ordinator of the Coalition for Peace in the Horn of Africa, an association of 60 non-governmental and church groups.

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Congressional Staff Forum
on
International Development

March 28, 1990

Director
William E. Hellert

MEMORANDUM

To: ODC Staff
From: Anastasia Primbas

SUBJECT: HEARING ON WAR & FAMINE IN THE HORN OF AFRICA
Senate Foreign Relations Subcommittee on African Affairs

Testimonies:
Panel I - Byron Dorgan (D-ND), Howard Wolpe (D-MI)
Panel II - Herman Cohen, State Department; Andrew Natsios, AID
Panel III - NGO Representatives
Members in Attendance: Chairman Paul Simon (D-IL), Nancy Landon Kassebaum (R-KA), Gordon Humphrey (R-NH)

This hearing seemed to transmit a very self-congratulatory tone. The Members of the subcommittee commended the efforts of their Congressional colleagues and Executive Department witnesses, while the government witnesses praised the leadership of the subcommittee for bringing this issue to the forefront. In turn, both the Members and the witnesses slammed the media for not picking up on this story. The NGO witnesses, however, assessed that neither branch of the US government was doing enough to reduce the suffering in the Horn of Africa.

Panel I
Summary:

Byron Dorgan, Chairman of the International Task Force Select Committee on Hunger, emphasized that the famine in Sudan and Ethiopia is not an "act of God" but a man-made tragedy. He stressed that both parties which have been involved in the bitter civil war must open the occupied borders in order to get food through to the millions of people that are likely die from famine.

Howard Wolpe, Chairman of the House Foreign Affairs Subcommittee on Africa, suggested the following elements which will be necessary to move food through Ethiopia and Sudan:

* temporary cease-fire of at least two months
* establishment of a strong UN coordinating role
* establishment of a Northern Corridor
* rapid expansion and consolidation of the Southern Corridor
* UN airlifts
* resumption of negotiations between parties at war
* de-escalation of the level of military aid from other countries

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Panel II
Summary:

Herman Cohen stated that neither of the parties in either Ethiopia or Sudan is demonstrating sufficient effort to provide relief to their war-torn and famine-stricken countries. Cohen acknowledged that although Ethiopia had, in the past, received arms from the Soviet Union, Israel, and various Arab nations, Soviet involvement is starting to "thin" and the Israelis have assured US officials that they have no military advisors in Ethiopia.

Andrew Natsios stated that the situation in Ethiopia is very grim due to the lack of rains in the summer and the continued civil war which has blocked food relief coming into the country by way of a northern passage. This is significant because 70% of the population has been displaced to the northern territories that are controlled by the country's two largest insurgent groups. According to Natsios, the situation in Sudan offers little more hope. Although the United States and other donor nations have been able to deliver food to Sudan through the "Operation Lifeline Sudan" agreement, the continued fighting has made it difficult for the private organizations to maintain their relief efforts.
In closing, Natsios stressed that the famine in Ethiopia is "past the point of no return." According to Natsios, even if all of the routes were open, we still would not be able to get a sufficient amount through to prevent mass starvation. He stated that people are going to die; it is now a matter of reducing that number.

Panel III
Summary:

NGO witnesses stated that State Department assessments of the situations in the Horn of Africa are too optimistic. Below were several key points asserted:

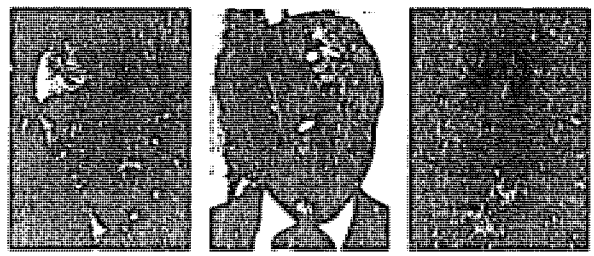
* Peace is nowhere on the horizon
* The Sudanese government has agreed to a "declaration of integration with Lybia", intended for the unification of the two countries
* US should stop supporting MDB aid to Sudanese government
* US has several points of leverage
  e.g. Ethiopia's desire for IMF and WB participation
* Israeli continued military assistance, especially to the Ethiopian Air Force
* UN should take a more aggressive role than it has in the past

SOUTH AFRICA

Pretoria's Reforms Take Sting Out of New Sanctions Drive

But the Hill prospects for lifting of old restrictions await broader steps to dismantle apartheid

South Africa's announcement that it will legalize the African National Congress (ANC) and release from prison its leader, Nelson Mandela, was greeted warmly on Capitol Hill the week of Feb. 5, but members stressed that reforms were only a first step toward ending the system of racial separation, apartheid.



Reforms by de Klerk, left, have encouraged many, but Rep. Wolpe, center, Sen. Kassebaum, and others await further steps to dismantle apartheid.

Republicans and Democrats alike commended South African President F. W. de Klerk, who in a Feb. 2 speech at the opening of Parliament unveiled the most far-reaching revisions of apartheid since its inception 42 years ago.

But members also called for more change, and most indicated that it would be premature to suspend the 1986 law mandating sanctions against South Africa. Sanctions must remain in effect, many contend, because de Klerk's announced reforms don't go far enough. The reforms, however, have deflated efforts for tougher sanctions, giving the Pretoria government time to take further steps toward dismantling apartheid. And the Bush administration gains more time to negotiate a bipartisan policy with Congress.

"The unbanning of the ANC, the release of political prisoners ... are very positive steps toward reconciliation," said Sen. Nancy Landon Kassebaum, R-Kan. But "much more needs to be done." Kassebaum said that she would be ready to see sanctions lifted when Pretoria releases Mandela, rescinds the state of emergency, and fulfills the other conditions in the sanctions law. Then, Kassebaum said, "we'll move to a proportionate response on lifting sanctions."

In addition to revoking the 30-year ban on the ANC, the leading black organization in South Africa, and promising the release of Mandela, jailed since 1962, de Klerk announced other changes. Among these were:

- The repeal of emergency regulations restricting freedom of the press, except for those governing television coverage of scenes of unrest.
- A more limited application of the death penalty, which has been used against political prisoners.
- The removal of curbs on the activities of 32 other organizations.
- The lifting of restrictions on the movements and contacts of 374 people who have been under government surveillance for political agitation.
- The provision of a doctor and lawyer to political detainees and the limiting of their detention to six months.

Dramatic as they are, however, de Klerk's reforms leave untouched the basic structure of apartheid. The Population Registration Act, which classifies every South African by race, and the Group Areas Act, which enforces the segregation of neighborhoods, remain in place. Also remaining are the national state of emergency laws, except for those curtailing radio and newspaper coverage. Thousands of dissidents have been jailed since the state of emergency was imposed in June 1986.

Rep. Ronald V. Dellums, D-Calif., chair of the Black Caucus and one of the most vociferous critics of apartheid in Congress, said of the new reforms: "It is imperative to clearly understand that even these measures, laudable as they are, do not constitute the establishment of freedom or true democracy for the black majority."

Dellums and other members dismissed speculation that de Klerk's announced reforms might warrant a review of the U.S. policy of economic sanctions against South Africa.

"The sanctions should be maintained in full force. This is no time to relax them," said Sen. Edward M. Kennedy, D-Mass. Kennedy credited the sanctions with helping force the reforms unveiled by de Klerk.

The Sanctions Law

With the passage of the sanctions law (PL 99-440) in 1986, Congress barred importation of South African coal, steel and agricultural products and prohibited air travel between the United States and South Africa. The sanctions also ban exports of oil, arms, computers and nuclear items to apartheid-enforcing agencies and forbid U.S. firms to extend new loans to South Africa or to make new investments there. *(1986 Almanac p. 359)*

A study cited in *The Washington Post* Jan. 14 indicates that U.S. sanctions, along with those of other countries, have cost South Africa between $32 billion and $40 billion in the last four years, including $11 billion in net capital outflows and $4 billion in lost export earnings.

Coenraad Bezuidenhout, a South African Embassy spokesman, noted that sanctions had hurt his country's economy. In order to help de Klerk along the path toward reform, he said, the United States should "encourage the moderates in South Africa by assisting the economy."

But under the U.S. anti-apartheid law, the South African government must do five things before sanctions can be suspended: free Mandela and all other political prisoners; repeal the state of emergency and release all persons detained under it; legalize democratic political parties and incorporate all South Africans into the political process; repeal the Group Areas Act and the Population Registration Act; and agree to enter into good-faith talks with "truly representative" black leaders.

The law allows the president to terminate sanctions if Mandela and others are released and if any three of the last four conditions are met.

So far, de Klerk has gone about halfway toward meeting the first three conditions. As of Feb. 8, Mandela remained in prison, although his release was considered imminent.

"These actions clearly fail to satisfy the conditions for repeal of the Comprehensive Anti-Apartheid Act," said Senate Majority Leader George J. Mitchell, D-Maine.

By Michael P. Shea

On Feb. 2, Howard Wolpe, D-Mich., who chairs the House Foreign Affairs Africa Subcommittee as well as a bipartisan task force on South Africa, ticked off a list of changes that Pretoria needed to make before the United States could consider ending sanctions.

Wolpe said de Klerk must follow through on the partial lifting of the state of emergency and must release some 1,000 political prisoners held under the nation's strict security laws.

In addition, Wolpe said de Klerk should "establish a specific timetable" for negotiations with black leaders. Wolpe dismissed as unacceptable de Klerk's "group rights" proposal, a formula that many say would grant political representation to blacks while preserving white-minority rule.

But while Wolpe's tough stance reflected prevailing sentiment on the Hill, some members back more flexibility. The ranking Republican on Wolpe's Africa Subcommittee, Dan Burton, Ind., favored a "carrot and stick" policy, one in which the United States would ease sanctions one by one as new reforms were instituted.

"If the South African government continues to move toward democracy ... I will be happy to lead the charge to start ending the sanctions," said Burton, a longtime sanctions foe.

Burton predicted that if the state of emergency is lifted and Mandela is released, pressure will build on the Hill to reconsider the sanctions policy.

The Bush Administration

The Bush administration has given signs that it would consider relaxing sanctions should democratic trends in South Africa continue. On Feb. 1, White House spokesman Marlin Fitzwater said Bush would invite de Klerk and Mandela to the White House for separate visits.

Speaking of the Pretoria government, Bush told reporters Feb. 2: "I think when people move in the right direction, it's certainly timely to review all policy." But the president refused to commit to a timetable or a quid pro quo on sanctions. "We haven't got into any specifics on that at this point. I mean, we want to see the policy initiatives go forward, and the release of Mandela."

A senior administration official Feb. 8 said that Bush agreed with members of Congress that de Klerk's reforms did not yet justify lifting sanctions.

Bush's reluctance to push for removal of sanctions reflects his acknowledgement of Congress' strong feelings on the South Africa issue. In 1986, Congress overrode President Ronald Reagan's veto to impose the sanctions. The action was the first override of a presidential veto on a major foreign policy issue since 1973.

Breaking with the Reagan administration's confrontational approach, Bush has tried to work with Congress in developing a bipartisan policy toward Pretoria.

When some on the Hill were calling for additional sanctions against South Africa last year, Bush persuaded leaders to delay imposing new sanctions until the de Klerk government, which assumed power in September, had a chance to deliver on its promise to move the country toward multiracial democracy. *(1989 Weekly Report p. 2659)*

"I think when people move in the right direction, it's certainly timely to review all policy." But "we want to see the policy initiatives go forward, and the release of Mandela."

—President Bush

According to an aide at the House Africa Subcommittee, administration officials want to work with Wolpe's task force on South Africa to develop a sanctions policy.

The aide said he doubted that Bush would make a bold move on sanctions without first canvassing people on the Hill. "He doesn't want a confrontation with Congress" over South Africa.

Administration reluctance to act unilaterally may also stem from the fact that South Africa has become something of a civil rights issue in the United States.

Pauline Baker, a senior associate at the Carnegie Endowment for International Peace, said Bush will not risk a fight on the South Africa issue during an election year, especially when the Republican Party is courting black voters. "Republicans are not going to want to jeopardize" their status with black voters, she said.

Added Sanctions Unlikely

If sanctions aren't likely to be eased, they aren't likely to be increased either. Many observers said de Klerk's announcement took the wind out of the sails of those pushing for added sanctions against South Africa.

The sanctions movement "is effectively dead in the water," said a researcher at the Center for Strategic and International Studies who asked not to be identified. The analyst said that even if Mandela's release were postponed indefinitely and the state of emergency dragged on through the spring, calls on the Hill for greater sanctions would come "only from the usual people" and would not reflect majority sentiment.

Even sanctions proponent Wolpe favors holding off on additional ones for now. "I'm prepared to wait a period here to see what will happen," he said. Wolpe said that for now the United States should "be doing everything we can" to see democratic reforms put into place. But he warned that if momentum for change slows, the issue of additional sanctions will be resurrected.

A Democratic staffer at the Africa Subcommittee said that de Klerk's reforms could delay the negotiations between Wolpe's task force and administration officials over a new, bipartisan approach toward South Africa and any additional sanctions. The aide said that de Klerk's speech had bought the South African government more time, but "how much more time is unclear."

"I think the likelihood is that Congress will wait until the South African parliamentary session has run its course" before deciding what to do about sanctions, said Randall Robinson of TransAfrica, a lobby group in Washington. The South African Parliament adjourns in June.

In late February, House Banking's International Development Subcommittee will hold a series of hearings on South Africa. The hearings ostensibly will focus on legislation (HR 3458) introduced by subcommittee Chairman Del. Walter E. Fauntroy, D-D.C., to bar U.S. banks from providing some financial services to South Africa.

But panel staffer Francis Kornegay said that de Klerk's announcement would "obviously affect" the progress of Fauntroy's bill, and the hearings may serve as a broad review of U.S. policy toward South Africa. ■

Number 107 January 29, 1990

CSIS AFRICA NOTES

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Africa in the 1990s

by Michael Clough

Since the dawn of the postindependence era in the early 1960s, Africa has been pushed and pulled by the tides of the Cold War. Although the influence of the European powers, especially France, survived the demise of colonialism, the axes on the charts used to plot the flow of events on the continent shifted dramatically. The challenges facing African leaders (the range of their options, the resources available to pursue different strategies, and the risks involved in doing so), as well as the issues confronting officials in the governments of the major powers, came to be defined in terms of simple dichotomies: East versus West, socialist versus capitalist, Moscow versus Washington.

From 1957 (when Ghana gained its independence and the Eisenhower administration recognized the need for a policy toward sub-Saharan Africa) until the mid-1980s, U.S. policymakers heeded one overriding prescription—prevent Africa from falling under the sway of the Soviet Union. Throughout this period, despite much lofty language about development and democracy, debates regarding Africa centered on strategies and tactics to counter Soviet influence. The amount of official attention and resources devoted to various areas of the continent was determined primarily by perceptions of the nature and extent of a Soviet presence or threat. In the early 1960s and mid-1970s, when the threat seemed great, Africa was a concern of U.S. presidents and secretaries of state. At times when or places where the threat seemed small and remote, Africa was left to the Africanists.

Gradually, in the years 1985-1988, the unexpected happened. The Cold War ended in Africa, and with it the relevance of the ideological and strategic compasses that had been standard issue to the officials and opinion leaders who had served as foot soldiers in the Cold War's many skirmishes. Both the East and West now face the challenge of developing new ways of understanding the continent and new means of addressing its problems. Toward this end, the Stanley Foundation convened a small but diverse group of experts from the United States, Europe, and the USSR at the Airlie House Conference Center near Warrenton, Virginia, in late October 1989 to discuss the changing global context of U.S. policy toward Africa. See page 3 for a list of participants. This issue of *CSIS Africa Notes* derives from a report of the three-day discussions prepared for the Stanley Foundation. (For an earlier commentary relevant to this topic, see "If the Cold War is Over in Africa, Will the United States Still Care?" by Martin Lowenkopf in *CSIS Africa Notes* no. 98, May 1989.)

The Cold War Sequence in Africa

Most of those present at Airlie House agreed that the Cold War has ended in Africa and that there is little prospect of its revival. Less clear, however, is what the end of the Cold War will mean for Africa and for the policies of the United States and other nations toward Africa. To answer these questions requires an understanding of what the Cold War meant for Africa in the first place and why it came to an end.

The Cold War was a bipolar competition for strategic and ideological hegemony between two militarily predominant superpowers, one of which was also the world's preeminent economic power. The end of the Cold War involves more than just an end to U.S.-Soviet competition in Africa and other parts of the Third World. It entails a transformation in the structural relationships underlying that competition. More concretely, it marks a decline in the ability of Washington and Moscow to shape and color events in Africa; it also signals the growing importance for Africa of some new external actors. In short, changes are occurring in *both* the nature of U.S.-Soviet interactions in Africa *and* the weight of those interactions in the African equation.

In traditional military terms, the United States and the Soviet Union are still the world's only superpowers. But that now seems to matter less than it once did, especially in Africa. This is largely the result of a recognition of the limited utility of military power. Through experience on terrain as varied in natural and sociopolitical terms as the rice paddies of Vietnam, the mountains of Afghanistan, and the bush in Angola, U.S. and Soviet leaders have learned how difficult and costly it can be to attempt to convert military might into lasting geopolitical victories in the Third World. In Africa, moreover, it is a paradoxical fact that most countries that have received large amounts of military assistance over lengthy periods of time (e.g., Angola, Ethiopia, Somalia, and Sudan) are among the least secure on the continent as the 1990s begin. For Africa at least, Mao is thus in need of amending: what flows from the barrel of a gun is the semblance of power but the reality of insecurity. This realization has altered the superpowers' thinking about military commitments in Africa.

There was agreement at Airlie House that, in the short term, neither Washington nor Moscow is likely to eliminate its military presence entirely. But the nature and significance of this presence have already undergone much change. Major new commitments of arms and advisers are not on any foreseeable agenda in either Washington or Moscow. Existing commitments are being steadily reduced. And, most significant, neither power seems more than perfunctorily concerned with the "threat" represented by the lingering involvements of the other.

The end of the ideological Cold War in Africa has been even more sudden and dramatic. The division of states into rival ideological groupings, one espousing socialism and nonalignment with an Eastern tilt and the other embracing capitalism and alignment with the West, was never very firmly rooted in African soil. These were nonetheless the terms in which many African leaders chose to represent themselves and their policies in international forums; and it was in these terms that U.S. and Soviet officials chose to calculate gains and losses on the continent and distribute largesse. Such ideological appeals have now lost their currency, and more and more constitutions are being rewritten in nationalist rather than ideological terminology.

Pretensions to building socialism or promoting capitalism have been punctured by the increasingly evident sameness of conditions on both sides of the rhetorical divide. What most observers found when they surveyed the results of three decades of ideological competition were countries (whether "socialist", "capitalist", or "nationalist") with authoritarian, sometimes brutal, one-party regimes and faltering economies overburdened by bloated and inefficient state sectors, huge external debts, and disastrous agricultural policies. By the mid-1980s, neither the East nor the West could point with pride to a single clear-cut model of success for its ideological project in Africa. With the ascent of Gorbachev and the sea changes that are now breaking in Eastern Europe, the very idea of socialism as an alternative path of development is in doubt.

Prospects for Constructive Collaboration

Signs of an end to the Cold War in Africa quickly gave rise to hopes that the superpowers might join together to address some of the continent's most pressing problems. Optimism about the prospects for a new era of constructive collaboration was heightened in late 1988 by the success of the negotiations the two powers cooperated in orchestrating on Namibia's forthcoming

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EDITOR: Director of African Studies Helen Kitchen.

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independence and the withdrawal of Cuban forces from Angola. For the first time in the post-World War II period, U.S. and Soviet officials worked together in an open and nonantagonistic manner to resolve a bitter political-military conflict. If the superpowers could work together to achieve Namibian independence, it has been reasoned, perhaps they could also work together to resolve other African conflicts, or solve the debt crisis, or protect the African environment, and so on. Most of those present at Airlie House were skeptical of this follow-on reasoning.

Without the stimulus of strategic and ideological competition, it is far from certain that either the United States or the Soviet Union will be inclined to retain anything more than a token presence in Africa, much less commit the human and material resources that would be required to cure the continent's myriad economic, institutional, and human ills. In the Horn of Africa, for example, neither Moscow nor Washington has indicated a willingness to do anything more than quietly urge the parties to the various conflicts in the region to go to the bargaining table, while holding out the possibility that they might simply cut their ties with the warring parties.

When the Angola-Namibia accords of December 1988 are cited as a prescriptive model for U.S.-Soviet cooperation, three points are usually overlooked: (1) Had it not been for concerns in the mid-1970s about growing Soviet influence in southern Africa, the United States probably would not have taken the lead in efforts to promote Namibian independence. (2) In cooperating to settle the Namibian issue, both Moscow and Washington were acting in ways that would eventually reduce their commitments in the region. (3) It should not be forgotten that the Angola-Namibia settlement became a feasible undertaking because of new circumstances and developments over which the two superpowers had at best limited control. As several participants noted, the real turning point in the negotiations came on the battlefields of southern Angola as a result of military actions independently taken (and not taken) by Cuba and South Africa. (See "A Guide to the Intricacies of the Angola-Namibia Negotiations" by Gillian Gunn in *CSIS Africa Notes* no. 90, September 1988.)

The most that can be expected in the way of U.S.-Soviet cooperation in Africa would seem to be a series of mutually self-denying understandings. Both powers, for example, seem largely to have abandoned the propaganda war whereby each sought to blame the other for most of Africa's troubles. They also seem to have agreed, implicitly if not explicitly, to avoid actions that might lead to confrontations. It would help to limit the damage inflicted in the continent's internal wars if they were to go a step farther and agree to eliminate arms transfers to the continent. Neither these actions nor any others that the erstwhile superpowers might take will end conflict in Africa, but they could encourage a change of direction.

One area in which most of those present at Airlie House agreed that the United States and the Soviet Union ought to be urged to play a significant role is that of

The name of CSIS Africa Notes derives from a three-day roundtable on "Global Change and Africa: Implications for U.S. Policy," hosted by the Stanley Foundation at Airlie House Conference Center near Warrenton, Virginia, in late October 1989. Africa was one of four world regions assessed in concurrent sessions of the Stanley Foundation's thirtieth Strategy for Peace, U.S. Foreign Policy Conference. Participants in the Africa roundtable, all of whom attended in their personal capacity rather than as representatives of their governments or organizations, were:

- Michael Clough (chair), Senior Fellow for African Studies, Council on Foreign Relations, New York
- Robert J. Berg, President, International Development Conference, Washington, D.C.
- John Chipman, Assistant Director for Regional Security Studies, International Institute for Strategic Studies, London
- Warren Clark, Senior Deputy Assistant Secretary for African Affairs, Bureau of African Affairs, Department of State
- Gary Cowan, Senior Technical Adviser on the Private Sector, Africa Bureau, Agency for International Development
- William J. Foltz, Professor of Political Science, Yale University
- Ralph P. Hofstad, Consultant and former CEO, Land O'Lakes, Inc., Edina, Minnesota
- Helen Kitchen, Director of African Studies, Center for Strategic and International Studies, Washington, D.C.
- Winrich Kühne, Head of Africa Department, Research Institute for International Politics and Security, Stiftung Wissenschaft und Politik, Ebenhausen, West Germany
- Neil MacFarlane, Associate Professor of Government and Foreign Affairs, University of Virginia
- J. Stephen Morrison, Staff Consultant, Subcommittee on Africa, House Foreign Affairs Committee
- Sergei Shatalov, Africa Institute, Soviet Academy of Sciences, Moscow
- John Stremlau, Deputy Director, Policy Planning Staff, Department of State
- Ernest J. Wilson III, Director, Center for Research on Economic Development, University of Michigan
- James L. Woods, Deputy Assistant Secretary of Defense, ISA/Africa
- I. William Zartman, Director of African Studies, School of Advanced International Studies, Johns Hopkins University
- Michele Bessin (rapporteur), Council on Foreign Relations

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providing humanitarian assistance and support for reconstruction in Sudan, Angola, Ethiopia, and Mozambique. The depth of human suffering in these war-torn countries is beyond the ability of most of us to comprehend. The combined toll of the dead, maimed, and brutalized is in the millions and rising.

Although spawned by local grievances and power struggles, the wars in these countries were fueled and fanned with arms and rationales proffered by the superpowers. It is not enough, therefore, for U.S. and Soviet officials simply to declare the Cold War over and go home. As the conflicts in these countries wind down, each in its own way, at its own pace, there will be a tremendous need for large-scale rehabilitation efforts, and neither Moscow nor Washington should be allowed to forget its obligation to support such an effort with more than hollow words and surplus goods.

In fields other than conflict resolution and rehabilitation, it is not realistic to expect joint action by the United States and the Soviet Union to yield significant results. With regard to the environment, health, population, and most of the other important nonsecurity issues in Africa, the superpowers' superpowerdom never had much significance.

Other External Actors

In economic terms, the superpowers, especially the Soviet Union, have never been the dominant force in Africa. The United States is the major trading partner of only a few; if trade in oil is excluded, the number of such countries shrinks to almost zero. Most African countries, especially the francophone ones, have remained closely linked economically with their former metropoles. This is even more true with regard to direct investment than with trade. Europe as a whole has always contributed far more in development assistance to Africa than has the United States.

As a result of trends over the past decade, the United States is becoming an even less influential economic force in Africa. In 1987, the United States ranked fifth on the list of major aid donors to sub-Saharan Africa, behind France, the World Bank, Italy, and Germany. It has now also been surpassed by Japan.

The most important external economic forces in Africa are currently the International Monetary Fund and the World Bank. (See "How the IMF and the World Bank Affect African Decision Making" by Carol Lancaster in *CSIS Africa Notes* no. 97, April 1989.) In the past, these institutions were perceived as extensions of the United States. While such perceptions linger on in Africa, the reality is that both institutions have developed an increasing degree of autonomy.

The two unfolding international developments that could have the greatest impact on Africa over the next decade are the integration of Europe and the emergence of a more independent, internationally minded Japan.

Europe's movement toward greater economic unity is a mixed blessing for Africa. On the positive side, a single European market could open new opportunities for African countries that are able to develop manufacturing export industries, as long as the preferential access that Africa receives under current agreements between the EEC and the African, Caribbean, and Pacific countries is not eliminated. On the other hand, a single European market may only serve to highlight the relatively marginal economic significance of European trade and investment in Africa. Moreover, the sudden changes in Eastern Europe have created a demand for economic assistance as well as openings for foreign investment that will inevitably reduce the resources available for Africa.

European bilateral interest in Africa also may have to be reassessed. For many years the one certainty in assessments of foreign involvement in Africa was that the French were on the continent to stay. (See chapter 3, "Which Outside Power Has the Most Influence in Africa?," of *Some Guidelines on Africa for the Next President* by Helen Kitchen, CSIS Significant Issues Series, 1988.) Several participants in the Airlie House dialogue believe that this is changing and that a mood of "Afropessimism" is developing in France. The Franc Zone is no longer as profitable an arrangement as it once was, and French investment in francophone Africa reportedly has declined by 25 percent. Among the other European countries, only Italy seems to be increasing its economic role in Africa.

Japan's emergence as an international economic power, on the other hand, could have positive ramifications for Africa. The Japanese government has already announced its intention to make $60 billion in economic assistance available to the continent and there is speculation that Japanese investors might seek to use Africa as a base from which to penetrate the new European market.

Uncertainty about the Japanese role in the 1990s focuses on the fact that Tokyo has increased its aid in large part because of urging from the United States and others, and does not appear to have an Africa policy per se. Part of the problem is that Japan lacks any real expertise or experience with Africa and has not yet developed a clear sense of where Africa fits into its overall foreign policy. In the short run, at least, the Japanese are likely to continue to concentrate their aid in the cofinancing of projects with the World Bank.

In sum, Africa is becoming less and less the economic preserve of any country or group of countries and more and more the concern of multilateral institutions. Increasingly, bilateral aid will take the form of contributions to the multilateral agencies. Any future efforts to address African problems will have to take this new reality into account.

Dimensions of Africa's Crisis

There was a consensus around the table at Airlie House that Africa is in a state of crisis and that the crisis has many aspects. Among the most critical of the problems facing the continent in the decade ahead are:

- Political and institutional crises that have contributed to the collapse of effective government in a host of

countries and spawned civil wars in at least seven.

- An AIDS crisis more serious than that on any other continent, with incidence of the disease among professionals of the critical nation-building elite—politicians, civil servants, the military, business. (See "AIDS in Africa: Knowns and Unknowns" in *CSIS Africa Notes* no. 74, July 1987, and "AIDS as a Factor in U.S. Foreign Relations" in *CSIS Africa Notes* no. 93, December 1988, both authored by Lynn W. Kitchen, M.D.)
- A debt crisis from which a growing number of countries seem to have little hope of escaping without wholesale debt cancellations.
- An environmental crisis that is gobbling up critical arable lands and forests.

One of the Airlie House participants suggested that we should think in terms of "two Africas": (1) those countries such as Niger and the Central African Republic where it is not realistic to expect significant economic development in the foreseeable future (short of unexpected finds of minerals or oil), and the main challenge is survival; (2) countries such as Nigeria and Zimbabwe that could, with future-oriented leadership, policies, and assistance, experience at least modest takeoffs. The first group of countries are destined to remain dependent on the international community for the foreseeable future, whereas the second have a more encouraging option.

A Basis for Hope?

The dismal record of the past three decades has caused many outside observers, and a growing number of Africans, to question whether more external assistance is the answer to the continent's needs. An old slogan—"African solutions to African problems"—is gaining new currency among both Africans and Africanists. A consensus appears to be forming that Africans must face up to the fact that most of their problems are home-grown and that, as the superpowers and others pull back in a world reshaped by the end of the Cold War, ways must be found to address those problems which do not depend on large inflows of foreign assistance.

In this regard, almost everyone around the table at Airlie House agreed that Africa's future hinges in large part on (1) the emergence of a stable middle class capable of providing continuity of managerial and entrepreneurial leadership and (2) the establishment of representative, responsive, and enduring governmental structures. Such an agenda would refocus the policies of the major external powers on helping to strengthen nongovernmental sectors in African societies and encouraging African governments to pursue policies that will allow those sectors to thrive.

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Richard H. Solomon

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Sustaining the Dynamic Balance in East Asia and the Pacific

United States Department of State
Bureau of Public Affairs
Washington, D.C.

Following is a statement by Richard H. Solomon, Assistant Secretary for East Asian and Pacific Affairs, before the Subcommittee on Asia and the Pacific, House Foreign Affairs Committee, Washington, D.C., February 22, 1990.

Is History Ending, Recurring, or Advancing?

We have all been consumed of late with the extraordinary rush of events in Eastern Europe and the Soviet Union that are restructuring major aspects of our political universe. But as you well know, Asia is no less dynamic a region. And, while the political shifts now unfolding in Asia and the Pacific have their own character and significance, they are spurred by the same global trends that have brought such dramatic change to Europe: the failure of communism as a political and economic system; global economic integration sparked by rapid technological change; and movement toward free-market policies and democracy. I should also note another current that is increasingly evident on a global scale—renascent ethno-nationalism.

All these trends are playing out in Asia's unique political, cultural, and historical milieu, just as they are in Europe and the U.S.S.R. I should add that in all these developments, we see not the end of history, as some have surmised, but, if anything, the return of historical patterns of an earlier era as we move from the bipolar world of superpower dominance to a polycentric world. Some even hear echoes of an earlier time when problems with resurgent powers and American economic turmoil fostered tendencies toward an isolationist, protectionist America.

But I firmly believe that we are not headed back to the 1930s, much less to the 19tn century. America's economy is fundamentally sound; we are enhancing our competitiveness even as we press to open markets worldwide; and we maintain vital alliances that help stabilize the peace. Moreover the American people understand that meeting the challenges of the 1990s will not work with a "fortress America" mentality. What is required is a purposeful engagement in both the economic and security affairs of Asia as well as Europe.

Reaffirming our role as a Pacific power, Secretary Baker has called for "a new partnership in the Pacific." As the features of the world of the coming century become more clearly defined, I am more convinced than ever that the U.S. role, as the dynamic balancer in Asia, is crucial to regional—and global—stability in the 1990s.

At my confirmation hearings last June, I outlined a five-part agenda for meeting the challenges of the 1990s: managing the U.S.-Japan partnership; reaffirming the consensus on collective security; resolving regional conflicts; stabilizing the troubled Sino-American relationship; and enhancing Pacific economic cooperation.

In the subsequent 9 months, I have come to better understand the full meaning of that somewhat daunting expression usually attributed to the Chinese: "May you live in interesting times." Many of our most significant foreign policy successes of

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the 1980s—democratization, economic dynamism, and national growth—have also generated the challenges that are our agenda for the 1990s.

Asia-Pacific Developments

In the Bush Administration's first year in office, we have seen the nations of East Asia undergoing difficult rites of passage as they lurch toward the world of the 21st century.

• The demise of communist regimes in Eastern Europe, particularly of Honecker in East Germany and Ceausescu in Romania, has put new pressures for reform on the communist governments of Asia.

• The difficulties in consolidating democratic gains are painfully evident in the recent events in the Philippines; yet we see continuing advances in political reform in South Korea and in Taiwan.

• Generational leadership changes are unfolding at varying paces, with those in China, North Korea, and Vietnam holding potentially far-reaching consequences for regional stability, while those in Burma, Indonesia, and Singapore also will have a significant impact on the region.

• In China, we see continuing political repression and the potential for instability as Deng Xiaoping and other leaders struggle to sustain economic reform and openness to the outside world.

• In Asia, the rhetoric of Soviet "new thinking" has outpaced its reality, although we have begun to see reductions in Soviet troop concentrations, particularly those arrayed against China.

• A continuing devolution of power toward a more traditional multipolar geopolitical configuration is underway as Japan, China, and India emerge as new global and regional power centers.

What do these developments mean for U.S. interests, and what policy responses does the Administration envisage?

U.S.-Japan Partnership

Japan remains the keystone of our engagement in Asia; and it increasingly is a partner in our global endeavors. As Tokyo adapts both domestically and externally to its new status as a leading world power, both the United States and Japan are striving to bring about fundamental structural changes in the U.S.-Japan relationship.

Domestically, 1989 was an atypical year in Japanese politics: there were three prime ministers and two elections. Opposition parties have gained control of the upper house for the first time. The results of this week's elections, however, suggest that the situation has stabilized, with the Liberal Democratic Party (LDP) in firm control of the lower house, and the continuation in office of Prime Minister Kaifu. Although the Japan Socialist Party (JSP) did score impressive gains, these were largely at the expense of other opposition parties.

During the campaign, the LDP said it was the only party capable of managing the complex U.S.-Japan relationship. We hope that with elections now over, we can make rapid progress on our diverse agenda of economic adjustment and foreign policy coordination.

Our policy toward Japan has three main pillars: economic relations; security cooperation; and a global partnership.

• Through the Structural Impediments Initiative (SII), the latest round of which begins today, we are addressing fundamental obstacles to **economic balance** on both sides of the Pacific. SII must be viewed as a long-term endeavor providing a framework for correcting the asymmetries in our economic relationship and further opening up the Japanese economic system to the world.

In addition to the SII talks, we are pressing for progress on sector-specific problems such as opening the construction market and the "Super 301" issues of satellites, supercomputers, and forest products. I should point out that Japan's economy is becoming increasingly driven by domestic expansion rather than export growth. Japanese imports of manufactured goods have doubled since 1985, accounting in 1989 for 50% of Japan's total imports. Japan's overall current accounts surplus for 1989 fell to $57 billion, a $30 billion drop since 1987; and U.S. exports to Japan grew by 18% as our bilateral trade deficit fell to $49 billion. U.S. exports to Japan totaled $44.6 billion last year—equal to those of the U.K., West Germany, and Italy combined.

At the same time, we know that a bilateral trade deficit of this magnitude is politically unsustainable; and the Administration is determined to pursue programs which will rapidly bring the total down to a manageable level.

• The second pillar in our Japan policy is the **security relationship.** Our defense cooperation with Japan continues to deepen. Japan already provides 40% of the costs of stationing U.S. forces in-country and has continued to increase its capabilities to fulfill agreed- to roles and missions. Secretary [of Defense] Cheney is in Tokyo this week, exploring the prospect of further Japanese contributions to the common defense.

The codevelopment of the FSX fighter plane is proceeding apace. The program will not only provide U.S. industry with $2.5 billion workshare during the production phase, but it will also ensure a flowback to the United States of all technologies Japan brings to the program—and at no cost to U.S. taxpayers. We see this program as the harbinger of more balance in technology flows between our two countries. It is a program that clearly serves the interests of the United States.

• The third main pillar is our effort to expand our already considerable cooperation and coordination on a broad range of foreign policy matters into a truly **global partnership.** For example, Japan is expanding its role in international financial

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and political institutions. Prime Minister Kaifu's recent trip to Eastern Europe, where he unveiled a package of loans and guarantees for Poland and Hungary totaling $1.95 billion, is a good example of the new Japan pursuing foreign policy objectives in parallel with our own. Japan has also played a large role in the Multilateral Assistance Initiative (MAI) in the Philippines and in ameliorating Third World debt. The recent write-down by Japanese banks of Mexican debt is a good case in point.

Similarly, Japan continues to increase its overseas development assistance, already the largest development assistance program in the world. And Tokyo's interest in contributing to a solution to the Cambodia conflict is an important factor in the emerging peace process. Japan is also playing a larger role in transnational issues such as the environment and drug control. For instance, Tokyo is providing some $160 million in economic support for Colombia. In all these areas, we are coordinating closely with Japan and view this array of issues as the substance of our global partnership.

China

Deputy Secretary Eagleburger has recently given your committee a detailed analysis of the Administration's China policy; of our consistent efforts to balance our outrage at the repression with our national interest in sustaining our engagement with the People's Republic of China (PRC) on a broad range of issues. I would, however, like briefly to update and amplify his comments.

First, our human rights report, which was released yesterday, lays out a frank assessment of the widespread human rights abuses and repression initiated with the massacre at Tiananmen Square last June.

At the same time, Chinese authorities have taken some positive, if limited, steps toward normalizing the situation: the lifting of martial law in Beijing; assurances on M-9 missile sales; the release of 573 detainees; the accrediting of our Voice of America (VOA) correspondent; and progress toward resumption of the Fulbright program. For our part, we have taken modest steps such as resuming basic human needs loans by the World Bank and licensing commercial satellites for launch on Chinese rockets.

Chinese authorities, however, have yet to take the steps necessary to heal the wounds of last June's tragedy, end the climate of repression, and resume the reform process. Tighter restrictions on study abroad have recently been imposed; Fang Lizhi is still in the U.S. Embassy; VOA is still being jammed; and we remain concerned about reports of possible Chinese weapons sales to unstable parts of the world.

While the steps China has taken in recent weeks are insufficient to return the situation to normal, they do signal a desire on the part of Chinese leaders to sustain a working relationship with the United States and to keep the door to the outside world at least partially open. Deputy Secretary Eagleburger expressed the President's view that it is not in our interest to see an isolated China return to a "spoiler role" in Asia. He also explained that China's strategic significance should not be seen through the narrow prism of the so-called strategic triangle. Instead, China's strategic significance lies in its potential role in an increasingly multipolar world. A modernizing China at peace with itself and its neighbors is critical to stability in East Asia.

Taken together, the elements of our policy—sanctions still in place and continuing economic, cultural, and other contacts designed to encourage a return to reform—reflect a balance of competing objectives with regard to China and the world at large. Dialogue with Beijing on regional conflicts, such as Korea and Cambodia, conventional and nuclear arms control, and global issues, such as the environment, serves our national interest; just as continuing opportunities to study abroad, receive information about global developments, and promote economic development serves the interests of those in China who seek modernization and reform.

Consolidating Democracy in the Philippines

The struggle for political openness in China is but one expression of the global surge toward democracy—as we have seen most dramatically in recent months in Eastern Europe.

One of our most important friends and treaty allies, the Philippines, is struggling to sustain the democratic gains of its "people power" revolution. The failed coup attempt of last December was the most serious challenge yet to President Aquino's government. We condemned this extraconstitutional activity in the strongest possible terms and made clear that our law would require suspension of aid should President Aquino be overthrown. We unequivocally stand by this policy.

Indeed, when rebels began their assault on military installations on December 1, President Bush immediately issued a statement affirming U.S. support for Philippines democracy—in deeds as well as words. We are grateful for the bipartisan support the President's decisive action has enjoyed.

After 4 years in office, the Aquino Administration has many important achievements to its credit. The restoration of democratic institutions and 4 years of robust economic growth are essential foundations of the prosperous and stable Philippines we all want to see. In addition, the communist insurgency has plateaued and has begun to decline.

Since the December coup attempt, Mrs. Aquino has taken a number of important, measured steps to apprehend and punish rebel leaders, limit economic disruption, and bring new blood into her government. She has put increased emphasis on government competency and efficiency. Clearly, Manila's performance in delivering basic services and fighting

corruption—issues the coup plotters sought to play on—along with implementing market-oriented economic reforms, is critical to preempting any future extraconstitutional threats to democracy and consolidating the gains made in the post-Marcos period.

Finally, I want to stress the fundamental importance we attach to democracy in the Philippines. The MAI, for which the Administration last year requested a multiyear $1 billion allocation, reflects our commitment to strengthening the economic basis of social and political reforms in the Philippines. As we approach negotiations on our use of the important military facilities at Clark and Subic Bay, it is important to stress that our overriding concern is the development of democracy and our historic friendship with the Filipino people, to which our support is primarily directed. I believe we share with them a strong common interest in the development of their society and in regional stability, to which our defense cooperation makes such an important contribution.

Regional Conflicts

The most immediate challenge to stability in East Asia and the Pacific is the resolution of regional conflicts. The two remaining conflict zones in this region are Indochina and the Korean Peninsula; and we have been active diplomatically in both areas, particularly regarding the Cambodia conflict.

Indochina. After suspension of the August [1989] session of the Paris Conference on Cambodia and the withdrawal of Vietnamese combat units, action initially shifted to the battlefield. The resistance forces have made some significant gains in recent months, particularly in western Cambodia. The noncommunists, particularly Son Sann's Khmer People's National Liberation Front (KPNLF), have also expanded the areas under their control.

And while the Hun Sen regime in Phnom Penh still controls the majority of Cambodian territory, its military performance has been weak. There are even reports suggesting that Hanoi is again giving active military support to its Cambodian surrogate.

At the time of last fall's UN General Assembly, Secretary Baker expressed our determination to prevent a dialogue of the battlefield from supplanting the dialogue at the negotiating table. He proposed that the UN Security Council's five permanent members take more initiative in formulating a political solution which could be recommended to the Khmer factions. To overcome the central obstacle of powersharing, which impeded success at the Paris conference, you, Mr.Chairman [Stephen J. Solarz], and Australian Foreign Minister Evans put forward the idea of an enhanced UN role in a Cambodian settlement—a concept the Administration had been exploring for some time.

This idea quickly attracted considerable interest toward the end of last year as the conflict on the battlefield intensified. In mid-January, the five permanent members of the UN Security Council met in Paris and reached agreement that an enhanced UN administrative role could be an important element in fostering a stable environment in which the United Nations could also organize free and fair elections. The five permanent members met again in New York February 11-12 to explore in greater detail how the United Nations might advance the Cambodian peace process.

The five members are still some distance from agreement on important practical aspects of how a comprehensive peace settlement might be attained. But there is general consensus that a UN peacekeeping and monitoring force and UN supervision of a transitional administrative structure are essential to creating a neutral political environment in the run up to free and fair elections. It is also significant that UN Secretary General Perez de Cuellar recently established a Cambodia task force under his personal direction to facilitate planning for such a UN role.

The challenges to the United Nations and to the international community in creating such an unprecedented peace process are daunting. Yet momentum seems to be building: Indonesia, cochair of the Paris conference, is hosting a meeting of concerned regional parties next week in Jakarta and the permanent five will meet again in Paris in mid-March. In this continuing endeavor, we remain guided by our three basic policy objectives: a verified withdrawal of all Vietnamese troops; effective measures to prevent the return to power of the genocidal Khmer Rouge; and self-determination for the Cambodian people. These are the essential conditions for moving into a new era in Indochina—including normalizing our relations with Vietnam, which depends on an acceptable political settlement in Cambodia.

Korean Peninsula. On the Korean Peninsula, we see fewer signs of momentum toward conflict resolution. Yet the North may be reassessing some of its long unproductive policies. South Korean President Roh Tae Woo's innovative policies of *nordpolitik* have achieved important economic contact with China and political and economic breakthroughs with the Soviet Union and the emerging democracies of Eastern Europe. Unfortunately, the North-South dialogue, which we view as the key to reducing tensions on the peninsula, has produced few concrete achievements.

At the same time, we are sustaining our efforts to build a dialogue with North Korea in support of Seoul's objective of drawing Pyongyang out of its self-imposed isolation. We have had seven meetings with North Korean officials at the political counselor level in Beijing since December 1988. And we have widened academic and other unofficial exchanges with North Korea. We hope to expand our contacts further, but such a development re-

quires reciprocity. Gestures such as Pyongyang's acceptance of an International Atomic Energy Agency (IAEA) safeguards regime, the return of Korean war remains, and credible assurances that the North has ceased to support terrorism will allow us to advance our dialogue.

We are deeply concerned about Pyongyang's continuing unsafeguarded nuclear activity. Secretary Baker pursued this issue at the recent Moscow ministerial with Foreign Minister Shevardnadze. We view Pyongyang's acceptance of an IAEA safeguard regime as an important indicator of North Korean intentions.

Finally, I should note that while Pyongyang has made ambitious arms reduction proposals, it continues to refuse the most basic confidence-building procedures such as the exchange of observers at military exercises, not to mention the exchange of mail with the South. We view the Korean Peninsula as one place in Asia where European-style "confidence-building measures" can reduce tensions and ultimately lead to stabilizing arms control agreements.

If Pyongyang is serious about reducing the massive levels of arms on the peninsula, it would do well to follow Mr.Gorbachev's example and reduce and reconfigure its forces into a posture of "reasonable sufficiency." I am sure that both Washington and Seoul would respond to any such tension-reducing initiatives.

Reaffirming the Security Consensus

The unresolved military confrontation on the Korean Peninsula highlights the continuing importance of our forward deployed deterrent forces which have maintained stability in the Asia-Pacific region for the past four decades. As we speak, Defense Secretary Cheney is in the region consulting with our allies on modest reductions in our forces deployed in Korea, the Philippines, and Japan. These adjustments in our regional security presence, which are the result of our East Asia security strategy review, are designed to consolidate and modernize our forces, taking into consideration the enhanced strength of our allies and likely threats in the region.

The Administration will be reporting soon to Congress in great detail on the results of this strategic review. But I would like to make a general comment on the security situation in East Asia.

For four decades, the United States has been the central unifying hub of a network of bilateral security relationships in the Pacific. We are the dynamic balancer, the buffer force, and the ultimate security guarantor in a region of great political, cultural, and historical diversity.

We see a new strategic environment emerging in Asia. It is characterized by the emergence of new power centers—Japan, China, and India—and by the growing strength of smaller states that are attaining unprecedented high-tech military capabilities.

We also see the Soviet Union adjusting its military presence in Asia in an effort to strengthen its political and economic access to this dynamic region. As Mr.Gorbachev's Asia policy has evolved since 1986, Soviet rhetoric has outpaced Soviet behavior. Nonetheless, we have seen ground force reductions in Mongolia and along the Sino-Soviet border and reductions in Soviet forces deployed at Cam Ranh Bay. Along with Sino-Soviet detente, these developments are to be welcomed. They clearly move the Soviets toward a military posture of "reasonable sufficiency" and help reduce tensions.

At the same time, however, we see the continuing modernization of Soviet air, naval, and strategic nuclear forces in the Far East. While the absolute numbers of Soviet planes and ships have lessened, their replacement with more state-of-the-art hardware is enhancing Soviet firepower and mobility. In addition, Moscow continues to deploy forces on Japan's occupied Northern Territories.

While Soviet initiatives, such as improved relations with China, are welcome, they in no way mitigate the importance of our security presence in the region. When we examine real and potential conflicts in the Pacific, we see a region in which the world's largest armies—U.S., Soviet, Chinese, Japanese, North Korean, South Korean, Vietnamese, and Indian—coexist in uneasy balance.

Any diminishing of the credibility of the U.S. forward deployed deterrent would only produce an increase in regional tensions, with other powers tempted to fill any perceived gaps. For the forseeable future, we—and most nations in the region—view the United States as the irreplacable balancing wheel. No other power is viewed as an acceptable substitute for our critical stabilizing role.

All the same, recent reductions in superpower tensions and the increased capabilities of our allies are opening new possibilities for redefining the character of our security presence in the region. This has been the focus of our strategic review; and it will be an important component of our diplomacy in the region. I should emphasize, moreover, that the specific number of forces deployed in the Pacific should in no way be viewed as the measure of our commitment to regional security. We intend to remain a Pacific power in every respect, for our engagement in the region remains crucial to the pursuit of fundamental U.S. security and economic interests.

Pacific Economic Cooperation

Our economic relations with the states of East Asia and the Pacific constitute the third—and increasingly the most important—pillar of U.S. engagement in the region. Increasingly, economic factors are the key to national strength—above all in Asia—and the Administration has actively pursued efforts to enhance Asia-Pacific economic cooperation. The economic dynamism of the Pacific Rim has made this region one of the major engines of global economic

growth. Yet the dynamic economies of the individual states of East Asia have outgrown international mechanisms of coordination and cooperation.

In order to address this fact, last November, Secretary Baker, along with his colleagues from 11 other Pacific Rim nations, attended the first ministerial of what has become known as APEC—Asia Pacific Economic Cooperation process. This meeting launched what in time may become a new multilateral institution for strengthening the infrastructure of regional economic cooperation.

We are currently preparing for a second APEC ministerial meeting this summer in Singapore. Senior officials of the 12 APEC states have met on several occasions to begin putting together a work program focusing on such issues as regional transportation and telecommunications development, environmental concerns, and human resource growth. And APEC trade ministers have met informally in the General Agreement on Tariffs and Trade (GATT) as we try to build an APEC caucus in support of the success of the Uruguay Round of trade talks.

APEC is an evolving process designed to strengthen the world's open trading system. We hope it will provide a framework for drawing in other market-oriented economies in the region and encouraging reform in those countries coming late to the region's economic dynamism. We view the APEC process as a critical economic initiative designed to build a sense of collective purpose among economies that have grown strong on open trade and to bring more balance to our economic relationships with Asia and Europe.

In sum, these are the elements of our overview of regional developments and challenges and our agenda for maintaining the United States as a stabilizing power in the dynamic Pacific region in the 1990s and beyond.■

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UNITED STATES POLICY TOWARD SOUTH ASIA

An Address By

Richard N. Haass

Special Assistant to the President and

Senior Director for Near East & South Asian Affairs,

National Security Council

to

The Asia Society

Washington, D.C.

January 11, 1990

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I am pleased to be here this evening. The Asia Society has a long and distinguished tradition of providing a forum for serious and well-informed discussion about some of the most important public policy issues facing this country. I shall do my best to keep this tradition intact.

