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WASHINGTON ECONOMIC WATCH

A Digest of Development Policy Information

A Project of the Overseas Development Council

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WASHINGTON ECONOMIC WATCH

A Digest of Development Policy Information

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July 13, 1990

Dear Reader:

We are pleased to present you with the second edition of the Washington Economic Watch. As in the previous edition, this digest captures the pulse of Washington by providing up-to-date, insider information on developments in the area of US-Third World economic policy as they emerged over the second quarter of 1990.

Each digest is separated by tabs into six functional categories, followed by a section on issues of relevance to your region. Within categories, material is organized according to subject, beginning with official policy statements, followed by congressional testimony, and concluding with expert analysis from the press and Washington "think tanks". In the event that you would like to acquire any additional information on these materials, we have provided you with a "contact sheet" of source institutions.

We hope our service continues to be a valuable research tool. Please feel free to send us any reactions as to how we may improve future editions.

Sincerely,

Richard E. Feinberg
Executive Vice-President
Overseas Development Council

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Remarks

News Division, Office of Public Affairs, Room 404-A, U.S. Department of Agriculture, Washington, D.C. 20250

REMARKS PREPARED FOR DELIVERY TO THE JOURNAL OF COMMERCE AND THE NATIONAL FOREIGN TRADE COUNCIL'S URUGUAY ROUND CONFERENCE BY SECRETARY OF AGRICULTURE CLAYTON YEUTTER

June 6, 1990
New York, New York

It is time to quit pretending that supply management works as a farm income enhancement program. It may in the short run; it doesn't in the long run.

It is time to stop pretending that protectionist trade policies help America's agriculture. They may in the short run; they don't in the long run.

While a combination of rigid farm production controls and restrictive trade protection is advocated by some in Washington, it is absolutely the worst agricultural policy combination for U.S. farmers. In a fast changing world the long run arrives quickly!

America will reach its full agricultural potential only through market-oriented farm policies and freer world trade. The Administration's 1990 Farm Bill proposals and trade reform recommendations in the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) will continue to move us in this direction.

FARM POLICY

In an era when capital can be shifted instantaneously to any nation offering opportunity, when technology can be transferred freely, and when farmers around the world are increasingly competitive, it is foolish to think that throttling back America's agricultural productivity somehow benefits American farmers. It doesn't.

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Economic isolation, no matter how you disguise it, doesn't work. Creating our own Berlin wall around U.S. agriculture would be foolish. United States farm policy isn't formulated in an international vacuum, and it's a mistake to pretend that it is. U.S. price support and acreage restriction programs influence American farmers' production decisions, but they also have an impact on the planting decisions of competing farmers in other countries.

- Higher U.S. set-asides increase our per unit cost of production, thereby impairing our international competitiveness;

- Foreign producers take advantage of our supply management programs to expand their own agricultural production and capture market share;

- Market share, once lost, is difficult and expensive to regain.

Over the years, our supply management attempts have (to our chagrin!) done a great deal to stimulate increased farm production in competitor nations. Whenever we restrict crop acreage to cut production, or use high price supports to move commodities into government storage rather than the marketplace, farmers in other countries inevitably take up the slack.

During the 1980's, for example, U.S. farm programs encouraged farmers to plant corn instead of soybeans, even though the world marketplace continued to signal for more beans. Latin American farmers enthusiastically moved to expand oilseed production to meet the unfilled demand. Latin American oilseed output rose from 24.1 million metric tons per year in 1980 to 40.5 million metric tons in 1989.

Those additional 16.4 million tons of Latin American oilseeds now compete directly each year with the output of about 20 million acres of U.S. soybeans, competition that didn't exist in 1980. This is competition that we generated by our own folly.

Unfortunately that's not the only example. Over the last five years, while the U.S. set aside an average of 58 million acres per year, many of our competitors increased their acreage, their production intensity, or both.

For 20 years, as the United States spent billions of dollars attempting to throttle back farm production, the European Community has transformed itself from a grain importer that purchased about 28.1 million metric tons of wheat and coarse grains per year, to a grain exporter, exporting about

32.3 million metric tons of wheat and coarse grains per year. Those exports now compete directly with American farm products in the world marketplace.

Western Europe's increased productive capacity now cancels out the annual supply management effects of about 31 million acres of U.S. set-aside land.

We pulled back on production while the Europeans and Latin Americans forged ahead. We gave them market share -- invaluable market share -- on a silver platter, with hardly a whimper of protest.