I am especially pleased to be here this evening speaking about South Asia. It is a part of the world that for reasons I will confess to not understanding does not receive the attention in this country that it should. I say this not to be polite, but out of basic self-interest. South Asia is simply too important for so many of us in the United States to know as little about it as we do.

I believe this importance is self evident. But in case there are some who remain unpersuaded, let me take a moment to catalogue the reasons why Americans ought to inform themselves about South Asia:

South Asia--defined to include India, Pakistan, Bangladesh, Sri Lanka, Nepal, Bhutan, the Maldives and Afghanistan--is home to well over one billion people. Some 1/5 to 1/4 of the world's population can be found between the western reaches of Afghanistan and Pakistan on one side and the eastern reaches of

Bangladesh and India on the other. One cannot ignore this fact any more than one can ignore China or all Latin America.

The combined GDP of South Asian countries is some $350 billion. This represents a collective annual rate of growth in recent years of approximately 4.5%. U.S. trade with India alone totals about $4 billion a year now. And the potential for additional growth in trade and investment is great.

A quick glance at the map indicates something else. South Asia is located between the energy-rich Persian Gulf and the Asia-Pacific, and borders on both the Soviet Union and China. Strategic thinking may be out of fashion in some quarters nowadays, but it is not out of date. South Asia is not only important in itself, but has the potential to affect developments in other areas of great significance as well.

Closely related to this last point is the fact that South Asia demands our attention because of its potential for conflict. There is an unfortunate history of violence--the 1947 clashes that occasioned Indian and Pakistani independence, the 1962 Sino-Indian war, the 1965 and 1971 wars between India and Pakistan, the 1979 Soviet invasion of Afghanistan and the subsequent decade of strife. Bad enough in its own right, the potential for conflict in South Asia is especially worrying given the prospects for the continued proliferation of advanced conventional as well

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as unconventional weapons and the danger that local conflict could draw in the great powers, resulting in something far more terrible.

It is for these and related reasons that South Asia remains an important foreign policy concern of the United States and the Bush administration. This is in itself nothing new, for previous administrations have also concerned themselves with this region. But some things have changed. Again, let me look backwards before I attempt to address the present and future.

For much of the post World War II era, U.S. policy toward South Asia was characterized by three tendencies. First, we tended to see the region in East-West terms. The global policy of containment of communism was extended to and applied in South Asia much as it was elsewhere, with the key exception that no U.S. military forces were stationed in the region. U.S. aid was provided in copious amounts over the past 40 years--nearly $4 billion in military aid, another $22 billion in economic loans and grants--in an effort to limit the reach of China and even more the Soviet Union. Pakistan was incorporated into the worldwide system of alliances, while India was seen by many Americans as a potential showcase of non-communist development.

Second, and related to containment, we sought to carry out a policy that promised close U.S. relations with both India and

Pakistan. Not surprisingly, this proved easier to design than conduct. We often ended up with a policy that left us little choice but to choose between friendship with India and friendship with Pakistan. And even this less-than-ideal policy often fell short of the mark--more than once we did enough on Pakistan's behalf to alienate India but not so much that we managed to please Pakistan.

Third, our interest in these two countries and in the region as a whole was at best uneven. The tendency was to ignore South Asia except when local tensions boiled up and forced themselves onto our agenda. We would then engage in some crisis diplomacy, only to pull back once the crisis had passed. The result was that we were not in a position to do as much as we might have to help prevent crises or manage them effectively once they did occur.

My intention here this evening is not to critique my predecessors, any more than I look forward to being graded by my successors. What I will say is that for a host of reasons containment mostly worked, that both China and the Soviet Union gained influence but that this influence was and is limited; that the United States often did underestimate the power of local rivalries as it saw the region through a global lens; and that we may have paid a price for our inconstancy.

But I would quickly add that on balance I think the United States

has much to feel good about. South Asia today is, like much of both Europe and the Asia/Pacific, largely democratic. The foundations for sustained economic growth are increasingly in place. Violence between the region's two principal states has been avoided for nearly two decades, and there is reason to believe that renewed conflict between them is less likely now than it has been at any time during these two decades. I would like to think that the United States, by its example and its policy, can take some credit for these developments.

But my intention here tonight is not to talk about the past so much as the present and future. What I want to address is what is taking place in South Asia, the challenges as we see them, and what we think ought to be done about them.

Let me begin with how we see South Asia. It is important to view South Asia, both its governments and its peoples, in their own right. By this I mean we in the United States no longer view the region as a subset of our relationship with either the Soviet Union or China, as some piece on the global chessboard if you will, but rather as a key political and economic entity in and of itself. The mellowing of East-West rivalry will only increase this tendency to see this and other regions as distinct rather than as part of a global whole.

Second, it is important to note that we will do everything

possible to resist making our relations with India and Pakistan an "either/or," "zero-sum" proposition. Here we are fortunate. One of the little noticed legacies of the Reagan administration was improved U.S. relations with both Islamabad and New Delhi. It is our intention to maintain and where possible extend this legacy. In my view there is no choice. In the modern age it is neither prudent nor possible to have a successful relationship with only one of these two states. We will require good relations with both or we will likely end up with good relations with neither.

Third, we intend to remain engaged and avoid swings of neglect and embrace. Thus, and returning to my first point, the calming or relaxing of the Cold War will not bring about a period of neglect of South Asia, benign or otherwise, in Washington. U.S. interests are not linked to the interests of others in some mechanical way. Our interests in South Asia are direct, not derivative.

This, then, is the background or the foundation to what we are seeking to do. Our ability to succeed, however, will depend upon our ability to meet the challenges that face us in the region. Let me address them one by one.

The first and most important challenge facing us all is the need to make democracy permanent. I say this not simply because I

believe democracy to be the finest form of organizing political and social power known to man--although it is. I also say this for reasons of realpolitik. Only democracy offers a political system that provides flexibility for change. Only democracy offers a political context in which dynamic economic growth can take place. And only democracies offer the kind of government in which regional conflict is far less likely to take place. Governments that are accountable to their own people and free institutions are much less likely to embark on foreign folly.

South Asia has made important strides in this area. Like millions of others, I was much struck by a photograph that appeared in the newspapers this past December. It showed Rajiv Gandhi, the outgoing Indian Prime Minister, congratulating V.P. Singh, his successor. The peaceful transfer of political authority was taking place. What was remarkable is just how normal it all appeared. This scene was the fitting culmination to a vigorous and free election--not to mention more than forty years worth of experience--in the world's largest democracy.

Fortunately, India is not alone here. People everywhere applaud the fact that Pakistan just celebrated its first anniversary of the end to martial law and the return of democracy. There is a strong democratic tradition in Sri Lanka. We look to democracy putting down roots elsewhere; in this regard, I want to single out Bangladesh, the region's second most populous country. We

often hear from the people of that country how much they desire democracy. We wish them every success, and strongly hope that district elections being considered for later this year will constitute a step toward the creation of a functioning democracy.

But in all these countries democracy is under strain or even attack. At its core democratic government is government of restraint. The government understands and accepts that there are limits to what it can do. And the governed, the people, accept that they too must accept limits on their behavior if democracy is to work. There is no place for extremism. Nor is there any place at all for violence.

Unfortunately, South Asia is home to a variety of individuals, groups and forces that are no friends to democracy. Politicians who put party or personal gain before country, soldiers who reject popular choice, terrorists who resort to violence, those who profit from the trade in drugs, religious zealots who seek to impose their vision upon others--all are to be condemned and resisted. Democracy will only be assured when such concepts as civilian primacy, loyal opposition, the rule of law, an apolitical judiciary, political pluralism and religious tolerance are recognized and practiced.

South Asia's future will also only be bright if the standard of living continues to rise. Here too the key is in the hands of

both the governments and the governed. What is required is less government--reduced regulation, streamlined bureaucracy, fewer restrictions--and in their place more opportunity for entrepreneurship, investment and development.

Much has already been accomplished. India already possesses by some counts the world's largest middle class. Economic growth rates averaging 5% over the past decade (and 10% in 1989) testify to both the innate talent of the Indian people and the advantages of unleashing economic forces. Pakistan can point to similarly impressive rates of economic growth for the decade just ended.

But more can and needs be done. South Asians would be better served by increased privatization and decreased subsidies. Foreign investment can play a major role here as a source of resources, technology and know-how. But it can only play such a role if given the chance. South Asian governments must ease the rules governing foreign investment if companies are to choose to invest in South Asia as opposed to investing elsewhere.

Moreover, liberalization of investment and of trade go hand in hand. We for our part are sensitive to the need of South Asian countries for access to the U.S. market. But trade must be a two-way street. If we are to expand the already impressive access enjoyed by developing countries for their manufactured goods, we will need to be assured that our exports, including

services and intellectual property, will be fairly treated.

A third principal challenge concerns less the political and economic developments within individual states than it does developments between and among them. As I noted earlier, South Asia has all too often been a venue of conflict. It remains a region where enormous resources are devoted to preparing for conflict. India, with the world's fourth largest army, devotes some 16% of its budget to defense. Pakistan meanwhile allocates more than 1/4 of all government spending to its military. Among the developing regions of the world, South Asia enjoys the uncertain distinction of possessing the fastest rate of growth of military spending.

The key to regional stability remains relations between India and Pakistan, South Asia's two most powerful states. The reasons for rivalry between these states are many and are deep-rooted. Where the sources of potential conflict can be negotiated--for example, on territorial disputes such as that over the Siachen Glacier in Kashmir--they should be. Both sides will have to compromise in the end; both sides can expect to benefit from the result. Nothing less than strong leadership, or better yet statesmanship, will be required.

Other steps can also be taken to lessen tensions. Increased trade as well as cultural and educational exchanges can work to

break down walls of mistrust. Cooperation against terrorism is another area where both countries would benefit. A firm commitment by governments to work against individuals and groups fomenting separatism and violence in the other would be an important step. So too would intelligence sharing and joint police-military patrols of relevant border areas. Similarly, there is the potential to cooperate on narcotics enforcement.

Another fruitful area for expanded cooperation falls in the realm of what are commonly known as "confidence building measures." Here, the U.S.-Soviet relationship and the East-West relationship in Europe more broadly indicates the large menu of potential choices. The two governments could make formal the practice of providing advance notification of all military exercises above an agreed threshold. Exercises could also be kept away from sensitive border areas. And each government could be invited to send observers to witness the exercises of the other. Pakistan's decision to publicize and then invite observers to its recent military exercise was a step in the right direction.

Similarly, the two governments could continue efforts to establish special procedures and dedicated communications links to facilitate communications in times of tension and in the event of military accidents. They could also agree to common "rules of the road" at sea and in the air. Such understandings, by building trust and reducing uncertainty, should help avoid

accidents and incidents occurring in the first place; failing that, they should help limit the damage and work to prevent something minor from becoming something major.

What makes all of this so important is the reality that both Pakistan and India have made significant strides toward the development of nuclear weapons and the means to deliver them. Some 16 years after India's test of a nuclear explosive device, the reality is that both India and Pakistan refuse to sign the Nuclear Non-Proliferation Treaty, refuse to accept full-scope IAEA safeguards or open their nuclear facilities to international inspection, and refuse to halt research and development related to nuclear weapons.

There are those in both countries who will defend these policies. Some will point to the U.S.-Soviet relationship, arguing that nuclear weapons can be stabilizing and in any case ought not to be restricted to the original "haves" and denied to the "have nots." Some will point more directly to the other, arguing that Pakistan needs nuclear weapons to counter India or vice versa. There is the view that a bilateral or even South Asian accord makes no sense given the capacity of China and others to affect regional security. And some in both countries simply are attracted to nuclear weapons, be it for security, prestige, or both.

In the interests of time, I will not address these and related arguments in great detail. What I will say is that whatever the alleged benefits of nuclear weapons, the risks are great. The process of managing the transition from a non-nuclear to a nuclear regional balance is fraught with danger. And any potential for deterrence must be weighed against the potential for pre-emption and the certain costs if deterrence breaks down. Nuclear weapons are anything but a panacea for the region's ills; they are far more likely to make these ills far worse.

If, however, for the reasons cited here just a moment ago neither country is willing to eschew the nuclear option altogether, there are steps that each can take to add stability to a potentially destabilizing situation. One step has already been taken in large part: an agreement by Islamabad and New Delhi not to attack one another's nuclear facilities. What is needed now is to fully implement this historic pact and to exchange the required information about designated nuclear facilities.

Other confidence building measures in the nuclear field would also be useful. A bilateral ban on the testing of nuclear explosive devices in any environment would be a major milestone. So too would arrangements to exchange visits of observers to one another's nuclear facilities. Worth considering too are bilateral consultations on doctrine, safety, and command and control.

My emphasis here tonight on India and Pakistan is not meant to imply that they alone are somehow synonymous with all of South Asia. They are not. Any arrangement for the region's security must include all South Asian states if it is to be truly effective. The 1988 South Asian Association for Regional Cooperation (SAARC) Convention on the Suppression of Terrorism is a good example of what can be done. There is the opportunity to develop greater regional economic integration. Similarly, the SAARC has the potential to become a key forum for the discussion and treatment of regional issues.

In meeting South Asia's challenges, India, as the region's largest and strongest state, bears special mention. Both economically and militarily, India has resources at its command far beyond those available to any other South Asian state. But with these resources comes a corresponding responsibility. The Indian government is aware that if Indian power is to be welcomed and constructive rather than feared and resented beyond its borders, it must use its strength wisely and fairly and not for narrow national advantage. India could help allay concerns by providing an explanation of its purposes and intentions to its neighbors as well as others with legitimate interests in the region.

The United States stands ready to assist South Asians as they

enter the 1990s. No one should question our political commitment to democracy. It is a cornerstone of our foreign policy. We are similarly prepared to assist economic growth, be it through aid, investment, or trade, which transfers know-how as well as capital. Here I would only point out that there are limits to what we as a government can accomplish. The private sector will have to assume the lion's share of the effort; this in turn requires that the governments of the region create an atmosphere receptive to American firms.

We are also prepared to contribute to regional stability. This is nothing new. We have long promoted and suggested ways to enrich a dialogue among the region's states. Moreover, South Asia and Pakistan in particular has been a principal recipient of U.S. security assistance for years. And we are also willing to make available some of our advanced technology, such as F-16s for Pakistan or assisting in the development of India's Light Combat Aircraft.

But such participation on our part in South Asia cannot be maintained apart from consideration of its consequences or developments in the region more broadly. Let me then state for the record what I see as governing our security cooperation:

--We begin with a recognition of India's position in the region. Our desire is to work with India so that its substantial

capabilities are developed and used in a manner that serves not only our bilateral interests but also those of all the people and countries of South Asia with which we enjoy friendly relations.

--Sale of high technology equipment is an important component of our exports to India. Other than those items barred from sale because of potential nuclear or ballistic missile applications, there are no automatic criterion for determining whether some technology or system ought to be transferred. In cases of advanced technologies, we will have to consider the potential for compromise as well as the potential impact on Indian military capabilities and the potential consequences of an increase in the reach and destructive power of these systems.

--At the same time, our readiness to make available desired systems will be affected by India's foreign and defense policies and by its willingness to articulate a convincing and reassuring rationale for itself and its role in the region. Toward this end, we look forward to a more developed set of consultations with India on matters of regional and indeed global security--consultations that are commensurate with India's growing role and that in my opinion are long overdue.

--We have no desire to exacerbate the rivalry between India and Pakistan; indeed, our policies aim at encouraging improved relations between them. At the same time, the United States has

a special relationship with Pakistan. Pakistan's valiant support for the Afghan resistance was and is much admired by Americans. That said, ours is a relationship that pre-dated the conflict in Afghanistan and one that will survive its end. An important element of this relationship remains our willingness to contribute to Pakistan's security requirements and the means for its self-defense.

--Our willingness and our ability to assist Pakistan is not and cannot be open-ended, however. Resource constraints are a reality that affect our assistance program worldwide. More important, the specific military items we can provide must be able to meet the criteria of contributing to the legitimate self-defense needs of Pakistan. A regional arms race is in the interests of no one.

--I would be remiss if I did not add that our continued ability to meet any of Pakistan's needs in this area depends upon our continued ability to certify, as President Bush did with some difficulty this past autumn, that Pakistan does not possess a nuclear explosive device and that U.S. security assistance reduces the risk that Pakistan will develop and come to possess such a device. This has been a policy of Democratic and Republican administrations, and one that enjoys widespread support in the executive branch and the Congress. Prime Minister Bhutto's June 1989 pledge, that "Speaking for Pakistan, I can

declare that we do not possess, nor do we intend to make, a nuclear explosive device," is thus most welcome. Nevertheless, Pakistan's continued efforts in the nuclear field are troubling and raise concerns about the potential for a regional nuclear arms race.

Before concluding my remarks, I want to take a few minutes to address another strategic challenge to the region. I speak now of Afghanistan. We are assembled here this evening just over a decade after the Soviet invasion of Afghanistan--an invasion the Soviet Foreign Minister now characterizes as "illegal"--and nearly a year since the last Soviet combat forces were driven out by the valiant mujahedin. Yet this signal accomplishment of national resistance does not provide much opportunity for cheering, for the fighting and the suffering continue. Afghans continue to die. More than 3 million remain refugees in Pakistan. The rebuilding of a country awaits.

The United States was and is proud of its support for the Afghan resistance. And we are prepared to continue this support. But let me also make clear that what we seek is not continued fighting but peace. We prefer and are committed to a political settlement of the conflict. But it must be a settlement that is just and it must be a settlement that will actually bring peace.

Right now, the war continues for some very simple reasons. Far

and away the most important factor is that Najibullah and his cohorts refuse to step down. Until they do, peace will remain little more than a hope. And let us not kid ourselves--what enables Najibullah and his associates to hang on is Soviet military and economic aid, now estimated at some $250-$300 million a month, or $3-$4 billion a year. The Soviets have only departed Afghanistan in form, not fact.

The position of the United States is quite easy to explain. We seek a non-aligned Afghanistan that is at peace with itself and its neighbors. We seek a political settlement that will satisfy most Afghans and be representative of the many shades of Afghan political opinion. We believe that Najib and his closest associates will have to agree to transfer political power as part of a process leading to a settlement. Beyond that, we are not wedded to any single political course, political grouping or political outcome; again, what we are supporting is an Afghan solution to Afghanistan's conflict.

This, then, is the fourth challenge for South Asia: to end the war in Afghanistan. Together with the institutionalization of democracy, the creation of the foundations for sustained economic growth, and the building of arrangements for regional stability, the end to this conflict provides a basis for South Asia to enter the 1990s and participate fully in the decade's promised prosperity.

Acting Secretary Eagleburger

Current
Policy
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U.S. Actions Toward China

United States Department of State
Bureau of Public Affairs
Washington, D.C.

Following is Acting Secretary Lawrence S. Eagleburger's statement before the Senate Foreign Relations Committee, Washington, D.C., February 7, 1990.

I know that many of you and your colleagues in the Congress have serious concerns about the Administration's actions toward China. I believe, however, that we have a strong case to make for the policy we are pursuing. I am here today to make that case to the best of my ability.

In the early 1970s, China was still gripped by the repression of the Cultural Revolution. Yet, as the normalization process began, we Americans were charmed by ping pong diplomacy, panda bears, and the exotic banquet cuisine of sea slugs and *mao tai*. Somehow, the political repression of that time received scant attention here—until the Chinese themselves made a critical assessment of Chairman Mao's rule.

The China of the 1980s—despite the appalling tragedy of Tiananmen Square—has come a long way from the era of the Gang of Four. China, under Deng Xiao ping's modernization program, opened itself to foreign news media—and it largely remains open today, with some important exceptions. It encouraged foreign investment and joint ventures—and still does so today. It sent tens of thousands of students abroad—and, despite the events of last June, they are still coming. Indeed, the children of senior Communist Party leaders continue to work and study abroad—not in the countries of the East bloc but in the United States, Western Europe, and Japan.

Yet these changes—in a country long isolated from world trends—seem to escape our attention as we focus on the violence of last June. Today, in the eyes of many foreign observers, China's leaders seem unable to do anything right, even as many of them seek to sustain key elements of Deng Xiaoping's modernization program.

As we reassess our China policy, we should keep in mind that the P.R.C. has changed over the past two decades. We need a better balance between our fascination with the China of the early 1970s and today's mood of disappointment and hostility. Scholars of U.S.-China relations have long noted the pendulum swings in public attitudes toward China: the "good China" wartime ally that all too easily became the "bad China" of Red Guards and revolutionary repression. In the real world, we need to see that China is less completely charming than the land of panda bears and the Great Wall and also less completely evil than a night in June when the "Goddess of Democracy" was crushed by tanks in Tiananmen.

U.S. Interests and Policy Objectives

Through five Administrations, representing both parties, the United States has pursued a consistent set of policy objectives with regard to China.

First, we have sought to nurture a strategic relationship with China aimed at drawing the Chinese out of their isolation and encouraging their cooperation on major international issues. While initially China was clearly perceived as a counterbalance to Soviet expansionism, its strategic role has evolved over the years to encompass a number of global issues.

Second, we have sought to encourage China to use its influence in the East Asian region to reduce tensions and to promote stability. Here, too, there has been an evolution from our initial preoccupation with differences over Taiwan and the conflict in Vietnam to a broader range of regional concerns—including our concern that there be peace in Cambodia and in Korea.

Third, we have sought to engage the Chinese in a wide variety of exchanges and other activities that will bolster political and economic reforms and the promotion of human rights.

Fourth, we have sought to increase economic and commercial relations with China, so as to advance the movement toward a market-oriented economy.

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These objectives have guided U.S. policy for the past 20 years and will continue to do so for the foreseeable future. Why? Because a secure, stable, modernizing, and reforming China, at peace with itself and with its neighbors, is in America's best interests.

The Strategic Dimension. Much has been said and written about China's strategic value to the United States. There has been talk of "the China card" and the "strategic triangle." Indeed, in the eyes of many, China's value to the United States has been as a strategic counterweight to the Soviet Union. For some, therefore, a decline in U.S.-Soviet tensions apparently diminishes the importance of the relationship between the United States and the People's Republic of China.

But that is emphatically not the view of this Administration. While U.S.-Soviet tensions may be declining, the strategic value of our relationship with China is not. In an earlier time, both the United States and China were justifiably alarmed by the expansionist appetite of the Brezhnev regime. Quite naturally, the United States and China found common cause in seeking to stem this adventurism. We readily found parallel interests in Cambodia, Afghanistan, the Horn of Africa, and elsewhere.

Today we cannot yet say that those regional crises have been fully resolved or that our parallel interests with China in resolving them have come to an end. At the same time, however, we all recognize that the dramatic reforms occurring in Eastern Europe and the Soviet Union have altered the strategic scene. But such changes have not reduced the importance of China to the United States so much as they have transformed the way in which we must view the international significance of the P.R.C.

Yes, China remains relevant in resolving the conflicts left over from an earlier time of Soviet expansionism. But of even greater importance is the fact that, as the world's most populous nation, a country with great economic potential, and the possessor of a significant military capability, China's participation is essential to coping successfully with a number of transnational issues. These include, among others, the proliferation of missiles and nuclear weapons, chemical weapons proliferation, and environmental pollution. Thus China's strategic significance needs to be seen not simply through the narrow prism of the Soviet factor but on the far broader scale of its place in an increasingly polycentric world.

The Regional Dimension. Even were we to decide that China's world role is not critical to global stability, it should be self-evident that the same could not be said about its impact on regional tranquility. Peaceful resolution of border disputes, restraint on the Korean Peninsula, and political settlement in Cambodia, for example, are all matters of consequence for regional stability in Asia. As our own web of relationships with the countries of Asia continues to grow, our stake in the peaceful development of that region is obvious. Neither we nor our friends in the region wish to see an isolated China return to a "spoiler role" in Asia, supporting subversive activities as it did in the 1950s and 1960s. This Administration, therefore, believes that dialogue with China on important regional issues is both desirable and inevitable.

Internal Reform and Respect for Human Rights. Dialogue with the Chinese is essential for other reasons as well. Since the beginning of our post-World War II relationship with China, we have witnessed substantial, though not always steady, progress in the material and spiritual well-being of the Chinese people. As the Chinese moved to put the excesses of the Cultural Revolution behind them in the late 1970s, political relaxation at home and the opening to the outside world gradually increased.

We and the Chinese agreed to normalize relations in December 1978, a watershed period in Chinese history. At the time, Deng Xiaoping redirected the path of China's modernization effort at the "Third Plenum," a party meeting that charted a dramatically new course of economic and political reforms. The benefits of that new course soon spread throughout the country, bringing freedom to publish, to speak, to travel, and to engage in private economic enterprise. The Chinese opened their universities, Chinese students came to our shores, and American scholars traveled to theirs. Indeed, as a measure of the popular influence of these reforms, Deng Xiaoping became *Time* magazine's "Man of the Year"—not once but twice.

One of the features of this period was the deliberate and painstaking effort by people in the United States and in China to create as broad and deep a set of institutional relationships between our two countries as possible. The impulse to building these relationships was the realization that historically, the Chinese political process has performed unevenly; that is to say, that China has been subject to episodic convulsions, that these convulsions have sometimes directed Chinese energies inward and sometimes outward, and that there is no guarantee of consistency or evenness in our relations with the Chinese.

It was precisely with these considerations in mind that those who normalized U.S.-China relations sought to develop quickly as many relationships—economic, political, educational, scientific, cultural, athletic, and social—as possible. Contacts and relationships such as these could only help promote reform within China and enhance respect for human rights. Such contacts and relationships could also help to shorten the periods of tension between China and the United States that experience suggested would likely occur from time to time.

Economic and Commercial Ties. Finally, since we have normalized relations with the Chinese, we have sought to expand our economic and commercial ties through trade and investment. U.S.-China trade has jumped from $2.3 billion in 1979 to approximately $18 billion in 1989. And U.S. investment in China has grown from virtually nothing in 1979 to $4 billion in 1989. This U.S. support for economic development has greatly enhanced progress in the P.R.C. toward market-oriented reforms.

The Constancy of U.S. Efforts to Achieve Our Policy Objectives

It is this set of objectives that has guided U.S. policy over the past two decades. It was not always that way, however. Our opening to China in 1971 was preceded by the difficult experience of the 1950s and 1960s, when our policy of isolation and sanctions against China led to frequent confrontations, expensive defense precautions, periodic threats to regional stability, and a notable absence in China of internal reform or respect for human rights. Some of the very same voices now condemning us for seeking to maintain a relationship with the P.R.C. were criticizing the United States 20 years ago for refusing to recognize the regime of Mao Zedong and for ignoring the Chinese people.

When we opened relations with China in 1971, it was not because of the promise of internal reform or positive external behavior by the Chinese. Rather it was because of our own assessment that we could best pursue our national interests by beginning a dialogue with them.

The same is true today and for the same reasons. A balanced, step-by-step approach to China, exercising a mix of incentives and constraints and avoiding the extremes of our policy of the 1950s and 1960s, has well served U.S. objectives.

To be sure, problems have arisen along the way. The Chinese—a people who historically have harbored within themselves a struggle between internationalist forces seeking contact with the outside world and nativist, xenophobic forces inclined toward isolationism—have exhibited a strong tendency to take two steps forward and then one step back. For example, in the 1970s, we witnessed a backward plunge during the so-called anti-Confucius campaign, the short-lived ascendancy of the Gang of Four, and the closing of Democracy Wall. In the 1980s, there were the campaigns against "spiritual pollution" and "bourgeois liberalization" and now, far more seriously—and far more visibly—the brutal suppression of protest in Beijing.

Our effort—always—has been to try to shorten the time required for China to work its way through its internal crises. No matter how much the current critics of our policy may try to portray it otherwise, the issue has never been whether or how fervently we support reform and respect for human rights in China. Of course we support those objectives and with as much fervor as our critics. Rather the issue is how best to transform rhetoric into reality. Do we seek to isolate China and cause it to turn inward, or do we seek to facilitate its return to reform and openness by continuing to pursue the contacts and ties that encouraged such reform in the first place? To President Bush, the answer is clear. The very same framework we have used in managing our relations with China since 1971 is the one that continues to guide us today.

The U.S. Response to Tiananmen

The terrible tragedy that occurred in China's capital city last June is fresh in all our memories. The sight of millions of China's young and not so young in the streets of Beijing and other major cities demonstrating peacefully for reform and democracy inspired all Americans and freedom-loving people everywhere. The "Goddess of Democracy" moved us deeply, as did the heroism of the young man who confronted the column of tanks approaching Tiananmen Square. This made the tragic bloodshed of the government's assault—vividly conveyed by television to the entire world—all the more immediate and appalling to us.

This Administration's opposition to the outbreak of violence in Beijing on June 3 and 4 was swift and firm. The President was the first major world leader to condemn the crackdown at Tiananmen and promptly indicated that there would be no "business as usual" with the Chinese. In speaking out against the violence directed toward peaceful demonstrators, the President stated that we stand with those who seek greater freedom and democracy.

On June 5, the President ordered a suspension of all visits between military leaders of the two countries and of government sales and commercial exports of weapons. In addition, the President announced that he would review sympathetically all requests by Chinese students in the United States to extend their stays. The President also offered humanitarian and medical assistance through the Red Cross to the Chinese people and ordered an interagency review of other aspects of the bilateral relationship in response to developments in China.

The President followed those measures with additional ones on June 20. At that time, he ordered the suspension of high-level exchanges of government officials with China, which promptly led to the cancellation of scheduled trips to Beijing by Commerce Secretary Mosbacher and Treasury Secretary Brady. The Administration also sought successfully to postpone consideration of all new loans to China by international financial institutions.

Basically, these sanctions remain in place today, with only a few adjustments that have been made in support of U.S. interests. Along with these sanctions, however, the President made clear that he did not want to take actions that would unnecessarily harm the Chinese people—actions that would only victimize the victims once again. He knew, for historical as well as practical reasons, that we had only limited leverage on the Chinese leadership. The challenge was to make clear American revulsion at and condemnation of the bloodshed at Tiananmen yet express it in a way that would maintain, to the extent possible, our ability to influence events within China and encourage a return to reforms of the economy and society. The Administration has, therefore, sought to demonstrate its repugnance for the actions taken by the Beijing government, while preserving the framework of our relationship with the Chinese people—links wisely forged in a spirit of bipartisan consensus in the 1970s and 1980s.

The First Trip to Beijing

The secret trip that Gen. Scowcroft [Assistant to the President for National Security Affairs] and I made to Beijing last July was intended precisely to convey an undiluted message from the President to the Chinese leadership about America's horror over Tiananmen. As we all know only too well, messages delivered below the level of the top leaders often get softened or altered on the way up the chain of command. Moreover, actions taken in the glare of publicity often engender public posturing, in which saving "face" becomes more important than a sober consideration of the issues.

Accordingly, the President decided to send a quiet mission directly to China's leaders. Our purpose was to convey to the Chinese, without ambiguity, a clear sense of the reaction in this country, beginning with that of the President, to what had happened. We firmly communicated that the United States does not condone the appalling violence used to suppress the peaceful demonstrations, nor do we condone the repression that has followed. I can tell you that our July visit was neither easy nor pleasant.

I have heard some say that the first trip may have stiffened the spines of China's leaders and delayed the day of relaxation. I do not believe that. I believe that the first trip demonstrated the seriousness of American purpose, made clear the stakes involved in a worsening of our relations, and, ultimately, provided an incentive for a return to the path of reform.

A few months after the trip, the President had to decide whether to sign the Pelosi bill, a well-intentioned and broadly supported legislative act that sought to provide ironclad protections for Chinese students in this country from being forced to return to their homeland. Obviously, the easy and popular choice for the President would have been to sign the bill into law. But there were other considerations.

The President could take administrative action that would accomplish all of the objectives of the Pelosi bill yet reduce the likelihood of retaliation by the Chinese against exchange programs with the United States.

Accordingly, the President issued a directive that included the substantive measures in the Pelosi bill—and more. Indeed, some of the protections under the President's directive, such as the authorization for employment in this country, are actually broader than those in the Pelosi bill.

The subsequent debate over whether to override the President's veto demonstrated that this was not a popular decision. Yet the sustaining of that veto in the Senate should assure us not only that the Chinese students and scholars in this

country may remain here but that the door will still be open for more to come. Thus, the process of exchange so vital to strengthening the forces of reform in China will continue.

The Second Trip to Beijing

In December, the President decided that it was time for a bold move to try to begin a process leading to better conditions in China and better U.S.-China relations. Having heard over and over again that it was up to the United States to "untie the knot" in our relations, we noted that, after visits to China by former President Nixon and former Secretary of State Kissinger, China's spokesmen had begun to join us in talking of both sides taking steps to improve relations, a subtle but distinct signal.

Our Message to the Chinese. The President decided to act. Again he ordered Brent Scowcroft and me to be his special emissaries to the Chinese leadership. Again our mission was to deliver an undiluted message of the need for China to take steps to improve our relations. We also briefed the Chinese on the Malta summit, in accordance with our general practice of consulting with them after our summits with the Soviets.

The President knew that he would be taking this action in the face of popular opposition and at substantial political risk. But it was a risk he was willing to take because of his experience over the years in dealing with China and the Chinese, because of his personal acquaintance with many of China's leaders, and because of his judgment that it just might begin a process which would lead to improvements in the lot of the Chinese people. All the talk of clinking glasses, surprise announcements, and warm toasts misses the point. The Chinese leadership needed to know how they could improve their relations with the United States, and we told them.

The Results. The first thing that needs to be said about assessing the results of that second trip is that it is far too early to come to conclusions. Again the goal was not a specific result but to give impetus to a process of interaction, where each side would address the other's concerns and establish the basis for resolving our differences. That process has only just begun.

Steps have been taken. They represent movement in a direction I believe most Americans recognize as favorable. Nonetheless much more needs to be done.

In bilateral U.S.-China relations, Beijing has agreed to resume discussions on the Fulbright program of scholarly exchanges. Beijing has also agreed to receive Peace Corps volunteers for the first time. Even before Tiananmen, the agreement to receive those volunteers was a difficult and sensitive matter for the Chinese. We see movement today as a symbolically important step to deepen relations at the grass roots level.

Beijing has also accredited a resident correspondent from the Voice of America. You all know that U.S. reporters were expelled last year. This step to renew VOA's presence in Beijing is welcome.

More broadly, China's foreign ministry spokesman issued a statement that China would not sell medium-range ballistic missiles to any Middle East country and denied plans that China would sell M-9 missiles to Syria. This statement, and the related denial, went beyond previous Chinese pronouncements on the subject and addressed specific U.S. concerns. The Chinese statements are positive, but we will remain vigilant on the issue of missile sales, especially to unstable regions of the world.

Internally, too, there has been guarded, cautious—even grudging—movement in a direction we see as right for the people of China, as well as right for U.S. interests. Early last month, China lifted the martial law regime imposed in Beijing last May. Many observers regard this action by the Chinese as "cosmetic." We wish it had been far less ambiguous than it was. But it is, nonetheless, an achievement of some significance. The process of reducing tensions has to begin somewhere, and I do not believe we should give the back of our hand to what was evidently a difficult Chinese decision to begin to respond to foreign and domestic calls for moderation. We should seek to build on it, to urge that it be made less "cosmetic," and not reject it and risk providing a pretext for darker forces to block China's movement toward positive reforms.

On January 18, Beijing took another step by releasing 573 detainees. We wish that detailed information about these cases had been provided for the world to examine for it would have greatly increased the impact of this act of leniency. Naturally, we will press for the fullest possible accounting of all those detained and sentenced since the Tiananmen events and for further acts of leniency and amnesty by the authorities. Nevertheless, the act of releasing hundreds of people may be the beginning of efforts at reconciliation that are sorely needed in China today.

U.S. Moves. Subsequent to our second trip, the President also faced a series of decisions—some forced by legislative action, some by timetables for projects, and some by the steps taken by the Chinese themselves. The United States has decided to respond in a carefully calibrated way designed to promote the process of change and reform. There is still no "business as usual" with China, and our sanctions of last June essentially remain in place. But we have taken a series of steps to try to put relations back on a positive track and to try to prevent any further retrogression.

In December, for example, the President exercised his authority to permit the export of U.S.-made, Australian-owned satellites for launch on Chinese rockets. This benefits our ally Australia, it demonstrates that we remain reliable suppliers, and it benefits our own manufacturers.

The President also invoked his authority to determine that it is in the national interest to maintain our modest Export-Import Bank programs with U.S. companies competing for business in China.

In response to the lifting of martial law in Beijing and to our own observation of the general security situation in China, the State Department has modified its travel advisory for Americans resident in and visiting China. The standing travel advisory is now approximately at the level of that prevailing prior to Tiananmen.

Finally, as I have noted, the President, along with leaders of other countries, had earlier moved to postpone consideration by international financial institutions of loans to China. As a result, neither the World Bank nor the Asian Development Bank had proposed any new loans to China between June and December 1989. However, in light of our belief that we should avoid actions which harm the Chinese people, we have indicated that the United States would be prepared, on a case-by-case basis, to have the World Bank consider earthquake aid and other basic human-needs loans to China. This is a humanitarian action, which conforms with our human rights legislation. We still do not support a general resumption of World Bank lending.

Overall, I hope it can be said that the steep decline in U.S.-China relations has been arrested and that there is movement in a positive direction. Indeed, I would note that there has been more movement since our second trip to Beijing than during the first 6 months following Tiananmen.

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The danger is that this incremental process will stall or that it will be set back. Since December, the Chinese have done things, bilaterally and domestically, that few in this country would agree are enough to restore our relations to what they were a year ago. The Administration knows that not enough has been done. What we have done is to initiate a process that we hope will lead to further meaningful actions by the Chinese to help improve relations. We never expected to reverse events overnight.

The Future of the Relationship

So where do we go from here?

We shall not surrender our values. We shall seek to preserve the linkages that we have painstakingly forged with the Chinese over the past 20 years. We shall continue to encourage the flow of people, ideas, information, and commerce between our two nations—those activities that constitute the lifeblood of material progress and spiritual advance. In our view, we need to keep faith with the people and the institutions of China that can move the society toward reform. Our efforts to maintain economic and commercial relations and to keep alive exchange programs are among the policy instruments at our disposal for keeping that faith.

In short, we seek to soften the blow to the Chinese people brought about by the crisis in China. We have tried to be as ready as we can for the day when it would be appropriate once again to normalize relations. We are convinced that this is the right course. China is not a benighted society from top to bottom. Indeed, the forces favoring reform have not disappeared. We owe them an approach that strengthens their hand, not the hand of those who would welcome isolation.

Having acted to express the outrage of the American people and yet to soften the blow to the Chinese people, we must also pause to consider the limits of our ability to affect the course of events in China. We need to remain cognizant of Chinese realities. China's traditions of centralized authority, hierarchy, anti-individualism, and life-and-death politics exist amid much greater poverty and backwardness than we have ever known. To recognize this is not to say that we would accept less in the way of human dignity and freedom for the Chinese people than for ourselves. But experience suggests that we have to be patient while China finds its own path to a freer, more prosperous society.

Our ability to adhere to the course of improving relations is, obviously, not dependent on us alone. China bears its own responsibility for advancing the process. Greater relaxation and reform, long advocated by China's present leaders in other circumstances, need to be realized. A China moving toward peace with itself is a China with which we can cooperate in peace.

The policies pursued during the last two decades by five Administrations, along with those of a sometimes daring Chinese leadership, have made an important difference to the Chinese people and have helped to make the region and the world more stable. There have been setbacks—some of them, as in the case of Tiananmen Square, tragic setbacks. There may be more setbacks in the decades ahead. But American policy should look forward, not backward. With steadiness of purpose, we must seek to build on the constructive ties we have developed with the Chinese and, thereby, encourage the ongoing process of reform and development.

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It's Beijing's Move

Restoration of anything like normal relations between the United States and China will have to await changes in policy and attitudes within the Chinese leadership.

BY ROCHELLE L. STANFIELD

China is at the center of two mighty power struggles—one in Beijing and the other in Washington.

In Beijing, the one that's taking place among Chinese leaders will determine the political direction and economic course of the world's most populous country.

In Washington, the tussle between President Bush and Congress is over the best way to influence the outcome of the contest in Beijing. But it is likely to have a greater impact on executive-legislative relations in the United States than on policies in China.

Congress's acrimonious and unsuccessful attempt last month to override the President's veto of legislation to protect Chinese students in this country from deportation back to China after their visas expire ended 20 years of bipartisan consensus and executive-legislative cooperation on U.S. policy toward China.

Bush won the first round when the Senate sustained his veto. The second round, a few days later, was something of a draw. The Senate, 98-0, approved legislation imposing economic and military sanctions on China. But the bill, which the House passed last November and which the President signed on Feb. 16, gives Bush broad waiver powers. In fact, he has already waived three of the law's provisions, most recently by authorizing one World Bank loan and two loans from the Export-Import Bank of the United States.

Since then, however, Bush has nullified the sale of a Seattle aviation firm to a Chinese government agency. In doing so, he accepted the recommendation of an eight-agency federal committee set up to review national security implications of foreign investments in U.S. companies. And on Feb. 21, he sent Congress a sharply worded State Department report on human rights violations in China.

"It states the case as it is on human rights in China, and I'm sure it will be very unpopular in China," a senior Administration official said. At the next meeting of the United Nations Human Rights Commission, "we will be at the table there, and similar kinds of reports will be issued," the official said.

Congress is not satisfied with these steps. Senate Foreign Relations Committee members closely questioned deputy secretary of State Lawrence S. Eagleburger at a Feb. 7 hearing on China policy. The panel's senior Republican, Jesse A. Helms of North Carolina, who had introduced a much harsher sanctions package last year, remains committed to such legislation. A group of Senate Democratic staff members is discussing a tougher sanctions bill. And in the House,

"I VIEW THE LIFTING OF MARTIAL LAW AS A VERY SOUND STEP." - BUSH

Richard A. Bloom

Veteran China scholar A. Doak Barnett
Flexibility "is likely to encourage the forces in China in a moderate direction."

Mel Levine, D-Calif., a member of the Foreign Affairs Committee, is counting potential votes to assess the practicality of introducing his own version.

"There are a lot of calendar events, and they will keep the pot boiling," the senior Administration official acknowledged.

Members of Congress insist that they will not let the issue die this spring but say that they don't expect to seriously consider new legislation until June. That's when Bush must send Congress his annual notification of whether China has a policy of unrestricted emigration, a condition for its exports to this country to continue to receive preferential tariff treatment. To reject that treatment, Congress would have to change the law.

Throughout the year, the subject of U.S.-Chinese trade is likely to arise in conjunction with questions of exporting technology to China and granting China observer status at the General Agreement on Tariffs and Trade.

"So, maybe our policy will be pretty much in limbo [until then] unless there is some movement by the Chinese themselves, which the Administration has indicated they were under the impression would be forthcoming," Rep. William S. Broomfield, R-Mich., said in an interview. Broomfield, the senior minority member of Foreign Affairs, voted to override Bush's veto of the Chinese students bill. "I guess the Administration does feel the Chinese have moved to some extent, but it doesn't really meet the approval or support of many of us, including myself."

DIFFERENT PRIORITIES

The central irony in this fight is that Bush and Congress say they have exactly the same goal: to enhance the prospects of China's moderates without totally isolating the current Chinese government. But they differ on emphasis. Bush's top priority is maintaining contact with the Chinese leadership; Congress places the U.S. stand on human rights above all else.

"I want to keep contact. I do not want isolation," Bush said at a news conference on Jan. 24 before the overwhelming House vote to override his veto of the Chinese students bill. "Put it in the totality of a policy, and, you see, I think there are some real reasons—Asian reasons, if you will, Cambodia and Japan—that we should retain relations with China. That doesn't mean we endorse the lack of human rights. . . . That is absolutely ridiculous. I want to see China move forward."

But Levine said: "I happen to think that America has a stake in communicating to the Chinese people much more clearly than we have that we continue to be outraged by the policy of the Chinese leadership. That message has not yet been adequately communicated because the President continues to blunt the message. That's the frustration."

American experts on China disagree about how China's leaders view the U.S. debate and how the Chinese may respond to somewhat mixed U.S. signals. But they agree on one thing: No matter what the United States does, it will have only a marginal impact on China's leadership struggle. "Ultimately, they will make their basic judgments based on what they think will keep them in power, rather than outside opinions," said Winston Lord, who was the U.S. ambassador to China until shortly before the violent crackdown on student demonstrators in Tiananmen Square early last June.

While the contest for power continues, the situation in China is likely to remain more complex than snapshot news reports convey. In the view of some China experts, the top leadership maintains its repressive policies but can't really carry them out because of widespread passive resistance among mid-level bureaucrats and the population. Things are not as bad as they could be, the experts say, but that's not because the government isn't trying to make them so.

The situation in the United States is no less complicated. American public opinion is never neutral on China. After Tiananmen Square, reinforced by negative press reports and congressional reaction, it sank to extremely negative levels.

Nor are the reactions of Congress and the Administration devoid of other agenda items. Bush, who considers himself an old China hand, has a large investment in former President Nixon's China Opening of the early 1970s. The vote on the Chinese students bill had partisan overtones. And sanctions are bound up with more general trade considerations.

The collision of these disparate motives has shattered the long-standing bipartisan, executive-legislative unanimity on China. "In the Congress, there used to be a passive consensus in favor of the relationship with China," a congressional expert on China explained. "Congress was willing to go along with executive branch initiatives, although not initiate things itself. I think it will be much harder to get those initiatives through now because fewer people will be willing to stand up and say, 'We may not totally like this, but our relationship with China has geopolitical importance, so we'll swallow hard and go forward.' "

BUSH V. CONGRESS

Symbolism plays as important a role in the fight between Bush and Congress over China policy as in the relationship between the United States and China.

The Chinese student visa confrontation, for example, had more to do with Chinese face-saving, the Administration's credibility and the style of its diplomatic overtures than with protecting Chinese students from deportation. In vetoing the Chinese students bill, Bush announced that he had issued an executive order providing the same protections administratively. He argued that the Chinese considered such administrative action palatable but found the legislation humiliating and would retaliate if it became law.

"I have direct evidence provided to me that the Chinese were ready to close down access to the United States for all these [student, cultural and other] exchanges," a senior Administration official insisted. Two weeks after the veto fight in Congress, the Chinese government imposed

new restrictions on graduate students seeking to study abroad, requiring them first to work for five years in China.

A congressional majority—although not enough in the Senate to override the veto—responded that it no longer trusts Bush because he had sent Eagleburger and national security adviser Brent Scowcroft on two secret missions to China since June even though Administration policy forbids high-level contacts. "On the issue of China, the President has lost his credibility," Rep. Steven J. Solarz, D-N.Y., chairman of the Foreign Affairs Subcommittee on Asian and Pacific Affairs, said during the House override debate on Jan. 24. "He simply cannot be relied upon not to rescind the executive order."

In fact, it was the symbolism of the Scowcroft missions more than the visits themselves that angered Solarz and other Members. On his second trip in December, Scowcroft was videotaped at a Beijing banquet toasting Chinese senior leader Deng Xiaoping. The videotape was featured in Chinese news broadcasts and replayed around the world and on U.S. evening news shows. "It is not good enough to send our top leaders there to clink champagne glasses six months after the acts [in Tiananmen Square]," Majority Leader Richard A. Gephardt, D-Mo., said during the House debate.

Scowcroft's first trip, in July, also antagonized Congress because it came so soon after Tiananmen Square and because it was kept secret until December and then only reluctantly confirmed after it was revealed by other sources.

White House aides now say they expected the Scowcroft missions to be controversial but considered them worth the risk if they could reopen communications between Washington and Beijing. "We gambled," a senior Administration official said. "We took a big bold step that was very unpopular, in an effort to convince the Chinese that we were serious about trying to improve the relationship and put the ball back into their court."

In the weeks following Scowcroft's December trip, the Chinese agreed to resume participation in the Fulbright scholars program, accept Peace Corps volunteers, admit a Voice of America correspondent, release 573 political detainees, refrain from selling missiles to Middle Eastern countries and lift martial law in Beijing.

Congress was unimpressed by the Chinese response. The lifting of martial law was accompanied by an increase in police patrols. Though fewer than 600 political prisoners were released, there were reports of as many as 10,000 others still being detained. Chinese dissident Fang Lizhi and his wife Li Shuxian remain in refuge in the U.S. Embassy in Beijing. The Chinese government issued stricter rules for foreign correspondents.

"The President has held out his hand to China's leaders, and they have slapped it," Claiborne Pell, D-R.I., chairman of the Foreign Relations Committee, said in the Senate debate on the veto override.

"The 'concessions' that the Chinese have made don't seem to be worth the price of the Scowcroft initiative in the minds of many Americans," said Robert G. Sutter, a China expert on the Congressional Research Service (CRS) staff who was in China on a congressional aides' tour at the time of the second Scowcroft mission. "In the atmosphere we have in the United States today—the argument was made by Americans in Beijing when we were there—almost nothing would be enough."

That's not the unanimous conclusion of China watchers, however. "I think President Bush is on the right track," said A. Doak Barnett, professor emeritus at the Johns Hopkins University School of Advanced International Studies and a respected China scholar. "His narrow victory in the Senate [veto override] vote accomplishes one very limited objective, and that is to prevent the sort of downward spiral and further deterioration of the relationship."

The difference between Bush's calculations and Congress's reaction gives evidence of the wide disparity in strategies for dealing with the Chinese. Bush's preferred approach is one of reciprocal favor-giving. "They [the Chinese leaders] owed us after that [Scowcroft] trip," the senior Administration official said. "We had done a lot for them, and they did some things afterward."

Bush's critics insist that a hardball approach is required. "My reading of Deng is he thinks he's got Bush," Lucien Pye, a political science professor at the Massachusetts Institute of Technology (MIT) and a longtime China scholar, said. "He stuck his thumb in Bush's eye. He got Bush now, so Bush has to make concessions to him. Bush might think that Deng has to make concessions, but I'm sure the feeling in Beijing is 'Bush can't be rough on us because he spent so much on us. We can therefore be tougher in our negotiations because there is no need for a quid pro quo.' Bush is going to have to negotiate from weakness, not strength."

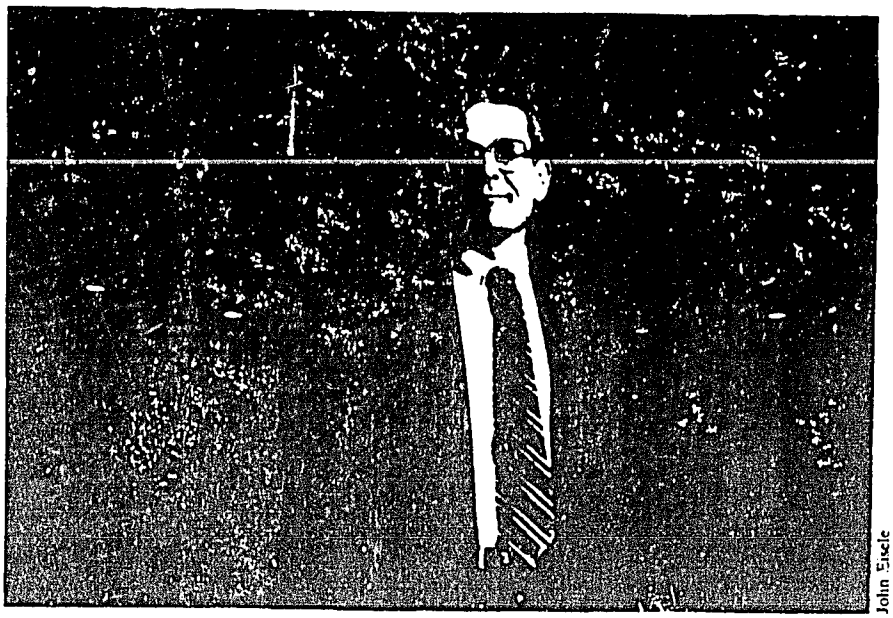
Analysts call the fight between Bush and Congress unfortunate because it sends a mixed signal to the Chinese, who can use it to their own political ends. "They look at American policy and say it's in shambles," Pye said.

Others contend that the conflict could have been avoided had the President consulted with Members of Congress and decided what actions to take in concert with Congress.

"If the Administration had been some-

"If you seem too forgiving of what [China's leaders] have been up to, you rob the moderates in China of the argument that suppression entails costs overseas. You hurt them in the internal debates."

—Winston Lord, former U.S. ambassador to China



John Eisele

Congressional Research Service China expert Robert G. Sutter
In the current U.S. atmosphere, almost no Chinese concessions "would be enough."

what firmer in recent months in its posture toward China, it might have preempted some of the congressional eagerness to pass legislation to take stronger steps," Lord said. "But I think there's an impression in Congress that the Administration is too eager to get back to business as usual, and they need to balance the over-all picture toward China."

Bush's China policy is very personal. It is directed by him and executed primarily by the National Security Council (NSC). Although Eagleburger went along on the Scowcroft missions, the State Department is understood to have little influence on the policy. State's staff refers to Bush as "the Chinese desk officer."

Susan M. Muniak

Foreign Affairs Committee member Mel Levine, D-Calif.
Bush "continues to blunt the message" to the Chinese.

Bush's interest in China dates to 1974-75, when he headed the U.S. liaison office in Beijing before full diplomatic relations were established in 1979. In those days also, China policy was a one-man show, the province of Secretary of State Henry A. Kissinger. In his autobiography, *Looking Forward* (Doubleday & Co. Inc., 1987), Bush comments that "China was Henry's private diplomatic domain" and recounts the efforts of the State Department and NSC to control all information and exclude Bush and the Beijing liaison office from the policy loop. The senior China staff member on the NSC at that time was Richard H. Solomon, who is now assistant secretary of State for East Asian and Pacific affairs.

"The word was out that China policy was to be handled only by [Kissinger] and his closest aides: Solomon . . . and Winston Lord, director of the State Department's Foreign Planning staff," Bush writes in *Looking Forward*. Now the word is out that Solomon has had very little role to play in Bush's China policy. Lord has become a critic of the Bush policy since the December Scowcroft mission.

MEANWHILE, IN CHINA

The point of the battle in Washington is to influence the outcome of the power struggle in Beijing. Assuming the United States can have some impact—and most analysts agree that U.S. influence will be limited—the question is how best to help the Chinese moderates without strengthening the hand of the hard-liners.

The image generally portrayed of the current Chinese scene is of a leadership of orthodox octogenarians, headed by the 85-year-old Deng. He had seemed on his way to retirement last spring but wrested control from a more-moderate, slightly younger generation of reformers, led by Zhao Ziyang, 70, who has been stripped of his position as party general secretary and is now under house arrest. According to this picture, the ancient hard-liners have been waging a campaign of repression that began with the June 4 massacre in Tiananmen Square.

The real situation is much more complex, American experts on China contend. Most of the reformers are still on the scene, though maintaining a lower profile than before Tiananmen Square. Though Premier Li Peng is a tough Communist of the old school, Jiang Zemin, the new party general secretary, is considered somewhat more moderate, as are several members of the party politburo.

"Genghis Khan does not rule in Beijing," the CRS's Sutter said. "The same people who wanted reforms in the past are still there. Very few people have been purged. I get a very mixed picture of the political dynamics in the decision making in both the political and the economic area. Why aren't they really cracking down? Why isn't there a mass campaign? Maybe they feel they can't do it. Maybe they are afraid of sanctions. Maybe they are divided among themselves. Maybe they're going to do it later."

On one thing the American experts agree. The Chinese economy is in a terrible mess. How to fix it will figure prominently in the internal power struggle.

While U.S. public opinion about China is colored by the upheaval in Eastern Eu-

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rope, China scholars differ on whether the events in that region will have any impact on China. Whatever the effect, China is seen as unlikely to repeat the revolution in Romania that toppled dictator Nicolae Ceausescu late last year.

"People think that the same thing will happen in China, that the old regime will be swept away and we'll be dealing with a new set of actors who will be unhappy we had anything to do with the old regime," a senior Administration official said. "Historically, that is not the pattern in China, and I don't think it will happen. The chances are greater that elements within that regime eventually will prevail and bring a more moderate domestic foreign policy forward."

The best way to foster that kind of development, Administration supporters say, is to gently encourage improvements in China by nurturing America's relationship with the country. "I think the kind of flexibility Bush has shown is likely to encourage the forces in China in a moderate direction," Barnett said, "whereas I think escalation of American pressure or further cutting of ties with China would delay that process and would strengthen the arguments of hard-liners who say, 'We can't deal with the United States, which is trying to force us to do these things.' "

Critics contend that though the United States will not be able to force the Chinese into liberalization, international pressure is important. "If you seem too forgiving of what they have been up to, you rob the moderates in China of the argument that suppression entails costs overseas. You hurt them in the internal debates," Lord said. "If they feel they can continue repression and still have business as usual or the kind of symbolism of these high-level visits, it gives them the sense that they can have their cake and eat it, too."

The debate over how best to approach China is predicated on the notion that China is a crucial international power. Now, some geopolitical strategists are having second thoughts. Nixon's China Opening in the early 1970s was intended to use China as a Cold War counterweight to the Soviet Union. With the warming of U.S.-Soviet relations, the so-called China card in the U.S.-Soviet-Chinese triangle is no longer seen as necessary.

Critics of the Bush approach keep bringing up the China card argument in order to knock it down. Bush supporters now play down its importance but not the continued strategic significance of China. "I personally thought earlier that although the triangle was important, it tended to be exaggerated by many people," Barnett said. "Although it is less important now, that does not mean that China is unimportant in a broad strategic sense in East Asia."

China, in addition to being the world's most populous nation, is a nuclear power and an enormous potential market for U.S. goods and services. It has influence over North Korea and Cambodia, and its policies are crucial to Hong Kong and Taiwan. To Asia specialists, these issues are important global concerns; to others, they are merely regional.

"They are an important part of the world situation," Broomfield said. "That's why I strongly support the President keeping communication open. But the Chinese have got to clearly understand the position of the Congress and the Administration on human rights and that we expect some movement there. But I feel we shouldn't cut them off. We ought to keep an olive leaf extended."

John Engle

Senior Foreign Affairs Republican William S. Broomfield
"We ought to keep an olive leaf extended" to the Chinese.

SHIFTING MOOD

The U.S. power struggle over approaches to China is being played against a background of hostile public opinion about China that has been reinforced by negative reportin in the news media.

"I haven't seen a positive report out of China since June," Sutter said. "[The press] used to be full of these positive, human interest stories. Now there are none. I understand why they are not there. They would be considered inappropriate."

A senior Administration official complained that "there is a real resistance on the part of editorial boards to take any of that [positive reporting] on. That can be documented. The public mood has really shifted."

American mood swings over China are familiar to China experts, who have traced American passions pro and con since the beginning of the century. In 1958, Harold D. Isaacs, then an MIT professor, wrote *Scratches on Our Mind* (John Day Co.), in which he documented the vivid, conflicting American images of ancient, sage, civilized wisdom and impenetrable, barbarous cruelty. "These two sets of images," he wrote, "rise and fall, move in and out of the center of people's minds over time, never wholly displacing each other, always co-existing, each ready to emerge at the fresh call of circumstance."

As an example, Sutter recalled that Deng, who is now portrayed in very negative terms, "is the same fellow who came here in 1979 and was the belle of the ball, the cute little emissary from China who appeared with a cowboy hat on. Somehow we identified with him. Although nobody ever called him a democrat, we imposed our values on that guy."

None of the analysts is willing to predict when the American mood will swing back to the positive or what the Chinese will have to do to begin that shift. Many expect it to take years, just as they predict that the changes likely to occur within the Chinese leadership could take as long as five years—though no one rules out a faster pace.

"I think there will be a fluid situation, and no one would be so bold as to predict how it will come out," Lord said. "But I think the forces for opening to the outside world and reform at home are very strong. I can't really [write] an exact scenario. Nothing, after 1989, would surprise me, including events moving faster in China." □

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INTRODUCTION

Economic Reform in China

James A. Dorn

> China's reform process has both mass and acceleration. A collision of reform and special interests must come with great force at some point in time.
>
> —Steven N. S. Cheung

The Collision Course

The momentous changes occurring in China support Steven Cheung's concern with the collision course of economic liberalization and the incentive of China's nomenklatura, or ruling elite, for maintaining the status quo. Over the past decade China has made significant progress in transforming its bureaucratic system of state planning into a more market-oriented economic regime. The agricultural reform, in which individual farmers were given more effective ownership and control rights over the land at their disposal, saw a flourishing of activity in the countryside. Agricultural production increased dramatically and the newly created wealth spilled over into the formation of thousands of small-scale private enterprises producing a variety of products. Nevertheless, the dynamism that has characterized the agricultural sector has been largely absent in trade and industry, where the state continues to hold sway over economic life.

The persistence of state-owned enterprises and the lack of competition in trade and industry have hampered economic reform in China. The inefficiency of state enterprises has led to a vast network of subsidies,[1] and the deficits of state enterprises have been financed

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[1]In 1988, subsidies to state-owned enterprises amounted to nearly $11 billion—a figure representing about 50 percent of the earnings of China's industrial enterprises (Southerland 1988, p. F5).

to an increasing extent by bank credits. The resulting inflation, now in the range of 20–30 percent, is seriously eroding support for further economic liberalization. But the real culprit is the iron grip the state still has on all important aspects of economic life and the refusal of the elite to bow to the forces of the marketplace.

The Failure of Piecemeal Reform

The current situation in China points once again to the failure of piecemeal reform and especially to the impossibility of establishing viable markets and prices without ownership reform and the establishment of private property rights. In particular, a sound constitutional framework, which insulates economic life from political opportunism, appears as a necessary condition for social and economic stability in China. The current corruption that is splitting China at the seams really stems from the ruling elite's vast power over economic and personal freedoms. Ultimately, economic and political reform are inseparable. As long as a Chinese wall surrounds the ruling elite—preventing the free flow of market information and the free expression of ideas—the quest for economic and social stability will fail to be realized.

At the heart of China's chaos, then, is a massive government failure: namely, the failure to establish an effective constitutional framework limiting the power of government officials over the economic and social life of the nation. The problem of how to curtail the influence of special interests and move the economic reform forward, while at the same time satisfying the demands for greater political freedom, is a classic issue in public choice theory. The rent seeking that characterizes democratic governments in the West, and which stems from an erosion of the economic constitution of liberty (as discussed in the writings of F. A. Hayek and others), is widespread in China where the rule of law has been supplanted by the rule of men.

When enterprises are owned and controlled by the state, economic decisions necessarily become political decisions, and impersonal price competition is supplanted by forms of personal competition driven by the quest for political power and privilege. Bribery and corruption then become the rule rather than the exception. The resulting uncertainty surrounding economic transactions acts as a destabilizing influence on economic development. This predicament has clearly been true of China's mixed economy as it has tried to force itself free from the grip of the nomenklatura, who have so far refused to decontrol markets and prices in a large segment of China's vast economic landscape.

Constitutional Order and Economic Order

The problems of implementing a market-oriented reform in China and the prospects for transforming China's "ossified order" of state planning into a vibrant open society were the focus of the Cato Institute's conference on **Economic Reform in China: Problems and Prospects** held last September in Shanghai and cosponsored with Fudan University. The papers in the first part of this volume focus on the interconnection between constitutional order and economic order, and point to the difficulty of instituting price reform without ownership reform.[2]

With Hong Kong reverting to Chinese control in 1997, the path that China now follows will set up expectations that will shape the transition of Hong Kong. Any deviation from a market-oriented reform and an increased degree of freedom will destabilize the transition process and lead to economic and social chaos. The essays in this volume offer various proposals for achieving economic and social stability in China, and point to the importance of establishing constitutional safeguards for economic and personal freedoms. The privatization of state-owned enterprises and the introduction of competitive markets to replace state monopolies may appear radical to Chinese conservative leaders; but where it has been tried in Special Economic Zones (SEZs), the success has been resounding. The challenge now facing China is whether to continue on a piecemeal reform and suffer the fate of earlier Soviet and Eastern European reforms or to institute thoroughgoing ownership and price reform, thereby enhancing the prospect of achieving a spontaneous market order that could make China an economic giant in the next century.

The essays here draw from experience in the West, in Hong Kong, and in the Pacific Rim—and utilize recent developments in constitutional economics and public choice theory—to offer China guidance in mapping out a path toward long-lasting stability and prosperity. A major lesson is that economic order and stability ultimately require a constitution of liberty, in the Hayekian sense. Self-interest can then be harnessed for the wealth of the nation rather than deteriorate into a rent-seeking society. Experience has proven that private property, freedom of contract, and basic political freedoms are the indispensable basis for a dynamic economic order, and that information is best utilized via decentralized markets and prices.

[2]The complete set of conference papers will be published in the United States by the University of Chicago Press and in China by Fudan University Press. The forthcoming book is entitled *Economic Reform in China: Problems and Prospects*, coedited by James A. Dorn and Wang Xi.

China's experiment with central planning is now judged a dismal failure by virtually everyone. The coordination of over one billion people cannot be accomplished by social engineering, without a great loss of freedom and prosperity. The free-market order, grounded on a rule of law, offers an alternative to secure the freedom and prosperity desired by the Chinese people. These basic desires cannot long be suppressed without increased corruption and inefficiency. Thus, the real issue facing China is not whether reform is necessary but how fast and how far to go. As Zhao Ziyang stated: "Without reform there will be no way out for China. If reform is not carried out today, it will have to be carried out in the future, but that will only prolong China's backwardness."[3]

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[3]Quoted in Abrams (1988, p. 15C).

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The Washington Post, Jan. 4, 1990

Hobart Rowen

Banking on China's Good (Economic) Behavior

The World Bank is on the verge of a step-by-step resumption of loans to China, suspended in the wake of last June's massacre of students and other citizens in Tiananmen Square. The decision to restore normal relations between the bank and Beijing lacks only the formal approval of the board, which could come momentarily.

World Bank President Barber Conable is proceeding on the assumption that the needs of China's 1 billion people can't be ignored by his organization or major governments. All told, the seven suspended World Bank loans would provide China with about $750 million in new funds. In addition, China is slated to get $2.25 billion during the next three years in zero-interest loans through the bank's subsidized operation, the International Development Association.

If the bank goes ahead with loans to China, the decision is sure to touch off controversy, as did President Bush's ill-conceived, secret diplomatic overtures to the leaders who ordered the brutal assault.

Conable is said by associates to believe that the bank must act solely on economic, not political, considerations. But obviously, the bank's economic decisions have major political significance. If there were no connection, why would the bank have suspended consideration of seven loans in the first place? It took that decision on direct orders from the seven Economic Summit nations in July.

How to deal with nondemocratic governments has always been a thorny problem for the bank and the International Monetary Fund. The dilemma is that the same aid that can be justified on humanitarian grounds can also strengthen a regime whose political and social behavior is unacceptable.

The danger in the bank's resumption of lending is that the Beijing government will tout it as a political signal suggesting the world is willing to forgive and forget its rotten behavior of last year. Already, it's "business as usual" for most American and Japanese investors. They are back in harness, trying to make a buck in China.

If Conable's scheme works out, the bank proposes to test China's future good behavior—economic, that is. He does not intend to activate all of the pending loans, but would make but approval on a one-by-one basis, starting with funds to help economic recovery in areas hit by a recent earthquake. Next would come a loan tied directly to alleviation of extreme poverty. Those two are the easiest for the bank to justify on purely humanitarian grounds.

Presumably, the Beijing government would have to demonstrate that the bank's effort was improving the climate for the kind of economic reforms that were begun two years ago but then slowed or halted. If not, the bank could hold back approval of the balance.

In the initial burst of China's interest in free-market operations, the Beijing government approved decontrolling prices to reflect supply and demand. But when inflation soared, the Chinese leaders' courage failed, and they put price reform on hold. Similarly, a process of decentralization has been slowed down and to some extent reversed.

Toward the end of December, Conable raised with the bank's executive board the possibility of an early resumption of lending to China, but he did not ask it to take action then. He proposed, first, to touch base with key countries—the United States, Japan and a few others—then come back to the board with a specific proposal.

The former congressman from New York, a Republican and a close friend of Bush, is in the midst of that process now. Assuming he doesn't get strong negative views from any major bank member-country, Conable is expected to set a date for a bank board meeting early this month to approve the earthquake--and perhaps the anti-poverty—loan.

Meanwhile, the bank is getting set to play an important role in Eastern Europe, now that the IMF has broken the ice with a $710 million loan to Poland to bolster the zloty and bring inflation under control. Conable will be able to commit about $1 billion to Poland in the next year or so, along with the technical economic guidance the Poles so desperately need.

The one-two punch of the Bretton Woods institutions in Poland and other Eastern European countries will be a critical element in generating the economic uplift needed to validate their gutsy declarations of political independence.

As the decade of the '90s opens, it is clear the World Bank and the IMF have an ever bigger role to play in stabilizing the global economy. Remember that the commercial banks have almost totally withdrawn from new lending to the Third World, placing a new strain on the multilateral institutions. The bank is in a relatively comfortable position, its capital having been increased by $75 billion last year.

But a remaining, thorny item, which depends almost totally on a Bush administration decision, is the IMF's petition for a boost in its resources of at least that much, and preferably more. So far, the United States has talked in terms of an IMF boost limited to $40 billion.

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Preparing for the Day When the Winds Return

China: An army of exiles is waging a battle of information to make sure the pro-democracy movement, brutally crushed last spring, will rise again.

By KE GANG, YE NIN and D. LI DAVIS

A way of looking is also a way of not looking, according to one Chinese proverb, and a way of saying is also a way of not saying.

In his State of the Union message, President Bush neither saw nor spoke about the brave struggles of our compatriots in China. With the evident enthusiasm of a grandfather, the President talked about the great hope that America and the world places in its children. But for one fifth of the world's children—those trapped in China today—he had neither expressions nor visions of hope.

Nevertheless, the winds that swept through Eastern Europe last year will reach our homeland. We will be prepared.

This week, leaders of the major Chinese dissident groups from the United States, Canada and France gathered in Washington to join forces worldwide to ensure the inevitable downfall of the Chinese Communist government.

The world must never be allowed to forget what happened in Tian An Men Square. According to internal documents leaked to the underground information network from sympathizers in the Communist Party, more than 6,000 persons died the night of June 4, and at least 21,000 were wounded. The massacre in the square took place after the killing of demonstrators in other parts of Beijing. Bodies were removed and cremated quickly. The Chinese government has never published names of those killed or arrested and continues to deny the numbers. It remains for those of us privileged to be in free lands to preserve the sacred memory of those murdered by the totalitarian regime.

These last few months have been most trying ones for all those who care about democratic values in our great country. Despite our appreciation of the societies that are protecting and supporting us, we are Chinese patriots first and foremost. We long to return to our country, not as counterrevolutionaries destined for prisons, torture and death but as leaders of a new day in China.

The pro-democracy movement is not just a small group of students. It is a broad cross section of leaders and thinkers from major institutions in our great country. Thousands of us are now in exile, using fax machines and computer exchanges to relay information about events in China.

From this network we have been able to learn that Fang Lizhi, the astrophysicist who inspired thousands of pro-democracy advocates, was exiled to Australia on Jan. 26. Fang and his wife, Li Shuxian, had been sheltered in the U.S. Embassy since the Tian An Men Square crackdown.

Do not confuse the rhetorical easing of repression in China with any real progress. Secret trials are continuing of dissident intellectuals, writers and students whose human rights are being violated, according to Amnesty International. Those who are now judged to have not been tough enough on the demonstrators, such as Jiang Ping, the president of Beijing Law School, are being removed from their posts.

To bring the day of freedom closer for China, we are waging a battle—not with tanks but with information. From a mobile station, we are sending daily radio broadcasts into China. We are printing Chinese newspapers and sending these into the country, denouncing the current regime and advocating democratic principles and values. We are establishing a June 4th Foundation to support a global protest and memorial on Sunday, June 3, and to establish a research center to prepare for the social transformation of China. The Pope and other religious leaders are expected to assist our cause, as they have so nobly aided the Poles, Romanians and Russians in their search for religious freedom.

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What can the American people do to help our cause? The lesson of the radical change in Eastern Europe is clear: Economic sanctions do work. The nations that have so quickly rejected communist rule are those that had restricted trade relations with the United States and desperately need new capital. The Poles advise us that communism is the longest and most painful of the roads to capitalism. The American government can shorten that road by reducing direct financial support to the Chinese government, which is now rebuilding its army and weapons systems while millions more Chinese are now unemployed.

We urge this great country to confront the corrupt, unseeing Chinese government with the only message that Beijing may heed—denial of major trading benefit to state industries. This message also may be the only thing that the regime cannot afford. Centralized state industries are those most vulnerable to corruption. Targeted regional assistance and private-sector help are less corruptible.

The global village works on images, although these are no longer visible from China. Do not forget that tanks did run over people in Beijing—only seven months ago—and that the army killed doctors who were treating the injured. The Chinese government may punish the demonstrators, may even kill them, but it will never kill their ideas. Our time will come, and we will be ready to assist our country as it sheds its millenia of oppression.

Ke Gang, formerly a member of the Chinese Academy of Social Sciences, founded the Committee of Chinese Correspondence, an organization to assist those who resigned from the Communist Party. Ye Nin, a former instructor at Beijing Law School, was a founding member of the Alliance of Chinese Patriots. D. Li Davis is an adviser to Chinese dissident groups who has written for the South China Morning Post in Hong Kong.

The Los Angeles Times, Feb. 2, 1990

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EXECUTIVE SUMMARY

A. Recent Developments

1. In 1987/8 India was hit by its worst drought in over a quarter century. As a consequence, GDP is expected to grow by less than 2% and foodgrain output to fall by nearly 10%, while wholesale prices rose by 10.4%. Although this performance is worse than 1986/7's 4% growth, it is better than in past droughts, especially given the unprecedented failure of the 1987 monsoon. In the less severe drought of 1979/80, for example, GDP fell 4.9%, foodgrain production fell 17% and wholesale prices rose over 20%. Industry has displayed surprising resilience to the drought and is expected to grow 6.5% --the third consecutive year of above average performance. Higher growth rates in manufacturing, largely in response to the Government's reform program, have been a major factor in industry's improved performance. Power generation increased 7.5% in 1987/8, somewhat less than in recent years but a good performance in light of the drought-induced decline in hydro generation. Services also continued their rapid growth in 1987/8. Railway traffic was up over 5%, reflecting petroleum and coal shipments to thermal electric plants, related to the drought. Although some of the drought's effects may persist through 1988/9, GDP growth should nonetheless be about 7%, assuming a normal monsoon and macroeconomic management that continues to encourage efficiency and exports and contains inflationary pressures. Over the longer run, India needs to achieve at least a 5% p.a. growth rate to improve the living standards of a population that is still rising by more than 2% p.a., provide productive employment for the growing labor force, and reduce poverty. This will entail i) continued action on the government deficit and saving and maintenance of real export growth of about 6.5% p.a., ii) reversal of the poor agricultural performance of the last four years, iii) maintenance of the recent high growth rates in manufacturing, iv) increased supplies of power, transport and urban services, v) improved delivery of education and health care to ensure broad participation in the growth process, and vi) improvements in the employment and targeted poverty programs to assist those left behind in the growth process.

2. Government actions played an important role in mitigating the impact of the drought. During 1987/88 the Central Government released over Rs. 16 bil. in 1987/88 for relief measures to offset the drought and floods. A large portion was channelled through the States, which are expected to spend an additional Rs. 2.4 bil. Public works and relief programs have been increased sharply at all levels. The Centre also has tried to maintain the availability of basic foods through the Public Distribution System, by drawing down its large foodgrain stocks and by importing edible oils and pulses. Consortium members quickly supported the Government's efforts with concessional funds. Although there have been reports of problems and delays in the relief programs, particularly in areas of persistent drought where programs were already strained, overall India's relief system has performed well and averted what could have been a catastrophe.

3. Prior to the drought, GDP growth had averaged about 4.4% p.a. over the period 1974/5-1986/7, significantly higher than the 3.2 % p.a. rate for the period 1962/3-1974/5. The first two years of the Seventh Plan were consistent with this higher growth path--4.8% in 1985/6 and 4% in 1986/7--though somewhat below the Plan target of 5% p.a. growth. Last year's drought pushed the economy off the new growth path but the projected rebound in 1988/9 would put the economy back on the track. The ratio of

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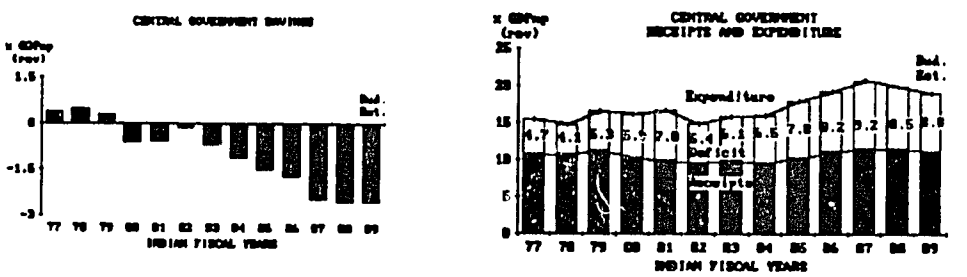
real fixed investment to GDP seems to have risen only slightly in the post 1974/5 period (although nominal investment and savings rates have increased by over one-third). This suggests that much of the higher growth was due to greater efficiency. Further increases in efficiency will be the key to maintaining and increasing growth, since India already saves a large fraction (23%) of GDP.

4. The improvement in the average growth rate after 1974/5 reflects higher growth in industry (up from 3.8% p.a. to 5.5% pa.) and services (up from 4.3% p.a. to 5.8% p.a.). Agricultural growth, on the other hand, averaged about 2.4% p.a. between 1962/3 and 1986/7, with substantial year-to-year variations as a result of the weather and no pick up after the mid-1970s. In the last four years agricultural performance has been poor, and the 1987 drought, coming after two years in which value added in agriculture first grew only 0.3% and then declined 2.6%, has led the Government to take a fresh look at its strategy for agriculture and for water mangement and renew its emphasis on the sector.

5. Perhaps the most important short run element in maintaining high growth will be the continuation of India's traditional macroeconomic stability. India's moderate inflation and high private saving rate would be the envy of most developing economies. However, in the last ten years a serious resource problem has emerged in the public sector. In particular, Central Government savings have fallen from an average of 0.5% of GDP in the last half of the 1970s, to -0.8% of GDP in the 6th Plan and then to -2.3% of GDP in the first three years of the 7th Plan. The Central Government's overall deficit has worsened from an average of less than 5% of GDP in the last half of the 1970s, to about 6.5% of GDP in the 6th Plan, and then to an average of 8.6% of GDP in the first three years of the 7th Plan--higher than in most inflationary economies. This has occurred despite a reduction (as a percentage of GDP) in Central Government contributions to Central Public Enterprises. In 1987/8 the deficit was brought down to 8.5% of GDP from 1986/7's figure of 9.2%--a commendable achievement in a drought year--and the 1988/9 budget proposes a further reduction, to about 8% of GDP. Nevertheless, the size of the deficit remains large and continued efforts will be needed to ensure further reductions and higher savings.

Figure 1



6. The Government's large deficit and dissaving reflect a continuing tendency for current spending--public administration, defense, subsidies, and interest (which mainly reflects past deficits)--to outstrip current revenues. This is despite buoyant tax

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revenues since 1985, which reflected first the 1985/6 tax reforms and then the drought-related, revenue-enhancing measures taken in August 1987. Capital expenditures have grown less than current spending and their constancy in 1987/8 explains most of the reduction in the deficit. In the 1988/9 Budget, interest, defence, and subsidies account for over 60% of the proposed increases in spending. Attainment of Plan targets (in real terms) has thus far been much better than in previous periods, but the drought did lead to a reallocation from capital spending to advances to the States in 1987/8. According to the Planning Commission's Mid-Term Appraisal, to carry out the Plan the Centre has depended much more on borrowings and RBI finance than planned, owing to shortfalls in its own saving and in the surpluses of public enterprises.

7. State Governments and public enterprises also have resource gap problems. The States' problems are similar to the Centre's, although the States' capacity to run deficits is quite limited. The question of State finances and the relation between Centre and State finances forms a major part of the agenda of the upcoming 9th Finance Commission. As to the public enterprises, they were projected to finance much more of their investment with internal resources during the 7th Plan, thereby reducing the need for budgetary support. However, they have not been able to fulfill the Plan's ambitious targets for saving and in 1986/7 and 1987/8 the proportion of public enterprise investment financed by internal resources actually was less than in the 6th Plan period. Much of the shortfall has been made up by borrowing, including entry into the domestic capital market by some of the major public enterprises. While the public enterprises are net savers as a group, most of these savings, and internal resource mobilization, is done by a few firms in the oil and gas, power and transport sectors that generate large profits and depreciation allowances; the great majority still heavily rely on budgetary support.

8. Although the gap between public sector outlays and revenues has widened, macroeconomic stability has been maintained by the rise in private savings and by the increasing share of savings passing through the financial sector, which has made it easier for the public sector to tap these savings. Foreign capital inflows also have risen as a percentage of GDP, compared to the late 1970s. However, the growing private sector surplus reflects a downward tendency in the rate of private investment, as well as a rising private saving rate. In 1985/6 private investment did rise rapidly, in an exception to the trend. Since public sector saving remained low, this spilled over into a large current account deficit and required large foreign borrowing. Then, in 1986/7, the rate of private investment declined and the need for foreign borrowing fell, even though public sector saving fell somewhat. In 1987/8 the crowding out problem was reduced, because the drought reduced investment demand, but it may appear again in 1988/9, when private investment picks up.

9. In sum, the factors that have allowed the government to finance a rising deficit appear to have reached their limit. Other countries' experience suggests that continuation of large deficits and low saving eventually leads to spiraling public debts, "crowding out" of private investment, greater dependence on foreign borrowings and, ultimately, higher inflation. The Government rightly recognizes that this would be a burden on the poor and a threat to growth.

10. The Central Government reduced its deficit somewhat in 1987/88, and is exploring a number of options for further reductions. The most desirable option would involve slowing the growth of current spending, but this has proved difficult. Another option would involve some scaling-down of Plan outlays, where a substantial resource gap has been recognized. The States have taken this route: Plan spending by the 15

largest states is projected to rise only 7% in 1988/9. Other options might include a) broadening of the tax base to include agriculture and small scale industry; b) improving efficiency in the public enterprise sector, for example through greater reliance on NTPC and NHPC, which have higher efficiency than the State Electricity Boards, and by increasing productivity in the public steel and fertilizer sectors; and c) reducing and targeting subsidies and improving cost recovery in areas like credit, irrigation, rural electricity, fertilizers, and higher education.

11. The external sector has shown surprising resilience to the drought. Exports, led by manufactured exports, have performed well in the last two years. In 1987/8 exports were up about 20% in dollar terms, and over 10% in real terms (World Bank estimate). Real exports seem to be responding to improved profitability, as a result of the appreciation of most major currencies and the enhancement of export incentive programs such as CCS, IPRS, Advance Licenses and REP licenses. In some cases a weak domestic market also may have played a role. In the past, India's exports have picked up temporarily, only to stagnate later and, hence, continued efforts will be necessary to sustain export growth. In this regard, the new Import Export Policy for 1988-1991 provides further support for exports, although continued efforts will be necessary on the administrative side to ensure the full impact of the new measures.

12. Imports were up about 14% in dollar terms in 1987/8. Petroleum and other bulk imports rose as a result of the drought. However, growth in imports of capital goods and non-bulk intermediates slowed as pent-up demands were exhausted and investment demand weakened somewhat.

13. Despite the drought, and thanks to a strong export performance, the current account deficit rose only about US$ 100 mil. in 1987/8. It now represents about 1.6% of GDP, down sharply from 1985/6's figure of 2.5% of GDP. Financing of the current account deficit was eased by a large increase in concessional disbursements in 1987/8, in part in response to the drought, and concessional inflows are expected to remain high in 1988/9. Hence, debt service will grow slowly and the debt service ratio will decline as a result of rising exports. India's international reserves, though declining about US$ 375 mil. in 1987/8, continue to be adequate. Foreign exchange reserves amount to about 4 months' imports. Continued emphasis on export growth will be a critical factor in maintaining a viable balance of payments and providing room for additional import liberalization.

B. Issues in Key Sectors

14. Discussions of the Mid-Term Appraisal of the 7th Plan and the 8th Plan's basic framework indicate the need to sustain or even surpass the 7th Plan's target of 5% GDP growth. A 5% p.a. growth rate is needed to provide a satisfactory increase in per capita incomes for the growing population, absorb the rising labor force productively and reduce poverty. Achieving these goals will mean resolving a number of issues in key sectors-- agriculture, manufacturing, energy and power, and social services. As discussed below, a common theme across these sectors is the need for increased efficiency--doing more with less--in light of the need for greater fiscal stringency. A second theme is that in many cases this will mean greater reliance on incentives--prices, taxes, subsidies and cost recovery--to achieve sectoral objectives. While emphasis is often given to increasing growth by modernizing the capital stock, the efficiency gains from better incentives can be large, as well as less costly.

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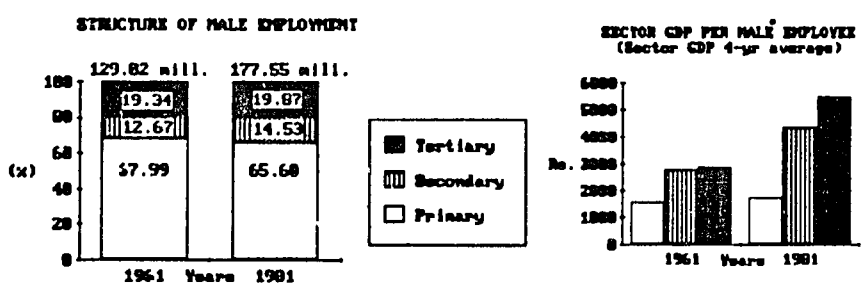
1. Demographic Background: Population, Employment, Urbanization and Poverty

15. India's population will reach 800 million in 1989 and one billion in 2000--perhaps sooner since the projected decline in population growth may prove optimistic. The birth rate seems to be reaching a plateau as the impact of sterilization programs levels off and female age at marriage rises less rapidly and in spite of the official figures showing rising contraceptive use. At the same time, death rates are likely to fall with improvements in health services in some of the Eastern states. Further reductions in the birth rate, and population growth, will entail a) more widespread education in and access to contraceptive methods and b) improved education and employment opportunities for females.

16. Employment patterns have changed only slowly; for example, between 1961 and 1981 the proportion of the male labor force in agriculture declined only two percentage points, from 68% to 66%. This slow shift reflects a weak push off the land and a limited pull from the secondary and tertiary sectors. On the one hand, agricultural productivity per man has risen only 0.6% p.a., which implies only a small annual reduction in the numbers needed to produce a given quantity of food and, hence, only a weak push off the land. On the other hand, the pull from secondary and tertiary industry has been limited by slow growth; increased capital intensity; and a labor market dualism that has limited employment growth and has pushed up wages and other labor costs in the organized sector, relative to the unorganized sector. The main source of employment growth in the secondary and tertiary sector has been, and likely will continue to be, the unorganized sector. The quality of this employment will depend, in part, on the education and training that the workers can bring to the job. Care must be taken in promoting this sector; for example, provision of low cost credit may well encourage increased capital intensity, and reduce employment generation. Moreover, many of the sector's current advantages simply reflect its being outside the tax, labor, and wage regulations that constrain the organized sector. Efficiency and employment could be increased by judicious reductions in the institutional barriers that constrain the modern sector and raise its labor costs.

Figure 2



17. India's urbanization has proceeded slowly, reflecting the slow shift in employment patterns. Nonetheless, even conservative projections suggest that urban population will more than double between 1981 and 2000. This will imply massive demands

for urban infrastructure and services. In addition, existing infrastructure in most cities will need upgrading. Satisfying these demands will require large investments, in the smaller urban areas as well as the megacities. Institutional changes will also be needed to speed up the lengthy infrastructure investment process, that now escalates costs.

18. Poverty seems to have declined in the 1980s, at least until the 1987 drought. The latest NSS data suggest a significant fall in poverty between 1977 and 1983. Nonetheless, official estimates are that about 273 million persons were below the poverty line in 1984/85. A substantial fraction of the poor are members of scheduled tribes and castes. About eighty percent of the poor live in rural areas, largely the rainfed agriculture and arid zones of eastern and central India. This has made the poor especially sensitive to drought-induced agricultural variability and underlines the critical importance of improving rainfed agriculture.

19. India's numerous anti-poverty, relief, and nutrition programs, such as Integrated Rural Development Program (IRDP), the National Rural Employment Program, Fair Price Shops, the Integrated Child Development Service (ICDS), Andhra Pradesh's Rs. 2/kilo rice scheme, and the Tamil Nadu's Chief Minister's Nutritious Meal Program, have improved the lot of the poor. They also have been critical in mitigating the impact of the 1987 drought and preventing a widespread catastrophe. However, most of these programs have had problems reaching the very poor. Those that serve a broad clientele involve large delivery and administrative costs and their costs have risen to the point where they are a large burden to some states. Direct inverventions are essential to help those left behind by the growth process. It must be recognized, however, that even though improvements are made through better targeting and cost control, the numbers of India's poor and near-poor are very large relative to the availability of resources. Hence, improvement in the lot of the majority of the poor will depend upon the growth of productive employment and improvements in the provision of social services like education and health.

2. Agriculture

20. Between the 1960s and the 1980s India went from being a major grain importer to feeding itself and holding large cereal stocks. These stocks, distributed through the extensive public distribution and relief network, have averted the worst effects of the 1987 drought. Agricultural GDP grew about 2.4% per year over the past twenty five years with foodgrain output growing about 2.8% p.a., reflecting rapid growth in HYVs using heavy doses of fertilizer and irrigation. Coarse grains, pulses, oilseeds and other non-cereals have generally grown more slowly. Agricultural exports have lagged, reflecting many of the same problems as industrial exports.

21. In the last four years, however, agriculture's performance has been poor. Agricultural GDP and foodgrain output peaked in 1983/4 and have not attained that level since. A number of problems have come to light that may constrain future growth. First, Indian agriculture is still highly dependent on the vagaries of the monsoon. While the drought-resistant base of irrigated agriculture has risen, the planting of sensitive HYVs on unirrigated land has brought greater variability to marginal production, along with higher yields in good monsoons. Second, with the new technologies largely tied to water availability, the locale and pace of agricultural growth have depended heavily on irrigation. Hence, much of the initial growth in foodgrains and the benefits of the Green Revolution were concentrated in Haryana and Punjab, which were already well-endowed regions. Moreover, unless the slowdown in real public investment in irrigation is reversed

and reliance on irrigation is diminished, through better use of water resources, there is a danger of agricultural growth slackening. Third, subsidies and price policy have contributed to a number of distortions, including excessive and imbalanced use of fertilizers, which depletes soils and leads to contamination of water tables; switches from other crops to cereals, which explains partially the poor performance of the other crops, as well as having implications for income distribution; excessive water use and switches to water intensive crops such as sugarcane; and limitations on exportable crops like cotton and tea while import substitution in oilseeds, in which India does not at present have a comparative advantage, is encouraged. Finally, the higher agricultural growth rates in other South Asian countries and elsewhere suggest room for improvement even in the long run underlying growth rate.

22. Improving agriculture's performance will be critical to future growth and poverty reduction, especially in light of the potential increase in demand for food. The 1987 drought was a harsh reminder of agriculture's importance, but it did lead to some useful rethinking of the Government's agricultural policies. Irrigation will remain the center of the strategy to raise output and "drought-proof" the economy. This will involve implementation of the recommendations of the 7th Plan and the 1987 National Water Policy: a) concentrating on completing existing works and making key investments needed to improve drainage and safety and b) improvements in operation and management, which will begin under the National Water Management Project. This may also require reassessment of groundwater strategy and the costs and benefits of implicit and explicit subsidies in irrigation charges, not only to improve efficiency but to reduce their fiscal drain. In addition, efforts are needed to curtail the spiraling cost of public irrigation programs. Improvements in rainfed agriculture are the second vital element in the strategy, both because of the limits to expansion of irrigation and the role which better rainfed agriculture can play in poverty alleviation. Agricultural research and extension will play a critical role in these two areas. In irrigated agriculture, extension can assist in the crop diversification that better water management would entail. In rainfed agriculture, all facets of research on farming systems could be improved; indeed the whole research program could be slanted more heavily toward problems of rainfed farming. Moreover, there are a number of existing techniques for moisture conservation and soil preparation that could be disseminated more effectively by the extension services. Wasteland development and resource conservation also will play a role. This will involve greater emphasis on watersheds as a whole, attention to erosion control and to forests and public lands and improved management of common property resources. Finally, price and subsidy policy needs a thorough-going review from the standpoint of its impacts on production and distribution, highlighting opportunities for increasing efficiency, taking better advantage of international markets, and controlling fiscal burdens.

3. Manufacturing

23. Manufacturing has always been accorded a special role in India's development, as the sector that would lead the country into the modern world, generate the higher incomes for eliminating poverty, and reduce dependence. In India, a broad consensus has existed that this requires a centrally planned strategy; implementing this consensus led to a number of more detailed objectives--import substitution, a dominant role for the public sector, control of large private firms, dispersal of industrial production, employment preservation and small scale promotion along with a diverse and complicated set of overlapping policy tools for controlling and regulating the domestic economy and foreign trade (See last year's World Bank report, India: An Industrializing Economy in Transition).

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24. Although progress toward some of the objectives was impressive, a growing awareness has developed that the performance of manufacturing between the 1960s and the end of the 1970s did not generate the growth, employment and foreign exchange that the economy required. Growth was slow and the combined productivity of capital and labor also rose slowly. The technology used often was outmoded and the goods produced often did not match world market standards of quality and price. India's share of LDC manufactured exports, once among the highest, fell substantially.

25. The causes of this less-than-hoped-for performance are generally recognized to lie in lack of internal competition, import competition, and export rivalry. The licensing system, reinforced by controls on large firms (MRTP) and preferences for small scale industry and public enterprises, tended to maintain a seller's market that reduced incentives for cost cutting and quality control. The high level of protection from external competition permitted the growth of capital-intensive, power-using industries, and the set up of high cost plants, producing goods of less-than-international standards. The high profitability of sales in the domestic market made exporting unattractive despite export incentive programs. Finally, the complicated and case-by-case nature of licensing and import controls diverted entreprenurial talent from cost-cutting, innovation, and quality improvement to dealing with the government.

26. Although many of these problems porsist, they have been reduced by recent policy changes. Performance of the manufacturing sector has improved noticeably. Recent policy changes have reduced the scope of controls and the distortions in incentives. In addition, the administration of the control system has been streamlined and its application has given greater emphasis to efficiency--changes that probably have been as important as the policy reforms themselves. Growth of manufacturing has averaged nearly 9% in the last three years and manufactured exports have picked up noticeably in the past two years. Nevertheless, a number of problems remain with the regulatory system. Eligibility conditions and new controls have limited the impact of the recent changes and the export growth may prove transitory. The need for further change is recognized by analysts inside and outside the Government (e.g. the Mid-term Appraisal of the 7th Plan). Hence, the real questions relate to the pace and scope of change and the appropriate measures for easing transitional costs, such as sick industries and displaced workers. There are a number of suggestions such as the measures proposed in a Planning Commission's discussion paper on industrial policy, that would increase competition substantially. The recently announced Import Export Policy for 1988-91 should boost exports and increase import competition somewhat.

4. Energy and Power

27. India has been pursuing a fairly energy-intensive development path. Energy use has grown faster than GDP by a factor of 1.2-1.5. In part, this reflects an industrial strategy that encouraged energy-intensive industries and provided little incentive for energy saving. In the mid-1970s, in order to cut down on petroleum imports, the Government embarked on a strategy of increasing domestic energy supplies, which in turn required allocation of substantial investment resources to exploration and production of oil and coal. In oil, discoveries of oil reserves have not kept pace with production in recent years and the Bombay High field, which accounts for 70% of production, appears to have reached a plateau. Unless further oil reserves are discovered, imports will increase sharply. The Government consequently has stepped up exploration and signed exploration/production contracts with five foreign firms. Accelerated development of gas would ease the demand for oil, but this will require further large investments in in-

frastructure. India has vast coal reserves that can be mined cheaply, and hence it has relied on coal-fired thermal plants for much of the growth in power capacity. However, Coal India Ltd., which accounts for 90% of coal production, suffers from a number of problems. Putting the coal industry on a sounder footing will entail increased efficiency of production as well as pricing policies that provide sufficient internal resources for expansion. Efforts are also needed in the oil, gas, and coal sectors to ease the administrative problems associated with new projects and to encourage more efficient management.

28. Good performance in the power sector is critical to India's development, as it provides a key input and absorbs a 20-25% of Plan outlays. The drought has caused some short run problems but the sector has held its own, achieving 7.5% growth through record thermal capacity utilization and record additions to thermal capacity. Nevertheless, the significant power deficit that has existed in India for the last twenty years continues. It is estimated that the current total electricity deficit is almost 10%, with much higher "peak" shortages. Unplanned power cuts and planned rationing are common, and the quality of power supply is poor in terms of voltage and frequency. This is costly to the economy. The problem lies not only in the size of investments in the power sector, but in the power sector's poor performance in constructing and utilizing capacity, particularly the State Electricity Boards, and in the inefficient use of power throughout the economy, including large power losses. Indeed, the traditionally high priority given to power investments has resulted in a steadily increasing share of power investments in total Plan outlays. Although continued high outlays will be needed, the need for tighter fiscal control suggests that large increases in Plan allocations are unlikely. Hence, reductions in the power deficit will entail increased efficiency in energy generation, distribution and use.

6. Social Sectors

29. India has made substantial progress in the social sectors, especially given the expanding population that they have served. For example, there has been a substantial increase in health care facilities, including the rural Primary Health Care Centers and Subcenters and ICDS. The number of primary schools has increased from 210 thousand in 1950 to 520 thousand in 1984 and over 90% of the rural population is now within one kilometer of primary schools. Middle schools have risen tenfold in the same period. These increases have undoubtedly contributed to the improvement in India's social indicators. For example, in the health area, life expectancy at birth has increased from 47 years in the 1960s to 57 years in the mid 1980s, infant mortality has fallen nearly a third between 1970 and 1985, and the birth rate has declined from about 42 per thousand in the 1960s to about 33 in 1987. In the education area, the literacy rate has risen from 17% in the 1951 Census to 36% in the 1981 Census.

30. Despite these accomplishments, it is generally recognized that performance in India's health and education sectors leaves substantial room for improvement. Although the literacy ratio has risen, the number of illiterates also has risen, from about 200 million in 1951 to 440 million in 1981. Only a third of those enrolled in primary school complete the sixth grade, a figure much below other countries. High enrollments are belied by much lower net enrollment figures (which exclude overage and underage pupils) and offset by high dropout rates and, according to the National Sample Survey, much lower attendance rates. In the health and family planning sphere, life expectancy and contraceptive use remain below a number of other countries. The Government

itself has recognized that past programs for immunizing mothers and child could be improved.

31. The Government is aware of these problems and taking steps to improve matters. For example, the Universal Immunization Program was initiated in 1985 with promising results and aims to cover the whole country by 1989. A new approach is being used in family planning that aims at wider acceptance of reversible methods. Educational problems are being addressed by the New Educational Policy adopted by Parliament in 1986. Operation Blackboard, a key component, aims at improving facilities and teaching material and increasing staff in primary schools. A comprehensive literacy mission has been formed to step up efforts to reduce adult illiteracy. Model schools are being set up and vocational training also will be increased.

32. There are a number of common issues in the social sectors. One is financing. Expenditures on the social sector, particularly education, are slated to rise. But these increases may fall victim to fiscal stringency, hence the need for adjusting the allocations of funds to better achieve social objectives and for improving cost recovery in education. In health care, expenditures continue to be skewed toward urban hospitals, rather than to controlling infant mortality and morbidity in rural areas. In education, outlays on secondary and higher education have risen at the expense of primary school; although a much larger fraction of costs (17%) is recovered from college students than primary schooling (3%), the per pupil subsidy in post secondary education is seven times that for primary schools. The government's education review has suggested that new funds could be raised by reducing subsidies to education above the primary level and encouraging private entrepreneurs to play a larger role in vocational and professional education. A second issue relates to improving the performance of field workers. Many of the social sector programs have begun large pre-service and in-service training programs that should help, but there is also a role for better management and for definition of field workers' tasks for performance and evaluation. A third issue is the surprisingly weak demand for many services, as evidenced by high dropout rates and low attendance in education and by low utilization of some health services. In part, this is due to social and cultural norms and economic pressures. But the Government's marketing of these services also could be improved by greater efforts to learn what social services clients want, what fees they are willing to pay, and what are the best types of delivery arrangements.

C. Domestic and Balance of Payments Prospects

33. India's prospects for 1988/9 are good, provided the 1988 monsoon is normal. This would mean a rebound in rural output, implying about 9% agricultural growth. This alone would generate nearly a 3% rise in GDP. Industrial growth might remain somewhat below the high rates achieved in the mid-1980s, owing to the lagged effects of lower rural incomes, high inventories in some sectors and low hydroelectric generation. Nonetheless, with a normal monsoon GDP growth in 1988/9 should be about 7%.

34. Over the longer term, attaining at least a 5% p.a. growth rate will depend on continued improvements in productivity, encouraged by measures such as those discussed above. At the same time, the investment rate will need to be maintained or even increased from its current high level in order to further "drought proof" agriculture, modernize the capital stock and provide the necessary infrastructure. To finance this investment India can largely rely on its own high saving rate. Some additional investible resources can also be generated by further reducing the Government's deficit and in-

creasing its saving, which, more importantly, would ensure India's traditional macroeconomic stability. Nonetheless, India's resources are inherently limited by its low per capita income and there are also claims on these resources from the social sectors and poverty programs. Hence, continued inflows of foreign resources will be needed to maintain India's growth.