What goes on here! Does this sound like a winning scenario for the American farmer? Of course not.

It is little wonder a number of our world trading partners have been reluctant to rush into GATT policy reforms in agriculture. Why promote change if the United States is willing to unilaterally pare back crop production each time it appears world commodity supplies might become burdensome.

World wheat prices drop, and the U.S. activates government programs that encourage U.S. farmers to hold wheat off the market. Corn prices tumble, and the U.S. government adjusts commodity programs to make it more lucrative for farmers to take land out of production rather than plant corn. The U.S. has even been willing to store the bulk of any excess commodities for the rest of the world. Even more amazing we have been willing to take all these steps, regardless of the internal farm subsidy programs of competing nations, regardless of their export subsidy programs, and regardless of their restrictive import policies! Have we shot ourselves in the foot? You bet -- over and over again. Yet some Members of Congress wish to repeat the experience, one more time, in the 1990 Farm Bill. And some are fretting over the GATT negotiations which are trying to tackle the unfair practices of our competitors head on.

This has to stop! We've had enough agricultural masochism, and enough of giving away export sales and the earnings they would have generated.

Supply management in agriculture fails wretchedly in a globalized economy. The theory supporting supply management in the past was centered on the idea that the earth's farming resources were limited, and that the U.S. was one of a limited number of places where agricultural crops could be efficiently produced. Therefore, we could establish farm

policies on our own, and not worry about the reaction of producers elsewhere. Modern farming technology, economic development, and scientific education have turned that idea on its head. More and more nations continue to increase their agricultural productivity and efficiency.

While the U.S. currently enjoys a competitive edge in many segments of agricultural production, it is an advantage that can't be taken for granted. Our own government policies have already shifted too much agricultural production outside the United States.

Micro-management of agriculture by government doesn't work; it's time we accept this lesson and move on. American farmers need open, aggressive, trade-oriented farm policies that help strengthen their competitive position in world markets. Farm programs that are more flexible, not less flexible; more market-oriented, not less market-oriented!

I have great confidence in American farmers' ability to make their own management decisions and to continue improving their production and marketing efficiencies. That is why we have proposed additional flexibility in the 1990 Farm Bill. This has raised anxious cries inside the Washington, D.C. beltway, but farmers want to make their own decisions, and they merit that privilege. Why not give them the flexibility to respond quickly to changing world market conditions, capitalizing on marketing opportunities as they see them. Regrettably, Congress seems determined to insist on program rigidities that drastically under estimate the decision-making skills of U.S. farmers.

TRADE POLICY AND THE GATT

In trade policy, it's time to reverse 40 years of neglect in the GATT agricultural rules. Following World War II, the GATT made great strides in facilitating the flow of industrial goods between nations, knocking down tariffs on manufactured goods in the industrialized nations from 40 percent in the mid-1960's to a current level of 4-6 percent. But during the same period, the nominal rate of protection on agricultural goods in industrial nations rose from 21 percent to 40 percent.

A barrage of protective agricultural tariffs and non-tariff trade barriers has been thrown up all around the globe during the last 40 years. All nations have been guilty, including the United States, and now all must work together to clean up the mess.

The Uruguay Round offers by far the best opportunity ever to clear away trade distortions and restrictions, and to phase out costly export subsidies that only developed countries can afford. The Punta del Este Declaration is the most forceful statement in favor of agricultural trade reform ever adopted in the GATT; now we need to follow that commitment with positive action.

Failure to reach an agricultural trade reform agreement in the GATT would dramatically increase tensions in world agricultural trade, and would likely trigger an escalation of restrictive trade actions and counter-actions -- in short, an agricultural trade war nobody wants, and nobody wins.

What are the positive alternatives?

The United States has recommended a set of agricultural trade policy reforms we believe to be reasonable and realistic. Let me briefly outline those recommendations; you decide whether they are unreasonable, as our European colleagues have suggested.

To improve import access, the United States is advocating the conversion of all non-tariff measures, including import quotas, variable levies, restrictive licensing and voluntary restraints, to a tariff equivalent beginning in 1991. All tariffs would then be progressively and substantially reduced over time, just as the GATT has done with industrial tariffs through the years.

In export competition, our objective is to phase out, over time, all export subsidies and export prohibitions. This might well be the greatest contribution that developed countries can make to developing countries in the Uruguay Round. With limited treasuries, the developing countries can not compete in the export subsidy game against the giant economies of the world. It'll be a contribution to our farmers too; they can complete against European farmers, but not European treasuries.