35. The need for external capital is evident in the balance of payments projections. Imports of capital goods and key inputs will need to rise from their drought-depressed levels, reaching about US$ 14.2 billion in 1990/91, compared to imports of US$ 10.2 billion in 1987/8. Real bulk imports will rise less rapidly but total imports will reach about US$ 24.2, billion in 1990/1, versus about US$19 billion in 1987/8. There will also be some increase in interest payments, which are projected to rise from about US$ 1.7 billion to US$ 1.8 billion. Remittances and growing net non-factor services will supply some of the necessary foreign exchange but exports will have to provide the bulk. Specifically, real export growth of about 6% p.a., during the next three years, much less than the growth rate of the last two years and less even than the 7th Plan target, should permit India to maintain a viable balance of payments. Such a growth rate should be feasible if export profitability is maintained, particularly as costs in India's East Asia competitors are rising. With this export growth, the current account deficit should be about US$ 4.. billion in 1988/9 and rise to US$ 5.4 billion in 1990/1 (equivalent to about 1.6% of GDP in each year) and implying a corresponding need for foreign inflows. In addition, amortizations of medium and long term loans and IMF repayments will average roughly US$ 3.4 billion p.a.

36. As in the past, most of India's external financing requirements will be met by the Consortium members. Non-concessional disbursements of publicly guaranteed funds will need to rise over US $600 million p.a, from US$ 1.7 billion in 1987/8 to US$ 2.3 billion in 1988/9 and to US$ 3.7 billion in 1990/1. To ensure these disbursements, commitments would have to reach about US$ 3.7 billion in 1988/9 and rise to US$ 4.1 billion by 1990/1. The World Bank would provide the majority of these inflows with the Asian Development Bank playing a growing role. However, financing current account deficits of this magnitude through ever-increasing reliance on non-concessional funds would not be prudent. The decline in the availability of concessional funding has already led to an increase in India's non-concessional borrowing and a rise in its debt service ratio to over 25%; India is now reducing that ratio to a more moderate 20% by increasing its exports rapidly.

37. Larger concessional flows will be necessary to support this process and avoid further pressure on India's already low consumption levels. Such flows also would demonstrate the Consortium's support for India's recent performance and reforms. In addition, concessional inflows are necessary to provide a "safety net" against periods of natural calamity like the recent drought. Finally, larger concessional flows are necessary to support the Indian Government's efforts to improve the lot of those living in absolute poverty, whose numbers exceed the population of all of sub-Saharan Africa outside of Nigeria. In sum, India's performance and needs warrant a substantial increase in real concessional flows. The balance of payments projections suggest that, at a minimum, concessional disbursements, which rose from about US$ 2 billion to US$ 3.1 billion in 1987/88, should increase to at least US$ 3.2 billion in 1988/9 and to a minimum of US$ 3.5 billion in 1990/1. Ensuring these levels of future concessional inflows, given the time profile of disbursements, will entail a rise in concessional pledges by the Consortium, from last year's figure of US$ 3.3 billion to at least US$ 3.8 billion.

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"India: Poverty, Employment, and Social Services"--A World Bank Country Study, 1989

ABSTRACT:

This report consists of two parts: Chapter 1, which analyzes recent economic developments and growth prospects; and Chapters 2-6, which discuss the problem of poverty in India and the Government's poverty alleviation efforts. The review of recent developments emphasizes the vigorous recovery the Indian economy has made from the drought of 1987. The economy is likely to grow by 9% in 1988/89, making it likely that the Seventh Five Year Plan's target rate of growth of 5% will be reached, and rendering the 6% target of the forthcoming Eighth Plan attainable. The report emphasizes, however, that the fiscal and balance of payments deficits will have to be reduced in order to establish a sound base for sustained higher growth. It suggests that real export growth of at least 10% per annum will be required to pay for the increased imports required for higher growth and to avoid an unsustainable build-up of external debt. Reducing the fiscal deficit is required to reduce the pressure on the balance of payments and permit efficiency-enhancing liberalization of the trade regime. The second part of the report finds that the more rapid growth of the Indian economy during much of the 1970s and 80s, coupled with an expansion of programs aimed at poverty alleviation has led to a decline in the incidence of poverty. At the same time, poverty has become more strongly concentrated in Eastern India and more closely associated with landlessness and wage dependency, especially in unirrigated rural areas. It suggests that, while more rapid growth can lead to greater progress on the poverty front, policies which have inhibited the growth of employment both in agricultural and non-agricultural pursuits will have to be changed. At the same time, partly because of fiscal pressures, but also to increase their effectiveness, programs designed to increase the ability of the poor to participate in the growth process by improving their health and educational status will have to be more sharply targeted, simplified in their administrative structures and more closely attuned to the needs of the communities they serve. Finally, the report urges that some sort of safety net, in the form of guaranteed employment will be required to protect those who, because they lack the human or physical capital, or live in chronically depressed regions, cannot benefit directly or immediately from the growth process.

ABSTRACT

This Report analyzes the industrial and trade policies that would help assure a smooth transition from the highly protected industrial environment of the past, in which direct controls were a key means of allocating resources, to a more open environment in which competitive forces have a much greater role in shaping investment, output and pricing decisions. After a surveying recent economic developments (Chapter 1) and analyzing of progress and problems in domestic resource mobilization (Chapter 2), the report examines the past framework of domestic regulatory policies and incentives for industrial development, the impact of these policies on industrial structure and performance, the recent changes in industrial policies, and extensions of these measures that would accelerate the transition (Chapter 3). As domestic regulatory policies have been closely linked to external trade policies, the following chapter examines ways in which trade policies have protected domestic industry, the effects of this protection on manufacturing performance, and the measures which could be taken over time to restore a greater degree of competition--both with imports and in export markets. The report concludes that reforms of domestic and external regulatory policies would need to be made simultaneously over the medium term to effect a successful transition to a more competitive, efficient and faster growing industrial sector. Chapter 5 ends with a call for a significant increase in concessional assistance to provide the resource cushion needed to reduce the risks of BOP problems--and thus to help assure the success of the liberalization process that is already underway.

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Deputy Secretary Eagleburger

Current
Policy
No. 1250

America's Opportunities in Eastern Europe

United States Department of State
Bureau of Public Affairs
Washington, D.C.

Following are remarks by Deputy Secretary Lawrence S. Eagleburger before American Chamber of Commerce's International Forum, Washington, D.C., February 16, 1990.

Introduction

The year 1989 saw the most dramatic changes on the European Continent since the end of World War II. From the June elections in Poland, in which communist candidates were soundly defeated, to the fall of the Ceausescu dictatorship in late December, we have witnessed the steady march of democracy, freedom, and human rights across central and Eastern Europe.

However, the mind can only absorb so much change before numbness sets in and we begin to lose perspective. It is important, therefore, that we not lose sight of the fact that the democratic transformation of Eastern Europe represents the vindication not only of U.S. policy during the cold war but also of the commitment of American lives in two World Wars toward the making of a Europe which is prosperous, stable, and free. So our stake in the success of the East European revolutions is substantial. We are faced with the challenge and the opportunity to help assure the economic growth and stability which eluded the region in the wake of the First World War and to consolidate the freedom which was denied to Eastern Europe after World War II.

Make no mistake about it, this will be a tall order. But the United States cannot—and will not—shirk its duty. As I will describe to you this morning, we are committing substantial resources to East European economic recovery, but we are doing so in a careful and calibrated manner. Our efforts should be focused on projects where we can make a difference, not dispersed over so many programs that none in the end will have a substantial impact. Our goal is to encourage reform and self-generating economic growth in the region and in a way which emphasizes close coordination with our allies to avoid duplication of efforts and to maximize our comparative advantages in the assistance field. Moreover, as I will also be discussing, our blueprint for central and Eastern Europe accords perhaps the highest priority to the role that you, the American private sector, will be called upon to play in the revolutionary transformation of these economies.

It is clear that a new Europe will demand new thinking and new vision on our part. We have lived for the past 45 years with a divided Europe and are still inclined to think of Eastern Europe as a place apart. But those days are gone—or going fast. The Berlin Wall has come down. The Iron Curtain has been drawn aside. We can no longer think of Eastern Europe as a bloc. We must now think of each country in the region in its own light, with its unique history, aspirations, and potential. Our policy, therefore, demands a new democratic differentiation—one based on the progress of these countries in moving toward democratic societies with market-oriented economies.

A Framework for U.S. Assistance

The United States has been a leader among Western nations in providing assistance to Poland and Hungary. We must now expand our assistance efforts to the entire region of central and Eastern Europe, including Yugoslavia. We must develop a process and framework for managing the transformation of these countries from communist governments with centralized economies to pluralistic democracies with market-oriented economies.

The provision of U.S. assistance shall be based on the extent to which these countries are taking steps toward the achievement of four objectives that are very much in our mutual interests.

First, we want progress toward political pluralism, based on free and fair

elections and an end to the monopoly of the Communist Party.

Second, we want progress toward economic reform, based on the emergence of a market-oriented economy with a substantial private sector.

Third, we want enhanced respect for internationally recognized human rights, including the right to emigrate and to speak and travel freely.

Fourth, we want a willingness on the part of each of these countries to build a friendly relationship with the United States. As President Bush emphasized in his speech in Hamtramck [Michigan] last April, hostile intelligence activities and technology theft are not friendly acts.

In deciding on the level and mix of assistance that we provide to each individual country, we shall be influenced by their movement toward these objectives.

I should add here that not all of our assistance will be conditional; some of it will be available to countries as they need it and are able to use it. In this category, I would place emergency and humanitarian aid, designed to relieve deprivation and give a new government some breathing room. The medical supplies we have provided to Romania and the food relief we have provided both to Poland and Romania are examples of this assistance.

I would also include here support for democratic institutions, including the promotion of free elections and the advancement of political reform through the rule of law. Free speech, free media, and free political parties must be guaranteed by law, not simply honored in rhetoric, and we are more than willing to help in these areas.

Another critical need relates to technical assistance and training, designed to promote the transition to market-oriented economies. Initiatives in this area include instruction in the principles of market economics, training in financial and accounting methods, and schooling in productivity and management.

Finally, we shall provide environmental assistance, designed to promote sustainable economic growth while cleaning up the environment.

Assistance in these areas will promote open markets and open societies and enhance the U.S. relationship with each of the recipient countries.

Beyond this first level of assistance, we are prepared to ease the barriers to trade and investment as the countries of Eastern Europe meet the requirements of U.S. laws. Bilateral trade and investment agreements, most-favored-nation (MFN) treatment, eligibility for export credit guarantees from our Export-Import Bank and Commodity Credit Corporation, authority for the U.S. Overseas Private Investment Corporation (OPIC) to operate in these countries—all these are tools which would benefit both the United States and the countries of Eastern Europe.

Finally, we are prepared to offer a third level of assistance to those countries which are committed to the difficult and painful task of institutionalizing political and economic reforms. We know that making the transition from a controlled, planned economy to a market-oriented economy is tough; in fact, it has never been done before. But we believe this is the only avenue to self-sustaining growth, and, therefore, we are prepared to extend transitional economic support to those countries which are willing to bite the bullet to help themselves.

Our approach includes bilateral measures such as money for stabilization funds designed to bring hyper-inflation under control and make possible a shift to convertibility of local currencies. It also includes the provision of capital to stimulate private sector development, whether on a bilateral basis through "enterprise funds" or through a willingness to consider participation in a new multilateral institution such as the proposed European Bank for Reconstruction and Development (EBRD).

Debt relief can be an important tool as well; we are prepared to join our partners in the Paris group in providing such relief. Access to concessional trade programs, such as the generalized system of preferences (GSP), also fits into the category of transitional economic support. Finally, we believe international financial institutions, such as the International Monetary Fund (IMF) and World Bank, can provide important assistance in integrating Eastern Europe into the world economy. We will support the efforts of those countries committed to reform to join these institutions as they meet membership criteria.

As you know, Poland and Hungary have led the way on the path of reform and thus are beneficiaries of our new policy of differentiation. Czechoslovakia is clearly determined to move rapidly to institutionalize political and economic reforms, and Secretary Baker announced a package of U.S. assistance measures last week in Prague which take account of this fact. The other countries of Eastern Europe—as well as Yugoslavia—are, to various degrees, preparing the ground for free elections and institutionalized political and economic reforms. We look forward to the time when they are clearly committed to representative democracy and a real transition to free markets. In the legislative proposal which the Administration has sent to Capitol Hill, we seek the flexibility to respond as these countries move into a new phase of political and economic developments.

What government can do, we are doing. Some have said that we are not doing enough, that we should, in particular, be spending more money. There have been calls in this vein for a new "Marshall Plan" for Eastern Europe. To such criticism, I would say two things.

First, we are, in fact, devoting substantial resources to Eastern Europe. Figures can be deceiving. If we used the same accounting methods as our friends and allies—that is, if our figures included tied aid, export credits, and debt rescheduling in addition to actual budget outlays—our overall assistance levels would be second to none.

More important—much more important—is the fact that we are not dealing with a situation similar to postwar Western Europe, where we had to help rebuild a region that was physically devastated but which still possessed the technical skills, public institutions, and market experience to recover quickly. In Eastern Europe, which is emerging from a 40-year time capsule and which lacks those skills and institutions, our strategy must be different. We must not transfer substantial sums, as Western banks did in the 1970s, before the implementation of truly fundamental market-oriented reforms. Our primary goal, at least in the early stages, must be to provide the democratic institution-building skills and entrepreneurial know-how without which the privatization of the Eastern economies simply will not succeed. In short, we must aim to create the infrastructure of a market economy—and this is where your role will be vital.

The Role of the Private Sector

Building a sound infrastructure is a way of encouraging the flow of Western capital. In a time of budget constraints, we have deliberately sought to wield those instruments at our disposal—OPIC insurance and Export-Import Bank credits, above all—which will act as a catalyst for private sector investment. We are also working to reduce, and where possible

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eliminate, barriers to American business throughout the region.

Your expertise—as well as your financial resources—are vital to achieving our overall national objectives in Eastern Europe. Obviously there is much that we as a government can do, both in the area of resources and in terms of building democratic institutions. But Eastern Europe is never going to overcome its legacy of underdevelopment and instability unless East Europeans learn how to become self-reliant and self-sufficient economically. And this they must learn from you. It is you who can impart the genius of entrepreneurial success. Your trade, your know-how, and your investment can be the engine for economic growth and the political transformation of Eastern Europe.

It is true that during the transitional phase ahead, foreign companies will face a difficult landscape. Laws and policies will be changing. New ideas will be clashing with old habits. Credit, banking, communications, and other facilities for doing business will be well below Western standards, at least in the beginning. The entrepreneurs you deal with are going to be inexperienced and often unrealistic in their expectations. And they will be constantly adjusting to change themselves.

But with all that said, Eastern Europe presents an unusual opportunity. The needs are obvious, and the East Europeans are looking outward for investment and know-how. Our experience, our advice, and our capital are needed and welcome. Lech Walesa, in his visit to the United States, repeatedly stressed to U.S. businessmen the opportunities in Poland. A presidential mission to Poland last November, led by Secretary of Agriculture Yeutter, found numerous areas for Western investment, including agriculture, environmental technology, telecommunications, banking, housing, and energy.

The same needs exist throughout central and Eastern Europe. Privatization of state enterprises, badly needed infrastructure projects, the growth of private sectors, and the creation of capital markets all offer major openings for foreign firms.

The East Europeans, for their part, are moving quickly to open their economies to foreign investment. Poland has embarked on a major structural adjustment program approved by the IMF. Part of that effort includes a plan for making the zloty convertible and passing new laws on banking, foreign investment, and customs, all designed to work in the free-market system. East Germany has adopted legislation allowing joint ventures and in some cases majority foreign ownership of East German firms. Czechoslovakia is revamping its joint venture law to allow majority foreign ownership of companies. Hungary has created a stock market and is actively pursuing foreign investment; General Electric's deal with Tungsram is just one example of the opportunities in that country. Yugoslavia has made its currency convertible, created a stock market, and introduced a program of market-based economic reform.

I understand your responsibility to your companies and to your shareholders. Obviously, you have to be satisfied that the mix of risk and return on investment in Eastern Europe is competitive with other opportunities. And it may not be easy today to see when an investment in Poland or Hungary or Czechoslovakia will finally turn a profit.

What I would ask of you is to be both aggressive and patient at the same time. If you wait until Eastern Europe's markets fully stabilize before going in, you will probably find when you arrive that foreign competitors have beaten you to the punch. But by the same token, if you go into Eastern Europe expecting quick profits, you will probably be disappointed. Moreover, I can assure you that your West European competitors will decidedly not be aiming to make a quick buck. Thus, the most successful American firms will be those that move quickly to establish a long-term presence in Eastern Europe—a presence upon which our long-term national influence in the region will largely depend.

One of the first things Secretary Baker did at the State Department was to inform our diplomatic representatives overseas that improving American export performance is a top priority of this Administration. He told the chiefs of American overseas missions to be the principal commercial officer at their posts and to become personally involved in promoting U.S. exports and assisting U.S. business. He also instructed them to assure that each member of their mission is committed to promoting U.S. business interests. We are serious. We mean it. And we intend to succeed.

As you may know, the President has appointed me as his coordinator of U.S. assistance for Eastern Europe. I view support for U.S. private business in Eastern Europe as an essential component of that job. We appreciate that many U.S. companies will be trying to develop market share against stiff West European competition. U.S. firms may need, and certainly deserve, an extra measure of support and advice from their government. I intend to see that you get it.

To that end, I recently reminded our Embassies in Eastern Europe of the Secretary's desire that supporting U.S. business interests be a top priority of the Department. A delegation of which I am a member is leaving Tuesday for Poland, Hungary, and Yugoslavia. We are going to see how their reforms are coming along, and we are going to talk about our assistance efforts. We are also going to tell them that they should listen carefully to business proposals from American companies.

The U.S. Government is meeting the challenge in Eastern Europe. We are supporting the establishment of democracy and free enterprise. The challenge to American business is to seize the historic opportunities which now exist in the heart of Europe to demonstrate that free enterprise and freedom are but two sides of the same coin.■

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FEBRUARY 28, 1990
Testimony of Carla Hills, United States Trade Representative
before the Ways and Means Committee of the
United States House of Representatives

Good afternoon. It is a pleasure for me to appear before the Committee this afternoon. I look forward to discussing with you recent developments with regard to trade with the Soviet Union and the countries of Eastern Europe, the European Community's single market program, and foreign direct investment in the United States. In all three areas, the Bush Administration is pursuing a consistent policy of fostering freer play for market forces as the proven recipe for increasing economic opportunities and efficiency in the United States and internationally.

EASTERN AND CENTRAL EUROPE

Political and economic reform in Eastern Europe is transforming one of the most stagnant areas of the world into one of mind-boggling possibilities. Working together with the Congress, the Administration responded to the first reform initiatives by launching a wide-ranging assistance program for Poland and Hungary, which we have implemented pursuant to the "Support for East European Democracy" (SEED) Act of 1989 and through our cooperation with the Group of Twenty-Four (G-24) countries. This year the Administration has continued to promote the reform efforts by proposing legislation which will authorize

assistance to all emerging democracies in Eastern Europe, and Yugoslavia, pursuing market-oriented reforms.

Our trade and investment policy toward Eastern Europe complements our financial aid and technical assistance. The trade and investment aspects of our policy are being coordinated by the interagency Trade Policy Review Group (TPRG), within the context of our broader foreign policy objectives. Very simply, we seek a normalization of relations with Eastern European countries to the extent that they are taking steps toward political pluralism (based on progress toward free and fair elections and an end to the monopoly of the communist party), respect for human rights, a willingness to build a friendly relationship with the United States, and movement toward market-oriented economies.

As we seek to normalize trade and investment relations with Eastern European countries we will be looking for:

1) market-oriented reform consisting of privatization, decentralization of economic decision-making and reliance on price mechanisms; and

2) adequate access for U.S. traders and investors to those countries' markets and protection in those markets for U.S. investments and intellectual property.

The degree and the speed of economic reform in these centrally-planned economies will be the determining factor in whether their economies develop and their products are able to become competitive in world markets. Hopefully the new leadership in these countries and the population at large will realize that minimal measures to reform a command economy simply will not work. Real substantive change is the best hope. The West can help through aid and technical assistance of the kind envisaged in the SEED Act and the Administration's proposal, and through providing opportunities for expanded market-based trade, but the bulk of the effort will have to stem from domestic reforms. We already are taking several initiatives in the field of U.S. trade and investment policy to normalize economic relations with Eastern European countries.

First, we are negotiating trade and investment agreements which will provide reciprocal assurances and protection for enterprises, traders and entrepreneurs, but which also will be effective instruments for advancing market-oriented reforms. The particular forms of agreements sought depend upon whether the

country in question already has MFN status and whether it is covered by the Jackson-Vanik amendment.

Under Title IV of the Trade Act of 1974 ("Jackson-Vanik"), commercial agreements are required before we can grant most favored nation (MFN) status to Czechoslovakia, East Germany, and Bulgaria, as well as the Soviet Union. (We may also wish to revise our 1975 agreement with Romania as a condition of restoring MFN treatment to that country.) We also view these trade agreements as tools for removing significant barriers to commercial activity, for improving intellectual property protection standards, and for ensuring effective procedures for addressing market disruption resulting from import surges from these reforming command economies. The timing for initiating such negotiations with each country will depend on the pace and extent of democratic reforms.

Subsequent to the President's announcement of a one-year waiver of the Jackson-Vanik amendment during President Havel's recent visit to Washington, we agreed to initiate the process of Title IV trade agreement negotiations with Czechoslovakia. The elements of such an agreement are spelled out in Title IV and include reciprocal MFN treatment, support for trade promotion activities, protection for intellectual property, a market disruption provision, and a three-year term that can be renewed.

I will be guided by the President's decisions on Jackson-Vanik in proceeding with negotiation of trade agreements with the other Title IV countries as well.

I believe it also would be useful to negotiate investment agreements with Eastern European countries (including Yugoslavia). These would contain the model Bilateral Investment Treaty (BIT) provisions and in some instances may need to be broadened to include other business facilitation assurances or to address characteristics unique to centrally planned economies in transition.

Key elements of our investment treaties are: the right to establish and thereafter to be treated on a basis no less favorable than the better of MFN or national treatment; binding dispute settlement procedures; international law standards for expropriation; and unrestricted transfers of funds associated with investments. In the case of centrally planned economies in transition, we would also require opportunities for competition for U.S. investors equivalent to state-owned enterprises.

In the case of Poland, which already benefits from MFN and GSP treatment, we are in the process of negotiating a Business and Economic Agreement. This agreement is composed of the model BIT provisions and, in addition, covers commercial activity,

business facilitation and intellectual property rights. We have held two rounds of talks, in which we were guided by consultations with the Congress and advice from the private sector, notably the Investment Policy Advisory Committee (INPAC). Important issues, such as the right to repatriate profits, screening of foreign investment, the scope of third party arbitration, and adequate intellectual property protection are still outstanding. The third round of negotiations is scheduled for March 8-10.

We have explored informally with the Hungarian government negotiation of a similar agreement, since Hungary also already enjoys MFN status. Actual negotiations probably will await the election of Hungary's new government in late March.

Complete "normalization" of our trade relations with these countries, especially GATT members such as Hungary, Czechoslovakia and Romania, cannot occur as long as U.S. trade law (i.e., the Jackson-Vanik amendment) conditions the grant of MFN on satisfaction of statutory requirements. (These provisions do not apply to Poland and Yugoslavia, both GATT members, with which the United States enjoys full GATT relations.) Article I of the GATT requires unconditional application of MFN treatment to other GATT signatories. As a result, the United States invoked Article XXXV (non-application) of the GATT at the time of

Hungary's and Romania's accession, and Czechoslovakia and the United States mutually suspended GATT obligations in 1951, an action which was subsequently sanctioned by a declaration of the GATT Contracting Parties.

As the democratization and economic reform processes in Eastern European countries evolve, pressures for full normalization, stemming both from their governments and from the U.S. private sector, will mount. From a trade perspective, integration of their economies into the world trading system, based on strict compliance with the requirements of the system -- adoption of price based mechanisms being the key -- is in the United States' economic interest.

SOVIET UNION

Let me turn briefly to the Soviet Union, where we also have the negotiation of trade and investment agreements underway. Initial trade agreement talks were held in Washington February 12 and 13. The basis of the agreement will be the elements required by Title IV of the Trade Act of 1974, including a safeguards provision dealing with threat of market disruption, intellectual property protection, and trade promotion. Nevertheless, we envisage an agreement which is broader than the Title IV requirements.

Congressional Staff Forum
on
International Development

Director
William E. Hellert

March 26, 1990

TO: ODC Staff

FROM: Laura Rawlings

SUBJECT: Hearing on the European Bank for Reconstruction and Development (3/21/90)

Senate Foreign Relations Subcommittee on International Economic Policy, Trade, Oceans and the Environment.
Members in Attendance: Chair Paul Sarbanes (D-MD), Jesse Helms (R-NC), Nancy Kassebaum (R-KS)
Testimonies: David Mulford, Undersecretary for International Affairs, U.S. Treasury; Michael Mandelbaum, Council on Foreign Relations; Ed Hewitt, Brookings Institution; Paul Craig Roberts, Center for Strategic and International Studies

Summary

The hearing covered the question of U.S. participation in the European Bank for Reconstruction and Development (EBRD). The United States is presently conditioning its membership on two points:
1) that at least 60% of the loans go directly to the private sector and that the other 40% go toward supporting infrastructure projects or environmental projects
2) that Soviet borrowing be limited to Soviet contributions

Mulford discussed the above caveats, but said that the Administration generally supports the program because: it is transitional in nature (as supported by the fact that it is for countries with a high per capita income) and it is oriented toward the private sector and open markets. He sees the EBRD as an appropriate vehicle for leveraging funds to support Eastern European reform.

The main concern over Soviet borrowing was that this country alone could decapitalize the bank, leaving no loans available to Eastern European countries. Furthermore, Helms adamantly opposed Soviet participation in the EBRD on the grounds that this would a first step to Soviet membership in the IMF and the World Bank.

Sarbanes' main concern was over the impact on U.S. leadership if we did not participate in the EBRD. He also expressed doubt over the fact that there might not be enough attention to infrastructure.

Mulford expressed concern over the proposed Ecu-denomination of EBRD currency, because there is no fixed dollar-Ecu exchange rate. He sees this as a foreign currency risk that would complicate U.S. appropriations for the EBRD because of unpredictable foreign

exchange fluctuations.

Mandelbaum and Hewitt both adamantly supported U.S. participation as well as voiced concern over how the question of Soviet participation was being approached. Both suggested that general principles for borrowing be established that would preclude the Soviet Union from depleting the funds of the EBRD, but not single out that country as a specific problem.

GENERAL NOTES ON THE EBRD:

* the primary promoters of the EBRD have chosen the end of 1990 as the target date for opening the bank
* there are now 41 countries seeking membership in the EBRD, including Israel, Egypt, Canada, Japan, and Korea; the non-OEDC countries are throught to be joining as an act of political solidarity
* borrowing is limited to the Eastern block; the status of borrowing by the USSR is still under debate
* the EBRD will be financed through 30% paid-in and 70% callable capital for the first five years
* the U.S. share of EBRD 30% initial paid in capital would be $450 mil., to be paid over 5 years (using the present $1 to 1.2 Ecu exchange rate); this would correspond to a 8.5% to 10% share in the bank, which would correspond to an 8.5% to 10% voting power
* the EBRD will be a $10 billion Ecu institution.
* a meeting on the EBRD will be held in Paris in early April

EASTERN EUROPE

Havel Makes Appeal for Help But Not in the Usual Form

With aid money tight for newly emerging democracies, Czech president suggests giving Soviets a hand

In a matter-of-fact tone, the new president of Czechoslovakia appealed to an assembled Congress on Feb. 21 for help — not so much for his country but for its oppressor of more than 40 years, the Soviet Union.

Vaclav Havel, the dissident playwright turned reluctant politician, brought to the United States the flesh-and-blood reality of the past year's dramatic changes in Eastern Europe. Meeting with President Bush and speaking to a joint meeting of Congress, Havel asked the United States to nurture the fragile freedom in his part of the world.

But Havel did not ask for massive aid for Czechoslovakia or for a guaranteed continued U.S. military presence in Europe, as some others in the region have done. Instead, he urged the United States to lead by the example of its democracy, and especially by encouraging the Soviets' slow march away from communism.

R. MICHAEL JENKINS

Vaclav Havel: Europe "will begin again to seek its own identity without being compelled to be a divided armory any longer."

Acknowledging that his appeal might seem "paradoxical," Havel answered the question of how to aid Czechoslovakia this way: "You can help us most of all if you help the Soviet Union on its irreversible but immensely complicated road to democracy." The sooner the Soviet Union begins down the road toward "genuine political pluralism," he told Congress, "the better it will be, not just for Czechs and Slovaks, but for the whole world."

Havel couched his appeal in broad philosophical terms, but there was an element of pragmatism to it as well. Officials accompanying Havel said they realized that the United States by itself cannot propel Eastern Europe out of the Third World status into which it fell under communist domination. In recognition of Washington's budget limits, Havel also traveled to New York City in search of private investments to help transform Czechoslovakia's stagnant communist economy into one based on capitalism.

By John Felton

While they are eager to assert an active U.S. role in Eastern Europe, Washington's politicians are having trouble finding the money to come to the region's aid in a substantial way. The Bush administration and Congress are again arguing over the extent of aid to the countries that have struggled out from under Soviet domination. But the response so far has been halting in comparison with the needs, particularly in Poland and Romania, the nations in the most precarious economic state.

The administration has not yet carried out the full extent of aid programs for Poland and Hungary that Congress approved last November. While it has shipped food aid and put up $200 million as the U.S. contribution toward an international economic stabilization fund for Poland, the administration is still ensarled in bureaucratic red tape blocking what Bush foresaw as the centerpiece of U.S. aid: a $300 million program to promote private enterprise in Poland and Hungary. *(Status of aid programs, p. 609)*

The day after Havel left Washington for New York, one leader of Romania's bloody revolution against Stalinist-style communism made the pitch for U.S. aid — and in a hurry.

Dumitru Mazilu, minister of state in Romania's coalition government, told Washington audiences that his country desperately needs humanitarian aid, such as food, and the lifting of U.S. trade restrictions. "Our situation is the worst possible, even in comparison with the other countries in the East European bloc," Mazilu said at a Feb. 22 forum sponsored by *Foreign Policy* magazine.

Havel's Words to Washington

Havel was the second major political figure from Eastern Europe to come to the United States since the region's political upheavals began last year. The first was Lech Walesa, the larger-than-life leader of Poland's Solidarity labor union, who cut an emotion-filled swath through Washington last November, just a week after the breaching of the Berlin Wall. *(1989 Weekly Report p. 3170)*

Havel brought a different style and a different message to the United

States. Still overwhelmed by the experience of his last arrest in October and his ascension to the presidency in December, Havel struck a low-key stance. His remarks, both in formal speeches and in answers to questions, tended to the philosophical side, with little of the diplomatic verbiage standard for such events. *(Box, p. 608)*

Accustomed to the outstretched hands of foreign dignitaries, Washington as a whole was most interested in what Havel wanted from the United States. His refusal to conform to standard practice surprised and pleased members of Congress. Less than an hour after Havel finished his address to Congress, Rep. Silvio O. Conte, R-Mass., went to the House floor to marvel that: "In all of those sweet sounds, there was not one request for money for his own nation. It is like a revolution within the revolution."

Answering questions on that score, Havel said repeatedly that rather than large amounts of direct U.S. aid, Czechoslovakia needs limited technical help in specific areas, such as creating democratic institutions, moving toward a market economy, cleaning up its environment and establishing privately run broadcasting stations.

Moreover, Havel said Washington's greater contribution over the long term would be in encouraging democracy in the Soviet Union.

Carrying through a pledge that Secretary of State James A. Baker III had made during his trip to Prague on Feb. 6, Bush told Havel that he was lifting one major barrier to U.S.-Czech trade: the 1974 Jackson-Vanik restriction that requires increased tariff rates on goods entering the United States from most communist countries. Bush also said he would ask Congress to approve other trade concessions for Czechoslovakia.

In easing the trade barriers, Bush appeared to be giving Czechoslovakia at least a partial exemption from his policy of setting firm conditions on such steps for Eastern European countries. Among those conditions are the holding of free elections and the codification of laws to protect human rights.

"I assure you the United States will be part of your nation's democratic rebirth," Bush told Havel at a White House ceremony on Feb. 21.

Administration officials said Havel's requests for other forms of technical aid will be considered and fulfilled as quickly as possible.

Troops in Europe

If there was a discordant note in Havel's message, it was that the United States must itself adjust to the new world of Europe, in part by preparing for the day when American troops no longer will be needed there.

Havel coupled that statement with an even stronger demand for the Soviet Union to pull out of Europe, Czechoslovakia in particular. In the interest of "political stability," he said, as many Soviet units as possible should be withdrawn before the Czechoslovak elections scheduled for June. During his trip to Moscow set for Feb. 26, Havel was expected to sign an agreement calling for all

An Intellectual's Lessons

American politicians do not often call themselves "intellectuals." Doing so might be considered arrogant, at the least. In many sections of the country, it might also be political suicide.

One of the world's most famous politicians entered the world's premier political club — the U.S. Congress — on Feb. 21 and proudly declared himself an intellectual first and a politician second. Of course, Vaclav Havel had the credentials: Czechoslovakia's leading playwright and foremost political thinker, Havel served long stretches in prison for opposing communism and boldly advocating freedom and human rights. After the communist regime collapsed in December, Havel was the consensus choice as president to lead Czechoslovakia into a new era.

Havel

In a soaring speech to a rapt audience of America's senior politicians, Havel demonstrated that some of the deepest thinking about the rights of man in modern society is taking place in Eastern Europe — among leaders who have not yet mastered the art of the 15-second "sound bite."

A diffident figure still unaccustomed to pin-stripe suits, Havel dominated Washington for two days as few foreign dignitaries could. Officials and members of Congress came away awed by what they called his moral authority. Washington seemed most impressed by Havel's refusal to conform to stereotypes. Standing at the rostrum before Congress and a television audience, Havel nervously nodded in response to the thunderous applause. Twice, he flashed a tentative "V" for "victory" sign, each time quickly pulling down his arm as if surprised that his fingers had acted on their own.

Havel offered the obligatory tributes to Jefferson, Lincoln and the American political legacy. But his words bore the stamp of a man who wants his country to establish its own tradition of democracy and independence.

Both the United States and Czechoslovakia are still approaching democracy, the former with more than 200 years of experience and the latter after four decades of communist rule, Havel said. But Czechoslovakia and other countries emerging from communism may have "a special capacity to look, from time to time, somewhat further than someone who has not undergone this bitter experience," Havel said. "A person who cannot move and live a somewhat normal life because he is pinned down under a boulder has more time to think about his hopes than someone who is not trapped that way."

Havel offered a "single thought" for the United States in return for expected advice on the mechanics of political institutions and a market economy. The thought, he said, was his "great certainty" that "Consciousness precedes Being, and not the other way around, as the Marxists claim."

The assembled members of Congress applauded that statement, and a handful cheered. But some admitted later that, inspired as they were by Havel's words, they were not quite sure what he had in mind.

Rep. Robert J. Mrazek, D-N.Y., describing himself as the only Czechoslovak in Congress, wrote a column for *The Washington Post* saying he was surprised to see his colleagues "nodding sagely" in response to Havel's words. "Congress must be full of eggheads these days, or maybe it was just that none of us wanted to appear dumber than we are," Mrazek said.

—John Felton

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Aid Plans for Eastern Europe

Poland remains the focal point of economic assistance flowing to fledgling democratic governments in Eastern Europe. And most of the aid to the region continues to come from two multilateral institutions, the World Bank and the International Monetary Fund (IMF).

Efforts to promote private-sector investment through the use of U.S. tax dollars — as envisioned by last November's Poland-Hungary aid package (PL 101-179) — have been slow getting off the ground, despite appropriations of $50 million for the current fiscal year.

Talks continue in Paris on formation of a European Bank for Reconstruction and Development to funnel aid to Eastern Europe and potentially to the Soviet Union for private-sector projects.

Focus on Poland

World Bank President Barber B. Conable announced in Warsaw, Poland, Feb. 22 that the bank expects to make $5 billion available to Eastern Europe over the next three years. Half of it will be earmarked for Poland, which is somewhat ahead of other East-bloc countries in its effort to make the transition from a planned to a market-based economy.

The additional Polish aid would be on top of $360 million, approved by the bank on Feb. 6, which will be used to promote development of industrial exports and agricultural processing. In addition, the IMF approved more than $700 million in short-term credits to Poland Feb. 5.

The World Bank loans are the first since Poland joined the bank and the IMF in 1986.

Hungary, Romania and Yugoslavia are also members of the international organizations. Czechoslovakia applied for membership in the IMF at the end of January, as a precursor to bank membership. An IMF spokesman said the application process might take six months to a year. Bulgaria has signaled informally that it, too, would be interested in joining.

Other Initiatives

During the Washington visit of Czechoslovak President Vaclav Havel, President Bush on Feb. 20 waived trade restrictions imposed on Czechoslovakia by the 1974 Jackson-Vanik amendment. That provision bars non-market countries that have restrictive emigration policies from receiving so-called most-favored-nation (MFN) status. MFN grants the lowest level of tariffs available on U.S. imports.

Bush has said he would waive Jackson-Vanik for the Soviet Union once a trade agreement is negotiated and Moscow enacts a liberalized emigration law. He set no conditions for granting MFN status to Czechoslovakia, which has neither a trade agreement with the United States nor a revised emigration law. Trade talks began Feb. 20. *(Weekly Report pp. 381, 28)*

In a comprehensive Eastern Europe aid package sent to Congress earlier this month, Bush proposed that he be given broad latitude to grant MFN status to all Eastern European countries. Romanian official Dumitru Mazilu told a Feb. 22 meeting sponsored by *Foreign Policy* magazine that his country would like its MFN status restored as soon as possible. Romania lost MFN in 1987.

Bush also sought authority to grant eligibility for government guarantees of U.S. private-sector investment through the Overseas Private Investment Corporation and financing through the Export-Import Bank for U.S. firms selling goods to Eastern Europe.

Senate Foreign Relations Democrats have offered a similar plan, which they hope to mark up in mid-March. *(Weekly Report p. 400)*

Aid for Private Development

Plans to foster private enterprise in Eastern Europe have focused largely on the proposed European Bank for Reconstruction and Development. It would be capitalized at about $12 billion; the United States would have to put up about 8.5 percent of that, under current expectations.

Raymond Seitz, assistant secretary of state for European and Canadian affairs, told the Senate Foreign Relations Committee on Feb. 22 that negotiators for the European bank are currently discussing the possibility that the Soviet Union may apply as a borrower.

The United States has expressed reservations, and Seitz said that more restrictive criteria may be set for borrowers, including the establishment of democratic political institutions and market-based economic structures.

The European bank is expected to closely resemble the International Finance Corporation, an arm of the World Bank that makes loans to private enterprises in developing countries.

Its purpose would not be too different from the two private enterprise funds authorized under the Poland-Hungary aid bill. Those funds have not yet been created, however. Bush has not nominated members for their boards of directors, a step that must occur before the funds are formally created.

—John R. Cranford

73,500 Soviet troops to be withdrawn from his country sometime in 1992.

Because of the "historically irreversible" forces under way in Eastern Europe, Havel told Congress, the continent as a whole "will begin again to seek its own identity without being compelled to be a divided armory any longer. Perhaps this will create the hope that sooner or later your boys will no longer have to stand on guard for freedom in Europe, or come to our rescue, because Europe will at least be able to stand guard over itself."

That statement brought polite applause from members of Congress. But Havel's repeated insistence that the United States should match the Soviet Union in withdrawing militarily from Europe seemed at odds with what U.S. officials say they are expecting.

Baker told the House Foreign Affairs Committee on Feb. 22 that he expected that, among the European countries, "there will be continuing strong support for maintenance of United States [military presence] for some time." ■

INTERNATIONAL FINANCE AND TRADE

Cold War Barricades Remain As East Bloc Crumbles

Lawmakers will be called on to relax old restraints, but members aren't pushing to take the lead

If the "new partnership" proposed by President Bush after the Malta summit in December is to be translated into significant opportunities for U.S. business in the Soviet Union and Eastern Europe, Congress will have to dismantle a web of Cold War-era laws restricting trade with and investment in those countries.

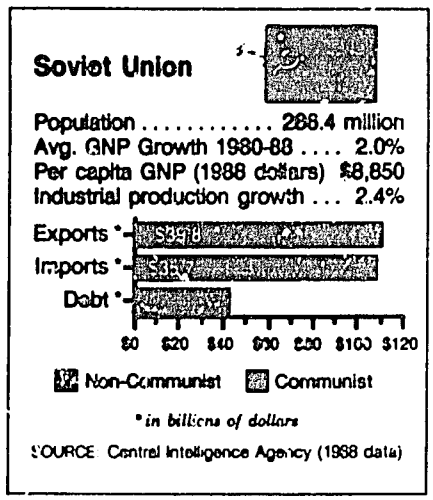
But the rapid pace of political upheaval in the region has left lawmakers, in recess since late November, little chance to respond. Moreover, signs are that Congress will not move in any comprehensive fashion on its own, absent requests from the administration. And except in a limited way, Bush thus far has put forward no such plan.

"As recently as six months to a year ago, Congress was very strongly disinclined to get involved in offering credits to the Soviet Union," said Rep. Jim Leach, R-Iowa. "It may be less confrontational today, but I suspect that Congress as an institution would prefer to let the executive display a great deal of discretion — rather than tackle the issue head on."

U.S. business leaders eager to take advantage of *perestroika* in the Soviet Union and promises of market-based economies across the old East bloc seek a comprehensive approach to removing bans on trade and financial dealings with communist countries and providing government financial assistance.

"We are concerned that without high-level governmental attention U.S. business may not be able to compete in the Soviet Union on an equal basis with other industrial nations," Charles E. Hugel wrote to Bush in November. Hugel is chairman of the National Foreign Trade Council (NFTC), an organization of more than 500 companies, including many industrial giants, that has taken the lead in pressing the administration to open the doors for U.S. businesses.

By John P. Cranford



BARBARA SASSA-DANIELS

The Bush administration has embraced the political and economic changes in Eastern Europe — particularly in Poland and Hungary — where Bush asked for and Congress approved a package of economic aid and the removal of some trade barriers (HR 3402 — PL 101-179). And at his summit with Soviet President Mikhail S. Gorbachev, Bush promised to work with the Soviets on a trade agreement that would be signed by June. *(Poland-Hungary, 1989 Weekly Report p 3299)*

But otherwise the administration has moved cautiously and has not outlined an overall agenda for clearing the legislative roadblocks to U.S. investment.

Congressional caution is reinforced by academic experts who emphasize the problems in the communist-crafted economies — low growth, low productivity and high debt in some cases; currencies that are not readily convertible on world markets; a lack of pricing structures; layers of bureaucracy; and inconsistent supplies. These, not U.S. legal constraints, are the first line of impediments to expanded U.S. economic and financial flows, many insist.

"There's a modest potential for U.S. trade with the Soviets, minimalist with Eastern Europe," Leach said.

"On the financial and economic side, there's still reason to be cautious," agreed Rep. Charles E. Schumer, D-N.Y. "On the political side, there's much more of an impetus now to lend."

Both are members of the House Banking Committee, which would have a key role in eliminating barriers to investment or opening the way for U.S. development aid.

Reflecting on the lack of a consensus on how to encourage private investment, Sen. Bill Bradley, D-N.J., told a forum in September: "Western guidance about how to do these things has collapsed into a cacophony of often self-serving voices. Joint venturers clamor for free-trade zones. Western investors and traders eager to make foreign policy, while eliminating risk, urge credits and guarantees. Academics and 'intellectuals' inside and outside government suggest pet theories.... No wonder the Soviets are confused over where the West stands."

What Is to Be Done?

Although there are few clear signs of what specific changes in existing law the administration might propose to Congress, it is nearly certain that lawmakers will be asked in the first part of 1990 to ratify several overtures to the Soviet Union.

Bush's first step is likely to be a waiver of the 1974 Jackson-Vanik amendment blocking normal trade status for the Soviet Union. The next would be consideration of the new trade agreement, which would remove barriers to U.S. firms that want to do business with Moscow. Just what such an agreement might cover is far from certain, however. Senate Majority Leader George J. Mitchell, D-Maine, and other congressional leaders have strongly endorsed the waiver. *(Story p. 15; 1989 Weekly Report pp. 3381, 3311)*

But there are other legal obstacles to U.S. trade with the Soviets and

East Europeans that have gotten little attention so far. These include bans or stiff limits on export credits to most communist countries, prohibitions on bank loans to the Soviets and purchases of Soviet securities by U.S. citizens, and national security export controls on high-technology goods to the Soviet Union and the East bloc. *(Barriers, this page)*

In addition, before many banks and firms take significant risks in the region, there are likely to be demands for more public money — both aid to help finance massive economic changes in Eastern Europe and government guarantees.

And Western European countries have begun negotiations to create a new multilateral development bank for Eastern Europe, to which the United States would be asked to contribute capital.

Increased Business Interest

The dramatic events of recent months have accelerated business efforts to persuade the administration to review barriers to trade and investment. In particular, attention is focused on the proposed U.S.-Soviet trade pact.

"We're going to be really humping on this," said Will Berry, who is tracking progress on the trade agreement for the NFTC. "If they are going to try to get an agreement signed in June, they have to have everything in mind by the end of January."

He said his organization is working closely with officials at the Commerce Department and other agencies to identify issues to be put on the negotiating table.

The NFTC in its November letter to Bush sought a variety of changes in U.S. policy. Among its concerns are continued national security export controls on many high-technology goods, limits on the Export-Import Bank as a means of financing sales to the Soviet Union, and the lack of government guarantees and insurance for investment and other ventures.

The NFTC and like-minded organizations are hopeful that a trade agreement with the Soviets, and similar pacts being negotiated with Poland and Hungary, will lead to a comprehensive revision of trade and investment barriers, including those in U.S. law.

"I'd love to see a trade package that would get rid of all of these. We could, if the president would ask for it," said Margaret Chapman, who handles trade matters for the Washington-based American Committee on U.S.-Soviet Relations, which represents business and academic interests. But Chapman also complained about the administration's cautious moves to date. "The most important thing is political will," she said. "The president held back for almost a year."

One former lawmaker who is actively encouraging both the administration and Congress to act is Don Bonker, D-Wash. (1975-89). "The time is past due for a full review of policies with the Soviet Union and East-bloc countries," he said.

Bonker, a former chairman of the House Foreign Affairs International Economic Policy Subcommittee who now works with an affiliate of the Washington law firm of Arnold & Porter to advance U.S. business interests in the Soviet Union, has long sought to relax some trade restraints as a means to reduce the U.S. trade deficit.

"Because we have these policy restrictions, because we're not up to speed on this global economy, we're losing future opportunities," Bonker said. "By the time we remove all these restrictions, the game will be over."

The NFTC expresses a similar concern over losing out to foreign, particularly West European, competition.

While Western Europe and other

Trade and Investment Barriers

Export-Import Bank — The 1974 Stevenson amendment prohibits loans or loan guarantees in excess of $300 million to the Soviet Union. Other provisions of law prohibit loans or guarantees of any amount for fossil-fuels production. The president may waive those limits, if Congress agrees by adopting a concurrent resolution. Current law also specifically bans loans and guarantees to Estonia, Latvia, Lithuania, Czechoslovakia, East Germany, Hungary, Bulgaria, Romania, Yugoslavia and the Soviet Union. The Ex-Im Bank is controlled by Jackson-Vanik restrictions *(see below)*.

Overseas Private Investment Corporation (OPIC) — Insurance against losses by U.S. investors abroad due to political upheaval is denied by current law in countries that do not adhere to internationally recognized workers' rights or make progress on human rights. The recently enacted Poland-Hungary aid bill lifted OPIC restrictions for both those countries.

International Monetary Fund (IMF)/World Bank — Under current law, the U.S. executive directors of these agencies are ordered to oppose loans and other credits to communist dictatorships unless the assistance would benefit the population, improve the country's balance of payments and improve market forces.

Bank Loans/Security Holdings — The 1934 Johnson Debt Default Act prohibits U.S. bank loans to countries whose governments have defaulted on loans from the U.S. government. The law also prohibits purchases of securities from such a country by U.S. citizens. The law applies to the Soviet Union, which defaulted on $188 million in pre-communist debt in 1917. The law does not apply to loans made by foreign branches of U.S. banks, to loans made explicitly for purchase of U.S. exports and to countries that are members of the IMF and World Bank.

Export Controls — Current law prohibits sales of certain high-technology goods to the Soviet Union and certain Eastern European countries, unless the sales are specifically authorized. U.S. law is tied to an international agreement among 17 Western countries, enforced by the Paris-based Coordinating Committee on Multilateral Export Controls.

Most-Favored-Nation Status (MFN) — This system of normalized tariffs for most industrial-country exports to the United States is prohibited for certain countries by the 1974 Jackson-Vanik amendment if those countries deny their citizens free emigration and other basic human rights. The president may waive Jackson-Vanik if Congress agrees by adopting a concurrent resolution. Jackson-Vanik also restricts the president's ability to negotiate trade agreements and loans and guarantees from the Ex-Im Bank. Hungary, Poland and Yugoslavia currently have MFN status; the Soviet Union, Bulgaria, Czechoslovakia, East Germany and Romania do not.

Generalized System of Preferences (GSP) — These special reduced tariffs for developing-country exports to the United States are denied by law to Czechoslovakia, East Germany and the Soviet Union. GSP benefits also are denied to communist countries unless they are members of the General Agreement on Tariffs and Trade and the IMF and they are eligible for MFN status. The recently enacted Poland-Hungary aid bill lifted GSP restrictions for both those countries.

industrialized countries exported $21 billion in goods to the Soviet Union in 1987, the NFTC said, the U.S. share was $1.5 billion — mostly agricultural products. And, the letter noted, while the Ex-Im Bank does not help finance exports to the Soviet Union, other governments have more than $16 billion in outstanding credits.

The 12-nation European Community (EC) is moving ahead on other fronts as well. The United States is just beginning trade negotiations with the Soviet Union, Poland and Hungary. But the EC recently has signed agreements with Czechoslovakia, Hungary, Poland and the Soviet Union and hopes to have an agreement with East Germany by summer.

Western Ventures Grow

Existing barriers notwithstanding, there has been an accelerating pace of investment in the Soviet Union and in Eastern Europe, documented in the daily newspapers.

Some reports put the current count at 1,000 foreign joint ventures with the Soviet Union, while the CIA said there were only 191 at the end of 1988 and 20 the year before, when the Soviets amended their laws governing joint ventures to allow majority ownership by Western firms.

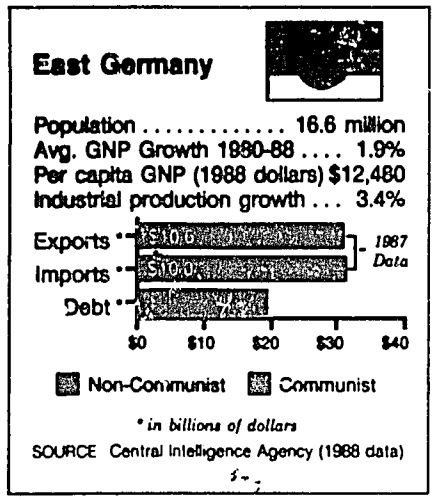
Some of the deals are large: Combustion Engineering Inc. plans to build a $2 billion petrochemical plant in Siberia; US West Inc. wants to stretch a fiber-optics cable across the Soviet Union, linking Japan to Europe. Other telecommunications firms have announced plans to upgrade telephone and data-transmission service across East Europe. And General Electric Co. has bought a 50-percent-plus-one-share interest in a Hungarian light bulb factory.