Turning to internal agricultural support programs, we propose developing stronger, more effective GATT rules, the objective being to phase out the worst of those trade distorting policies, and to discipline the others. We do <u>not</u> ask that any nation give up its safety net of support systems for farmers; we simply ask that safety nets be designed to function in a manner that does not distort, or only minimally distorts, international trade.

In the sanitary and phytosanitary area, we ask that the participating GATT nations attempt over time to harmonize their varying food, animal health, and plant health standards. This should be done on the basis of sound scientific evidence, not politics or media hysteria; working through accepted international scientific organizations. Harmonization of international standards is a big job, but it can be done, and almost all nations recognize the potential health and trade benefits of doing so.

CONCLUSION

I believe the U.S. GATT proposal is reasonable, realistic and achievable. What seems unrealistic to me is for any nation, including the United States, to bury itself so deeply in the swamp of government trade interference and agricultural micro-management that it chokes off incentives to its individual farmers and the productive efficiency of its agriculture.

Regardless of what happens in the Uruguay Round or the 1990 Farm Bill, agricultural trade and production policies will change, in the U.S. and elsewhere. The question is whether we will work together in the world to constructively guide that change, or whether we will continue to add layer after layer of counter-balancing trade barriers, export subsidies and internal supply management schemes to agriculture, until the entire policy structure collapses under its own weight -- as has already happened in Eastern Europe and the Soviet Union.

America's economic greatness stems from our unique belief in individual opportunity, market incentives, and performance rewards. Whether in the final Uruguay Round negotiations, or in the 1990 Farm Bill debates, these principles still hold. Let us honor them in action as well as in rhetoric.

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90-39

FOR IMMEDIATE RELEASE
Thursday, June 14, 1990

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U.S. TRADE REPRESENTATIVE HILLS SAYS INDIA UNREASONABLE BUT RETALIATION INAPPROPRIATE AT THIS TIME

Following investigations under the Super 301 provisions of the 1988 Trade Act, United States Trade Representative Carla A. Hills today determined that India's insurance and investment practices are unreasonable and burden or restrict U.S. commerce, but that retaliation is inappropriate at this time given the ongoing negotiations on services and investments in the Uruguay Round of global trade talks.

The Uruguay Round is set to conclude in December. If necessary, a post-Uruguay Round review will determine whether action under Section 301 of U.S. trade law is warranted, Hills said.

India on May 31 announced measures to reduce the government's role in approving foreign investments under certain circumstances and exempt those investments from requirements stipulating use of local materials or export of a portion of production.

"Our message that foreign investment brings jobs, technolog and prosperity may be getting through," Hills said. "I hope thi attitude will be reflected in India's approach to these issues i the Uruguay Round.

"Government-mandated restrictions such as foreign equity ceilings and local-content and export-performance requirements do not constitute fair treatment for U.S. investors and only serve to drive potential investors elsewhere in Asia or to Eastern Europe."

Hills said U.S. interest in opening the Indian insurance market to foreign participation remains strong.

"A healthy, diverse financial services infrastructure complements India's drive for accelerated economic growth," Hills said. "U.S. insurance companies have a lot to offer. India cannot expect to continue to expand its services exports while denying fair and equitable market access to its trading partners."

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FOR IMMEDIATE RELEASE
April 27, 1990

HILLS ANNOUNCES ANNUAL GSP CHANGES

U.S. Trade Representative Carla Hills today announced the results of the 1989 annual review of the Generalized System of Preferences (GSP). These decisions will significantly expand GSP benefits by adding, continuing or restoring GSP eligibility to nearly $2.4 billion in 1989 U.S. imports.

"GSP continues to be an important part of our trade policy with the developing world," Hills said. "This year's decisions demonstrate our commitment to adapting the U.S. GSP program to a changing trade environment. We will continue to work to make GSP a more valuable incentive for economic development and to encourage developing countries to fully participate in the world trading community."

GSP benefits will be expanded as a result of decisions which add 23 products to the GSP program in response to requests from

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beneficiary countries and the private sector. These accounted for $33.4 million in 1989 imports from GSP beneficiaries. Waivers of the program's benefit ceiling (the competitive need limit) were granted to 22 other petition requests, which affect $645 million in 1989 imports.

Seven products representing $20.7 million in trade will be removed from GSP as a result of petitions filed by U.S. industry and trade associations, or statutory program requirements.

Products from beneficiaries valued at $1.22 billion will be removed from GSP treatment from countries exceeding the statutory competitive need limits; another $353 million will continue to receive GSP even after exceeding the competitive need limits because trade in these products was small.