But most, according to the CIA data and anecdotal evidence, are still quite small, valued at $10 million or less.

Upbeat, but Cautious

Encouraged by announcements of new ventures, the Bush administration is decidedly optimistic about opportunities for U.S. firms. Commerce Secretary Robert A. Mosbacher, for instance, has embraced the proposed telecommunications deals and indicated that, especially with Poland and Hungary, national security controls on high-tech exports should not be a barrier.

But he and Agriculture Secretary Clayton Yeutter, the administration's point men on openings to Eastern Europe and the Soviet Union, also are careful to qualify their optimism.



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In December, they led 50 government officials, academicians and businessmen to Poland, which has moved closer than other East-bloc countries to democracy and a free-market economy. After, Mosbacher lamented the "tremendous gaps" in Polish law allowing for and protecting foreign investments.

And Yeutter on Dec. 12 told an audience at the National Press Club, "It will do no good for us or the Western world to plow billions of dollars into the Polish economy if Poland does not create the institutions that can put that money to good use and put it to good use over a period of time."

He pointed out the lack of "a basic legal system, a basic accounting system, a basic banking system, a basic marketing system."

U.S. Legal Barriers

There are dozens of roadblocks to expanded U.S. economic activity in the East bloc.

Most advocates of freer trade regard repeal or presidential waiver of Jackson-Vanik as a crucial first step, which would allow the granting of most-favored-nation (MFN) status to the Soviets and potentially to Eastern Europe. Only three Eastern European countries currently enjoy MFN status: Hungary, Poland and Yugoslavia.

MFN status chiefly benefits foreign exports to the United States, by granting them the same low tariffs as those paid by Western industrialized countries. But MFN status also has implications for U.S. firms that want to do business in the region.

None of the countries has a currency that is freely convertible on world markets. Without convertibility, it is difficult for those countries to obtain dollars with which to buy U.S. goods or to repay profits earned by joint ventures. An enhanced ability to export could mean a greater flow of dollars into those countries.

The lifting of Jackson-Vanik also would allow for negotiation of trade agreements with the Soviets and others, which will provide business groups a means to attack other barriers to trade.

Another item on the NFTC's list is the so-called Stevenson amendment, which limits to $300 million Ex-Im Bank loans or guarantees to the Soviet Union.

That seems an insignificant amount of money, especially if trade with the Soviet Union were to accelerate. But Mosbacher told reporters Nov. 16 that he doubted there would be discussion about changing that restriction.

"We're talking about, frankly, $300 million, which is more than the Ex-Im Bank at this point would be prepared to be involved with anyway. It's really a non-starter," Mosbacher said.

Potential investors in Eastern Europe would also like to obtain guarantees through the Overseas Private Investment Corporation (OPIC), a federal agency that insures against political losses in developing countries.

Most investments in East-bloc countries are ineligible for OPIC insurance on human-rights grounds similar to those in Jackson-Vanik. The recent Poland-Hungary aid bill did lift the ban for those two countries.

Bonker, who likewise would prefer a comprehensive review of legal barriers to enhanced trade and investment, is focusing on export controls, which prevent sales of militarily significant goods to the Soviet Union and most Eastern European countries. These controls, while a part of U.S. law, are enforced by the 17-nation Coordinating Committee on Multilateral Export Controls, which includes most NATO countries, as well as Japan and Australia.

Bonker said a good opportunity for a comprehensive congressional review of export-control policy will present itself this year when the underlying Export Administration Act is up for reauthorization.

In recent months there have been signs that the administration is relaxing its control policy. Some classes of personal computers are now available for export, and the NATO foreign ministers in December endorsed "rationalizing export controls."

While acknowledging the thaw, Bonker said the administration had not taken steps "that are essential if these coun-

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tries are to modernize their industries."

And he noted that revising national security controls will be difficult. "Export controls are to some conservatives what 'no new taxes' is to supply-siders and abortion is to the religious right," Eonker said. "It's red meat that's tossed out there."

High-tech exporters would like the list of 10,000 or more controlled items to be sharply reduced. Others have suggested a "green line" of permissible exports to Eastern Europe similar to that in effect for China, while the goods remain banned for sale to the Soviets.

Economic Barriers

Even if U.S. limits on trade and investment with the East bloc are lifted, most business executives and academics believe that the real hurdles to significant private-sector activity in those countries will remain.

"Most of the barriers to investment [in the Soviet Union] are in Soviet law, and the most important in my mind is the economic environment," said Ed A. Hewett, a Brookings Institution specialist on the Soviet economy, who has been advising his counterparts in that country. *(Economic snapshots, pp. 28, 30, 31)*

Despite the problems, most observers see the Soviet Union as a good investment opportunity; it is a huge country, and by many traditional measures it qualifies as an industrialized nation, with a population slightly larger than that of the United States and a gross national product estimated to be half as large.

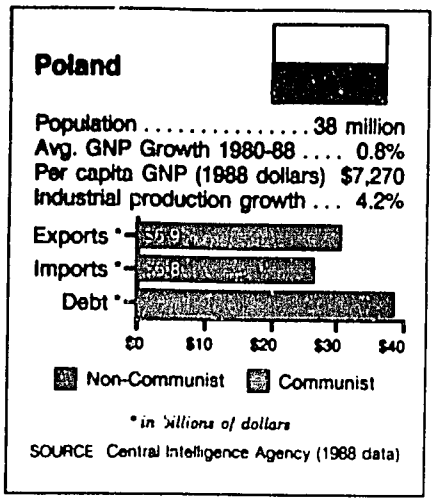
The views are mixed on Eastern Europe, however.

Czechoslovakia and East Germany have per-capita gross national products significantly larger than that of the Soviet Union, while Romania's is quite low and Poland is suffering under a severe debt burden.

Hewett said some East European countries offer a relatively well-educated labor force and wage rates and cost of capital below anywhere else in Europe. "Smart investors will move quickly," he said.

George D. Holliday, a Soviet specialist at the Congressional Research Service, is more dubious. "Eastern Europe is not attractive anyway for a number of firms," he said. "There's hyperinflation in Poland, poor growth in all the countries and poor productivity in all of them."

At the same time, Holliday noted. "These are small countries, and a little private investment could help a lot."



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It also remains to be seen how far these countries progress toward free-market economies. Only Poland, thus far, has embraced the idea wholeheartedly, and many fear a political backlash from the resulting inflation, unemployment and other dislocations.

Lawrence Brainard, senior vice president of Bankers Trust New York Corp. and an economist with experience in the Soviet Union and Eastern Europe, expressed a common concern.

"There's a fantasy of a middle way between capitalism and socialism," he said "The Hungarians and the Yugoslavs failed; the Chinese failed; there have been a lot of attempts at reform and none worked."

Money Still a Problem

In many ways, the real question is: Where will the money come from?

Said Hewett, "The ability to attract private capital will make or break [these countries], not official credit."

But Poland is relying on a $700 million loan from the International Monetary Fund (IMF), a $500 million bridge loan from Western governments until the IMF money comes through, and a $1 billion currency stabilization fund, most of which will be donated by Western governments.

If there is going to be private money, it will need to come from banks. And U.S. banks in particular, which have seen their loan losses in the Third World mount, are not particularly interested without substantial government guarantees.

"Commercial banks are hanging back. They don't know how to evaluate a loan or do credit analysis," said the NFTC's Berry. "They've got to have some way of mitigating risk, and that's where the government comes in."

Brainard said, "The perception of worsening credit risk is true, including the Soviet Union. The Soviets are creditworthy at some level, but that doesn't translate to a desire to do business. It's hard to make money there" because interest rates they will pay are so low.

Nevertheless, some U.S. bankers are more willing to consider investing in the Soviet Union and in some Eastern European countries, Czechoslovakia and East Germany in particular.

But those bankers want assurances — both political and financial.

"Clearly Congress needs to provide a strong political signal for U.S. banks and corporations to do business" with the Soviet Union and East bloc, said one senior U.S. bank official who asked not to be identified.

The four countries — Poland, Hungary, Romania and Yugoslavia — that are members of the IMF and of the World Bank can draw on financial and technical assistance to ease their way.

But while Bush agreed in Malta that the United States would support Soviet observer status in the Geneva-based General Agreement on Tariffs and Trade, which governs multilateral trade, apparently there was no discussion of membership for the Soviet Union in the IMF or the World Bank, where it probably would be a donor country, not a borrower. And the administration continues to oppose Soviet membership in those organizations.

One possibility that has been endorsed by the European Community, and is currently being debated, is creation of a new Eastern Europe Bank for Reconstruction and Development. Some U.S. experts believe such a bank would mostly benefit Western European exports.

But in a December meeting with French President François Mitterrand, Bush expressed interest in the idea for such a bank.

The idea has also attracted some Capitol Hill support. Senate Majority Leader Mitchell has embraced it. And Schumer said he may favor the idea as "a way to fuse public and private interests." He noted that creation of such a bank would enable Congress to leave in place existing barriers to financing for East Europe, such as those on the Ex-Im Bank, but still make money available. Leach, however, was skeptical. "Rather than new institutions, I'm more inclined toward new windows at existing institutions, like the World Bank." ■

Richard A. Gephardt
House Majority Leader
Remarks Prepared for Delivery
To the Center for National Policy
"American Leadership in the New World"
Washington, D.C.
March 6, 1990

AN AMERICAN VIEW OF EASTERN EUROPE

Two months ago, I led a Congressional Delegation to Eastern Europe. As I traveled through Central and Eastern Europe this winter, I felt that I was witnessing history in the making.

In Czechoslovakia, especially, I was struck by the depth of the commitment to democracy. The nation that was founded by a former resident of Pittsburgh -- the nation whose flag is red, white and blue -- is the nation whose "Velvet Revolution" echoes the goals and aspirations of the American Revolution. In Prague I presented the leaders of the Civic Forum with a copy of the Bill of Rights. With tears in their eyes they told me of how the ideals embodied in that Bill of Rights inspired them while they were imprisoned for advocating basic human rights.

As I talked with those young patriots in the basement of a Prague beer hall, I was flooded with emotions. Yes, pride that these courageous young men and women look to America for inspiration. But more than a little anger, too. I was angry that at the very moment when the power of ideas for which America has fought are winning the world over, America may be losing its power to help secure and consolidate that victory.

I believe that America is at risk of losing its position of leadership in the world economy. I believe that if steps are not taken to recapture our strength and reassert our leadership we endanger not only prosperity at home, but stability around the world. And I believe the current Administration lacks either the vision to know what steps we must take, or the courage to take them.

The lens of bipolar ideological struggle through which we saw the last half-century has been shattered by events. Now through the broken pieces a pattern is beginning to emerge -- a vision of a world in which economic competition will take precedence over military conflict.

Our first duty is to the truth of our circumstances. We must realistically assess our present situation -- by asking whether or not the "long twilight struggle" of which John F. Kennedy spoke is truly over. Then we must candidly assess whether American foreign policy is adequately responding to the challenges and changes we face. Next we must begin to articulate what lies beyond. We must have a coordinated, coherent plan for making certain that the changes occurring are changes for the good. Finally we must be willing to take risks. We must have the vision to know what to do, and the courage to get it done.

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IS THE COLD WAR OVER?

It's important to recognize that the policies we pursued to achieve our Cold War objectives -- successful though they were -- weren't handed down from Mt. Sinai on stone tablets, meant to be followed for the ages. Rather, they were a response to a set of events -- a means to shape a safer world.

The Cold War itself was not inevitable. It evolved principally from three events or conditions:

First, the Western European democracies were no longer in a position to lead on world events. Second, Germany and Japan were in a state of ruin. And third, the Soviet Union solidified its hold on the nations its armies had swept through on the way to Berlin, with Stalin breaking his promise of free elections and refusing to allow participation in the Marshall Plan, the World Bank or the International Monetary Fund.

Today, each of those three conditions has fundamentally changed. Western Europe and Japan have strong, stable democracies and free economies; and the Soviet Union is tolerating free elections and free markets in Eastern Europe.

Let me state it plainly, once and for all: The Cold War as we have known it for four decades is over. It has ended just as the giants of a half-century ago knew it would. Surely if men of vision such as Churchill and Truman; DeGaulle and Marshall; Monnet and Spaak could somehow return today, they would be leading the fight to change the very structures they created. Because they intended them to serve a purpose, and that purpose has been served.

While retrenchment in the Soviet Union is always a possibility, the essential characteristics of the Cold War -- a spiralling arms race and superpower competition for spheres of influence -- have changed in fundamental ways.

Moreover, one of the main effects of the Cold War -- a million troops facing off across the inner-German border -- is changing as well. Even as we speak the process of German unification continues. The position of the United States on the issue of German unification is clear. It is a position I support. A unified and democratic Germany must be part of the community of free nations and allied with other democratic nations. We respect and support the right of self-determination, and believe the "two plus four" approach is well-suited to address the concerns of all of us who have been drawn into two European wars in this century. But it must be made unequivocally clear that the United States recognizes the existing border between Poland and Germany, and that the Germans do as well. The end of the Cold War cannot be a cause for resurrecting any of the conditions that led us into the last World War.

As we sail with breathtaking speed into the future, it is absolutely essential that we be guided by the constellation of democratic values. 1848 was called "the springtime of nations." I believe 1990 will be remembered as the springtime of <u>democracy</u>, with

freedom in full bloom. With spring elections planned in the G.D.R., Hungary, Poland, Bulgaria, Romania, and in Czechoslovakia, we truly face a world that has changed.

If we have the fortitude and the determination to seize the day, we can ensure that the days of the Cold War will never return.

PRESIDENTIAL LEADERSHIP

Up until this point, however, the day has seized us, rather than the other way around. Thus far in these remarkable times, events have been happening to us, and we have been left groping for a reaction. To be sure, some of this is a function of the dizzying pace of change. But there is no escaping the conclusion that America's lack of leadership in this most crucial moment of this half-century is due in large measure to the fact that our President is not providing the direction we need.

If the nature of the challenge is indeed self-evident, why is it unseen or unfathomable to our President? Why, for example, is he asking the American people this year to give him a military budget that consumes nearly one out of every three federal dollars -- to meet yesterday's challenges? Why does he want to spend $112 million on the LANCE missile for West Germany when it can only reach East Germany? Why does he want to spend billions of dollars on armaments aimed at "communists" who don't want to be communists anymore -- and yet has to be pushed into spending a tiny fraction of that to assist the anticommunist patriots that have replaced our old adversaries in Eastern Europe?

It's as though George Bush's Pentagon budget were written by someone who hadn't read a newspaper in a year. It was almost certainly written by someone who hadn't read William Webster's CIA analysis of the unlikelihood of a renewed Soviet threat -- even if Mikhail Gorbachev is ousted by hardliners. Indeed the question on the minds of people everywhere is: With peace breaking out the world over, why is our President intent on beating plowshares into swords?

I believe the answer lies in the President's lack of vision. George Bush campaigned for the Presidency without any sense of what he disdained as "the vision thing." As his campaign and the early days of his Presidency showed us, he would much prefer to occupy his time and the nation's attention with issues like Willie Horton and yet another tax cut for the privileged. It's not that issues like crime and fiscal policy are not important -- of course they are. But at some point it is the job of the President to summon the nation to meet new challenges on the horizon.

Thus far the President has failed to do so. Just last week he flew to California to pledge his opposition to crime, drugs -- and traffic jams. As for the President's plans for the rest of 1990, the White House says, "We're going to spend more time on politics than you ever dreamed possible."

The country cannot afford that -- events will force the President to react to important international matters. In the past, he has reacted -- sometimes well, sometimes

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not -- but react is all he has done.

And so, without the vision to see where we must go, the President is reduced to making every decision on the basis of polls and politics.

When Governor Earl Long of Louisiana was asked why he didn't favor prison reform, he said, "Because there ain't no votes in prison." I believe the reason President Bush hasn't done more to promote democracy in Eastern Europe is because there are no votes there. Indeed, there are votes to be lost by being too closely identified with what is disparagingly and inaccurately called "foreign aid." There are votes to be lost in taking a risk for peace, in appearing insufficiently "tough" on the Russians. And there are votes to be lost in calling on the American people to make some changes to adapt to the changing world.

So what we are left with is government of the polls, by the polls and for the polls. The President, who defends foreign policy choices by pointing at his soaring popularity polls, seems to take seriously the mocking words of Mark Twain, who said: "Its name is Public Opinion. It is held in reverence. It settles everything. Some think it is the voice of God."

The President's pollster is frequently trotted before the captive White House media. He criticizes Democrats for decrying the President's lack of leadership. He cites poll data as proof that the President is doing what the American people want.

Yes, the President is doing what America says it wants in his latest poll. But is he giving the American people the information they need to make an informed decision when his pollster calls? Of course, every politician has to listen to the voice of the people -- there's nothing wrong with that. But the reason the American people seem reluctant to embrace the changes in Eastern Europe; the reason they oppose increased investment in democracy in that region; the reason they aren't sure if the Cold War is over, is because their President is not leading them. He is not explaining and interpreting these startling events for them. His not helping them understand the new world we live in -- its challenges, it opportunities, its dangers.

The President's lack of vision, and America's lack of leadership, have consequences that are both real and grave. The President of the United States retreats from the world by failing to lead the American people to see our self-interest in the success of democracy and free markets in Eastern Europe and the Soviet Union. But his timid posture may well create a self-fulfilling prophecy that at best confirms the status quo and at worst condemns the fragile new democracies to failure.

In short, the Bush foreign policy is a policy adrift; without vision, without imagination, without a guiding light save precious public opinion polls. But if he wanted to, President Bush could seize the day and marshall the American people into a mighty army marching for change.

History teaches us that it can be done.

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In 1947 the American people, having fought two world wars in thirty years, were loathe to be caught up in foreign entanglements. They desperately desired to focus their pent-up energies on domestic demands.

But President Truman and the wise men who advised him realized that the changing times demanded that we change with them. And so Truman shaped the change by proposing that America commit itself to building democracy and free enterprise in Europe. The Marshall Plan was a classic case of principled pragmatism.

But it was unpopular. In fact, in the Gallup Poll of 1947, only 14% of the American people supported foreign loans and assistance. No wonder why -- the American economy was only about one-fourth as large then as it is today, and the Marshall Plan represented an investment that would cost $82 billion today. One hardly needed Mr. Gallup to know such a proposal would face strong resistance.

President Truman was not in much better shape. To this day no President -- not even Nixon in the depths of Watergate -- has been as unpopular as Truman was as he headed into the election of 1948. Perhaps sensing the political advantage, mainstream Republicans like Robert Taft and extremist Republicans like Joseph McCarthy opposed Truman and criticized the Marshall Plan.

The record resounds with attacks like "socialistic", "dangerous", "simple-minded", and "giveaway." One Republican Senator -- William Jenner of Indiana -- summed up much of the opposition when he said: "It seems to be Mr. Truman's thesis that the international crisis can only be solved if we buy off the dangers of communism by giving large cash donations from the American taxpayer's pocket to already shaky European governments most of whom are, in fact, only a degree or two removed from the menace from which we are supposed to be protecting them."

But Truman did not flinch. He knew it was an investment that would reap tremendous benefits in new markets for America and more stability for the world. So he pressed on, despite the political repercussions. Ignoring the polls, Truman worked with the Republicans who controlled the Congress, especially Senator Arthur Vandenberg, and signed into law what one British newspaper called "an act without peer in history."

Harry Truman lived by Sam Houston's maxim: "Do right, risk consequences." The maxim of the Bush Administration seems to be: "Do polls, risk nothing."

There is no substitute for Presidential leadership. And given the fact that President Bush has record-high levels of popularity and more than two years to go before he faces re-election, he is in the perfect position to lead.

If he were to come to Congress the way Truman did, I can assure him we would work with him the way Vandenberg did. If he would use his bully pulpit to lead, the American people would follow. And if he would summon us all to the challenges we face, this country would rise to meet them. The American people <u>will</u> support

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democracy in Eastern Europe if our President tells us it's in our deep self-interest to do so. But we risk freedom dying on the vine if our President doesn't take the lead.

The President should carefully articulate to the American people the risks and benefits of the new world. He should remind us of how fragile young democracies are. He should distinguish today's circumstances from those of 1947 -- why it is we don't have to replicate the Marshall Plan -- the Europeans don't need it, and we Americans cannot afford it. Of course, each nation is unique, but by and large the Eastern European countries have stronger physical foundations for their economies than the Western Europeans had in 1947 -- their dislocation was caused by the communist system, not by the destruction of war. However, while they have stronger economic bases than the Western Europeans had after the war, many Eastern European nations have weaker traditions of free government and free enterprise.

So the President should call on America not necessarily to spend a lot more on foreign aid -- but to spend a lot smarter. For example, the new military base in Italy the President's budget calls for will cost more this year than the total amount of savings we will receive from all the proposed base closings here in America. But do we need another military base to defend Western Europe -- or can we better advance freedom and democracy in all of Europe through economic, technical, political and moral support? By the same token, do we need an increase of almost a half a billion dollars in military assistance in our foreign aid budget, and converting another $400 million in military loans to grants, while at the same time reducing UNICEF emergency aid for children and United Nations Environmental Program assistance at a time when famine and disease and pollution are becoming more clear and present dangers than superpower conflict?

The President should lead America in reassessing and changing our priorities to meet the new challenges. Otherwise history will remember the Bush foreign policy as a latter-day Maginot Line. He should let us know that if we invest a small amount in freedom today, we can reap a tremendous benefit down the road -- a benefit that can include billions of dollars in savings from defense, new markets for American products, new jobs for American workers, new freedom to address old domestic difficulties. But most of all we stand to gain peace and stability. We have an historic opportunity to lower the deadly levels of tension in the nuclear age, and pull our children farther back from the brink of Armageddon.

With the demise of the Cold War, the American people are awaiting a new vision -- a new way of looking at the world and understanding these momentous events. In Eastern Europe and around the world, the challenge for the United States is to help free people consolidate their gains, and build nations that are free, prosperous and secure. Here at home the challenge is to reinvigorate the American economy and renew the American spirit. The most important tools for achieving both goals are economic rather than military.

America must once again assert itself as a leader. To do that we must change the way we think about national strength, and arm ourselves for the economic competition already underway. America must begin by helping to shape the change in

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Europe, or we will surely be a victim of it. To that end there is much that we can do right away.

THE AMERICAN ROLE

The Congress is taking steps to ensure that the tremendous risks taken by brave people are rewarded with the better future promised by free governments and free markets. We are making progress in granting many nations of what we used to call the "Eastern bloc" Most Favored Nation status.

Next we should expand the role American agriculture plays in encouraging change in Eastern Europe and the Soviet Union. I propose a Food for Freedom program that will share the strength of America's agricultural abundance with the Eastern European and Soviet people. There is no doubt that private ownership of farm land and the hard work of our family farmers are the keys to America's success in agriculture. But while Eastern Europe and the Soviet Union are moving in that direction, it is in our interests to help sustain them on that journey.

President Havel of Czechoslovakia made that very point about the Soviet Union in his recent address to Congress. If someone whose nation was invaded by Soviet troops, who was imprisoned by Soviet puppets, who was pinned under the boulder of Soviet domination for all his adult life can call on us to assist the Soviets in moving to democracy, the least we can do is listen.

I believe that support of the process of democratization in the U.S.S.R. is in America's self-interest. We have a stake in the success of peaceful change towards a pluralist system in that nation. A stronger Soviet economy will facilitate the process of peace. How can the Soviets pull Red Army troops out of Eastern Europe if they have no jobs and no homes for them to return to in Russia?

So America must think creatively and act boldly. Rather than pouring more and more money into weapons systems, we should be investing in our own self-interest. And stability, democracy and a market economy in the Soviet Union are in America's strong self-interest.

On this point I must say that President Bush has been right -- as far as he's gone. He has lent important political and moral support to the process of reform in the Soviet Union. I'd like to enlist American farmers and business people to make more substantive investments as well. Anyone who has seen the lines outside the McDonald's in Moscow knows the Soviets would appreciate American food and American goods. And American farmers and workers would appreciate the markets. We should waive trade restrictions such as Jackson-Vanik and the Stevenson Amendment, relax restrictions on high-tech exports, and encourage private investment in the Soviet Union. We provide Export-Import Bank loans and OPIC assistance to China, why not to the Soviet Union?

Another aspect of President Havel's speech that moved me was his point that rather than a hand out, the people of Eastern Europe want a hand up. The United

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States can offer that hand through a series of exchanges on a scale never before seen.

We need a Freedom International program for the 1990's -- a modern-day Berlin Airlift bringing planeloads of people across the Atlantic in both directions: religious, educational, and political leaders from Budapest and Bratislava coming to work in churches and schools and offices in San Francisco and San Antonio. If each of America's fifty states could offer scholarships to just forty Eastern European students, we will have doubled the number of Eastern Europeans studying in the U.S.

We should support conferences on issues affecting the environment, the arts and the military. We should encourage discussion of the sources and solutions of ethnic prejudice and religious intolerance. We have so much to learn from each other. So let the exchanges begin. The Congress will soon be considering a bill which will provide $190 million worth of technical assistance, Peace Corps programs, and exchanges to Central and Eastern Europe. In all, legislation currently before Congress will provide over a half a billion dollars in immediate investment in Eastern European democracy. And that is only the beginning.

America is well-positioned to take a leading role in providing the technical and managerial assistance the Eastern Europeans need. So much of the strength and the soul of our nation has its roots in Eastern Europe. How wonderful it would be if we could encourage experienced Americans -- as part of a Free Enterprise Corps -- to return to the nations from which their parents came to help a new generation have a new birth of freedom in their old countries. We in America would be benefitted by a return to those roots as well. The fight for freedom in Eastern Europe is rekindling the revolutionary spirit of America at a time when we badly need it. We have as much to gain from this as anyone.

"UNITED" FOR THE CHALLENGES OF THE FUTURE

But America cannot, need not and should not go it alone. History teaches us that a coordinated response from both sides of the Atlantic has been the answer to all the great challenges of this century.

For several years I have advanced the idea of forming an economic alliance as stable and as strong as the NATO military alliance. Over time, economic cooperation will be as indispensable as the military and political dialogue of the United Nations Security Council. As Trade Ministers become more vital to their nations' security than Defense Ministers, I would like to see more and more international dialogue and cooperation.

A Union of Nations for International Trade and Economic Development -- UNITED -- might be a means for giving structure to such cooperation. UNITED would bring together, on a regular basis, the leaders of the major trading democracies -- the nations of the European Community, the United States, Canada, Japan and Australia. By working together, and discussing our problems and opportunities, we could bring more order and stability to issues of development, trade and competition -- issues which

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threaten to divide us as much in the future as ideology did in the past.

UNITED would not be a new bureaucracy, but rather a new approach; an expansion and extension of what has worked so well for NATO and what is being done through G-7, the European Community, GATT, the IMF, the World Bank and others.

UNITED's mandate will be to coordinate, not to dictate. It can address so many of the topics facing leading nations today: from developing the economies of Eastern Europe to formulating new rules of international economic engagement to addressing the burden of Third World Debt.

The lessons of the past offer evidence that economic engagement can work -- and that all sides can "win." The Marshall Plan's initial commitment to Europe has grown to the point where we invested some $1.2 trillion in the 1980's alone for the common defense of the Continent. Today we are in a position to realize a dividend from 40 years of prudent investing. We must reinvest a part of that dividend. It's just good sense. A nation that spent trillions to contain Communism must be willing to spend a minuscule fraction of that to consolidate democracy. Only a prosperous and peaceful Europe will allow us to reduce our military commitments without reducing our national security.

If we hesitate now, if our resolve falters just at the moment when we are about to realize the peace and prosperity that our fathers fought for, the consequences could be disastrous. I realize the political risk such reinvestment entails. But as President Kennedy said, "there are risks and costs to a program of action. But they are far less than the long-range risks and costs of inaction."

Ultimately the attention of the world must move beyond responding to individual crises and toward building vigorous and vibrant economies in the developing countries of the world -- which will be the focus of so many of the new challenges we face. Herein lies the greatest challenge and the greatest opportunity of the next century. For too long we have allowed the threat of military confrontation between East and West to obscure the threat posed by the growing gulf between the superpowers and the superpoor.

CONCLUSION

Over time, I want to see a Europe in which America's young students have replaced our young soldiers; a Europe in which American technology has replaced American tanks; a Europe in which new American lasers replace aging American LANCE missiles.

But it is a grave mistake to think that the focus of history has shifted completely away from the United States and onto Europe. The difficulties we face here -- and how we rise to meet them -- will determine whether a strong America leads the world in the new era of economic competition, or a diminished and exhausted America shrinks from the challenges history has laid before it.

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This is our new call to arms -- to rebuild American strength, to restore Eastern European democracy, to redress the problems of unbalanced trade, and to reassure the world that the Berlin Wall that divided East from West is not succeeded by a chasm of poverty separating North from South. Economic engagement and competitive coexistence will be the watchwords of the new decade and the new century that will follow it.

The stakes could not be higher. The threat could not be more real. A hundred years from now the 1990's will be remembered as the time when America reinvented itself once again, and in so doing led the world into a new era of peace and prosperity -- if we have the vision to see the change in the course of history, and the courage to adjust our course to meet it.

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East Bloc Pot of Gold?

Despite the fanfare greeting new business with Communist nations, trade with the East Bloc is apt to be mostly symbolic—and a harbinger of scrambles within the West.

BY BRUCE STOKES

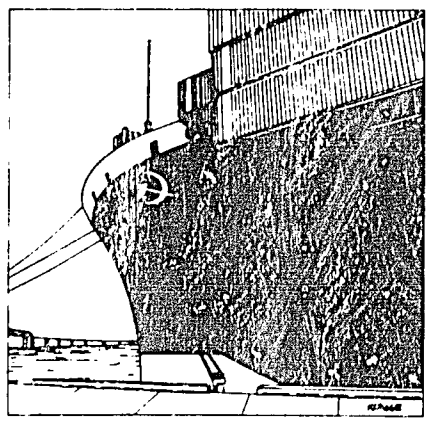
When Geza Bankuty escaped from Hungary in the aftermath of that country's failed revolution in 1956, this staunch foe of Communism could hardly have realized that he would one day return to his homeland as one of its leading capitalists. Yet today, in a foreign trade zone along Hungary's southeastern border about 120 kilometers from Budapest, a subsidiary of Bankuty's American-based New England Machinery Inc. is building equipment for packaging pharmaceuticals and cosmetics.

Having started last year with a half-million-dollar investment and 15 employees, Bankuty hopes to do $1 million in business this year. And within five years, he plans to employ up to 100 people and generate $10 million in sales.

"I am Hungarian, and I obviously feel strongly about rebuilding the Hungarian economy," Bankuty said. "But there were strong business reasons for this investment. This part of the world will offer tremendous business opportunities in the next 5-10 years."

In the wake of the political and economic revolutions that have swept Eastern Europe—and the more-limited economic reforms under way in the Soviet Union—scores of American businesses are now seeking a pot of gold at the end of the East Bloc rainbow.

Almost daily, newspapers chronicle a flood tide of East-West investment and trade deals. General Motors Corp. will soon be assembling 15,000 cars a year in Hungary. General Electric Co. (GE) has just bought a controlling interest in Tungsram Co. Inc., Hungary's largest light bulb maker. Japan's Suzuki Motor Co., too, has announced plans to build cars in Hungary. And numerous West German firms are busy setting up plants in Eastern European countries. *(For a report on lobbying and legal action on East Bloc trade, see this issue, p. 318.)*



This entrepreneurial frenzy is reminiscent of a similar rush of Western business activity to the region in the mid-1970s, a movement that quickly tapered off. And though economic and political conditions are definitely more auspicious today, obstacles again are presenting themselves.

Barely four years after Soviet President Mikhail S. Gorbachev launched *perestroika* (his restructuring of the Soviet economy) and only months after the apparent triumph of capitalism over Communism in Eastern Europe, "we are [already] in the first phase of disillusionment," said Sovietologist Edward A. Hewett, a senior fellow at the Brookings Institution in Washington.

Most of the joint ventures in what until recently was the Soviet Bloc, announced with much fanfare, have never gotten off the ground in those politically unstable, bureaucratized countries. A sober look at economic prospects in both Eastern Europe and the Soviet Union reveals moribund economies in which demand for imports starts from a small base. Moreover, observed Harald B. Malmgren, a Washington trade consultant, "they don't have a lot that is world-class to sell."

Alongside the glamour of the private-sector's East Bloc mega-deals, the U.S. government's business-related activities launched in response to Communism's upheaval seem pale by comparison. In the legal technician's world far from the public eye, bureaucrats and lobbyists are preoccupied with details of a new trade agreement with the Soviet Union and a reappraisal of controls on exports of militarily sensitive technologies.

While not nearly as splashy as opening a McDonald's in Moscow, the seemingly mundane policy changes now under way in Washington are far more portentous. They promise to permanently overhaul American business relations, not only with the East Bloc, but with other industrial countries, altering the lay of the land in such areas as export controls and export finance.

Furthermore, these policy changes are being made in response to pressures from trade rivals in Western Europe and from Japan. And that underscores the fact that the 1990s will be a period not only of intense international economic competitiveness between businesses, but also a time of growing policy competitiveness between governments. The United States, which in the 1970s and 1980s often ignored its economic interests to pursue foreign policy concerns in its relations with the Soviet Bloc, may no longer be able to afford such compartmentalization. Increasingly, U.S. economic policies toward the East Bloc will be formulated with an eye on the actions of America's industrialized competitors.

Hence, the substance of what happens in U.S. trade and investment with the East Bloc may not be nearly as important as what is symbolized by the process of reordering relations. Today's jockeying between the United States, Western Europe and Japan for Soviet and East European business may be a preview of

stepped-up competition between the major economic powers worldwide.

SMALL-POTATOES TRADE

The United States has always had limited business relations with Eastern Europe and the Soviet Union, which is why many analysts question the potential for a major trade and investment relationship now.

Still, last year was the best in history for U.S.-Soviet trade. In the first 11 months of 1989, U.S. exports to the Soviet Union totaled $3.8 billion, a 53 per cent increase over the same period in 1988, according to the Commerce Department's latest figures. Nevertheless, the total of exports and imports, $4.5 billion, equals only about half of American commerce with Switzerland, a country a fraction the size of the Soviet Union.

America conducts similarly small-potatoes trade with Eastern Europe. It is true that in the first 11 months of 1989, U.S. exports to Hungary were up 73 per cent over the previous year's, and exports to Poland were up 36 per cent. But total U.S. trade with all of Eastern Europe is still only about a sixth of that with Hong Kong.

East Bloc nations, of course, intend to boost their trade with the West as they liberalize and modernize their economies. PlanEcon Inc., a Washington economic research firm specializing in the East Bloc, predicts strong annual growth in East Bloc imports from nonsocialist countries: 12.2 per cent for the Soviet Union in 1992 and 10 per cent for Czechoslovakia. *(See charts, this page.)* But it will take years for such growth to translate into sales of any significance.

This low level of commerce is attributable to many factors. Trade with the West has also been held back by the mercantilist relationship between the Soviet Union and its allies in the Council for Mutual Economic Assistance (COMECON), the Communist Bloc's equivalent of the European Community (EC), under which the Soviet Union trades raw materials for manufactured products at bureaucratically set prices. In 1988, for example, 60 per cent of all Soviet trade was with COMECON.

With the Warsaw Pact in the throes of change, this indentured relationship is unraveling. But the ties that bind are strong. Even as Hungary was negotiating a new trading relationship with the EC last year, it was recommitting itself to massive oil purchases from the Soviet Union—the subsidized price was too good to pass up.

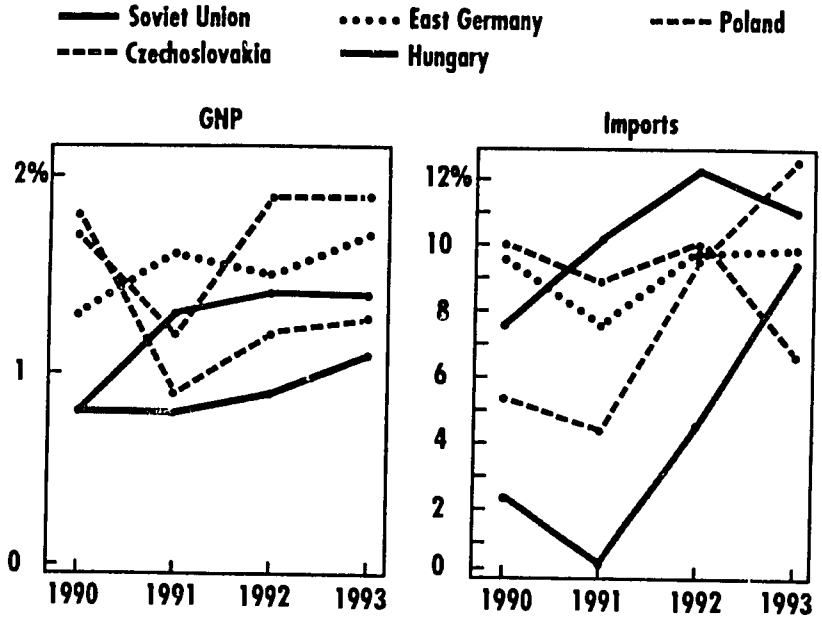
Moreover, the recent dramatic rise in U.S. trade with the East Bloc is somewhat deceptive. Booming U.S.-Soviet trade is being carried by a 75 per cent increase in U.S. grain sales and a 69 per cent increase in Soviet fuel exports. U.S. export growth to Poland reflects a onetime purchase of three Boeing 767 aircraft. The leading Eastern European exports to the United States are still raw materials: meat and fish from Poland, fuel and fertilizer from East Germany and oil from Romania.

Another reason for the meager trade with the East Bloc is U.S. competition with other industrial nations; the United States has never been able to capture more than a fraction of the East Bloc's limited trade with the West. *(See table, this page.)* That's mainly because of Western Europe's proximity to the East obviously, but this does not fully account for recent trends. Japan, for example, trades more with the Soviets than the United States does. *(See box, p. 317.)*

And West Germany in key sectors dominates Soviet business with capitalist nations far more than its 18 per cent share of over-all trade suggests. The Germans have captured 45 per cent of the critical

Modest Growth Prospects

Over the next few years, the Soviet Union and Eastern Europe are likely to offer a weak investment climate and a limited market for U.S. exports, according to the Washington research firm PlanEcon Inc. The following figures represent projected annual percentage growth in gross national product (GNP) and in imports from nonsocialist countries for the Soviet Union and the major countries of Eastern Europe.



SOURCE: PlanEcon Inc.

How U.S. Rivals Fare

Despite recent dramatic growth in U.S. trade with the Soviet Union, the United States is still being outcompeted in that market by Europe and Japan. The following figures, the latest available, show selected countries' shares of total Soviet trade with industrial capitalist countries, in percentages, according to Soviet statistics.

	1983	1984	1985	1986	1987	1988
United States	5.0%	7.7%	8.3%	5.0%	4.3%	6.8%
France	10.9	10.3	10.0	9.2	9.3	8.9
Italy	11.6	10.9	10.0	10.5	12.4	9.8
Japan	7.8	7.1	8.5	11.0	9.3	10.1
United Kingdom	4.7	5.4	5.0	6.2	7.5	7.8
West Germany	18.3	18.3	18.7	19.2	17.7	18.2

SOURCE: PlanEcon Inc.

Eastern European machine tool market, for example, while the United States holds less than 2 per cent, according to the U.S. National Machine Tool Builders Association.

INVESTMENT BARRIERS

U.S. investment prospects in the East Bloc are equally suspect. True, for now, investor interest is at a fever pitch. In 1987, only 3 American joint ventures in the Soviet Union were announced; in the first six months of 1989, 51 were announced. And these deals involve some of America's largest companies. The American Trade Consortium, which is made up of Archer-Daniels-Midland Co., Chevron Overseas Co., Eastman Kodak Co., Johnson & Johnson, RJR Nabisco Inc. and Mercator Corp., an investment banking firm, currently has 25 joint-venture projects under consideration that could lead to $5 billion-$10 billion in new investments in the Soviet Union.

Investors are drawn to the East Bloc for several reasons. First, labor is cheap compared with that in Western Europe and the United States. Bankuty pays his Hungarian workers, all engineers, three times the Hungarian average, and yet those salaries are still half what he pays comparable employees in the United States.

Secondly, investors find the proximity to the soon-to-be-unified EC tantalizing. "It does not matter that we are in the eastern part of Europe," GE executive Paolo Fresco told the *Financial Times* when GE bought into Tungsram in Hungary. "It gives us a strong foothold in Europe."

But for the United States, the promise of joint-venture deals, especially in the Soviet Union, where the numbers are the greatest, may be overshadowed by the reality. Of the 940 foreign joint ventures registered in the Soviet Union as of last Oct. 1, only about 10 per cent are in full operation. Most of them are relatively small. More than half are capitalized at under $1.5 million, hardly the level of investment likely to have a major economic impact or generate a substantial financial return. And though the United States, with 97 joint ventures, far outstrips most of its industrial nation competitors, it still trails far behind West Germany, which has 153.

Aside from a few high-profile projects, investors have been slow to move into the East Bloc, and for good reason. PlanEcon estimates that economic growth in the region is likely to be slow for the next few years, with the Soviet Union, East Germany and Hungary not even equaling the anemic rates of growth of 1986-88. As long as Hungary and Poland are hobbled with foreign debts that consume more than two-fifths of their export earnings, prospects may remain bleak.

Richard A. Bloom

Trade consultant Harald B. Malmgren
Communists sell little that's world-class.

Per capita incomes in the East Bloc are less than half those in the West. And even this meager purchasing power may soon be eaten away by inflation. Over the next year or so, as formerly Communist-controlled governments begin to let markets determine prices, demand will far outstrip supply, and prices, long constrained, are likely to explode.

"If economies are fundamentally unhealthy, you can't protect joint ventures," Hewett warned.

Moreover, given the lack of currency convertibility in all East Bloc countries but Poland, foreign investors will have trouble repatriating their profits, unless they produce for export. *(See box, p. 315.)*

Finally, though many countries are moving rapidly to try to meet the needs of foreign investors, the legal and business infrastructure needed to attract any but the most adventuresome investors is almost nil.

"To transfer funds from Warsaw to Krakow can take weeks," said J. Michael Farren, Commerce undersecretary for international trade. "If you are trying to run an export business, that is death."

The worst conditions may exist in the Soviet Union, where, as Hewett said, "in many ways, it's a worse place to do business than five years ago. [With all the political turmoil], many bureaucrats you deal with aren't sure if they will be there next month."

In addition, there is no stable tax system, and relations with local governments are unclear. Crime and corruption, long endemic on the fringes of the Soviet economy, are now rampant. "Many cities and regions of the U.S.S.R. now operate like the worst days of Chicago crime in the 1920s and 1930s," Malmgren said. Police protection for investors' property is spotty at best, and "there is no legal framework to ensure that you get the supplies you actually contract for," he noted.

"There will be some big deals signed in the energy sector, some in manufacturing, raw materials and consumer goods," Hewett said. "And there will be a lot of fanfare about them. But there is a difference between that and a qualitative change in the business environment" that could lead to widespread investment.

Given these problems, the short-run U.S. business outlook in the East Bloc is uncertain at best. And current activities in Washington, to decontrol some exports and formalize trade and investment relations with the Soviets and others, take on even greater importance.

DECONTROLLING EXPORTS

The political revolutions in Eastern Europe are causing a revolution in U.S. policy on export controls. Since 1949, the United States and its principal allies, working through the Coordinating Committee on Multilateral Export Controls (COCOM), have restricted the export of sensitive technologies to the Soviet Bloc. An extensive licensing process grew up to police such transactions. Permits are even required for Western countries to sell certain technologies to each other.

The Reagan Administration, stung by Soviet technological piracy in the past, dramatically lengthened the control list to include not only military hardware but also items that could help improve East Bloc economies. Because approval from all COCOM members is needed on certain export licenses, the United States was able to unilaterally impose its definition of export controls on its allies.

All this may now be about to change. The U.S. business community has long chafed under the administrative burden of export controls and resented their drag on competitiveness. A 1987 National Academy of Sciences study estimated that such restrictions cost American industry $9.3 billion a year. The 1988 Omnibus Trade and Competitiveness Act attempted to liberalize controls, but implementation of the law has been slow.

Eastern Europe's efforts to break away from the Soviet Union's stranglehold have brought the issue to a head. "It is impossible to give aid to Eastern Europe to help them develop their economies without giving them access to [advanced] technology," an EC diplomat in Washington said.

As a result, Commerce's Farren predicted, the issue of export controls will

Richard A. Bloom

West German Embassy's Count Hagen Lambsdorff
The United States should decontrol exports faster.

"permeate every business transaction in Eastern Europe."

With American businesses vying for the East Bloc's limited market, the implications for U.S. competitiveness are now starkly evident. Citing recent British and French deals that circumvented COCOM controls by refusing to submit them for review, U.S. industry has begun to press the Bush Administration to shorten the list of controlled products and to harmonize controls within COCOM.

The Administration seems to be getting the message. In mid-January, the White House proposed permitting the sale of more-powerful computers and higher-precision machine tools to Hungary and Poland.

But few observers think this initiative will satisfy other COCOM members. "We are glad about this [U.S. proposal], but we don't think it is sufficient," said Count Hagen Lambsdorff, economic minister at the West German Embassy in Washington. "We think the streamlining of the list should be faster."

Moreover, in an implicit acknowledgement that competitiveness considerations are now shaping attitudes toward COCOM, Lambsdorff complained that the U.S. decision to go along with sales of some machine tools to the East Bloc was of little solace to West Germany because "our machine tool industry doesn't build these old-fashioned machines [anymore]."

When COCOM meets in Paris on Feb. 14-15, the allies intend to try to resolve their differences. COCOM's very existence may well hang in the balance. "Unless U.S. leadership turns COCOM in a dramatic new direction in 1990, the institution is in danger of disintegrating," Paul Freedenberg, Commerce undersecretary for export administration in the Reagan Administration, told a recent hearing of the House Foreign Affairs Subcommittee on International Economic Policy and Trade.

U.S. business groups, such as the Emergency Committee for American Trade (ECAT), the Business Roundtable and the National Foreign Trade Council Inc., all representing major exporters, already say they know what that direction should be. And it is only tangentially related to East Bloc trade. Rather, the groups are attempting to use current interest in liberalizing trade with the East to push a much broader agenda, most important being creation of an export-license-free zone among COCOM members and other free-market industrial nations around the world.

Currently half of all U.S. export licenses, accounting for two-thirds the value of all licensed U.S. exports, are granted for trade with free-market economies. "Selling to the East may be very important, but it's a drop in the bucket," said Calman J. Cohen, ECAT vice president. "Our focus is on the need to overhaul the export control system because of what it's doing to West-West trade. We have to improve our ability to sell in the West."

The business community feels some urgency in its task because the EC will effectively create a license-free zone upon completion of its unified market at the end of 1992. Then, "if we don't do something," said William T. Archey, international vice president of the U.S. Chamber of Commerce, "we will be asking American firms to produce in Western Europe because their exports won't be hassled."

The Administration's need to seek congressional reauthorization of the Export Administration Act, which expires in September, will provide an opportunity for a full debate over these and other business concerns, such as speeding up export licensing, decontrol and dispute-resolution procedures.

The House is expected to act first. Despite Administration pressures to simply reauthorize the act for a year pending completion of a new National Academy of Sciences export control study, Rep. Sam Gejdenson, D-Conn., chairman of the International Economic Policy and Trade Subcommittee, predicted "a review of those issues needing to be addressed immediately, with a view toward surgical changes." His subcommittee has jurisdiction.

"Where the Senate goes in part depends on where the House goes," a Senate staff aide said.

Whatever the timetable, the business community's more ambitious agenda probably means that the debate over export controls, initially sparked by interest in selling more to Eastern Europe, will ultimately turn on competition in the West.

A TRADE PACT

An analogous situation is emerging as the Administration prepares to negotiate a trade agreement with the Soviet Union. In 1972, the two nations signed such an accord, granting Soviet exports the low tariffs that accompany most-favored-nation (MFN) status. Congress, however, used the Jackson-Vanik amendment to the 1974 Trade Act to condition MFN status on free emigration from the Soviet Union for Jews and other disgruntled minorities. Moscow refused to go along.

At last year's Malta summit, Presidents Bush and Gorbachev agreed to begin negotiations on a new trade accord to be signed at their meeting this June. Congressional approval of the final document is widely expected, as long as the Administration waives the Jackson-Vanik amendment, an action most of the American Jewish community, Jackson-Vanik's principal supporter, now appears willing to accept.

A recent International Trade Commission study concluded, however, that because of the Soviets' limited purchasing

John Eisele

U.S. Chamber of Commerce's Don Hasfurther
Trade and investment issues are tightly linked.

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power, "U.S. exports would probably be little altered by a U.S. decision to grant the Soviet Union MFN treatment."

So, with little to gain immediately from a trade agreement, the business community is focusing on the content of the accord and on protecting its interests relative to its European and Japanese competitors.

Although negotiation of a U.S.-Soviet investment pact is slated to follow the trade agreement, "it is [also] critical to get investment guarantees in the trade agreement," said Don Hasfurther, the Chamber of Commerce's East Bloc expert. He noted that in modern economies, it is increasingly difficult to separate investment from trade issues, as witnesses their being linked in the current round of multilateral trade talks.

At the same time, said J. Daniel O'Flaherty, vice president of the National Foreign Trade Council, "our companies are concerned about getting as good an agreement [on investment] as the Germans" got. (Bonn recently negotiated the right to repatriate certain profits from the Soviet Union.)

Moreover, the business community is worried that the trade deal the EC just struck with the Soviet Union gives the Europeans leverage in trade with the Soviets because it allows Brussels, the EC capital, to grant or deny access to the European market based on the EC's access to the Soviet market.

"When you talk about granting MFN," said Sen. Lloyd Bentsen, D-Texas, chairman of the Finance Committee, "you are talking about a major concession, much more than the Europeans are giving the Soviets. We want to ensure that there will be some of the Soviet market available for us."

To this end, Senate staff members are looking into how leverage could be built into the U.S. agreement with the Soviets—possibly linking MFN status more directly to Soviet market-opening concessions.

Finally, when Congress approves the Soviet trade agreement, business groups want it also to repeal a long-standing $300 million ceiling on the aggregate amount of loan guarantees that the Export-Import Bank of the United States can offer the Soviets. The Eximbank is currently not allowed to participate in Soviet deals. But a new trade agreement would give the bank a green light, and the ceiling could rapidly be reached.

"We are competing for access to the Soviet market with countries rich enough to buy access," said a Senate staff member, noting that West Germany has provided $2.9 billion in credits for sales to the Soviet Union.

Unless this problem is corrected, Malmgren said, American companies investing in the East Bloc "will look to buy equipment from other countries where they can get export financing and official investment insurance."

In business, history is not destiny. There could easily be a synergism between foreign investment, trade and economic growth in the East Bloc that triggers an upward spiral in those economies, defying both recent experience and short-term projections. "We are more optimistic than reticent because change is so rapid," said Joseph Tragert, a PlanEcon economist.

And Commerce's Farren said, "Looking at the enormity of the Soviet economy and the inclinations of Western Europe to broaden its market access [in the region], it would be lunacy to not think it is commercially advantageous to make investments now."

Nevertheless, as ground-breaking East Bloc business news continues to grab newspaper headlines in the months ahead, the truly substantive action, the stories with long-run implications for America's place in the world, are likely to be datelined Washington, not Budapest, Warsaw or Moscow. □

Japan's Scanty Presence

TOKYO—Though many Americans are worried by recent high-profile Japanese business deals—such as Suzuki Motor Co.'s move into Hungary—Japanese companies are actually taking a more cautious approach toward trade and investment in the East Bloc than many American businesses are.

Japanese firms rushed into the Soviet market in the mid-1970s, pouring billions into oil and natural gas projects in Siberia, only to find themselves bogged down in a bureaucratic swamp. With that lesson behind them, the Japanese today maintain only 20 joint ventures with the Soviets, and some of them are quite small—one is a noodle shop at Moscow's airport.

At the same time, though Japan's share of the Soviet Union's trade with free-market countries is greater than that of the United States, Soviet trade represents a declining portion of Japan's over-all trade, having fallen from about 2 per cent in the late-1970s to 1.3-1.5 per cent in recent years.

Prospects for increased Japanese trade and investment with Eastern Europe and the Soviet Union are murky. Japanese trade with Eastern Europe is up 42 per cent since 1980, but the total, $1.5 billion, is still relatively small.

Some Americans worry that Russo-Japanese business relations may take off if Moscow and Tokyo can resolve diplomatic differences over Soviet occupation of the Kuril Islands. *(See NJ, 1/20/90, p. 116.)* But Hiroshi Watanabe, a senior economist with the Japanese Association for Trade with the U.S.S.R. and the Socialist Countries of Europe, predicted that "even if the problem is settled, trade will not increase substantially."

Investment is also likely to proceed slowly. A $1 billion Japanese forestry project in the Soviet Union is in the offing, as is a big coal project. But because of changes in energy consumption patterns, Japan today is far less eager to plow big money into new Soviet energy exploration than it was in the 1970s.

Tokyo also seems determined not to get involved in a trade and investment footrace in the East Bloc with Europe and America. "We have 20 years' experience dealing with these countries," Watanabe said. "We know the problems. They don't. So they can be optimistic. In future years, they will be disappointed."

The American business community is quick to point out, however, that Japan has recently announced $500 million of Japan Export-Import Bank credits for Hungary and Poland, $350 million in trade insurance to cover Polish imports from Japan, $200 million worth of new trade insurance for exports to Hungary and $25 million for technological cooperation with Hungary. In addition, they note that Japan has provided guarantees for $3.3 billion worth of exports to the Soviet Union.

Americans who fear Japanese competition and who advocate increasing U.S. credits for the East Bloc often fail to acknowledge that key Japanese long-term credit loans to the Soviet Union stopped in the early 1980s, and Japanese corporations have not pressed the government to restart them.

So, while the U.S. businesses are rushing into the East Bloc, in part to keep pace with their Japanese rivals, they may get there only to find that the Japanese have not arrived.

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Bill Bradley

We Can't Afford Not to Help East Europe

And we could do it for one percent of the defense budget.

The Bush administration's unfair attack on House Majority Leader Dick Gephardt's speech at the Center for National Policy was a blatant attempt to cover up a major inadequacy of the president's policy toward Eastern Europe. The $380 million the president proposed to bolster economic growth and democracy in the region is barely enough to bail out a single major failed S&L, much less jumpstart national economies that have been dead for decades. Congress should seize the initiative and set aside an amount of up to one percent of the defense budget as a catalyst for East European reconstruction.

For almost half a century, the Soviet threat rested on troops stationed in the client regimes Stalin set up in Central Europe. Our security efforts focused on deterring Soviet assaults on Western Europe. Last year that defense cost about $125 billion.

Now new democratic governments have begun to insist that Soviet forces go home. The political and economic success of these East European democracies would significantly enhance our own security. Instead of a band of hostile armies, we could face a line of healthy, prosperous economies anchored in the West.

Although Eastern Europe's movement toward reform seems irreversible, success is unfortunately far from guaranteed. Even those countries that have made the most progress—Poland, Hungary, Czechoslovakia—face enormous problems because of the legacy of Stalinist controls imposed on them by the Soviet Union. Yet each has already faced up to the fact that success means submitting to the rigors of international competition and shedding rigid price controls. This is a revolutionary change.

The potential investment needs of Eastern Europe are enormous. According to a leading Western bank, Eastern Germany could absorb $500 billion in the next 10 years, and Poland's needs are even greater. With such massive needs, the question is how best to get momentum quickly into the process of development.

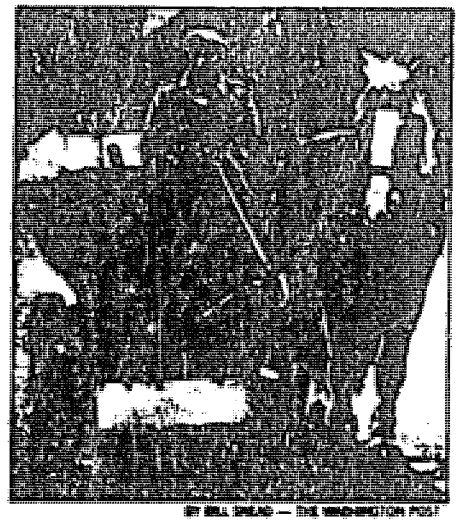
After World War II, the genius of the Marshall Plan lay in its premises: self-help, free trade and European economic integration. The United States provided some material resources and an open market, while Europe provided domestic political leadership and private initiative. For the most part, the salvation of Eastern Europe likewise has to come from within. The member states understand that, which is why they have already embarked on radical economic and political reform. But they need our help to sustain their revolution.

This doesn't only mean more money. Training and know-how are also important. There's an enormous requirement for private sector initiatives in filling in these gaps, and efforts are already under way, especially by West Europeans. But the U.S. government can also make a major contribution, as Sen. Joe Biden's effort in the Foreign Relations Committee recognizes.

Aside from supporting East European economic stabilization programs, our government should provide firm assurances that our markets will be open to the goods and services these countries produce. Unless people believe this, they simply won't invest anywhere near the sums required for real prosperity. This means granting Most Favored Nation status and extending membership in international economic and financial institutions as soon as these countries are ready.

We must also facilitate access to up-to-date technology and equipment. The U.S. government should take the lead in revamping strategic-trade controls so that East European nations can buy the robots, computers and other items they will need in a modern economy. This can be done without touching sensitive military issues.

In addition, the U.S. government should



provide technical assistance to build the institutions critical to the pluralistic market-based economies: tax, banking and accounting systems, a judicial system to enforce contracts and protect private property, an educational system to instill new attitudes and skills that are indispensable in a democratic entrepreneurial society, viable political parties and an independent press. The U.S. government can mobilize Americans—especially those with East European roots and language skills—to help.

Our government can advise on converting military resources to meet pressing needs such as roads, telecommunications and pollution controls. We should also cooperate with Western Europe and Japan in providing seed capital to modernize production systems and promote competitive small businesses.

In Poland, we must take the lead in marshaling support for the new government's urgent request for a comprehensive reduction of its huge foreign debt and debt service. This debt—some $40 billion, mostly owed to West Germany—is one of the world's highest and least payable debt burdens. It clouds prospects for desperately needed investment by Poles and foreigners alike. Without a solution, Poland has little choice but to abandon hope of achieving the prosperity its people's sacrifice and courage have surely earned.

Ironically, Germany is the example of why debt relief is a strategic opportunity. At the end of World War I, the victors turned their backs on the need to lower the burden of Germany's debt and reparations—with disastrous results. After World War II, the allied powers avoided a repeat of their earlier mistake and granted Germany deep debt relief in the 1953 London Agreement on German Debt. Such enlightened self-interest should guide us in dealing with Poland in the 1990s.

These initiatives are not costly. We could do them all for less than one percent of the defense budget. But unless we contribute these resources, we will be missing the opportunity to collect a security dividend—both military and economic—of our own.

At the same time, we should recognize that the Soviet Union is in a different circumstance. We should stand ready to respond forthrightly to the transition from a centrally planned to a market-based economy. But as leading Soviet reformers themselves recognize, reconstruction aid and guaranteed investment would be a mistake, at least for now. Mikhail Gorbachev's impressive strides in liberalizing Soviet society have yet to extend to the economic front. A nation that has an economy larger than Japan's, that is burdened with a 60-year history of collectivism, that unlike Eastern Europe has yet to bite the bullet of price decontrol and other crucial reforms, that still spends huge sums on military forces it does not need and cannot get food from field to shelf without much of it rotting: such a country simply cannot use foreign aid efficiently enough now to justify asking American taxpayers to foot the bill for it. I'd rather spend that money at home.

Finally, we should remember that if Eastern Europe succeeds, the patterns of economic and political relations and the perceptions of mutual interest that evolve during the transition will endure long into the future. That's the lesson of the Marshall Plan. If we give help, we can forge lasting bonds based on common democratic values, cultural ties and economic interests. If we fail to provide sufficient support, we cannot realistically expect that Western Europe, Japan and the other nations we leave to pay the costs will look after our interests.

Nor should we be surprised if the future of Eastern Europe has a major impact on Western Europe's economic evolution. Americans are unlikely to be pleased with the outcome unless our contribution is commensurate with our interests. And our contribution will not be big enough unless our ambition for our values is bold enough. This is the time to seize the initiative for democracy. If President Bush fails to do so, Democrats in the Congress have an obligation to try, now.

The writer is a Democratic senator from New Jersey.

The Washington Post, March 28, 1990

The New York Times, March 7, 1990

For Eastern Europe, a $25 Billion Aid Package

By Zbigniew Brzezinski

WASHINGTON

The external Soviet empire lasted 45 years. It is shattered, beyond redemption or repair. The Soviet Union, suffering from a bad case of imperial fatigue, itself is struggling for survival. The internal crisis — simultaneously ethnic, economic and political — will be of long duration.

In the meantime, a new geopolitical reality in the very heart of Europe is emerging. Today, Eastern Europe is again Central Europe — which it has always been historically, culturally and philosophically. This post-Communist region is threatened by chaos and instability even as it yearns for a Western European style of life and for Western-type institutional arrangements.

Designs for Europe
An Occasional Series

Central Europe's economies are in a shambles. Its political systems have to be rebuilt from scratch. The threat of national and territorial conflicts overhangs the internal difficulties that every Government will have to overcome on the way to the stable democracy all profess to seek.

A policy that responds creatively to all these overlapping dilemmas will have to be comprehensive geographically and ambitious politically.

It must be capable of harnessing Western popular support and of captivating the political imagination not only of the Central Europeans but also of the many Soviet nations. It must build on the success of Western policy, not diluting but enhancing the processes of Western European integration while also seizing the moment in Central Europe to capitalize on that integration's ripple effects.

That policy should be founded upon the grand concept of a trans-European commonwealth with the European Community at its core but embracing Central Europe and being open also to eventual association with the Soviet Union.

Such a strategic vision should include the following seven specific but interconnected and historically ambitious policy components:

Acceleration of Western European integration; enhancement of trans-Atlantic ties; consolidation of democratic reform in Central Europe; negotiation of a German confederation within an all-European security framework; facilitation of cross-cutting multilateral cooperation; promotion of Central European regional cooperation, and encouragement of a new Soviet confederation.

These components have to be viewed as a package, with the pursuit of one facilitating and necessary to the attainment of the others. The end result of the effort should be the emergence of a more stable, cooperative and democratic all-European order as well as the termination of the American-Soviet rivalry over the fate of Europe.

Accordingly, it will be critically important to the success of the entire agenda for Western Europe's political integration to be accelerated further. Indeed, that integration must serve as the cornerstone of any eventually wider European commonwealth and as an attractive, and badly needed, example of successful multilateral cooperation for the Central Europeans and Russians. Without such integration, any attempts to promote the regional recovery of Central Europe will lack the necessary source of stability and support.

American support for European integration is consistent with the fostering of even more intimate trans-Atlantic ties. Firm linkage with the U.S. would make it easier and safer for the Europeans to try to foster a more genuinely cooperative relationship, beyond Central Europe, with the Soviet Union. A continued — even if significantly diminished — American military presence in Europe is, therefore, in the self-interest of Europe and America.

The Marshall Plan cost $171 billion, in 1989 dollars.

The promotion of stable democracy in the post-Communist countries will require a major and immediate commitment of Western resources, far beyond existing commitments. In the first half of 1989, it appeared that only Poland — the spearhead and historic catalyst for the collapse of the Soviet bloc — and Hungary would require Western assistance. It is now obvious that all Central European countries will have to be aided in the extraordinarily difficult transformation of their economic and political systems.

The level of Western capital needed to prevent the region's slide into political and economic chaos might well range from $25 billion to $30 billion. Since this figure may appear at first glance appallingly large, it should be viewed in historical perspective.

Between 1946 and 1955, the U.S., then with a gross national product about one-third of today's, contributed a total (in 1989 dollars) of $171 billion to Western Europe's recovery. That came to an annual contribution of $17 billion. The result was a historical triumph.

The economic response to the challenge of Central Europe certainly should not be America's burden alone. Western European countries likewise have a stake in Central Europe's stability. Japan, with a G.N.P. more than half that of America's, also should play a role.

The peaceful transformation of Central Europe will require a stable security context, one that is reassuring to the West and East alike. Accordingly, the West, in embracing the cause of German unification, should move forward with a comprehensive plan for a German confederation and for special security arrangements to accompany it. Indeed, German acceptance of the existing frontiers is the sine qua non of international acceptance of unification.

Moreover, for an agreed transitional period, NATO and the Warsaw Pact should retain some military contingents in the two parts of united Germany, thereby guaranteeing a secure transition to the new European order.

Members of the two political-and-military alliances should also be free to choose their economic associations through memberships in multilateral organizations. Thus, the Central European states, as they move toward market economies, should be permitted and encouraged to seek some form of association with either the European Free Trade Association or eventually the European Community — even while they remain Warsaw Pact members.

The West should also encourage the Central Europeans to develop new forms of regional cooperation among themselves. Western economic and ecological assistance could even be made conditional to some degree on the recipients' willingness to engage in multilateral cooperation.

Finally, the Soviets must be constructively encouraged to see their future in trans-European cooperation. The option of participation in the expanding European adventure should be explicitly held open to a new and genuinely pluralistic Soviet confederation in the event that Mikhail Gorbachev's perestroika does lead to fundamental reformation of the Soviet Union.

A necessary concomitant to any process of creating a genuinely voluntary Soviet confederation will be the right of secession. Some parts of today's Soviet Union may choose to exercise that right. But such secession could become more tolerable to the Soviet Union if it led to new forms of association between the seceding states and the remainder of the current Soviet Union with an emerging trans-European commonwealth.

It is not too early for Europeans and Americans to start thinking about the implications of the epochal fact that the Eurasian map, as much of this century has known it, is being shaken. Given the accelerating velocity of history, we should begin charting deliberately the next phase in its trajectory. □

Zbigniew Brzezinski was President Jimmy Carter's national security adviser. (A longer version of this article will appear in the spring issue of The National Interest.)

Journal of Commerce, March 28, 1990

Searching for Boldness on Europe

WASHINGTON — The Bush administration wants over $400 million for a new U.S. embassy in Moscow — more than it is proposing in economic aid for Eastern Europe in fiscal 1991.

The White House also is requesting $800 million in economic aid for Panama and Nicaragua, nearly triple its East European request.

These sorts of monetary allocations, say Democrats in Congress, reflect misguided priorities. East-

TRADE SCENE

Richard Lawrence

ern Europe, they say, is where the winning of the Cold War can be consolidated and where big opportunities for U.S. business loom.

President Bush and Secretary of State James Baker are deemed by Democrats to be too cautious, failing to exploit this historical moment.

Not only Democrats are complaining. Last week, over one-fourth of the members of the House, in a letter to Commerce Secretary Robert Mosbacher, warned of a Capitol Hill backlash if the administration does not act more boldly to relax controls on high-technology exports to Eastern Europe.

Among those leading the demand for quicker export control reform are a pair of Republicans: Rep. Ron Wyden, Ore., and Rep. Bill Gradison, Ohio.

The U.S. Export-Import Bank is open for business in Hungary, Yugoslavia, Czechoslovakia and Poland, but largely as a guarantor of others' loans to those countries. By late summer, it may be underwriting U.S. exports to the rest of Eastern Europe and the Soviet Union.

Budget constraints, though, would appear to consign Ex-Im Bank to a very minor role in Eastern Europe, at least in comparison with counterpart agencies in Western Europe and Japan.

Administration caution and constraints aside, an important question remains: Is Eastern Europe really a potentially big market for U.S. firms?

Some U.S. businessmen apparently think not. Take Kempton Jenkins, a former U.S. diplomat and now an Armco Inc. vice president. He recently was quoted as describing Eastern Europe as "a great big collection of people with no money." U.S. business has "too many other challenges" to focus on rebuilding Eastern Europe, he told a conference here.

Robert Ebel, an Enserch Corp. vice president, was no more encouraging, at least regarding the Soviet market's outlook, in an address before another group this month.

Stories abound illustrating the prevailing Soviet economic fiasco. Consider a joint venture agreement between the Soviet foreign economic bank and five West European private banks.

It was signed a year ago, but the partners are still trying to find both office and apartment space in Moscow. The joint venture remains on hold.

A West European banker on a recent visit here described Poland, despite its admirable economic reforms, as basically "hopeless." There are "brilliant" Poles but no one knows where the country is going, he said.

It may take 10 to 15 years, acknowledges Andrzej Arendarski, head of Poland's revived National Chamber of Commerce and Industry, for Poland to achieve a "normal" economy.

Are U.S. firms generally willing to invest for such long-term payoffs? If their reputation is accurate, it suggests not.

West German industry evidently will dominate the East German market and the region's two other brightest prospects — Czechoslovakia and Hungary — have a combined population of only 27 million people.

Hardly helping to spur serious U.S. business interest is President Bush's withholding lower tariffs on Soviet goods until the Supreme Soviet "codifies" existing Soviet emigration policies, even though it is Washington, not Moscow, that now impedes Soviet emigration.

The administration's demand in the negotiations for an Eastern European economic development bank to deny the Soviets any net new funds from the bank does not enhance U.S. business prospects in the biggest Eastern European country of all.

This is especially disconcerting if, as the Washington-based Overseas Development Council has projected in its study, "Economic Reforms in the Three Giants," U.S.-Soviet trade has the potential to rise by tenfold in the 1990s.

Still, the administration is doing many things right, says Richard Feinberg, the council's vice president. He cites U.S. efforts toward trade, investment and tax accords with the Soviets and others in Eastern Europe.

Mixed signals on U.S. policy in Eastern Europe come from Congress, too. Sen. Robert Dole, Kan., the Republican leader, opposes U.S. participation in the proposed East European development bank. He prefers opening a special East European fund in the World Bank, a proposal unlikely to win much support abroad.

Sen. Jesse Helms, R-N.C., is preparing U.S. economic reprisals if the Soviets "use force" in Lithuania. His resolution warning the Soviets of "severe repercussions" cleared the Senate unanimously last week.

Richard Lawrence is a reporter in the Washington bureau of The Journal of Commerce.

THE NEW YORK TIMES, THURSDAY, JANUARY 11, 1990

In the East Bloc, It's Trade or Fail

By Robert D. Hormats

Moscow's proposal that members of Comecon, the Soviet-led trade bloc, begin trading at market prices is a sign that the old order is crumbling. To help fill the void, the West should move quickly to encourage new forms of economic collaboration among Eastern European nations. Otherwise, support for democratic government and for reform itself could be undermined.

Eastern Europe is engaged in five simultaneous transitions: from central economic planning to reliance on market forces; from backward, often heavily agrarian, economies to modern, competitive ones; from Communist Party domination to multiparty democracy; from trade and financing ties straitjacketed by Comecon to those that serve their own economic interests, and from regional and international political relationships dictated by Moscow to those shaped by these nations themselves.

All of these changes could be jeopardized, and Eastern Europe's new leadership could collapse, if living standards do not quickly improve. But economic transformation will take years. In the near term, cutting subsidies for food and rent, closing obsolete plants and laying off redundant workers could lower living standards.

Having spent trillions of dollars to contain Communism in Europe, the West would make one of the great mistakes in history if it refuses to spend the several billions more needed to help countries through this hard period. And assistance is a good investment: Even today, with all their problems, Czechoslovakia, East Germany, Hungary and Poland have a combined gross national product considerably greater than China's.

During the last 40 years, Eastern European nations have developed a heavy economic dependence on one another and the Soviet Union for credits, markets and supplies. More than one-half of their trade is with other Warsaw Pact countries. Whole sectors of industry in Czechoslovakia, East Germany and Poland cater almost exclusively to the Soviet market. Two-thirds of Poland's gas, oil and cotton imports come from the Soviet Union.

A lack of hard currency and shoddy products will limit the degree to which the Eastern Europeans can increase trade with the West. So they have an interest in working with one another to increase production, growth and commerce. Failure of reform in one economy of the region will strengthen opposition to it in others.

Following are four Western programs that could encourage more rapid development and closer cooperation in Eastern Europe:

Coordinated investment in infrastructure

The proximity and small size of the nations of Eastern Europe makes this vital. Taking a page from the Marshall Plan, the World Bank should organize a special consultative group of donors (including the Soviet Union) and Eastern European recipients to coordinate financing of roads, bridges, rail links, etc.

A regional development bank.

Such a bank, proposed by President François Mitterrand of France, could finance the modernization of inefficient industries and projects with a private sector orientation. It could provide start-up capital for private business, pay for the training of workers for new technologies and provide money for temporary unemployment payments to workers transferring from outmoded to modern industries.

A pool of Western technical experts.

These experts could help modernize factory management, privatize state companies, strengthen banking, develop market-oriented legislation (particularly on property ownership) and improve administrative procedures.

A revolving fund.

This would facilitate the transition from the closed trading system of today's Comecon toward open trading based on convertible currencies. The fund, similar to the U.S.-sponsored European Payments Union that enabled Western Europe to make this transition 40 years ago, would provide a supply of dollars, marks and other currencies on which the countries could draw to settle accounts. They would draw down their accounts when they are running deficits and pay the fund back when they have surpluses.

It is harder to create successful market economies than tear down failing Socialist economies. It will be harder still if Eastern Europeans do not work together, and if the West fails to help them do so. □

Robert D. Hormats is vice chairman of Goldman Sachs International.

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The Wall Street Journal, Jan. 15, 1990

Are East Europe's Executives Prepared for the 1990s?

Manager's Journal

By Piero Telesio

As General Electric implements its acquisition of a 50% stake in Tungsram—the large Hungarian electric lighting company—it undoubtedly will discover that its management system and procedures will baffle local managers, raised on a diet of ministerial control, production quotas and five-year plans.

The question of how these managers will respond to the competitive environment into which they are being thrust is no longer academic. Most countries in Eastern Europe, as well as the Soviet Union, are increasingly opening up to foreign investment. Hungary is far ahead of other Eastern European nations, with 628 registered foreign-local joint ventures. It is second in the Eastern Bloc only to the Soviet Union, with 685. Yugoslavia has 230 joint-venture registrations; Poland, 170; Bulgaria, 41; and Czechoslovakia, 20.

But can East European managers compete? A three-year-old study funded by the World Bank assessed the capabilities of CEOs and other senior managers from 29 of Hungary's major industrial enterprises. While the data in the report were compiled before the dramatic reforms of 1989, the managers who were questioned and tested are many of the very same people who now must perform in a much more competitive environment.

Senior managers in Hungary turn out to be a relatively young group: 55% of the CEOs and 72% of the other senior managers surveyed were under age 50. None were over 60. Also, there has been an infusion of new blood at the top: 40% of the CEOs occupied their positions for two years or less. Only 16% held the top job for more than 10 years.

But these managers have had little experience outside of Hungary. Fully 80% had no foreign business experience. Only 7% had experience in other communist countries and 13% in market economies. This inward orientation is reflected in language ability: 47% claimed no knowledge of a foreign language—almost unheard-of for Western European executives.

The study found that a relatively high proportion of Hungarian enterprises were lacking in those management capabilities needed to be internationally competitive, as is shown in the accompanying table.

It is hardly surprising to find that most Hungarian managers are short on marketing capabilities. In the export markets, most enterprises either use local international trade organizations or ship directly to their foreign licensers. This has insulated Hungarian exporters from their markets abroad. In the domestic market, control by the ministries and lack of competition did not hone marketing skills.

Hungarian financial managers are unprepared for the recent and rapid changes in the Hungarian financial system: development of a two-tier banking system; venture-capital firms; competing credit institutions; direct investment; introduction of a stock market. This is a far cry from previous arrangements, when the ministries allocated funds to enterprises under their jurisdiction.

The organization of Hungarian enterprises is generally rigid and unresponsive to rapid change. Historically, the basic organizational unit was the factory. This gives factory managers, even in large firms, important positions within the company hierarchy that they would not enjoy in comparable Western European firms. In one large firm, for example, all 14 factory managers reported directly to the CEO.

Many CEOs do not have a clear understanding of strategic planning. In the past, directives and plans were imposed upon management by the ministries. As a result, few senior managers today fully appreciate the difference between strategic planning and the old-style five-year operational plans.

Senior managers generally have not had access to adequate information about the business, legal, institutional and economic environments outside Hungary. Particularly lacking is an awareness of the world-wide competitive environment in their industries. Likewise, in most companies product-cost information is either unavailable or unreliable. The lack of timely information impedes effective decision-making. When available, information is not presented in a useful format and, consequently, is not acted upon.

Lack of Skills

Areas in which Hungarian managers are not internationally competitive

	PERCENT OF ENTERPRISES
Marketing	59%
Financial management	54
Organizational development	42
Strategic planning	41
Environmental analysis	39
Management of technology	34
Human resources	25
Production management	17

Source: Hungarian Ministry of Industry

Managers fare better when it comes to managing technology. This is not surprising, given the engineering background of most Hungarian managers. Nevertheless, domestic development of products and processes is often slow and not always successful because of inadequate enterprise support. In general, Hungarian companies tend to be technological followers. In most companies the equipment is obsolete and the level of automation fairly low by Western standards. Licensing from Western or Japanese firms, though, does increase the speed and success of technological adaptation.

Managers are generally satisfactory in the area of human resources. Many enterprises are establishing personnel and career-development policies. A few have internal management-development programs. Nonetheless, management evaluation and performance appraisal is often hampered by the absence of definitions of responsibilities and an inadequate control system.

Foreign investors in Eastern Europe should be aware that it is going to take both time and training to develop management capabilities taken for granted in the West. Local managers might be sent to the investor's home company for on-the-job training or to Western business schools. Within the country, in-house programs might be set up by the joint venture itself, with help from local management-training institutions.

If quality training programs are available locally, they should be utilized routinely in a comprehensive program of management development. Last year, Hungary opened the International Management Center, a multinational cooperative venture. IMC will train managers at all levels and eventually award MBAs. The dean is an American and the courses are in English.

Mr. Telesio is a Boston-based consultant who studied Hungarian managers while at Arthur D. Little Inc. together with Messrs. Robert Mueller and Robert Terry.

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Latin America

WASHINGTON ECONOMIC WATCH

A Digest of Development Policy Information

A Project of the Overseas Development Council

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Prepared Statement of
Bernard W. Aronson
Assistant Secretary of State
Bureau For Inter-American Affairs
Before The
Subcommittee on Foreign Operations
House Committee on Appropriations
House of Representatives
March 22, 1990

Mr. Chairman, I appreciate the opportunity to discuss with you the Administration's foreign policy priorities in the Inter-American region and our FY 91 foreign assistance request.

The past year has reaffirmed and strengthened the unparalleled transition to democracy in the western hemisphere that has marked the past decade. As in Eastern Europe, this breakout of democracy has dramatically altered the political landscape to our south. Panama, Nicaragua, Chile -- these nations add some 20 million people to the democratic community of the Americas. Haiti too, now has another chance. Our neighbors in the Americas, given a choice, have opted for free government and free enterprise. The dream of the Americas as the world's first fully democratic hemisphere suddenly appears within reach. The challenge to the hemisphere in this, the last decade of the 20th century, is to complete the transformation.

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Our policy and our resources played an important role in support of this remarkable trend toward democracy. We have sought to back this trend in each nation of the hemisphere, not only because it reflects our deepest values, but because it is in our interest. We enjoy the strongest relationships with those countries whose governments are founded on the consent of the governed, the only sure basis for respect for human rights, equitable development and the dignity of the individual.

We have an opportunity and a responsibility to continue to support the expansion, consolidation and development of democratic gains in Latin America and the Caribbean. Our policies have put us on the right course. We must keep moving on that course. And we must have the resources to get the job done. Were we to become complacent now, we could lose some very considerable gains; we would surely miss some crucial opportunities.

A bipartisan approach offers us the best chance of achieving our key objectives. I look forward to working with you and the subcommittee, Mr. Chairman, as we chart our policy priorities ahead.

The ability of this team effort to deal with the challenges of the '90's, particularly those that threaten the economic well-being of our region, faces a tough test in the coming year. High inflation, underdevelopment, and debt continue to restrict growth and undermine the stability of still fragile democratic governments. Our will to continue what we have begun is also being questioned by the region which sees Latin American economic and financial needs being marginalized in a rush to develop Eastern Europe.

Our contribution to economic development and to security, without which there would be no development, in Latin America and the Caribbean has been substantial in the past. To protect our investment, we will need to maintain a sustained level of support in both of these areas. And we must do so despite the competition for resources among the many crucial national interests at stake in other regions of the world. A stable, democratic and prosperous Latin American and the Caribbean can become even more profitable markets for U.S. goods and services, partners in productive commerce and investment. A region which creates sufficient jobs for its growing population also restrains illegal immigration.

Before we discuss the specifics of our FY 91 assistance request, I would like to set out four regional tasks facing us

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in the '90's, toward which we need to direct our energies and resources.

The four tasks are: consolidating and building on democratic gains, advancing economic development, promoting peace, and ridding our region of the scourge of drugs.

Consolidating Democracy

The first task, consolidating and building on democratic gains, is our top priority. In the cases of Nicaragua, Panama, Chile, and other countries of the region, a new generation of democratic leaders is emerging. The people of these countries have stated what they want: an open society, basic human rights and civil liberties, democratic political institutions and the chance to build a stable and prosperous future for themselves and their families. The challenge for the new leadership is to respond to the heightened expectations of improved political and economic conditions.

In Nicaragua and Panama, the tasks of political and economic reconstruction are massive. We must seize the opportunity to demilitarize the region, build the peace and democratic institutions. These new democracies will need court systems that are fair, free and reliable police forces that are

free from corruption, free trade unions and other democratic institutions. All this will require our and international support, including that of other western democracies. The UN and OAS also have roles to play in helping to enforce and verify compliance with the Central American peace process.

Meanwhile, Colombia, engaged in a mortal struggle with the drug cartels, prepares for a presidential election this Spring. Further south, Chile has peacefully ended 17 years of authoritarian rule and political isolation. Argentina, Brazil and Uruguay have successfully transferred power from one democratic government to another. Paraguay has entered the democratic ranks. In the Caribbean, Grenada held free elections this month, further consolidating its transition to democracy. In Haiti, President Trouillot, who has provisionally replaced General Prosper Avril, backs free elections and has promised to pass power to a democratically elected government. In our view, fair and free elections under international supervision offer the best hope for ending Haiti's longstanding suffering. Elections are also scheduled in May for the Dominican Republic -- the most populous nation in the democratic Caribbean where politics, allowed to flourish in the past quarter century, have become as popular as baseball.

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Advancing Economic Development

Advancing economic development, our second task, remains a major challenge. Strengthening of democracy and democratic institutions will depend importantly on a rising level of income and prosperity. However, during the 1980's, the predominant economic trend for the region as a whole was one of low growth, falling per capita income and rampant inflation.

From 1981 through 1989, real per capita gross domestic product (GDP) declined in the region by over 8 percent. This is in stark contrast to the region's strong economic growth between 1960 and 1980, during which real per capita GDP rose by more than 80 percent. Overall GDP in the region grew during the last decade by less than 12 percent. This masks the fact that in some countries, overall GDP actually fell for a number of years. Meanwhile, inflation, which soared to a startling 1,000 percent on a regionwide basis in 1989 continues to undermine the social fabric and political stability throughout the region.

Argentina, Peru and Brazil are now grappling with hyperinflation and continue to face an array of economic problems which vividly illustrate the principal underlying cause for the region's poor growth during the decade -- inappropriate economic policies.

Many of the region's countries, including Argentina, have begun to reorient and restructure economic policy. Brazil's new President has announced a program of comprehensive economic reforms. Impressive progress has been made or begun by such diverse countries as Chile, Mexico, Costa Rica, Colombia, Guyana, Bolivia, Uruguay, Jamaica, Venezuela, El Salvador, and Paraguay.

There seems to be a general recognition throughout Latin America -- indeed, throughout the world -- that development can advance only by discarding ingrained statist, inward-looking policies, and moving toward private-sector driven, trade-oriented economies. But change does not often occur quickly. And profound structural economic adjustments involve wrenching societal costs. On a regional basis, investor confidence is still low because the reform process has been slow and uneven. Availability of capital will remain a critical problem in the 1990's.

Foreign indebtedness also remains a major stumbling block to growth. Progress has been made, especially this past year under the Brady Plan in reducing the region's external debt. Most recently, Venezuela has reached a debt reduction agreement with the banks. But for many countries, especially those with

heavy official debt burdens, such as Jamaica, and those undertaking difficult reforms, the burden of servicing external debt will continue to hinder economic growth.

Latin America and the Caribbean face a twin development challenge in the 1990's. First, democratic governments must meet the demands of domestic constituencies for economic stability and prosperity. Second, the region's countries must take action to ensure that they are isolated no longer from the economic opportunities presented by a rapidly changing and increasingly interdependent world. The quickness of newly-emerging democracies in Eastern Europe to capture the world's attention and to make fundamental economic changes makes Latin American reforms all the more urgent as a basis for competition.

The first step -- and the most important one -- must be taken by the region itself. Open markets relying on private enterprise are key to broad-based and sustainable growth. Latin American and Caribbean governments must keep moving ahead to complete the reform process. But we can -- and must -- help.

For the peoples of Central America and the Caribbean, the Caribbean Basin Initiative (CBI) is a symbol of U.S. commitment to open markets and free institutions. Its investment and

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trade benefits drive much of the Basin's economic vitality, and contribute to a more prosperous, democratic, and stable region.

More than ever, CBI and the free market principles it represents must be the engine of growth. CBI has achieved rather dramatic successes, broadening and diversifying the region's exports.

In November 1989, the President called for enhancement legislation to consolidate and build on gains under the original bill. Last year, the House passed an enhancement bill repealing CBI's 1995 expiration date, crucial to maintaining investor confidence in the region. The Senate Finance Committee marked up its bill earlier this month, and I am gratified permanent extension is part of that bill as well.

I continue to hope, however, that Congress will not only extend CBI, but will strengthen it, particularly in areas currently excluded from duty-free treatment especially textiles and non-leather footwear. I know that these are sensitive issues domestically; however, I am convinced we can craft provisions which do not threaten U.S. industry, while offering meaningful new benefits to the Caribbean Basin.

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Our Economic Support Funds (ESF), and the policy dialogue which accompanies them, are critical for a number of countries in the region, to support economic stabilization and structural adjustment and economic reform programs that take several years to implement. Our ESF for Jamaica is a case in point; Prime Minister Manley is moving forward with a sustained adjustment effort that would be seriously undercut without our help in 1990-91. We need ESF for Guyana where President Hoyte has undertaken similar reforms and an international support group which has our strong backing has received a pledge for U.S. assistance which we have been unable to supply for lack of resources. ESF in the Dominican Republic will encourage a new government to enact needed economic measures.

ESF for Bolivia and Peru will be designed to help them face the major challenge of restructuring their economies away from reliance on revenue from narcotics. In the case of Colombia, ESF will help relieve the economic burden of its courageous war on the cartels.

Costa Rica and Guatemala have established a solid record of economic growth over the past several years as the benefits of economic reforms which both countries undertook several years ago have been felt. Economic growth in El Salvador and Honduras, while positive, is small. Both countries have recently adopted wide-ranging fiscal, monetary, trade and other economic reforms aimed at lifting growth rates.

El Salvador has been battered this past year by the fall in coffee prices on top of the economic cost of the continuing military conflict. Yet, President Cristiani remains absolutely committed to a modern, efficient, market-oriented economy. So serious is his administration in making these reforms that the Salvadoran assembly ratified a major set of tax, tariff and trade measures on November 30 of last year, while the offensive was still underway.

The Honduran government is just as serious about its economic reform program. On March 2, 1990, President Callejas presented a sweeping, historic economic restructuring package to the nation. The very next day, the Honduran Congress approved the measures.

We believe that our ESF levels to the Central American countries must be kept commensurate with the seriousness and short-term costs of these essential reforms. Costa Rica, Guatemala, Honduras, El Salvador are all now moving in the same economic direction - towards free-market and efficient economies. Mrs. Chamorro will launch Nicaragua on the same path beginning on April 25th. These economic reforms, supported by our ESF, lay the groundwork for the ultimate objective: self-sustaining, equitably spread economic growth in all countries of the region. We must stay the course to finish the work defined by the 1984 National Bipartisan Commission on Central America. Political stability and the opportunity to end regional conflict is far closer today than a year ago; we need to hold steady until this promise can pay off in a new era of peace, stability and development for all the people of that troubled region.

Lack of flexibility and reduced ESF levels for the region prevented allocation of significant FY90 ESF for the Caribbean region. ESF has a major impact on such small economies. The wide year-to-year fluctuations in funding make it very hard for these governments to plan fiscal and other policies. ESF also serves to recognize the Caribbean commitment to fighting drug trafficking even with limited managerial and physical resources. As traffic gets diverted

from established sea and land routes, the Eastern Caribbean offers an almost irresistable "target of opportunity" for traffickers. Our small neighbors cannot meet this challenge alone.

Economic development is entwined with the political process. As noted earlier, a civilian interim president in Haiti has promised free elections as her top priority. Our FY91 request includes ESF for Haiti to be used to reinforce democratic processes and meet urgent economic needs. It would only be obligated, however, after consultations with the Congress, and the clear agreement that our common democratic goals are being met. Elsewhere democracies are already established and ESF programs for the press, labor unions, and legal institutions contribute to deepening the democratic process, promoting democratic values, and, at the same time, making the rules of economic activity more transparent and equitable.

Promoting Peace

Our third task is promoting peace. President-elect Chamorro's overwhelming victory in the February 25 elections in Nicaragua and President Ortega's conciliatory public statements bode well for a successful transition on April 25

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to a more democratic, Western-oriented regime with a modified free market economy. Nevertheless, we are disturbed by reports that:

-- The outgoing Sandinista regime is distributing weapons to loyal followers;

-- That supplies of petroleum and basic foodstuffs are being run down, in an effort to exacerbate shortages and create unrest after the inauguration; and

-- That the Sandinistas are sacking government offices of supplies and equipment, and distributing other government property as rewards to loyalists.

We have urged the Nicaraguan Resistance to demobilize and reintegrate into Nicaraguan civilian society. But, we can only do so responsibly if mechanisms are in place to assure their safety and give them economic alternatives. The Sandinista Government has insisted frequently that the Resistance demobilize immediately, but it has refused Cardinal Obando y Bravo's request to bring Resistance negotiators to Managua to meet with him and the incoming and

outgoing governments to work out practical arrangements for demobilization. The time for posturing on this issue is over. The time has come for all parties to cooperate on solving this human problem and promoting the national reconciliation that Violeta Chamorro has called for.

In the period leading up to April 25 and beyond, the U.S., working with international organizations such as ONUCA and CIAV, must address the legitimate security concerns of the Nicaraguan Resistance, as well as support repatriation and assistance programs that will allow the resistance to resume a role in Nicaraguan society.

In order to facilitate that task of national reconstruction and reconciliation, on March 13 President Bush asked Congress for $300 million in immediate economic aid to the Chamorro government to help rebuild Nicaragua's prostrate economy, particularly its agricultural sector, and announced an end to trade sanctions imposed five years ago against the Sandinista regime.

In El Salvador, we are encouraged by the FMLN's announcement on March 13 that it is willing to end attacks on

civilian targets in order that peace talks with the Cristiani government -- broken off by the guerrillas last year in conjunction with their devastating assault on San Salvador in November -- may be resumed soon under the good offices of UN Secretary General Perez de Cuellar. The UN has been seeking for several weeks to facilitate talks between the Salvadoran government and guerrillas. The FMLN publicly announced on March 13 that it would unilaterally suspend some attacks against civilian targets, but reserved the right to attack the electrical power grid and to kill civilians "engaged in military and paramilitary activities." The Salvadoran government immediately acknowledged the positive elements in the FMLN announcement. The Salvadorans complained, however, that the FMLN announcement was a breach of confidentiality that both sides had agreed upon in requesting UN facilitation. We fully support the UN's efforts to get the two sides together, and believe that the government's positive response to the FMLN suspension of some hostilities will move the process forward.

We are also encouraged by the recent successful repatriation of thousands of Salvadoran refugees living in Honduras and hope that this will set a precedent for similar efforts on behalf of Nicaraguan refugees living in Honduras and Costa Rica.

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Attacking Drugs

The traffic in illegal drugs has emerged as a threat to democracy and stability in this hemisphere. As Secretary Baker told the Senate Foreign Relations Committee last month, ultimately, the illegal narcotics trade robs not only individual users but entire nations of their freedom. Further, he said, "The drug pirates and profiteers attack the central nervous system and vital organs of government: the administration of justice, the integrity of government, the right of free speech. That is what happened in Noriega's Panama."

Our Administration has advanced a determined strategy to confront the cocaine crisis in our hemisphere. It is a comprehensive strategy which balances demand reduction, enforcement and military action with U.S. economic assistance in the Andean region, in particular Colombia, Peru and Bolivia. The strategy is made possible by the deepening understanding between us and the Andean countries with whom we face a common threat. It is a promising start but it will not succeed if we do not follow through on our efforts to broaden our assistance to these countries in their struggle against the drug scourge. Certainly, we will encourage the international community to

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contribute generously as well. But we must acknowledge and assume our responsibility to lead the way.

In signing the Declaration of Cartagena on February 15, President Barco and his Andean counterparts endorsed a multinational approach to the drug problem. They committed their governments to stepped-up efforts in the war against the illicit drug trade, both bilaterally and through regional cooperation in the OAS. Our budget request seeks military and economic assistance, trade cooperation and alternative development aid to help fight the drug war. The latter is particularly important to strengthen the legitimate economies of the Andean nations and provide alternative economic opportunities to the farmers now growing coca leaf.

Elsewhere in the region, the Caribbean and Central America are natural drug transitting routes, caught between South America producers and North American consumers. The small countries of the region do not have the resources to take on the well financed drug cartels. Moreover, the spill over effects of trafficking is creating domestic drug problems on an ever growing scale. Drug traffickers continue to use their evil gains to corrupt police officials who, given low salaries, often fall prey to offers of big money.

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Overview of our Budget Request

I would like now to discuss the Administration's request for assistance for Latin America and the Caribbean for FY 91. These requests balance vital interests of the United States with the need to meet head-on the four tasks I have outlined earlier.

For FY 1991, we are requesting $1.4 billion for economic and anti-narcotics assistance and $296.3 million for military aid. This represents an increase of $261.9 million, or 18.3 percent over levels requested for FY 1990. In real terms, the increase is about 17.6 percent. The total requested, $1.696 billion, accounts for a little over 14 percent of our worldwide assistance request.

Security Assistance

I will now discuss the security assistance component of our request.

For FY 1991, we have asked for $651.9 million in ESF and only $296.3 million for military aid (FMF and IMET), totaling $948.2 million, or 8.9% of requested worldwide Security Assistance.

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Of the military aid requested, $13.19 million will go to the International Military Education and Training (IMET) program. This will provide first class professional and technical training to Latin American officers and NCOs. It will also expose the future military leaders of the hemisphere to our values with respect to human rights -- as well as to our model for the role of the military in a democracy. It is a fact of life that, in many countries, the military is an important institution whose leaders often move on to assume positions of political importance. At a very low cost, IMET affords us access to leaders and future leaders. This is particularly important in the emerging democracies of the Southern Cone where the use of IMET has been interrupted over the past years to the point that that there is almost a generation of officers who have not been exposed to U.S. training. For these reasons, we are requesting IMET programs in virtually every country in Latin America and the Caribbean with which we maintain diplomatic relations.

Of the $283.1 million Foreign Military Financing (FMF) we have requested, $139.0 million will support the President's Andean Counternarcotics strategy in Bolivia, Colombia, and Peru. (It also includes $2.0 million for Ecuador. A total of $135.5 million FMF will support key democratic countries in

Central America. Thus, we are requesting only $8.6 million in FMF aid outside the Andes and Central America. Of that amount, $7.1 million is for the drug-plagued Caribbean. The remaining $1.5 million will support improved civil-military relations in the key re-emerging democracies of Argentina and Chile.

Conclusion

Addressing the difficult tasks of the '90's is a challenge. Given the prospect of fiscal austerity and tight international affairs funding over the next several years, it will be imperative to make every dollar count. We will do that, Mr. Chairman. At the same time, we must all guard against the appeal of false economies, particularly where smaller programs are concerned, lest we risk missing substantial opportunities to promote U.S. interests for the sake of savings that mean very little for our overall budget picture. We have a unique opportunity to take advantage of positive world and regional trends to secure peace and stability in Central America. We must provide the resources necessary to assure that the people of this troubled region can escape from a decade of civil conflict to consolidate their democracies and rededicate themselves to development.

You can help us in one very key way: reverse the trend toward earmarks. Throughout Latin America and the Caribbean, U.S. assistance in advancing economic development requires careful planning and the ability to respond flexibly to take advantage of new opportunities or to meet crisis situations. As we have seen in the current fiscal year, extensive earmarking has served only to reduce the flexibility and effectiveness of our assistance programs. Let me join the Secretary of State, Mr. Chairman, in proposing that we make legislative earmarks a last resort, to be avoided if at all possible. Instead, let us work together to explore ways to achieve greater flexibility to respond to the dynamics of change in our region.

The movement towards a new era of democracy, open economies, and peace in our troubled region makes this an especially exciting time to be working with Latin America and the Caribbean. We can justly be proud of our contribution in helping events unfold positively. It is an investment well worth protecting. As we look to the future, I know that we can count on your committee, Mr. Chairman, to work with us in nurturing the delicate forces of democracy, prosperity and stability in our hemisphere.

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FROM: Stephen Lande/Nellis Crigler

DATE: March 1, 1990

SUBJ: CBI II Mark-Up

The Senate Finance Committee marked-up CBI II legislation this morning. The failure to include any footwear and textile provisions in the Senate bill precludes the possibility that they will contained in the final bill, unless the Finance Committee agrees to a committee amendment addressing these issues to be presented on the Senate floor. There will be a strategy session in Senator Graham's office tomorrow to consider drafting such an amendment. To succeed the committee amendment will have to be technical and non-controversial. Even agreement to include a non controversial amendment on these products would allow the product to be conferenced with the House where a more significant amendment could be passed. Another positive note was that Secretary Baker in testimony before another committee stated that footwear and textiles must be included as part of the CBI.

The Senate Finance Committee's bill does not contain provisions addressing cumulation, rules of origin, sugar, ethanol, the fifty percent duty reduction for leather goods. (You will recall that in the Ways and Means Committee, leather footwear was excluded from the duty reduction for leather products.) However, since these provisions were included in the House passed version they remain on the table for the House/Senate conference committee. Like the House bill, the Finance Committee's bill included a provision granting duty free treatment to items co-produced from one hundred percent U.S. components, and measures relating to labor rights, tourism, establishment of a Customs preclearance facility, scholarships, special consideration for the Eastern Caribbean. Also included in the Senate bill was a new provision calling for AID/US Department of Agriculture programs to improve CBI agriculture trade through improvement in transportation and cargo handling infrastructure.

Sen. Bob Packwood (R-Oregon) opened the session by introducing an amendment to reduce duties by 50 percent on rubber sole/canvas upper footwear. Packwood argued that domestic production of this type of footwear accounted for only 18 percent of U.S. consumption and only 10 percent of production. Furthermore, the impact would be a shift of imports from China rather than from the United States.

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Assistant Secretary of State Bernard Aronson said that the administration strongly supported the provision, and that all leaders in the region are watching the United States to see if it "practices what it preaches." He said while the U.S. urges CBI countries to reform economies, fight narcotics and open markets, their economic support funds were cut by 20 percent between 1989 and 1990. Aronson said that assembly of shoes in the CBI region will create some 25,000 U.S. jobs through use of patterns and materials produced in US.

Senator Heinz (R-Pennsylvania) refuted Aronson, saying that 17,000 jobs have been lost in the U.S. footwear industry since 1986, a high percentage of them belonging to minorities and women. Packwood's amendment was defeated by a vote of six in favor to ten opposed. Voting in favor were Senators Bradley (D-New Jersey), Dole (R-Kansas), Chafee (R-Rhode Island), Durenberger (R-Minnesota), and Roth (R-Delaware). Voting against were Boren (D-Oklahoma), Heinz (R-Pennsylvania), Daschle (D-South Dakota), Baucus (D-Montana), Matsunaga (D-Hawaii), Pryor (D-Arkansas), Moynihan (D-NY), Mitchell (D-Maine), and Bentsen (D-Texas).

Senator Packwood was expected to also introduce an amendment calling for duty-free treatment of Guaranteed Access Level apparel. However, following the defeat of the footwear provision, he withheld the amendment. This may have been in order not to have a negative vote on the record if further efforts are made to restore the provision as a committee amendment.

Senator Bradley then introduced amendments calling for a joint AID-Treasury study of how the region's debt burden offset CBI benefits and an amendment on scholarships. They were tabled since no one was familiar with them.

Bradley proposed a global floor on sugar imports, which would guarantee imports from CBI countries at a certain level without discriminating against other trading partners. The amendment was defeated for a number of reasons:

A. Members of the Committee claimed not to be familiar with it.
B. There were the normal protectionist sentiment against the bill led by Matsunaga.
C. The Administration could not take a position on the bill without formal clearance.
D. The administration needed time to analyze the implications of the bill for the GATT, Uruguay Round and the Farm Bill.

Senator Roth proposed that the report language accompanying the bill suggest that Jamaica be the site of customs preclearance procedures.

There was no effort to include a cumulation provision in the Senate bill, which may be positive in that it avoided debate and a potential negative vote. In any case, a cumulation provision is already contained in the House bill. The main opposition to cumulation is from the steel industry which may be assuaged if steel is excluded from cumulation. However, we have a suspicion that the staff of the Finance Committee may have some trade policy objections to it.

Given the non-controversial nature of the remaining provisions in the House and Senate bill (with the exceptions of cumulation, opposed by domestic steel industry, and sugar, opposed by the administration), it seems that passage of CBI II is imminent. However, the failure to include any meaningful provisions for the excluded items (except possibly leather products other than footwear) illustrates the need for a new approach that would take advantage of "fast track" consideration by Congress and would be cast in terms of a strategic economic and trade relationship for the hemisphere rather than a donor/beneficiary relationship.

We are transmitting articles supporting CBI which appeared today in the Journal of Commerce and the Washington Post, the chairman's proposal on CBI II, and an impressive letter signed by all the Ambassadors of the CBI beneficiary countries which was delivered personally to each Senate office. In addition, we delivered letters from FEDEPRICAP, CAIC and the Costa Rican AMCHAM, the day before the markup. There is no way that any one can now say that the region is not supportive of a significantly enhanced CBI.

With the Conference probably scheduled soon after Chairman's Rostenkowski's April 11th-13th visit to Costa Rica and April 13th-16th visit to Barbados, the visit becomes a crucial opportunity to influence CBI II's outcome.

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CHAIRMAN'S PROPOSAL ON CBI II

Repeal of termination date.--Repeals the September 30, 1995 termination date of duty-free treatment under the CBI, thus making the program permanent.

Treatment of articles assembled from U.S. components.--Grants duty-free treatment to articles assembled or processed in a beneficiary country wholly of U.S.-produced contents or ingredients, except water. This provision does not apply to any product excluded from duty-free treatment under CBI.

Conforming GSP amendment.--Conforms the rule of origin for the Generalized System of Preferences (GSP) to the rule of origin under CBI by requiring that GSP-eligible articles either be wholly the product of a beneficiary country or be substantially transformed in a beneficiary country.

Country eligibility and worker rights.--Prohibits the President from designating any country as a CBI beneficiary if that country has not or is not taking steps to afford internationally recognized worker rights to workers in the country, as defined in the GSP statute. The President may waive this requirement for U.S. economic or national security reasons.

Pilot preclearance program.--Requires the Commissioner of Customs, in fiscal years 1991 and 1992, to establish a pilot program in a appropriate Caribbean country for testing the extent to which having customs preclearance operations can enhance the development of tourism in the region.

Scholarship assistance.--Requires the Agency for International Development to establish and administer a program of scholarship assistance for students from beneficiary countries to study in the United States.

Promotion of tourism.--Declares that increased tourism should be a central part of the CBI program and directs the Secretary of Commerce to complete a study of Caribbean tourism development strategies that was begun in 1986, including information on mutual benefits to the United States and the Caribbean and proposals for developing increased linkages between the tourism industry and other local industries.

Increase of duty-free allowance for tourists returning from the Caribbean.--Increases the duty-free allowance for tourists returning from the Caribbean from $400 to $600 (the allowance for tourists to U.S. insular possessions would be increased from $800 to $1200) and increases the duty-free alcoholic beverage allowance by one liter if CBI-produced.

Eastern Caribbean and Belize.--States the sense of the Congress that special efforts should be undertaken to improve the ability of Belize and Organization of Eastern Caribbean States countries to benefit from CBI.

Presidential reports.--Requires the President to issue a complete report on the operation of the CBI program by October 1, 1993, and every three years thereafter.

Agriculture infrastructure support.--States the sense of the Congress that, in order to facilitate trade with, and the economic development of, the CBI, the Secretary of Agriculture should coordinate with AID the development of programs to encourage improvements in the transportation and cargo handling infrastructure in CBI countries to improve agricultural trade. [This provision does not appear in either S. 504 of H.R. 1233, but was suggested by the Administration and appears not to be controversial.]

TESTIMONY OF JAMES M. MURPHY, JR.

ASSISTANT UNITED STATES TRADE REPRESENTATIVE

FOR LATIN AMERICA, THE CARIBBEAN, AND AFRICA

BEFORE THE

SENATE JUDICIARY COMMITTEE

AND

THE CAUCUS ON INTERNATIONAL NARCOTICS CONTROL

MARCH 27, 1990

I am pleased to have the opportunity to discuss with you today the role of trade policy in the Administration's efforts to fight the war on drugs. The fight to eliminate illegal drug production and trafficking is one we must win. Our future depends on it. Ambassador Hills is committed to doing all that she can as the United States Trade Representative to help President Bush stamp out this scourge. As demonstrated at the Cartagena Drug Summit, we and the Andean governments know that working together is critical if we are to achieve this goal.

We appreciate very much the spirit in which you have called this hearing. From a trade policy perspective, the Administration believes that in fighting the war on drugs we should use our market as an incentive for expanding trade in legitimate items. We need to create opportunities for entrepreneurs to channel their energies into legitimate production. Our market should serve as encouragement and support for fundamental economic reform based on market-driven policies.

The drug traffickers have made major intrusions into the economies of our Andean neighbors. To combat this intrusion effectively, we must assist these countries in developing alternative economic opportunities. That is also why President Bush asked Ambassador Hills, as United States Trade Representative, to look carefully at our trade laws and policies to develop a package of initiatives which would help expand trade opportunities between the United States and the countries of the Andean region.

The President's Andean Trade Initiative, which he announced on November 1 of last year (see attachment), is our first step toward helping the Andean countries improve their trade performance. We recognize that this package alone does not provide all the assistance necessary. It is a beginning. While my focus today is on U.S.-Andean trade, I want to note, too, that on a broader scale, a successful conclusion to the international

trade negotiations currently going on in Geneva can only mean greater opportunities for legitimate trade to flow.

The Andean trade package demonstrates the Administration's deep appreciation for the personal risks and life-threatening actions the Colombians, in particular, are taking to fight the war on drugs. Since the President announced the trade package, we have done a great deal to implement it swiftly and efficiently. We have taken a full range of bilateral, regional and multilateral actions to implement the trade package:

BILATERAL AND REGIONAL ACTIONS

Generalized System of Preferences

President Bush promises to do all we can to enhance the benefits the countries of the region enjoy under the U.S. Generalized System of Preferences (GSP), including a special review to consider the addition of new products, both agricultural and industrial, to the program. That special review is well under way. On March 2, USTR announced that 129 products have been accepted for review. All products statutorily eligible to receive GSP have been accepted for formal review. On July 13, the President will announce the final results of the special review and those results will be implemented on August 1. In short, we are accelerating the normal review process by about one year.

The U.S. Government has conducted very successful technical seminars on the U.S. GSP program in Bogota, La Paz, Quito, Guayaquil, Lima, Caracas and Maracaibo. These seminars will help the Andean countries take full advantage of the opportunities provided by our GSP program.

Technical Assistance

Technical seminars to explain the climate and conditions for "doing business with the United States" were held in each Andean capital and in Guayaquil, Ecuador from February 5 through 23. We are also in the process of considering other forms of technical assistance which will help these countries improve their trade performance.

Textiles

In accordance with President Bush's pledge, we are exploring the interest of the Andean countries and consulting with U.S. industry on possible ways to expand textile trade with those countries. We are planning a technical seminar in late spring for the Andean governments and their private sectors on U.S. textile policy and programs.

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MULTILATERAL ACTIONS

Accelerated Uruguay Round Negotiations

We have asked our Embassies to remind Andean participants in the Uruguay Round of multilateral trade negotiations, taking place in Geneva, of our offer to engage in accelerated negotiations on tariff and non-tariff measures. We are awaiting responses.

Discussions with the EC, Canada and Japan

We held a senior officials meeting in Washington at the end of February to discuss ways we can help the Andean countries improve their trade performance. We intend to continue this dialogue to seek areas in which we can work cooperatively.

Multilateral Development Banks

We have been exploring areas of potential cooperation with the multilateral development banks and emphasizing U.S. Government support for World Bank efforts in the area of trade policy reform. This dialogue continues.

International Coffee Agreement

In the Andean Trade Initiative, we renewed our commitment to seek a new International Coffee Agreement (ICA).

Before going into our current efforts to conclude a new ICA, I believe some brief background concerning how the agreement has operated would be useful.

The United States was one of the principal architects of the first ICA in 1962. The ICAs have relied on export quotas to attempt to stabilize the price of coffee. The export quotas are intended to encourage the accumulation of stocks and the maintenance of coffee trees during surplus periods in order to mitigate the effects of sudden production shortfalls.

ICAs are normally negotiated in six-year increments, with the possibility of extension by a vote of the Council of the International Coffee Organization (ICO). For the United States to participate fully, we need congressional approval.

From 1972 to September 1980, the export quotas were not in effect because of relatively high prices and the inability of members to agree on an appropriate price range. When surplus conditions returned in late 1980, quotas were reintroduced.

The ICA worked reasonably well during the first few years following the reintroduction of quotas. As a result, we sought only modest changes to the ICA during the negotiation of the 1983 agreement.

Two related problems became very serious after the 1983 ICA had been concluded. First, allocation of the export quotas was not adjusted to reflect changes in consumers' demand for more Washed Mild Arabica coffee -- the type produced mainly in Colombia, Mexico and Central America -- and to take account of relative shifts in supply conditions.

The second problem was that exporting members -- particularly those whose quotas had not been adjusted to reflect increasing world demand for their coffee -- sold their excess coffee to nonmember importing countries at discounts of about 50 percent compared to the prices offered to importing member countries.

The United States tried various means within the provisions of the 1983 ICA to solve these two problems. Regarding the quota allocation, we made a number of proposals -- including formula approaches -- to attempt to get the allocation adjusted. Unfortunately, the status quo suited the majority of exporting members, and the quota allocation was not changed to meet the needs of the market.

To try to solve the problem of discount sales to nonmembers, we negotiated a Council resolution that prohibited such sales and proposed improvements in the control mechanism designed to ensure that discount sales would not occur. We also initiated an effort by the Council to recruit nonmembers to join.

All of our efforts were to no avail, as exporting members violated the rules with impunity. Furthermore, rather than succeed in bringing new members, the situation caused Israel and New Zealand to drop out.

In 1988, as we prepared for the renegotiation of the 1983 ICA, we had to conclude that both of the problems we had identified with the operation of the ICA were only getting worse. By January 1989, the price difference between the kinds of coffee had expanded. While the price of Robusta coffee -- a lesser quality coffee -- was below $1.00 per pound, the price of Washed Mild Arabicas had risen to over $1.50 per pound, and at times Colombian Mild Arabica coffee was so scarce its price was not even quoted.

At the same time, the export quotas were restricting our access to availability of the higher quality coffee; this kind of coffee was flowing in large quantities at discount prices to nonmembers. In brief, because of the way the ICA's export quota system was operating, nonmembers were obtaining better quality coffee at

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much lower prices than members, who were subsidizing this arrangement.

We were convinced that key provisions of the 1983 ICA had to be changed if the coffee agreement was going to survive in the long term. In particular, the quota allocation needed to be adjusted in accordance with market realities, and the new ICA had to impose quotas on exports to all destinations -- members and nonmembers -- in the same manner.

We participated actively in the negotiations and advocated specific proposals -- which were supported by other importing members -- that we believe would have solved the problems. Throughout the negotiations, we consistently and repeatedly emphasized that the United States could not continue to be a member of an agreement that failed to address the two problems.

The negotiations came to a head in June 1989. Two proposals emerged.

One proposal was presented on behalf of the EC, Brazil, the African producers and Colombia. This proposal would have allowed the ICA's problems to persist for at least two more years, after which the Council would decide how to proceed.

The United States -- along with several other importing members like Canada and Switzerland -- and a group of exporting members (e.g., Mexico, Central Americans, Peru, Indonesia) rejected this proposal.

As a counterproposal, a group of exporting members suggested an approach that would have: (1) extended the 1983 ICA for one year; (2) shifted about four percentage points of the quota to the exporters of Washed Mild Arabica coffee (from about 44 percent of the quota to 48 percent); (3) applied quotas on exports to importing members and nonmembers in the same manner. The United States endorsed this proposal.

Because the two sides were too far apart, negotiations stopped. The Council decided to suspend the ICA's export quota provisions from July 4, 1989 until September 30, 1991.

In September, President Barco of Colombia sent President Bush a letter seeking his support for a new ICA. President Bush responded that the United States was prepared anytime to resume negotiations and that he hoped a lasting solution to the two problems could be found.

Since that exchange of letters, the United States has been second to none in attempting to establish a new ICA. We have tried to stimulate negotiations by:

- consulting with representatives of interested governments in Washington, Brussels, London, Paris and San Jose, Costa Rica;
- holding sessions with officials of the U.S. coffee trade and industry;
- using our embassies to seek the views of all ICA members; and
- presenting ideas and concepts on ways to find satisfactory solutions to the two problems.

This process has been very useful in developing and exploring ideas and clarifying positions. However, we have not yet been able to develop a consensus on a framework for a new agreement.

Among the reasons for this situation are:

- some exporting members remained wedded to the old ICA;
- Brazil, the largest exporting member, has been going through elections and a change of government; and
- the price of coffee has recovered to a point where many producers would rather sell all of their production in a free market than to be confined to quotas under the ICA -- even if the ICA raised prices somewhat.

Under these circumstances, we plan to continue to consult with key ICA members to see if we can revive interest in the ICA. If market prices remain strong over the next few months, however, prospects for an ICA this year will continue to fade.

CONCLUSION

The President's Andean Trade Initiative offers a number of possibilities for increased trade and investment between the countries of the region and the United States. His trade package is a first step. We are committed to building on the President's November 1 package and we are currently developing and examining, on an expedited interagency basis, a broad range of options toward this end. We want to work with the Congress in this effort and are pleased to have the benefit of your views as we undertake this process.

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FOREIGN AID

Funds for Panama, Nicaragua Move Down Hill Runway

Yet extraordinary efforts are needed to get the plan off the ground by Bush's April 5 deadline

Responding to repeated appeals from President Bush, Congress has speeded its work on special aid programs for Nicaragua and Panama. Several obstacles remain, however, and only an extraordinary effort will get the bill to Bush by his requested deadline of April 5, just before the beginning of the Easter recess.

Three committees completed work March 27-28 on bills to provide most of the $800 million in aid that Bush sought for Nicaragua and Panama. But the key measure, a supplemental appropriations bill (HR 4404), encountered a snag on March 29 when the House had a scheduling conflict and quit for the week without taking it up.

House Speaker Thomas S. Foley, D-Wash., had pressed for rapid action on the bill after Bush began lobbying intensively for it.

As usual, the path could be rockier in the Senate, which usually turns supplemental appropriations bills into grab bags of special-interest provisions.

If it breezes through the House on April 3, as expected, the Nicaragua and Panama aid package will face its first significant Senate opposition in the person of Patrick J. Leahy, D-Vt., chairman of the Appropriations Subcommittee on Foreign Operations. Leahy has criticized as excessive the $800 million that Bush wants for the two countries, and he has vowed to try to switch a substantial part of the money to Eastern Europe.

Leahy has picked up little vocal support, however, so it is doubtful that he will be able to carry out his threat to slash the Panama-Nicaragua aid.

In addition to winning House committee approval in a money bill, the Nicaragua and Panama package received the endorsement of the two congressional committees that are supposed to be responsible for foreign policy. Writing an omnibus foreign aid authorization measure for fiscal 1990-91, the House Foreign Affairs Committee on March 27 approved all but $30 million of the $500 million that Bush sought for Panama, and it added $40 million to his $300 million request for Nicaragua. The committee also voted $579 million in fiscal 1991 aid for Eastern Europe, nearly twice what Bush requested.

The Senate Foreign Relations Committee followed suit on March 28, approving a 1990 supplemental authorization bill with most of Bush's request for Nicaragua and Panama.

Unlike the spending measure, neither authorization bill is assured of becoming law. Most recent foreign aid authorization bills have died in the Senate, where the Foreign Relations Committee has steadily lost political clout to the Appropriations panel.

Along with Bush's intense lobbying, the Nicaragua and Panama appropriations package benefited from a decision by Democrats not to use it as a platform for debate over aid to El Salvador. Democrats in both chambers had talked of offering amendments to the supplemental package to cut military aid to the Salvadoran government. But that talk diminished after Secretary of State James A. Baker III asked for a delay so he could try to work out a "bipartisan compromise."

BOXSCORE

Bill: Foreign aid — fiscal 1990 supplemental appropriations (HR 4404); fiscal 1990-91 authorization (unnumbered).

Latest action: Appropriations: House Appropriations Committee markup March 27; authorizations: House Foreign Affairs markup March 27-29, Senate Foreign Relations markup March 28.

Next likely action: House floor.

Reference: Supplemental, Weekly Report pp. 1011, 928; Eastern Europe, p. 1008; El Salvador, p. 1009; Israel housing aid, pp. 931, 539; Moscow Embassy, pp. 931, 611; authorization bill, 1989 Weekly Report p. 1705.

Complex Process

Bush's straightforward request for emergency and long-term economic aid to Nicaragua and Panama has become complicated. Each of the three committees that has worked on the request has put its own stamp on it.

For Nicaragua, Bush sought $300 million in aid, most of it to stimulate the economy after opposition leader Violeta Chamorro takes office on April 25. Chamorro, with U.S. backing, won elections Feb. 25 over the leftist Sandinistas, who have ruled since 1979.

The House appropriators approved Bush's $300 million program without major change. As requested, the bill would set aside $30 million to demobilize and resettle the U.S.-backed contras, many of whom have returned to Nicaragua from neighboring Honduras with their weapons.

As drafted by House Appropriations on March 27, the bill would also cut $80 million from Bush's $500 million Panama request. The administration had already accepted $30 million of the cut; under a previous agreement between Congress and the State Department, the money is to be spent in Africa.

House Foreign Affairs took a somewhat different tack, approving all of the Panama aid except for the $30 million shifted to Africa. Foreign Affairs also backed the $300 million for Nicaragua but added $40 million to help repatriate refugees other than the contras.

By John Felton

Upping the Ante for Eastern Europe

Solarz

Overriding a token protest by Republicans, the House Foreign Affairs Committee on March 28 approved substantially more aid for Eastern Europe than President Bush requested. But that panel's add-ons were minor compared with a bill being prepared by Democrats on the counterpart Senate Foreign Relations Committee.

Foreign Affairs adopted an amendment authorizing $422.5 million for Eastern Europe assistance in fiscal 1991, on top of $156.5 million in authorizations left over from an aid bill Congress passed last year for Poland and Hungary. That total of $579 million is nearly twice the $300 million that Bush asked Congress to approve for fiscal 1990. *(Weekly Report p. 756)*

The committee approved another $140 million for off-budget loan guarantees that the president did not seek.

Foreign Relations Democrats have been planning an Eastern European aid bill totaling about $2 billion. More than half that amount, however, would be a long-term commitment to a new international development bank for the region. The House committee did not include that item in its bill because it does not have jurisdiction over development banks.

Congress last fall approved a bill (HR 3402 — PL 101-179) authorizing $738 million over three years for aid to Poland and Hungary. The Foreign Affairs panel estimated that $156.5 million of that amount remains available for fiscal 1991. *(1989 Weekly Report p. 3256)*

Bush in January asked Congress to approve a total of $300 million in aid for all Eastern European countries in fiscal 1990 — including the carryover funding.

In drafting a new 1991 authorization bill, Foreign Affairs Democrats initially included a $334 million total for Eastern Europe — a relatively modest boost of $34 million over Bush's request. But Stephen J. Solarz, D-N.Y., led an effort to provide even more.

Solarz' campaign produced a general agreement among Democrats to nearly double Bush's request to $579 million. The panel on March 28 approved, by voice vote, a Solarz-sponsored amendment providing that sum.

Among the amounts in the committee bill were: $175 million to promote private economic development; $100 million for environmental cleanup; $80 million for programs such as training of businessmen, scholarships and medical aid; $65 million for housing; and $20 million to support "democratic institutions" such as political parties and labor unions.

Bush had wanted Congress to approve merely an overall amount, giving him total discretion to determine how much went for specific programs in individual countries. The Foreign Affairs bill contains no allocations for countries but does break the bill into programs. However, the president could transfer money among the programs by giving Congress 15 days' advance notice.

While a central purpose of U.S. aid is to promote capitalism, some of the money could be used to help state-run corporations make the transition to private ownership.

The committee bill would make Czechoslovakia, as well as Poland and Hungary, automatically eligible for aid. The president could let other countries in Eastern Europe qualify for aid by reporting to Congress that they have taken steps toward political pluralism and economic reform, including holding free elections and respecting human rights.

The Democrats' original bill also made Yugoslavia eligible for aid, even though it technically is not considered a part of Eastern Europe. Citing ethnic unrest and human rights abuses in Yugoslavia, William S. Broomfield, R-Mich., moved to delete that provision, calling it "disgusting." Broomfield eventually settled for a compromise making Yugoslavia eligible for aid but giving the president broad discretion to suspend the aid.

The Foreign Affairs bill makes no mention of the Soviet Union as a possible recipient of U.S. aid. House Majority Leader Richard A. Gephardt, D-Mo., has advocated limited U.S. assistance for the Soviet Union. And some versions of the Foreign Relations Committee bill would give the president discretion to make Moscow eligible for the same aid programs as Eastern Europe.

In a repeat of last year's debate over Eastern Europe, Foreign Affairs Democrats insisted they were taking the initiative because Bush has not been assertive enough in supporting the former Soviet allies who have broken with communism and embraced democracy and capitalism.

Rather than challenge the Democrats head-on, Republicans tried ridicule. Broomfield, the ranking Republican, offered an amendment doubling the Democrats' amounts. Mocking the Democrats' criticism of Bush as too timid, Broomfield said the panel "could rightly be criticized for acting too timidly" if it adopted the amounts proposed by the majority. Having made his point, Broomfield withdrew his amendment. The panel then adopted Solarz' language by voice vote, with most Republicans silent.

—John Felton

Senate Foreign Relations approved the same $470 million for Panama and the full $300 million for Nicaragua.

Over administration objections, all three bills stipulate that the $30 million for contra resettlement be channeled through a "verification commission" run by the United Nations and the Organization of American States. Opponents of the contras feared that the administration might use the money merely to extend a current program to keep the guerrillas intact.

The State Department had wanted no strings on how the $30 million would be spent. In a concession to that view, the three bills would allow the president flexibility to spend the money as he sees fit if he notifies Congress 15 days in advance.

Some Senate conservatives attacked a provision in all three bills that would allow resettlement aid only for contras who agree to lay down their arms.

During Foreign Relations action, Jesse Helms, R-N.C., said the contras

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"need their weapons for self-protection ... because they know that [outgoing President Daniel] Ortega is passing out machine guns and everything else like they were going out of style."

Foreign Relations rejected a Helms motion to delete the entire $30 million.

Most members said contra demobilization is now largely out of U.S. hands. A major contra faction on March 23 signed an agreement with Chamorro's representatives promising to demobilize by April 20. On March 28, the incoming Chamorro government and the outgoing Sandinista government signed a broader accord, providing for complete transfer of political and military power once Chamorro takes office. That agreement appears to guarantee Chamorro control over military and police forces, both now run by the Sandinistas.

Other Aid Issues

As expected, House Appropriations and Foreign Affairs and the Senate Foreign Relations panels used the supplemental legislation to address foreign aid issues in addition to Panama and Nicaragua:

• **Soviet Jews.** With virtually no debate, all three committees added a provision, sought by Israel, that would allow the United States to guarantee $400 million in private loans to build housing for new Jewish refugees from the Soviet Union. The loan guarantees would be off budget and would not count toward the deficit.

The only issue any of the panels debated was whether Israel would have to pay anything for the guarantees. Under standard procedures applied to all other countries, Israel would have to pay a one-time initial fee equal to one-half of 1 percent of the face value of the loans, or $2 million in this case. Israel would also have to pay an annual service fee of one-fourth of 1 percent ($1 million). Both fees would cover management costs and the prospect of a default.

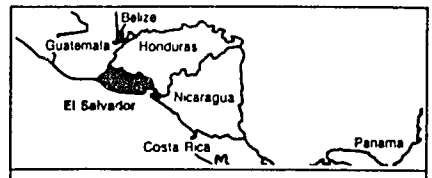
Some Foreign Affairs members argued that those fees would be excessive for Israel, which has never defaulted on an international loan.

Foreign Affairs and Foreign Relations voted to cut the fee for Israel. Under the Foreign Affairs bill, Israel would pay half the standard initial fee (or $1 million) and an annual service fee of no more than $150,000. The Foreign Relations bill would limit Israel's payment to the initial fee.

The House Appropriations bill left the issue up to the administration.

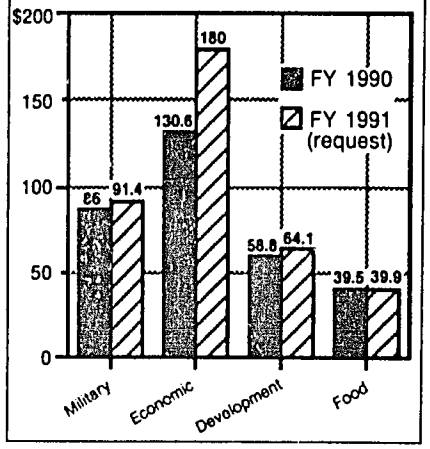
Looking for Salvador Deal

To head off growing concern on Capitol Hill about events in El Salvador, Secretary of State James A. Baker III hopes to negotiate a bipartisan policy agreement similar to last year's accord on Nicaragua. But Baker appears preoccupied with other foreign policy issues, and it is unclear whether he will be able to strike a deal with Congress soon.



El Salvador Aid Figures

(In millions of dollars)



BARBARA SASSA-DANIELS

Democrats in both chambers have been gathering support for legislation suspending 50 percent or more of aid to the Salvadoran government. Such a move would have two goals: forcing the government and leftist guerrillas back to the bargaining table and expressing outrage at the murder in San Salvador last November of six Jesuit priests and two women.

House Democratic leaders agreed on March 27 to delay action until Baker has had a chance to make his case for an agreement that avoids what administration officials fear would be a precipitous aid cutoff. *(Earlier aid, 1989 Weekly Report p. 469)*

Democrats in the Senate, meanwhile, have failed to agree on a unified approach to the aid issue, and they appear to have left the initiative to their House colleagues.

"It would seem to me that the executive and legislative branches in the two parties could find a way to come together on how we move in the future with respect to El Salvador," Baker told a House Appropriations subcommittee on March 1.

But Baker has not had time to spend on Capitol Hill discussing El Salvador. Aides said he may try during the week of April 2. It is unlikely, however, that he will be able to reach agreement before Congress leaves for its Easter recess at the end of the week. Baker will be busy with other matters as well, including meetings April 4-6 in Washington with Soviet Foreign Minister Eduard A. Shevardnadze on the full range of superpower issues.

Congress could consider El Salvador on two bills: a fiscal 1990 supplemental appropriations measure (HR 4404) centering on new aid for Nicaragua and Panama, and an omnibus foreign aid authorization bill before the House Foreign Affairs Committee.

House Democrats decided not to wage a battle over El Salvador on the supplemental. However, they agreed to reconsider that when the measure goes to conference with the Senate, depending on the talks with Baker.

In the meantime, House Foreign Affairs on March 29 completed work on its aid bill but left open the possibility of El Salvador amendments later.

Members and aides in both chambers said the El Salvador legislation with the most support among Democrats is a proposal (S 2125) introduced on Feb. 8 by Sen. Christopher J. Dodd, D-Conn., and several colleagues.

Dodd would suspend 50 percent of fiscal 1990 U.S. military aid for El Salvador unless the guerrillas refused to participate in negotiations or accept the mediation of the U.N. secretary general, or if the president certified to Congress that the military aid was needed to counter a guerrilla military offensive that threatened the government.

—*John Felton*

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Of the three committees, only Foreign Relations chose to address the sensitive issue of whether any of the housing might be built in the territories Israel occupied during the 1967 war. The panel said the loan guarantees would have to follow administration policies stipulating that Israel cannot use U.S. aid in the territories.

The House Appropriations and Foreign Affairs bills would also allocate $5 million in direct grants for refugee programs in Israel. That is in addition to $25 million in grants Congress has voted annually in recent years.

• **Africa aid.** The bills would send to Africa the $30 million the administration had intended for Panama. But they differed over where it would go.

The House appropriators allocated $10 million for Namibia, which recently won independence from South Africa; $10 million for aid to groups promoting democracy and peaceful negotiations in South Africa; $2.5 million each for economic aid to Mozambique and Zambia; and $5 million for U.S. development programs in sub-Saharan Africa.

House Foreign Affairs earmarked $10 million for Namibia, $10 million for democratic groups in South Africa and $10 million for development programs in sub-Saharan Africa.

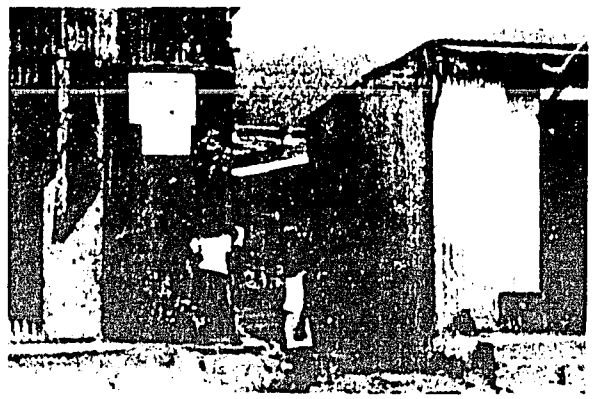
Senate Foreign Relations also earmarked $10 million for Namibia but set aside all of the remaining $20 million for development in sub-Saharan Africa.

• **Refugees.** All three bills approved Bush's request for a $70 million supplemental appropriation in fiscal 1990 to handle the increased flow of refugees into the United States, most from the Soviet Union. The House Appropriations bill also included $25 million for "emergency" refugee aid overseas.

• **Haiti, Caribbean.** The House Foreign Affairs and Appropriations bills also included aid for Haiti and the island nations of the Caribbean.

Recognizing the recent transfer of power in Haiti from a military to a civilian (if unelected) government, Foreign Affairs voted $20 million in aid. The money would finance imports of supplies to keep Haiti's troubled economy running, and up to $5 million could be used to plan and run an election. The spending bill would allow $10 million for development aid programs in Haiti.

Both bills allocated $20 million for Caribbean nations, $5 million of it for those in the Eastern Caribbean.



JOHN FELTON

On track: $300 million to help rebuild Nicaragua.

Fiscal 1991 Bill

Hoping to get a head start on the legislative process, House Foreign Affairs spent March 28-29 working on a full-scale foreign aid authorization bill for fiscal 1991. Chairman Dante B. Fascell, D-Fla., said the bill will be coupled with the committee's fiscal 1990 supplemental for Nicaragua, Panama and other nations.

Fascell admitted that putting the bill into law will be difficult; Congress has not enacted an omnibus foreign aid authorization bill since 1985. "We're going to try our hardest," he said. Referring to the Senate, which blocked other bills in recent years, he said: "If it doesn't happen, it won't be our fault."

The bill would enact most 1991 provisions of the foreign aid authority bill (HR 2655) that passed the House last year but died in the Senate.

The major focus of committee efforts was expanded aid for Eastern Europe. The panel voted to nearly double the $300 million that Bush requested in fiscal 1991 for the countries of the region that have broken with the Soviet bloc.

Other major issues:

• **Moscow embassy.** The panel rebuffed a Bush proposal to rebuild from scratch the bug-riddled U.S. Embassy in Moscow. With both House committees that have jurisdiction over the issue opposed to the plan, the administration's only hope for support this year is in the Senate.

On a 22-17 vote, Foreign Affairs adopted an amendment that would force Bush to await U.S.-Soviet negotiations on embassy properties before deciding what to do with the Moscow facility. Bush wanted $270 million in fiscal 1991 to tear down the embassy.

Sponsor Lee H. Hamilton, D-Ind., argued that his amendment would "keep open other options." Some members of Congress favor building a secure annex next to the embassy or tearing down and rebuilding only the top three floors of the building.

Hamilton's provision would authorize the $270 million but would force the administration to get the committee's approval before spending any of it.

The panel also agreed to increase the authorization from $270 million to $300 million to account for inflation.

• **Nicaragua.** Approving a request by Bush, the committee included $200 million for fiscal 1991 aid to Nicaragua. This money is in addition to Bush's $300 million for fiscal 1990.

• **Africa aid.** Without debate, the committee adopted an amendment promoted by the Congressional Black Caucus to authorize $1 billion in fiscal 1991 for development aid in Africa. That would be nearly twice the current $570 million appropriation.

• **Contingency fund.** In a small concession to Secretary of State Baker, the committee included a $100 million fund that the administration could use to aid "emerging democracies." Baker has lobbied for administration flexibility to spend foreign aid funds. His campaign has borne little fruit, but the committee provision would give him at least $100 million with few congressional restrictions.

• **Family planning.** Foreign Affairs voted twice to rebuff anti-abortion policies stemming from the Reagan administration and now embraced by the Bush administration. Those policies, in effect, bar any U.S. contributions to international family-planning agencies that provide abortion-related services or that work in China, which is accused of practicing forced abortion.

First, on an 8-21 vote, the panel refused to derail an amendment by Peter H. Kostmayer, D-Pa., to provide $500,000 each for the U.N. Population Fund and the International Planned Parenthood Federation to work in Romania. The administration opposes aiding either group. The panel adopted Kostmayer's amendment by voice vote.

Later, by 17-10, the committee approved a broader Kostmayer amendment to repeal the basic ban on U.S. support of International Planned Parenthood because some of its affiliates provide abortion-related services.

Christopher H. Smith, R-N.J., an ardent opponent of the Kostmayer amendments, warned that "this bill is dead" because Bush will veto it if those provisions remain intact. ■

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Inter-American Dialogue
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Latin America and the new winds

Abraham F. Lowenthal, a professor of international relations at the University of Southern California, is executive director of the Inter-American Dialogue, a conclave of Western Hemisphere leaders. He wrote this article for The Herald.

By ABRAHAM F. LOWENTHAL

"We recognize and welcome the new winds flowing from the Soviet Union and Eastern Europe, but we don't want the winds outside to turn into a cyclone that could hurt Mexico and Latin America," President Carlos Salinas de Gotari of Mexico recently explained to the executive committee of the Inter-American Dialogue. His was an unusual perspective on the exciting changes taking place within what until very recently we called the Communist Bloc.

As President Salinas observed, the dramatic developments in Eastern Europe are so fascinating for elites and government leaders in the United States, Western Europe and Japan that they may well deflect attention and resources from Latin America at a critical moment. Salinas reported that Mexican Foreign Minister Pedro Aspe had that very day returned from Japan to report that the $10 billion fund the Japanese government had previously reserved for debt relief and developmental aid for Latin America had just been reduced to $4.1 billion, half of that sum being available for Mexico alone and half for the rest of Latin America and the Caribbean.

A similar trend may well occur, Salinas forecast, with regard to public sector resources from Western Europe and from the United States. Perhaps even more important, private funds from the industrial countries may be attracted to the new Eastern European markets, and badly needed foreign investment in Latin America may consequently dry up. Latin American nations, including Mexico, that have based their economic strategies for the 1990s on restructuring their economies to attract renewed flows of external finance may find their calculations threatened by this new turn of events.

It is by no means clear yet how Latin America and the Caribbean will be affected by all the sea-changes occurring in the international scene: the apparent end of the Cold War as the central organizing fact of international relations, the diffusion of power to new centers, the globalization of the world economy and the changing agenda of world affairs — especially the rise to prominence of such "intermestic" issues as narcotics, migration and the environment.

The distraction of attention and resources toward Eastern Europe is readily apparent now, for instance, but this particular impact may not last. The opportunities in Eastern Europe may turn out to be more complex and uncertain than they seem in the first blush of the region's openings, and some Latin American countries may turn out to offer more solid prospects for investment and trade.

A second consequence of the changing global scenario that may already be occurring is to remove some of the inhibitions previously restraining the interventionist impulses of the United States in the Western Hemisphere. Some Latin American observers see a series of recent events — the Panama invasion, the dispatch of troops to El Salvador, the Coast Guard's shelling of a Cuban ship in international waters and the Navy's deployment of an aircraft carrier off the coast of Colombia — as signs of Washington's potential reversion to the habits of the 1920s.

A third possible effect of the changing global scene, quite the opposite in its consequences for Latin America, would be to allow the United States to be more relaxed about different social, economic and political approaches that evolve in Latin America, now that they are no longer credibly linked to alleged Soviet global designs. Had Brazil elected the Marxist labor leader Luiz Ignacio da Silva (Lula), who got 47 percent of the votes, Washington might have accepted that development far more readily than would have been the case at any other time in the last 40 years. It may also have been easier for the United States to have lived with a Sandinista victory, if that had occurred last month, than it would have been before the crumbling of the Soviet empire.

Finally, Latin America could be significantly affected by the apparent emergence of regional geo-economic units: the European community and the Eastern European nations, Japan and the booming economies of East Asia and the increasing silent integration of the economies of Canada, Mexico and the Caribbean islands with that of the United States. It is not yet certain, however, whether Latin America will be incorporated into some kind of Western Hemisphere community, whether individual Latin American nations can gain favorable access to such expanding markets and sources of capital and technology, or whether some or all of Latin America will be frozen out of a world of blocs.

It is too early to be sure whether the influence of long-settled global patterns will create new opportunities for Latin America, or whether instead it will leave Latin America the victim of global neglect, malign in effect if not in intent. Latin America and the United States may be freed by the relaxation of Cold War pressures to forge more effective partnerships, but Latin America could be left instead without partners, increasingly marginal in a dynamic post-Malta world that has left it behind. Much will depend on how creatively the governments of Latin America and the United States respond to a rapidly changing world.

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THE WORLD

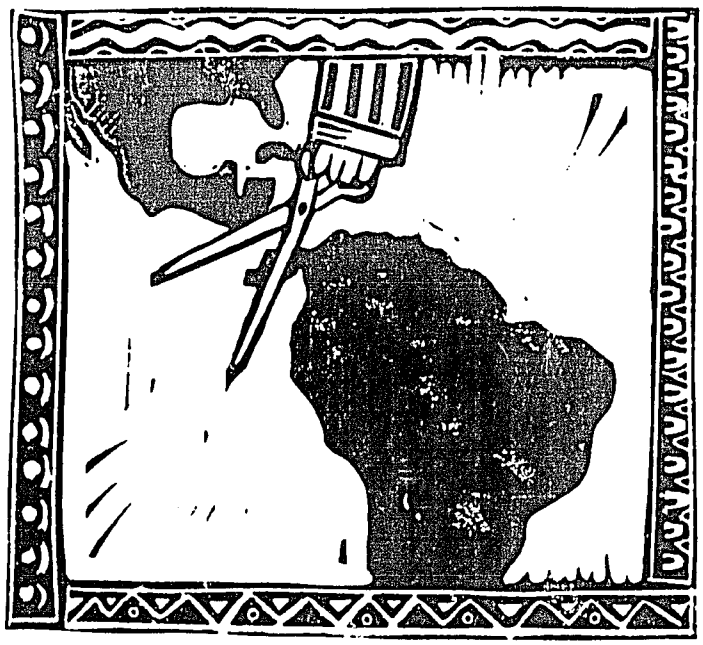
LATIN AMERICA ALONE?

By Mark Falcoff

WHILE LATIN AMERICA has not been the central theater of U.S. foreign-policy concern since the 1920s, it has occupied a firm, well-established place in Washington's overall strategic vision for more than 50 years. On one hand, the predictable political and military support for American interests offered by our closest neighbors freed the United States to pursue ambitious plans in Western Europe, the Far East, and elsewhere during World War II and well into the 1960s. On the other hand, the apparent complementarity of American and Latin American economies—characterized by the exchange of manufactured goods and financial services for raw materials—provided an additional, concrete dimension of mutual interest.

While there were always differences of opinion between the two halves of the Western hemisphere—over specific political and trade issues, immigration, even cultural matters—in general, most of the world (including the Latins themselves) regarded U.S. hegemony within the region as a fact of life, and not necessarily a bad one. Even the Soviets subscribed to the notion of "geographical fatalism": that the 20-odd republics of the Western hemisphere lay irremediably within the American sphere of influence. They—and we—were surprised by the Castro revolution in Cuba; since then, nothing has been quite the same. While Havana has been largely unsuccessful in its attempts to export its system elsewhere, it did at least successfully challenge Washington's claim to leadership in the region and open a space for other Latin American countries to pursue foreign policies more hostile to—or, as they would put it, independent of—U.S. interests.

Big changes in the geopolitical order, as in nature, often occur slowly. Years pass before publicists and diplomats admit they have happened at all. At one time, it was possible to argue that the United States and Latin America shared a common historical destiny and a certain community of interest. Today, the question is whether and when to finally acknowledge what is implicit in the day-to-day conduct of policy—namely, that the two halves of the hemisphere have split and are drifting apart, with no hope of reversing course. Instead of talking about "neglect" of Latin America or the need for a North-South dialogue, perhaps we should recognize that we are heading for a complex multipolarity in which bilateral relationships will be sorted out on a purely issue-to-issue basis. With the end of the Cold War, Washington will be free to disengage from the region and think about problems at home or elsewhere.



The question is whether and when to finally acknowledge ... that the two halves of the hemisphere have split and are drifting apart....

What are these unacknowledged changes that have so altered the regional environment? For one thing, most of the republics are now substantially nonaligned, which means that though none of them (with the exception of Cuba) have taken the trouble to revoke their membership in the Inter-American Treaty of Reciprocal Assistance of 1947 (the Rio Pact), they are no longer politico-military allies of the United States, but are neutrals. The fact that they may claim otherwise at any particular moment (when, for example, requesting new resources from the United States) is not evidence to the contrary. Nor is the persistence of military exchanges, troop ship visits, and joint maneuvers. These things merely attest to the power of inertia and the capacity for survival of institutions that have lost their original rationale.

Today, on no hard political issue requiring joint actions between, say, the United States and Latin America on one hand, and some Latin American country and the Soviet Union on the other, could Washington expect to win a vote within the Organization of American States (OAS) or receive decisive support from the Latin American bloc at the United Nations. In fact, at a recent conclave in Lima, the presidents of Mexico, Argentina, Colombia, Peru, Uruguay, Vene-

(Continued on page 13)

Mark Falcoff is a resident fellow at the American Enterprise Institute.

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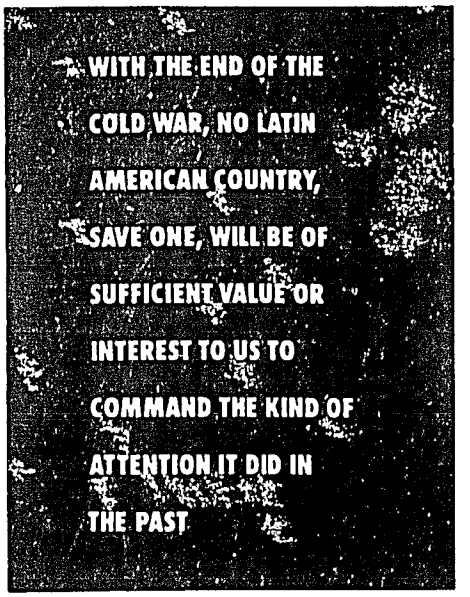
(Continued from page 11)
zuela, and Brazil formally endorsed the re-admission of Moscow's leading regional ally, Cuba, back into the OAS, from which it was expelled by almost unanimous vote more than 25 years ago. Think about it: if not only nonalignment but also specific alignment with an extra-hemispheric power are acceptable within the inter-American community, then what possible meaning could the notion of hemispheric political solidarity have?

An even bigger challenge to the old system is the decline of economic complementarity. Under that heading, Latin America's relative importance to the United States has been steadily dropping for many years. For example, in 1965 Latin America represented 19.1 percent of all U.S. direct investment abroad; today (1985 figures) the figure stands at 12.7 percent. The United States is also considerably less dependent on Latin American imports than it was. In 1965, 17.3 percent of all U.S. overseas purchases came from the area; today (1985) we derive only 12.6 percent. Though still an important market for U.S. exports, it is less so than formerly. Again by way of comparison, in 1965 Latin America represented 13.7 percent of all overseas sales; today, despite record U.S. trade deficits, it is 13.1 percent, slightly less than what it was 20 years ago.[1] At this point, financial services are the most important activity, though this is unlikely to remain so for long as individual debtors gradually default and U.S. banks write off ever-larger portions of their Latin American debt and decline to issue new loans.

Though many Latin American leaders have recently discarded nationalist rhetoric and called for new investment from the United States (and elsewhere), acts of punitive nationalization and discriminatory tax and exchange policies in the 1960s and 1970s have already taken their toll, driving away much foreign capital and destroying business confidence that will take decades to restore. Populist-statist economic policies are also being reversed, but for many countries this comes too late: too much local capital has fled to safer havens in the United States, Western Europe, and the Bahamas. According to figures recently released by Morgan Guaranty Trust Company, the combined assets abroad of Mexico, Venezuela, Argentina, and Brazil amounted to a whopping $222 billion dollars at the end of 1987—good news for U.S. capital markets, no doubt, but certainly not to U.S. exporters.



No Shared Assumptions

Latin America will continue to affect the United States in ways that can only be described as problematic, particularly in their export of drugs or illegal immigrants. These issues will continue to occupy a certain amount of policy space in Washington and in state capitals, particularly in the Southwest and Florida. But there is a crucial difference today: the old security-plus-investments rationale was based on the widely shared assumption that there were explicit trade-offs in the relationship, and that in the medium and even short run we could expect outcomes that could justify the expenditure of resources—even very large resources (the Alliance for Progress is the outstanding example). In present circumstances, what is the dollar figure the United States must be prepared to spend to convince every Bolivian and Colombian coca farmer to plant tomatoes instead of the deadly leaf, when the total amount of trade involved is estimated *conservatively* at between $10 and $12 billion a year for those two countries alone? And even more interesting, what is the due bill to Washington for the economic prosperity of the entire region, a prosperity that would presumably convince people who are leaving for the United States to stay at home? Even if we knew, and even if we could afford it, would we *want* to become a party to blackmail on such a cosmic scale? The questions answer themselves. There will be no new hemispheric pact. With the end of the Cold War, no Latin American country, save one, will be of sufficient value or interest to us to command the kind of attention it did in the past as part of a larger strategic equation. The exception, of course, is Mexico, with whom we share a border. For the rest, each will have to cut its own deal with the United States (and the rest of the world) as best it can. Let us wish them well. What is certain is that now, for the first time, our relationship with each of the 20-odd republics will have to pay its own way.

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[1] Figures from *Statistical Abstract of the United States*, various volumes, and *Yearbook*, International Monetary Fund, Department of Trade Statistics, various issues.

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NORTH AMERICA TRADE PACT: A GOOD IDEA?

by Patrick G. Marshall

The U.S.-Canada free-trade pact, which took effect early this year, may serve as a model for future bilateral pacts with Mexico, the Caribbean and Central America. Ultimately, such pacts could lead to the formation of a North American trading bloc. Some say expanding the U.S.-Canada pact to include Latin American countries is not politically feasible and that it wouldn't benefit the U.S. economy anyway. But economic developments in Europe and the Far East could force the United States to move in this direction.

When President Reagan announced the beginning of negotiations for a free-trade agreement with Canada in 1985, he envisioned it as a first step in the formation of a North American trading bloc that would stretch from "the Yukon to the Yucatan." That first step was completed on Jan. 2, 1988, with the signing of the U.S.-Canada Free Trade Agreement. The pact went into effect a year later, after it was approved by both countries' governments.*

The free-trade agreement puts the countries that comprise the largest single trading relationship in the world — with more than $147 billion in two-way trade in 1988 — into an unprecedented partnership. Under the pact, all tariffs on U.S.-Canadian trade will be removed by 1998. The pact also liberalizes trade

*The U.S.-Canada pact was the second U.S. bilateral free-trade agreement. The first, a much less comprehensive one with Israel, was signed in 1985.

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in services and agriculture, areas not yet covered by multilateral trade pacts, and it provides a mechanism for resolving trade disputes between the two countries.

As Reagan predicted, the U.S.-Canadian agreement has been offered as a model for other regional trade pacts. On Nov. 22, after a meeting with Mexican President Carlos Salinas de Gotari, Commerce Secretary Robert A. Mosbacher praised Mexico's recent economic reforms and said the United States and Mexico "are moving closer and closer to what may be a free trading zone between our two countries." The next day, Mosbacher backed down on his statement — it is "premature to talk about an overall comprehensive agreement," he said — and Salinas said he strongly opposed the idea of a U.S.-Mexican free-trade zone because the partnership would be too unequal.[1] But talk of such an arrangement is still alive in Washington. There is currently legislation before Congress, sponsored by Sen. Phil Gramm, R-Texas, calling for the negotiation of free-trade agreements with Mexico and countries in Central America and the Caribbean.

Two developments in the international arena have increased America's interest in bilateral trade agreements. First, the United States has encountered great resistance in its efforts to remove multilateral trade barriers. Specifically, the United States wants to lift such barriers in services and agricultural products under the auspices of the General Agreement on Tariffs and Trade (GATT), the main international agreement that governs trade practices. Past negotiations had succeeded in establishing rules for international trade in manufactured goods. In 1986, the United States initiated a new round of talks — dubbed the Uruguay Round — in an effort to include trade in services and agricultural products, and to address the role of government subsidies as well.

Second, the approach of 1992, the year in which the countries of the European Community (EC) are to remove all remaining internal trade barriers, has caused non-European countries to consider forming their own trading blocs as a kind of self-defense. They fear that EC-92, as it is called, could make it harder to gain access to the unified European market, and some believe they need to form their own trading blocs to ensure markets for their goods.

U.S. policy makers have made it clear that the U.S.-Canadian pact was in part meant as a signal to both the European Community and other countries involved in GATT negotiations that if the GATT negotiations fail, the United States may turn to bilateral agreements. "In essence, the United States has been using bilateralism as both a carrot and a stick to further the process of trade liberalization," writes Jeffrey Schott, an analyst at the Institute for International Economics in Washington, D.C.[2] The carrot has been the prospect of liberalized trade terms offered in the free-trade agreements, which may be extended multilaterally; the stick has been the threat to pursue such policies solely on a bilateral basis.

Despite the seeming drift toward further bilateral trade agreements, there still are nagging questions as to whether they are the way to go. For one thing, it is not yet clear that all that much has been accomplished by the U.S.-Canadian agreement. And, say critics, similar agreements with Mexico and countries in the Caribbean and Central America, with their dramatically different economies, would be much harder to work out.

Finally, there are worries that such bilateral agreements may not be in the best interests of free trade at all. Critics note that much of the value of bilateral agreements results from the fact that other countries are excluded from the benefits of the deal. For example, Canada was willing to make certain concessions to gain less restricted access to U.S. markets, but what would Canada think if the United States then turned around and granted other countries the same access, thus diluting the advantage of Canada's position? Subsequent bilateral agreements, therefore, could become a source of trade friction.

The Bush administration has indicated that it prefers a multilateral rather than a bilateral approach to trade. "Clearly our first priority is the Uruguay Round," says Ann Hughes, deputy assistant secretary of commerce for the Western Hemisphere. "We would prefer to see removal of barriers on a multilateral approach." But if the Uruguay Round doesn't produce the hoped-for improvements, things could change quickly. "Other countries may not be willing to go as far and fast as we might want to go," says Hughes. "After the Uruguay Round, if that's the case, then we can look at bilateral agreements."

The Uruguay Round is scheduled to conclude by the end of 1990, and, at this point, it seems unlikely that the negotiations will produce the hoped-for agreements. As a result, economists and policy makers are now watching the progress of the U.S.-Canada pact closely and are examining with equal interest the prospects for such pacts with Latin American countries.

The U.S.-Canada pact: Not-quite-free trade

As a precedent-setting document, the U.S.-Canada Free Trade Agreement is an important accomplishment. Where GATT aims at the reduction of tariffs, the U.S.-Canada pact completely eliminates them between the world's two largest trading partners. Where GATT is silent on services, agriculture and investments, the U.S.-Canada agreement establishes new rules for reciprocal liberalization of policies. The pact also eliminates a host of administrative impediments to trade. (*For details on the trade agreement, see p. 684.*)

But while the agreement is important for the

Terms of the U.S.-Canada Free-Trade Agreement

The U.S.-Canada Free-Trade Agreement reaffirms many of the trade provisions spelled out in the General Agreement on Tariffs and Trade (GATT). In addition, the pact breaks new ground by including provisions governing trade in agricultural products and services. Among other things, the agreement does the following:

- Eliminates all tariffs on U.S. and Canadian goods by 1998. Tariffs not eliminated immediately are to be phased out over five or 10 years, depending on the product. The agreement also allows for the tariff eliminations to be accelerated if both countries agree.
- Eliminates most import and export quotas and prohibits, with some exceptions, restrictions on import and export of energy products.
- Eliminates tariffs and export subsidies on agricultural products, including meat.
- Bars the use of product standards as trade barriers.
- Provides that service businesses will be able to operate across the border under the same rules as domestic service companies.
- Liberalizes Canadian laws affecting U.S. investment in Canada. Ensures that any future laws treat the other countries' investors the same as domestic investors. Eliminates performance requirements for foreign-controlled companies (such as requiring local purchase of materials).
- Exempts U.S. banks from Canadian laws limiting the size of banking assets in Canada held by foreign banks. Exempts U.S. banks from restrictions on foreign purchases of shares in government-regulated financial institutions.
- Lowers the threshold for foreign bidding for government procurement contracts. Either country's companies will now be allowed to bid on the other country's contracts that exceed $25,000 in value, instead of the previous threshold of $171,000.
- Establishes a binational commission to resolve disputes. Countries can still resort to countervailing duties, but complaints over such cases will be heard by a binational panel instead of by the courts.

precedents it sets, the actual benefits of the pact for the two countries are less certain. "I think that the [free-trade agreement] won't have major effects either way," says Canadian economist Brian Copeland, a professor at the University of British Columbia in Vancouver. "The measurable economic gain should be positive, but not very big."

Cutting tariffs on trade between the two countries is the most obvious benefit, but even there the gains may not be very large. For one thing, about 70 percent of the trade between the United States and Canada already receives duty-free treatment, so the actual impact of the tariff cuts will be relatively small. There will be a large impact only in those sectors where both tariffs and trade have been high, such as chemicals and machinery.

Nevertheless, eliminating tariffs will clearly help certain exporters, particularly American ones, because Canada's tariffs, at an average of 9-10 percent, have been among the highest of industrialized countries. By comparison, U.S. tariffs average only 4-5 percent. Although this means that Canadian exporters won't experience the windfall from a tariff cut that U.S. exporters do, the cuts are still important for Canada's economy. The United States absorbs about 80 percent of Canada's exports. (Canada buys only about 20 percent of total U.S. merchandise exports, a figure that still makes Canada America's largest export market.)

Indeed, most economists seem to agree that Canada stands to gain more from the trade pact than the United States does. Canada is gaining increased access to a market 10 times the size of its own domestic market, while U.S. companies are increasing their market access only by a fraction. But just as Canada has the most to gain, it will also have to bear the greatest burden of adjustment, because its businesses have been more heavily protected from competition and less used to operating in large markets. Some Canadian suppliers that have been doing business all along the heavily populated Canadian side of the border, for instance, will suddenly find themselves at a disadvantage to closer suppliers on the U.S. side.

Most U.S. businesses, on the other hand, accustomed as they are to operating in the immense U.S. market, will find little difference. On the U.S. side, "the U.S.-Canada agreement ... largely was a giant yawn. It just was not an issue," says Howard Lewis, vice president for international economic affairs of the U.S. National Association of Manufacturers.

The U.S.-Canada agreement would have had more of an effect on both sides of the border if the two countries had not excluded certain important areas from the agreement and put off dealing with others. The agreement, for example, while including services under its provisions, exempts several critical sectors, including transportation, telecommunications, medical services, legal services, child care and all government-provided health, education and social services.

And though Canada significantly loosened its tight regulations on foreign investment, several important sectors were left out there, too. "Substantial restrictions on foreign investment in the energy sector continue in force," notes the State Department's annual

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report on trade practices. "Canadians must own at least 51 percent of an individual uranium property when it comes into production. While any foreign firm may begin business in Canada, bid for leases, and explore for and develop oil and gas reserves, a Canadian ownership ratio of at least 50 percent is required before a consortium can receive an oil or gas production license on Canadian lands, including Canadian offshore areas." [3]

Another U.S. complaint is Canada's insistence on exempting so-called "cultural industries" from the trade agreement. Canada tightly controls foreign investment in such sectors as newspapers, film, television, book publishing and magazines. New investments will only be allowed on the condition that Canadians are given control of the venture within two years.

For their part, Canadians object to several exceptions to free trade that the United States insisted on retaining, especially U.S. restrictions on textiles produced in Canada and U.S. quotas on sugar.* The United States also insisted on grandfathering in the provisions of the 1920 Jones Act, which protects the U.S. shipping industry by requiring imports to the United States coming through U.S. ports to be carried by U.S. vessels. (Canada reserved the same right to protect its shipping industry, but Canadians prefer no restrictions at all. They believe the Jones Act hurts them more than it hurts Americans, because the Canadian shipping industry is more efficient and less in need of protection.)

In addition to these major areas of exception, the compromises both sides required have resulted in some pretty quirky restrictions. For example, Canadian subsidies on agricultural products shipped to the United States through West Coast ports will be eliminated, while subsidies on goods that move through Thunder Bay (on Lake Superior) will not. And Canadian controls on exports of unprocessed fish on the East Coast are not covered, while those on the West Coast are covered.

And the agreement left unresolved a whole list of trade irritants on both sides of the border. The State Department report, for example, complains that Canada refuses to give Canadian companies tax deductions for the cost of advertising in foreign broadcast media when the ads are directed primarily at Canadians. As the report dryly notes, "This negatively affects the operations of U.S. border television stations beaming programs into Canada." [4] Canada was also criticized for giving Canadian publications a lower postal rate than foreign publications. In April 1988, the State Department report says, the government announced that the subsidies — worth an estimated $225 million in Canadian dollars (about $192 million in U.S. dollars, at current exchange rates) — would remain in place for at least 5 years.

Given that so much was left out of the trade pact, continuing trade disputes between the United States and Canada are inevitable. In fact, according to Robert York, a policy analyst at the C. D. Howe Institute, a non-profit research organization in Toronto, they may even increase, at least temporarily. "There seems to be a rush of disputes now. It seems that all of a sudden we're really irritating each other on trade matters."

So far, 12 complaint actions have been filed under the pact's provisions. None of them has been fully resolved yet, though the first one is close to completion. It involves Canadian attempts to require all Pacific salmon and herring roe caught in Canadian waters to be landed in Canada prior to being sent to U.S. processing facilities. In the past, Canada had required all fish caught in Canadian waters to be processed in Canada, but the United States took the issue to GATT in 1986, and the organization ruled against Canada in March 1988. Canada responded in early 1989 with the landing rule, arguing that it was justified on grounds of conservation. The United States then submitted the new regulation to the bilateral trade commission established by the free-trade agreement. In early October, an investigative panel of the commission recommended that the Canadian regulation be ruled too extreme.

"The panel made a compromise," says York. "It recognized Canada's right to use conservation [as a reason to require landings]. . . . But they also recognized the U.S. case, that it did involve an undue cost on the part of American processors." York says the investigators believed Canada could require some, even most, landings be in Canada, but not 100 percent of them.

The commission itself has yet to decide on the panel's ruling but York says it is in both countries' interest to accept it. "It's the first case," he says, "and it would set a bad precedent not to." In fact, York puts great emphasis on the dispute-resolution mechanism itself. "The success or failure of the agreement at this point in time depends not on the economic merits, but on whether the dispute-settlement mechanism is able to contain disputes in a businesslike and objective manner, and whether or not we have to resort to retaliation," he says.

While York is encouraged by what he's seen so far of the dispute-resolution mechanism, others find it lacking. "Although the dispute-settlement panel can make binding decisions, what really is binding in this context?" asks economist Brian Copeland. "Suppose that the United States decides not to comply with a decision of the panel. According to the agreement, Canada then has two options: retaliation or abrogation. Given the relatively weak bargaining position in which Canada finds itself with respect to the United States, whether such options will be an effective deterrent is not clear." [5]

*The agreement does exempt Canadian food products containing up to 10 percent sugar from U.S. sugar restrictions.

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Unfinished business: The problem of subsidies

The most glaring weakness of the U.S.-Canada Free Trade Agreement is that it did not resolve the question of subsidies.* There was good reason to defer discussion of subsidies: The ideal solution, that of eliminating subsidies altogether, cannot be undertaken on a bilateral basis because it has such serious multilateral implications. After all, if Canada and the United States agreed to remove all subsidies, those previously subsidized industries would be at a serious disadvantage in competing with foreign firms that still receive subsidies. That's why both the United States and Canada agreed to put off dealing with the issue until after the Uruguay Round of GATT negotiations has a chance to deal with subsidies multilaterally.

In the meantime, however, subsidies represent one of the major obstacles to U.S.-Canada trade. Canadians have complained about high U.S. subsidies for grain products, particularly wheat, barley and oats. And, in fact, the free-trade agreement specifically allows Canada to continue restricting imports of those commodities until American subsidies are lowered to a level equal to or less than Canada's own price supports. The United States has several complaints of its own about Canadian subsidies. "The Canadians tend to concentrate their subsidies in areas where they think they have some competitive advantage, and that tends to be natural resources," says the Commerce Department's Ann Hughes. She says wood products and mining are among the primary beneficiaries of Canadian subsidies.

The major recourse for both countries in the event that it feels the other is unfairly subsidizing a product or industry is to impose a countervailing duty, a surcharge on the import intended to reflect the estimated value of the subsidy. If, because of subsidies or other factors, a product is being sold at below-market value, the importing country may impose an anti-dumping duty to bring the price up to market value.

Frequent recourse to countervailing and anti-dumping duties by the United States has irritated the Canadians. Just last summer, the United States imposed countervailing duties on steel rails and pork products. The U.S. threat to impose a countervailing duty on lumber caused Canada to impose its own 15 percent tax on lumber exports. In all, according to the Commerce Department, the United States currently has 38 anti-dumping duties and 17 countervailing duties in force against Canadian products.

One of the major obstacles to developing a subsidies policy, whether bilaterally or multilaterally, is that subsidies can be very hard to measure. In some cases, it is even hard to decide whether a given policy represents a subsidy or not. Recently, for example, some U.S. Commerce Department officials wanted to take action against Canada because they felt the government was using unemployment payments to subsidize its fishing industry. Canadian fishermen, who regularly worked only six months a year, paid the standard unemployment tax for those six months, but then collected unemployment for the other six months. The Commerce Department eventually decided this was not a subsidy.

Such uncertainties, however, caused great concern in Canada during the trade-agreement negotiations. "The Canadians were very concerned that the United States would question every manner of subsidy — including Canadian health care," says Pietro Nivola, a visiting fellow in governmental studies at the Brookings Institution in Washington, D.C. And, in fact, an argument could be made that Canada's national health-care system does amount to a subsidy for some industries. In the U.S. auto industry, for example, the automakers and their employees pay the health-care bills. Under Canada's national health-care system, the bills are paid for by all taxpayers. "It does appear that in the Canadian system the cost is spread through the entire population through the tax structure, whereas in the United States the cost is focused on those who are getting the benefits of the program, in this case the automobile industry," says Hughes. "You could, if you were of a mind, see some subsidy element there, especially since health costs tend to be about $300 to $400 a car." But, she adds, the United States has no intention of calling such subsidies into question. "I certainly can't predict the future, but I would be very surprised if any U.S. administration ever wanted to discuss that with the Canadians."

Nevertheless, the failure of the trade agreement to deal comprehensively with subsidies has some economists concerned about greater subsidies in the future. "If you get rid of tariffs, the governments that were protectionist before are still going to be protectionist, it's just that they've lost one of their options, which is to use tariffs or quotas," says Brian Copeland. "That means they'll look for something else. And you can accomplish almost exactly the same thing that you can accomplish with a tariff by using a subsidy, a purely domestic policy."

But other experts are more sanguine about the potential of subsidies being abused. "It's a lot harder to get the government to subsidize you than it is to impose a trade restriction," says Nivola. "One of the reasons why we have so much pressure for retaliatory trade restrictions in the United States is that beleaguered industries know they can't run to the government for subsidies." Hughes agrees: "There's a natural limiting factor, fortunately, on the spread of subsidies, and that is the budget problems that both countries have. You might be tempted, but can't afford it."

*The agreement did set up a working group to deal with the issue, which held its first formal meeting on Nov. 15. According to the Commerce Department's Ann Hughes, who heads the U.S. team, the process is expected to take five to seven years.

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Maquiladoras: Mexico's Free-Trade Zone

Since the early 1960s, Mexico has had an "export processing zone" along its border with the United States. Assembly plants within the zone, called *maquiladoras*, could import parts without paying the usual Mexican duties as long as the products were re-exported. And, unlike plants in the rest of Mexico, *maquiladora* plants could be 100 percent foreign-owned. The zone was made possible not just by Mexican government action, but by a 1963 U.S. law that allowed U.S. goods exported abroad for assembly to be reimported with duties assessed only on the value added abroad.

The program gradually picked up steam. In 1965 there were only 12 plants. By 1969 the number had grown to 108. In the 1970s a number of factors — primarily a strong U.S. dollar and increasing competition from the Far East — made the *maquiladora* program more attractive to U.S. firms. By 1979, there were about 540 plants employing more than 100,000 workers in the *maquiladora* zone. And today, the number may be three times as large.

The advantages for U.S. firms operating in the *maquiladora* zone are obvious: cheap labor (workers earn about 60 cents an hour) and very lax government regulations. Mexican environmental and work-place safety laws are much less demanding than those in the United States, which makes operating on the Mexican side of the border significantly less costly.

One reflection of the lack of oversight in the *maquiladora* zones is that nobody seems to have an accurate total of how many businesses now operate there. Current estimates range from 1,300 to 1,500 companies employing from 350,000 to 400,000 workers.

The *maquiladora* program has attracted a number of small- and medium-sized businesses, and some giants as well. According to economics Professors Philip Mirowski and Susan Helper, "By the late 1980s, most of the 100 largest U.S. manufacturing firms had at least one *maquila*." † One of those companies, General Motors, has become Mexico's largest employer.

U.S. firms aren't the only ones to take advantage of the *maquiladora* program. According to Mirowski and Helper, "Since 1986, Japan has become the second-largest foreign investor in Mexico, after the United States and just ahead of West Germany. Of the top 10 *maquilas* in Tijuana in 1988, four were Japanese, and their plants account for 45 percent of the employment of the top 10."

This development is a significant one for the United States. As Mirowski and Helper point out, "the statistics of the U.S.-Japan trade balance exclude products exported from Japanese *maquilas*, even though their Mexican content may be minimal." ††

How much benefit has Mexico actually gotten from the *maquiladora* program? Not as much as it might seem. "As of the late 1980s, 50,000 to 60,000 jobs per year were being created in *maquilas*," Mirowski and Helper write. "While far better than nothing, this figure represents less than 7 percent of the 900,000 new jobs per year that the World Bank estimates will be needed just to prevent the official unemployment rate of 20 percent from increasing. These jobs are often dangerous, involving toxic chemicals in plants with inadequate ventilation, or requiring workers to use machinery without safety devices." What's more, they write, "Linkages to the rest of the Mexican economy have been minimal; only about 2 percent of the components used by *maquilas* come from Mexican suppliers. Little technology has been transferred to Mexico; jobs are almost exclusively repetitive assembly work." ‡

Other critics of the program note that the benefits for the United States are limited almost completely to the owners of the companies taking advantage of the cheap labor. U.S. companies that move to the *maquiladora* zone take U.S. jobs with them. The *maquiladora* program has also been used for leverage even by U.S. companies that have not opted to set up operations there. According to Mark Anderson, an economist with the AFL-CIO, General Electric, during bargaining sessions in the Midwest, threatened to pick up and move across the border if the workers didn't agree to concessions.

Mirowski and Helper are hopeful that the *maquiladora* program may be put to better use. "Some improvements may be in the offing," they write. "Mexico is beginning to attract companies who see the country as a source of *permanent* cheap capacity, rather than as a place to set up fly-by-night plants whose operation is contingent on boom times." ‡‡

They cite Chrysler as an example. In 1985 the automaker opened a plant near Mexico City, far from the *maquiladora* zone. Even more important, Chrysler pays its workers a wage close to the Mexican manufacturing average, has provided job training and buys nearly half of its components from Mexican suppliers.

† *Philip Mirowski and Susan Helper, "Maquiladoras: Mexico's Tiger by the Tail?"* Challenge, *June 1989, p. 26.*

†† Ibid., *p. 27.*

‡ Ibid., *p. 29.*

‡‡ Ibid., *p. 29.*

There are some alternatives to an all-or-nothing treatment of subsidies that will likely be discussed by the bilateral working group, particularly if the GATT talks do not result in multilateral subsidy reforms. The two countries could, for example, agree to reduce or eliminate subsidies only in product areas that are of major bilateral importance but which do not involve third countries very much, such as paper. Another alternative suggested by the Canadians is the idea of "net subsidies," which was applied in the free-trade agreement's provision on U.S. grain, oats and barley. Basically, the subsidies by both governments are com-

puted and compared. If one country's subsidy is significantly greater, the other country could impose import restrictions or some other type of measure.

A third alternative is to allow subsidies so long as they remain below an agreed-upon threshold. This last option, of course, would depend on the prevailing subsidy levels in other competing countries lest the United States and Canada put their own industries at a multilateral disadvantage.

The difficulty of resolving the subsidy question on a bilateral basis points to an underlying weakness of bilateral trade agreements: They can only go so far without multilateral agreements. Ultimately, just as the U.S.-Canada trade agreement has been used as leverage in the GATT talks, so the fate of the U.S.-Canada free-trade agreement is tied to the fate of the GATT negotiations. If those negotiations result in a weakening of the multilateral system, there will be more pressure for the United States and Canada to complete the unfinished business of the free-trade pact.

Mexico: A promising, but problematic, partner

A free-trade agreement with Mexico holds much more promise for economic gains than the U.S.-Canada agreement, if only because there are many more protectionist barriers currently impeding trade.

The State Department's 1989 trade practices report contains a litany of complaints against Mexican trade and investment policies. For one thing, Mexico's tariffs average about 10 percent, roughly comparable to Canada's before the free-trade agreement took effect and twice that of the United States. In addition, Mexico makes far greater use than Canada does of import restrictions. Mexico currently requires licenses for products representing about 25 percent of the value of all the country's imports.

Important as the tariffs and import restrictions are, however, U.S. objections to Mexican policy focus on two other areas: restrictions on foreign investment and the lack of protection for intellectual property. Foreign investment, the State Department report complains, is limited by law to only 49 percent of an enterprise and, in the auto parts sector, to only 40 percent.[6] Certain sectors — including petroleum, radioactive minerals, electricity and railroads — are reserved for the state. Other sectors, including radio, television and airlines, are reserved for Mexican nationals.

As for intellectual property protections — patents, trademarks and copyrights* — an official at the U.S. Trade Representative's Office who asked not to be named said, "there is no protection, period." He added that the lack of such protections really hurts Mexico because it is such a disincentive for companies to do business there. "The basis of your product, your know-how, could easily be stolen and the pirate not subject to any retribution."

Mexico, for its part, has certain complaints about U.S. trade practices. Mexico's biggest export, oil, faces no real obstacles. But, as a result of pressure from the United States, Mexico imposed voluntary export restraints on iron and steel in the mid-1980s. According to Ignacio Trigueros, professor of economics at the Instituto Tecnologico Autonomo de Mexico, U.S. imports of iron and steel products from Mexico fell by 39 percent between 1984 and 1986. "As Mexico's export capacity expands," Trigueros notes, "it is likely that a larger set of import restrictions will become binding, and that new ones will be implemented."[7]

Despite these problems, U.S.-Mexico trade increased 25 percent in 1988, to $44 billion.[8] That makes Mexico the United States' third-largest trading partner, after Canada and Japan. Much of the credit for the increase in trade, and for the increased prospects for a free-trade agreement, goes to a program of economic reform undertaken by the Mexican government in the past few years.

If Mexico's current array of protectionist measures seem daunting, they are nothing compared with what was in place as recently as 1986, just prior to Mexico's joining the General Agreement on Tariffs and Trade in August of that year. "In less than three years, the Mexican economy moved from an extremely restrictive import regime in which almost every item was subject to an import permit, granted only at the will of foreign-trade officials and not at all in the case of some products, to a regime in which quantitative restrictions apply only to a few selected sectors of the economy — agriculture, oil and derivatives, motor vehicles, pharmaceutical products, footwear and electronic equipment — that comprise only 25 percent of the domestic output of tradable goods," writes Trigueros.[9]

Mexican tariffs, though they still average a relatively high 10 percent, were slashed in December 1987 from a maximum rate of 100 percent to a maximum rate of 20 percent. The Mexican government obviously hopes that the immediate result — a 50 percent increase in imports — will be offset by greater opportunities for Mexican goods abroad in the future.

Even more significant than the tariff reductions, the Mexican government last May greatly liberalized its foreign investment policies. Without changing the law that limits foreign investment to 49 percent, President Salinas' administration announced that it would allow 100 percent foreign ownership in all but a handful of sectors. It's not clear, however, just how much new investment the policy change will bring. One U.S. trade official pointed out that because the policy was

*For background, see "Artists' Rights and Copyrights," *E.R.R.*, 1988 Vol. I, pp. 245-256.

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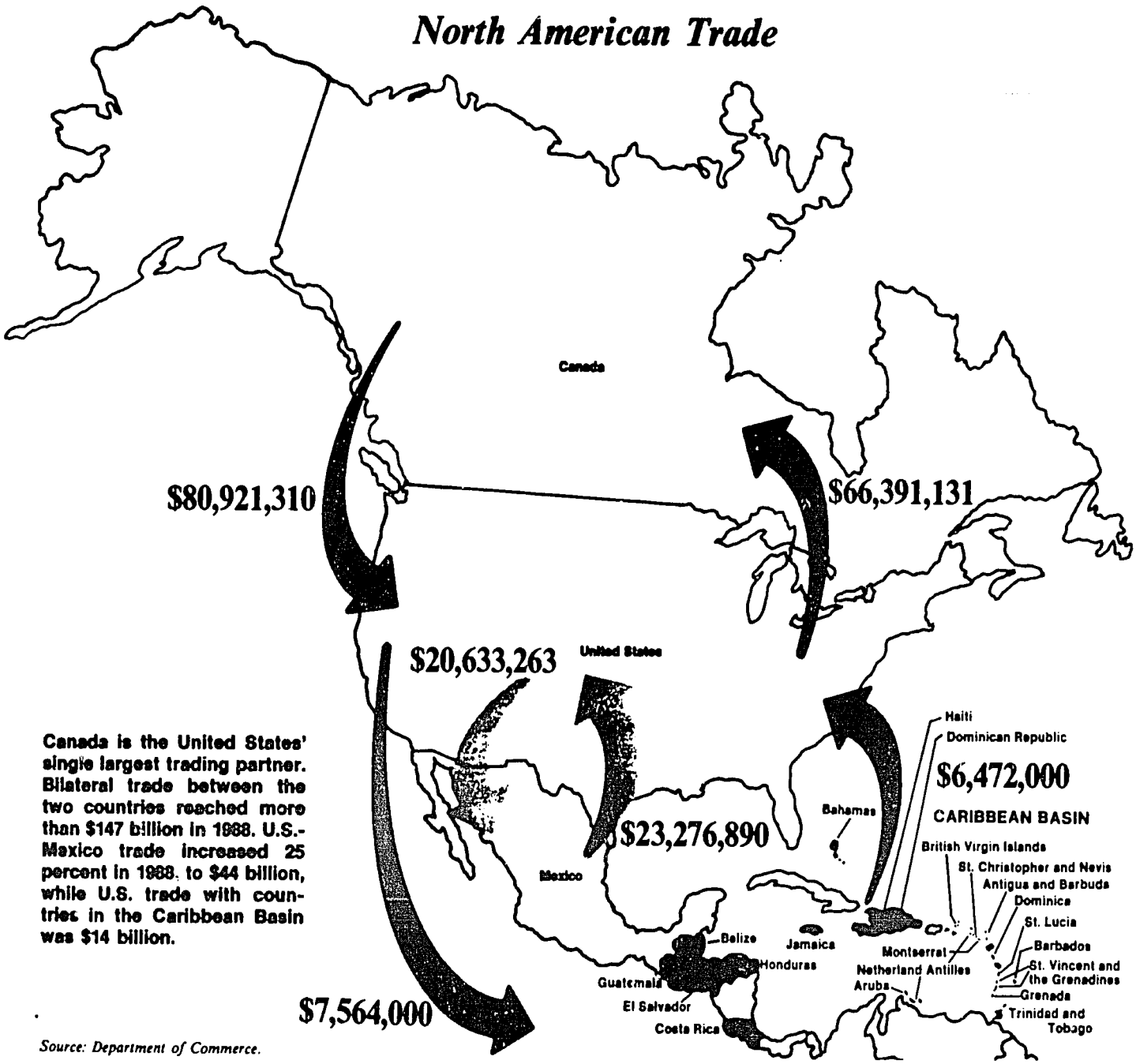

Canada is the United States' single largest trading partner. Bilateral trade between the two countries reached more than $147 billion in 1988. U.S.-Mexico trade increased 25 percent in 1988, to $44 billion, while U.S. trade with countries in the Caribbean Basin was $14 billion.

Source: Department of Commerce.

changed without changing the law, businesses may not rely on its durability. "You can't have an administrative guarantee," said the official, who declined to be identified.

The immediate cause of the reforms was Mexico's economic crisis: a stagnant economy and more than $100 billion in foreign debt. It is Mexico's clear recognition of the need for trade liberalization to deal with that crisis that has many in the United States hoping for further reforms. Meanwhile, the United States has responded to Mexican reform efforts with measures aimed at encouraging more trade. In 1987, Mexico and the United States established a non-binding mechanism for dealing with bilateral trade disputes. And in October U.S. Trade Representative Carla A. Hills announced the signing of an agreement with Mexico that mandates trade and investment negotiations. The agreement, Hills said at the time, "establishes a negotiating process for seizing and expanding trade and investment opportunities."

Nevertheless, Hills went out of her way to stress that "these talks are not aimed at reaching a 'free-trade agreement' with Mexico." And Ann Hughes of the Commerce Department stresses that "we are putting our efforts into the multilateral GATT round now,"

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although she says the United States "would be willing to consider any other agreements after the Uruguay Round."

A North American free-trade pact, then, is not completely off the Bush administration's agenda, but it definitely is on the back burner. Such is not the case for Sen. Phil Gramm, R-Texas. He has introduced legislation calling for negotiations for free-trade agreements with Mexico and countries in the Caribbean and Central America. While recognizing that there are obstacles to reaching such an agreement with Mexico, Gramm thinks the U.S.-Canadian agreement has paved the way. "I think the success of the Canadian free-trade agreement has helped. The success of the transition has been less difficult than some had thought, and the Mexicans are looking at that very closely."

Gramm concedes that such an agreement probably would benefit Mexico more than the United States, but he thinks the trade-off would be worth it. The primary benefits for U.S. companies, he says, would be easier access to Mexican markets and, for those companies that locate plants in Mexico, access to less expensive labor.

Gramm says the differences between the two countries' economies — particularly the fact that the United States is strong on capital-intensive industries while Mexico is strong on labor-intensive industries -- creates a "comparative advantage" each can benefit from. But critics contend that because the two economies are so different, a free-trade agreement isn't feasible. "If two countries have a free-trade agreement and they have the same sort of industrial capabilities — as the United States and Canada do — the disruption, the adjustment costs, are not that big," says Brian Copeland. "If you have free trade between countries that are very different then there is likely to be more disruption because all the unskilled labor jobs in the rich country are going to be wiped out by the poor country, and that leads to a lot more disruption and political resistance."

Howard Lewis of the National Association of Manufacturers thinks there would be objections to such an agreement on both sides of the border. "My God, look at the trouble you had getting the U.S.-Canada free-trade agreement through," he says. "Two countries with the same language, similar legal and commercial systems, similar historical background and ... you still have the nationalistic reaction in Canada that the government gave it away. If that happens in Canada, I cannot conceive of the type of nationalistic fervor you could ignite in Mexico over a similar thing."

In the United States, the strongest opposition is likely to come from organized labor, which also objected to the U.S.-Canada agreement. "People talk about comparative advantage as the best means of determining trade flows," says Mark Anderson, an international economist for the AFL-CIO. "But ... a nation's comparative advantage is made up of a whole series of things — the availability of capital, a highly educated work force, large markets, natural resources, etc. — all of which at least in the past have been present in the United States and have permitted a relatively high-wage economy. Indeed, we could have a high-wage economy because we were very productive because of all these other things."

Anderson points out that U.S. companies are already setting up operations in border enclaves known as *maquiladoras* to take advantage of cheap labor in Mexico (*see story, p. 687*), and he thinks more businesses would do so if there were a free-trade agreement. "Because of the ability to transfer all these other advantages — none of which is inherent in Mexico — somebody who's making $8 an hour in the United States sees his or her job being moved [to Mexico] out of some notion of competitiveness." The only ones that really benefit, says Anderson, are the American businesses, their stockholders, the banks that hold Mexican loans and the elites in Mexico. "There's been no evidence that this kind of production results in lower costs to consumers."

University of Texas Professor Sidney Weintraub, author of the forthcoming book, *Marriage of Convenience: Relations Between Mexico and the United States*, believes such concerns extend far beyond the ranks of organized labor: "I think the fear of cheap Mexican labor would scare the hell out of a lot of people." Weintraub figures that any such agreement is quite a few years off at best. "What's going to happen in the next few years is not a North American free-trade area, nor a bilateral free-trade agreement. I think what's more likely to happen is a series of negotiations on discrete agreements, which may deal with investment-related issues, intellectual properties, opening of transportation services, opening of agriculture, better quotas for Mexico on steel and textiles," he says. "Assuming that's right, and then making the second assumption — that Mexico recovers well — then I think the conditions for thinking about free trade would come more to the fore in Mexico."

Of course, economics is not the only issue of concern in our trade relations with Mexico. Much of the support for liberalizing trade with Mexico has clear political motivations. There is, for example, an obvious connection between the economic well-being of Mexico and its political stability, and many in Congress and the executive branch point to the value of having a stable, peaceful neighbor on the southern border. In addition, many in the United States are concerned about the waves of economic migrants searching for work in the United States. Sen. Gramm is blunt about the results he hopes to see from a U.S.-Mexico free-trade pact: "We're talking about Mexican nationals being able to earn a living in their own country, to stay at home and feed their children."

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Is the Caribbean Basin ready for freer trade?

If politics is an important consideration in U.S. economic policy toward Mexico, it is pretty much the *only* consideration with regard to the Caribbean and Central America. Trade with the region is simply too small for it to be of great economic importance to the United States, with the two-way total amounting to only $14.2 billion in 1988. The figure may seem like a lot, but it is way below the $147 billion in trade with Canada or the $44 billion in trade with Mexico.

It was, in fact, political concerns that were responsible for the Caribbean Basin Initiative (CBI) passed by Congress in 1983. The House report on the legislation — something of a one-way free-trade agreement with participating Caribbean and Central American countries[10] — makes clear the motive behind the CBI: "The Caribbean Basin countries have been seriously affected by the escalating cost of imported oil and declining prices for their major exports. This has exacerbated their deep-rooted structural problems and caused serious inflation, enormous balance-of-payments deficits, and a pressing liquidity crisis. This economic crisis threatens political and social stability throughout the region and creates conditions which Cuba and others seek to exploit through terrorism and subversion."[11]

Sen. Phil Gramm is even more candid about the political benefits he hopes to see come out of his own proposal for including the Caribbean region and Central America in a North American free-trade area: "You give Commandante [Daniel] Ortega [of Nicaragua] all the military aid he wants from the Soviet Union, and you give me a free-trade agreement involving Mexico and the Central American democracies, and his people will hang him within 10 years."

The centerpiece of the Caribbean Basin Initiative was duty-free access to the U.S. market on most products from the region, coupled with tax incentives for U.S. private investment. The CBI waived duties on Caribbean products if at least 35 percent of their value consisted of Caribbean parts and labor — or if up to 15 percent of that 35 percent represented U.S. parts and labor.

The results of the initiative have been mixed, in large part because pressure from labor unions and certain domestic industries convinced Congress to keep many of the traditionally strong Caribbean exports off the duty-free list. Petroleum products, for example, never got on the list, nor did textiles, shoes, leather goods, canned tuna and watches.

Sugar, another of the region's major exports, was allowed to enter duty-free, but imports were limited by strict quotas under a worldwide sugar-quota program passed by Congress in 1981.* As sugar quotas have gotten smaller and smaller over the past few years, Caribbean countries have been especially hard hit. According to José Orive, chairman of the CBI Embassy group, an organization of CBI-member countries, the countries have lost an estimated 400,000 jobs since 1983 as a result of shrinking sugar quotas.[12] In 1986, Congress made things tougher on Caribbean producers of ethanol, a fuel derived from sugar-based alcohol, by placing strict restrictions on imports.

In part as a result of the exceptions made to the CBI — and as a result of other forces, such as lower world prices for oil and bauxite — CBI countries have experienced little improvement in overall exports during the six and a half years the program has been in place. Indeed, exports to the United States actually fell from $9.2 billion in 1983 to only $6.5 billion in 1988.

But according to an official at the Commerce Department's International Trade Administration (ITA), those figures tell only part of the story. The bulk of the export decline, says ITA analyst Julie Rauner, is accounted for by just two products, petroleum and sugar. One of the main goals of the CBI program, she says, was to encourage participating countries to diversify their economies so that they would not be so vulnerable to the ups and downs in world markets. According to Rauner, non-traditional exports have grown 72 percent since 1983.

Rauner also says the program has been successful in encouraging economic reforms on the part of CBI countries. "Another inherent hope of the program is that countries will respond to the opportunity of access to the U.S. market and, in an effort to develop a more attractive investment environment and encourage exporters, adjust their policies accordingly," she says. "Some countries have done much better at that than others. Costa Rica is in the final stages of joining the GATT. All of the Central American countries are undergoing a bit of reform."

Still, progress has been slower than just about everyone expected. And a deadline approaches that could further compromise the program. Under the terms of the original legislation, the Caribbean Basin Initiative was to expire after 12 years, in 1995. Since most businesses work on five-year plans, policy makers are concerned that companies will hesitate to make new investments in the region until the future terms of U.S. economic policy toward the region are spelled out. An extension bill "is crucial," says Orive. "It will provide a guarantee for the people who have invested time and resources in our countries that the benefits will remain in place."

One major bill has been introduced to extend the CBI program and greatly liberalize some of its major features as well. Dubbed "CBI 2," HR 1233 has been

*The United States first erected a barrier to sugar imports in 1789, when a tariff was imposed. In 1934 Congress set quotas for sugar imports. The quotas were dropped in 1974, but were reimposed by Congress in 1981.

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slowly making its way through the House. But the bill's chief sponsor, Rep. Sam M. Gibbons, D-Fla., complains that it has been slowly picked apart in the process, much like the original CBI program was. For example, in addition to permanently extending the CBI program, Gibbons' bill would have loosened current restrictions on apparel imports from CBI countries and would have cut tariffs on petroleum, canned tuna and leather goods from Caribbean countries. All of those provisions were killed in committee. Says José Orive: "Once again, the pressure of protectionist lobbies here in the United States has prevailed." Nevertheless, Orive says that the whittled-down version is "very important," and Gibbons agrees. But Gibbons says he will keep pushing for more comprehensive legislation. "Once what little remains of CBI 2 gets through, I'll go back to work again," he says.

What about including CBI countries in a free-trade arrangement? "What's in it for the CBI?" asks Ann Hughes of the Commerce Department. "A free-trade agreement would mean they'd have to open their regime to the United States. It would only help [the United States], except insofar as there are those products included that are currently left out [of the CBI]."

But Orive insists that CBI countries are ready to move toward a free-trade agreement, even though it means lowering trade barriers in their own countries. "An FTA encompasses more than [simply opening up CBI-country economies]," he says. "It calls for the elimination of non-tariff barriers, procedural barriers and the like [in the United States]. That's a substantial problem for CBI countries. When you encounter several stumbling blocks with customs once your shipment is in Miami, you start crying foul. Definitely the expansion into textiles and apparel products that would come with an FTA would be of tremendous benefit for the region. The employment generation possibilities that that industry has for our region is substantial to say the least."

Unfortunately, Orive doesn't believe the Bush administration is willing to consider a free-trade pact for Caribbean Basin countries. Despite the fact that CBI countries are included in Sen. Gramm's legislation calling for negotiation of a free-trade area, Orive says U.S. officials have told him it would only be applied to Mexico.

Free trade vs. government regulation

Although both the Canadian and U.S. governments have proclaimed, perhaps prematurely, the U.S.-Canada trade pact to be a success, the Bush administration is cautious about moving too quickly into additional free-trade agreements. As Hughes has said, further bilateral agreements will be considered only after the United States sees the outcome of the Uruguay Round of GATT negotiations. But many experts, in and out of government, indicate that if those talks go badly the only answer may be further bilateral trade pacts.

The pressure will be all the greater if the economic integration of European economies in 1992 generates protectionist reactions in other countries. And it's not only Europe 1992 that has U.S. policy makers worried. There are growing concerns about the possible formation of an East Asian trade bloc led by Japan.* If there is a clear move toward regional trade blocs, the United States will find it hard not to move in the same direction.

But many economists worry that bilateral free-trade agreements work against the goal of attaining the preferred alternative: multilateral trade agreements. Each bilateral agreement confers preferential benefits on the partners to the deal vis-à-vis non-participating countries. Providing the same benefits on a multilateral basis would, therefore, dilute the relative value of the bilateral pact. "Once an FTA has been signed, an important constituency has been created in each of the participants *against* any wider multilateral negotiations lest they prejudice, destroy, or weaken the preferential benefits exporters in each of the signatories expect to receive from the FTA," notes Gardner Patterson, a former deputy director-general of GATT. "If the movement toward more and more FTAs continues, ... it would diminish not only the enthusiasm but also the administrative capacity of many countries, including the United States, to pursue multilateral negotiations vigorously." [13]

The same principle of diluted benefits makes it hard to negotiate other bilateral agreements, too. "Each new U.S. agreement would undercut the value of concessions obtained by partner countries in previous FTAs, because the preferences in the U.S. market would be shared, and thus diluted, by the new FTA partners," writes Jeffrey Schott. "For example, Canadians would be concerned if the United States negotiated an FTA with Mexico." [14]

Nor is it necessarily true that free-trade agreements even increase trade. In many cases, such agreements might just divert trade from other countries. For example, the United States might, under the tariff-free terms of the trade pact, start purchasing more chemicals from Canada. But if at the same time U.S. buyers cut their purchases from a third country by a like amount, then no new global trade would be created. What's more, if that third country had been producing the chemicals more cheaply than Canada in real terms — that is, without considering tariffs — the

*On Nov. 7, eight Asian countries, led by Japan and South Korea, met in Australia to discuss forming the Pacific Rim's first trade organization. The United States, Canada, Australia and New Zealand also participated in the talks.

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Past Coverage

America's Role in the New World Economy. A driving force behind the talk about a North American trading bloc is the fact that the postwar economic order dominated by the United States is unraveling. Other nations are catching up with the United States and could eventually surpass it in terms of wealth and general living conditions. These nations of Western Europe and East Asia are getting a major push by lowering barriers to free trade in their own parts of the world — forming their own trading blocs.

This changing world economic order leaves the United States facing a difficult situation. Staff Writer Mary H. Cooper explores the role of the United States in a world dominated by trading blocs, and also explains how the biggest winners of all may be multinational corporations, which already are moving to consolidate their economic power. E.R.R., 1989 Vol. II, pp. 665-680.

deal could end up giving the market edge to the less-efficient producer.

But even if bilateral free-trade agreements were only put in place where they did actually increase trade, there are many who would argue that they still aren't worth it. There are, say some analysts, very good reasons to want to regulate trade. Unregulated free trade is undoubtedly good for companies, says Mark Anderson of the AFL-CIO, but "the government ought to have a responsibility to defend national interest, as opposed to the interest of companies. There's a difference."

Anderson points to U.S. businesses operating in Mexican border areas as an example of some of the problems that come with unregulated trade. He says that because the *maquiladoras* are "an unregulated enclave that is outside U.S. territory but inside U.S. commercial territory," U.S. child-labor laws, environmental laws, occupational health laws, and other regulatory statutes have no effect. Though it's certainly cheaper to do business without the burden of such regulations, says Anderson, "We as a country, I think, have largely decided that things like clean air, clean water and a safe work place are general social goods."

Could the U.S. afford to conclude a free-trade agreement with Mexico without insisting that Mexico enforce the same environmental and safety regulations? If we did insist on those regulations, the deal would likely fall through. If we didn't, many U.S. industries would likely flee south to where the costs are cheaper.

Canadian economist Brian Copeland says he, too, is vexed by the problem. "Some countries want to take an active role in the productive sector of the economy, and international agreements have to allow governments to do that if they choose," he says. The problem, then, is how to have free trade while at the same time allowing regulation of business for the good of the society. "How do you reconcile the desires of countries to do their own thing internally and yet deal with this pressure to use internal instruments as a means of protection?" he asks. "I don't know the answer to that."

NOTES

[1] William Branigan, "Mosbacher Says U.S. Encouraged by Economic Changes in Mexico," *The Washington Post*, Nov. 23, 1989.

[2] Jeffrey J. Schott, *More Free Trade Areas?* Institute for International Economics, May 1989, p. 2.

[3] U.S. Department of State, *Country Reports on Economic Policy and Trade Practices*, March 1989, p. 348.

[4] *Ibid*, p. 347.

[5] Brian R. Copeland, "Of Mice and Elephants: The Canadian-U.S. Free Trade Agreement," *Contemporary Policy Issues*, July 1989, p. 53.

[6] U.S. Department of State, *op. cit*, p. 765.

[7] Ignacio Trigueros, "A Free Trade Agreement Between Mexico and the United States?," in *Free Trade Areas and U.S. Trade Policy*, edited by Jeffrey J. Schott, Institute for International Economics, 1989, p. 265.

[8] Figures provided by the U.S. Commerce Department.

[9] Trigueros, *op. cit.*, p. 259.

[10] The countries currently participating in the CBI program are: Antigua and Barbuda, Aruba, Bahamas, Barbados, Belize, British Virgin Islands, Costa Rica, Dominica, Dominican Republic, El Salvador, Grenada, Guatemala, Haiti, Honduras, Jamaica, Montserrat, Netherland Antilles, St. Christopher-Nevis, St. Lucia, St. Vincent and the Grenadines, and Trinidad and Tobago. Six other countries qualify for CBI trade benefits, but have not requested the designation. They are Anguilla, Cayman Islands, Guyana, Nicaragua, Suriname, and the Turks and Caicos Islands.

[11] *House Report No. 98-266*, p. 644.

[12] Paul Magnusson, "U.S. Consumers, and the Caribbean, Are Getting a Sour Deal on Sugar," *Business Week*, May 8, 1989, p. 41.

[13] Gardner Patterson, "Implications for the GATT and the World Trading System, in *Free Trade Areas and U.S. Trade Policy*, *op. cit.*, p. 357.

[14] Schott, *op. cit.*, p. 25.

Graphics: Cover, Margaret Scott; pp. 639, S. Dmitri Lipczenko.

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Wall Street Journal

L TUESDAY, MARCH 20, 1990

Help Latin America and Help Ourselves

By Peter F. Drucker

Who needs Latin America? "We don't," most American businessmen would say. But it is the wrong answer. Latin America, rather than Japan, holds the key to the U.S. trade deficit.

Whatever may be wrong with American industry—and many things are surely wrong—it is not "lack of international competitiveness." Since the overvaluation of the dollar was corrected nearly five years ago, U.S. industry has turned in a stellar performance, especially in exporting to Western Europe and Japan. A host of industrial exporters—South Korea, Brazil, Taiwan, Singapore—became bigger players in world trade. Yet the U.S. has regained the share of the world's manufactured-goods exports it held before the overvaluation—as large a share as the U.S. ever held except in the immediate post-World War II period.

Nor can the U.S. trade deficit be blamed on "excessive imports." Manufactured-goods imports account for a smaller share of America's GNP—9%—than they do in any other developed country except Japan. And the Japanese are now "outsourcing" at such a furious rate that the import share of manufactured goods in Japan's GNP is likely to match the U.S. figure within four or five years.

What then explains the massive American trade deficit? Its main cause is the collapse of the world's food and raw materials economy in the past decade.

World's Largest Producer

The U.S. is the world's largest producer and exporter of agricultural and forest products, and about one-third of the trade deficit is directly traceable to this collapse in prices and demand. Another third or so is owing to the impact of the raw-materials depression on what traditionally was one of U.S. manufacturers' best foreign customers—Latin America. Indeed in most Latin American countries U.S. imports traditionally accounted for half or more of all manufactured-goods imports. (By the way, most of Japan's export surplus is far less a result of industrial prowess than of the raw-materials depression; Japan—the world's largest raw-materials importer—is the main beneficiary.)

The trade deficit will not be eliminated by increasing exports of manufactured-goods to Western Europe and Japan. Indeed if Japan removed *all* restrictions to U.S. imports, U.S. exports would at most grow by $5 billion—as against a trade deficit with Japan of $50 billion. And the U.S. will be hard pressed to maintain current export volume with the developed world in the years ahead, when world manufacturing competition is bound to intensify.

We also cannot realistically expect food exports to bounce back. For a few short years ahead there may be sharply increased demand to assuage almost certain famine in the Soviet Bloc, but food relief on a massive scale can be maintained only for a few short years. Yet the U.S. trade deficit cannot continue indefinitely, and perhaps not even for many more years.

The interest payments on the debt due our suppliers already greatly exceed our capacity to earn foreign exchange to service them. While the foreign creditors can convert their dollar claims into U.S. assets—that is, buy American businesses and real estate—and most economists consider this to be harmless and perhaps beneficial, "buying America" clearly will not be tolerated long politically.

There are, in effect, only two ways to cut the trade deficit. In the wrong but traditional way, a very sharp recession cuts domestic consumption by 10% or so. The alternative: a revival of Latin America as a customer for U.S. manufactured goods.

It would be a great deal easier to turn around Latin America than to turn around Eastern Europe, the region on which most attention is focused now. Latin America is home to 300 million people—almost as many as in the Soviet Bloc. In sharp contrast to the Soviet Bloc, Latin America comfortably feeds itself and has a substantial surplus of both food and industrial raw materials. In the larger countries there is an excellent supply of well-trained engineers, entrepreneurs, accountants, economists and lawyers. And they did not have to become moral eunuchs to get an education or to get and hold a decent job.

Drucker on Management

About one-third of the trade deficit is directly traceable to the collapse in raw-materials prices and demand. Another third or so, to the impact of the depression on one of U.S. manufacturers' best foreign customers.

Nor do the educated people of Latin America have to be "re-educated" to function in a free economy. Until the raw-materials depression hit, Latin Americans worked effectively in a market economy and participated in rapid economic growth. And there is enormous pent-up demand for goods of all kinds.

Finally, Latin America, unlike the Soviet Bloc, has an adequate supply of capital. Indeed, Latin America probably has three times as much capital—or more—than it has foreign debt. There is only one thing wrong with it: It is not in Latin America. It has been driven out systematically—and often purposefully—by government policy.

But if the money that is now in Miami and New York, Zurich and Geneva—but also in the mattresses of virtually all but the poorest families in Latin America—could be enticed into productive investment at home, every Latin American nation, save perhaps the smallest and poorest, would have all the capital it needed for rapid economic growth. And the holders of Latin America's capital are willing, and indeed eager, to invest their money at home if only their governments were to stop expropriating savings and investment through inflation and punitive taxation, and were to stop discouraging productive investment through the granting of monopolies to military and governmental enterprises. As a result of these policies, even the shoeshine boys in Buenos Aires and Sao Paulo demand to be paid in dollars.

What needs to be done is clear enough: Stop inflation by turning off the spigot of government spending; dismantle the grossly overstaffed and unproductive monopolies owned by the government or the military (especially in Brazil and Argentina) or by the government's political cronies and the ministers' relatives (especially in Mexico); cut excessive nominal tax rates that discourage honest enterprise, but increase actual tax collection.

That these things can be done, and without political catastrophe, has been shown by two of the smaller countries: Chile under Augusto Pinochet's dictatorship, and (reasonably) democratic Bolivia. And there is now widespread demand throughout the region for a return to sanity.

Mexico has taken some fairly big steps in the right direction, especially in dismantling protection for governmental monopoly industries; the immediate results have been most impressive (including a more than two-fold increase in Mexico's purchases from the U.S.). The first priority of the new government inaugurated in Brazil last week is to sell more than a hundred unproductive, overstaffed and loss-making government enterprises. And the albatross of the foreign debt that the Latin American countries incurred when the raw-materials economy collapsed has largely been removed—it has been written down in all but legal fiction.

Latin America's turnaround is, in other words, no longer a matter of economics, but largely of the political will. It requires, above all, the backbone not to cave in—as did the governments of both Argentina and Brazil in both 1986 and 1989—at the first protest by a powerful group such as the labor unions or the army. The things that need to be done will at first be painful and unpopular. But within a year they will begin to produce results and to enjoy wide popular support.

But the U.S., too, has a crucial role to play: to stop the well-meaning but destructive policies it has pursued for almost 40 years. Maybe Latin America needs fairly small short-term loans to help assuage the pains of the transition. But the favorite "aid" policies of the past four decades—government-to-government aid; military aid; World Bank loans—must not be continued. They are largely to blame for the current crisis of the continent.

Anti-Entrepreneur Bias

These policies encouraged government spending. They paid for bloated government bureaucracies and for military establishments that are, in many countries, four or five times as large proportionately as that of the U.S.—and without any foreign threat. They diverted capital from productive investment into "prestige projects"—steel mills, for instance—without domestic markets that, in their own way, were not too different from the monstrosities of Stalinist planning. Above all, these policies all had a strong anti-business and anti-entrepreneur bias. To continue them would be like pushing drink on an alcoholic.

What Latin America needs from the U.S. is trade, not aid. It needs political support for policies that reward enterprise and discourage monopolies and protectionism, policies that stress savings rather than spending, and economic growth rather than growth of the bureaucracy.

And these policies also are needed precisely because the U.S. needs Latin America.

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