Other product decisions redesignate duty-free status to $1.37 billion in imports currently not receiving GSP treatment. A total of $287 million is not being redesignated, while decisions on $517 million in Brazilian products eligible for redesignation are being deferred until June 1.

The record expansion of GSP benefits in this annual review also reflects the increased flexibility in program administration which has been made possible by the removal from the program, based on the success of their economi of Taiwan, Singapore, Hong Kong, and S. Korea on January 1, 1989.

MEXICO

Mexico was the major beneficiary of this year's decisions, with 1989 trade of $1.97 billion being provided new, restored, or

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expanded GSP eligibility. This expansion is possible due to Mexico's extensive participation in this year's review. Thirty-four of Mexico's 44 petition requests were favorably considered. In addition, the previous policy of denying redesignation to the most advanced GSP beneficiaries has been changed. As a result, GSP eligibility has been restored on 209 Mexican products with a 1989 trade value of $1.35 billion. This year's redesignation decisions take into account the impressive changes in Mexico's trade practices over the past two years and its status as a developing economy.

ANDEAN TRADE PACKAGE

As part of the President's Andean trade package, announced last November 1, $44.3 million in 1989 imports from Bolivia, Colombia, Ecuador and Peru will be given duty-free status on an accelerated schedule. Five products are being added at the request of the four Andean countries, effective May 1; 16 other decisions restoring or extending duty-free treatment for these countries will also be effective May 1. A separate, special review to consider additional requests from Bolivia, Colombia, Ecuador and Peru is now underway. The results of this review will be announced by mid-July.

BRAZIL

The ability of GSP to adapt to changing conditions is also reflected in the deferral of redesignation decisions regarding Brazil. This delay was required to allow the decisions to fully

(More)

take into account the trade and economic reforms of the new administration of President Fernando Collor de Mello, who took office on March 16. These decisions will be announced by June 1.

WORKERS RIGHTS

After a review of allegations made by labor and human rights groups that eight countries do not meet the worker rights requirements of the amended 1974 Trade Act, Liberia will have its benefits indefinitely suspended. Thailand and Indonesia were found to meet the program's eligibility standards and will continue to be eligible for GSP benefits. Reviews of Syria, Benin, the Dominican Republic, Haiti and Nepal are being extended for one year.

COMPENSATION FOR EXPROPRIATION

Reviews of four countries were also undertaken to respond to petitions allegating that they have not and are not providing prompt, adequate and effective compensation after the expropriation of property owned by U.S. citizens.

Uruguay and Costa Rica were found not to be in violation of the statutory criteria regarding expropriation, and will continue to be eligible for GSP benefits. Two expropriation reviews, concerning Peru and Venezuela, were terminated at the request of the petitioner.

All changes, except the Andean decisions noted above, will be effective July 1, 1990.

GATT Going

A storm is brewing in the multilateral trade talks over such issues as farm subsidies and services trade. The world will soon look to Congress for a thumbs-up or a thumbs-down.

BY BRUCE STOKES

When rain clouds rolled in over the Carolina Piedmont, washing out plans for a Saturday afternoon of golf, it was the first bad news in the otherwise productive House Ways and Means Committee trade retreat in mid-April.

For three days, according to several participants, nearly two dozen committee members, top Bush Administration officials, corporate and union leaders and high-priced Washington lobbyists convened at a resort in Winston-Salem, N.C., and worked hard reviewing progress in the multilateral trade negotiations in Geneva under the auspices of the General Agreement on Tariffs and Trade (GATT). The golf break was to be their reward.

But the weather was more than a damper on festivities. It was an ominous reminder of the storm gathering over the GATT talks: Sharp differences in the goals of nations and the self-interests of businesses could dramatically water down the final agreement due in December.

The issues in the talks are many. The European Community (EC) and the United States differ on how to reduce trade-distorting, budget-busting agricultural supports. The United States stands virtually alone in its approach to eliminating controls on textile and apparel trade. And talks to create international rules for trade in services, such as insurance, are progressing slowly.

Such discord could damage prospects for congressional approval of an accord early next year. And a failure in the GATT, trade experts warn, could open a Pandora's box of trade disputes and special deals between key industrial countries that would inhibit world economic growth.

In a series of informal talks at the retreat, U.S. Trade Representative (USTR) Carla A. Hills outlined what remained to be accomplished in the negotiations. American Express Co. chairman James D. Robinson III spelled out the corporate community's objectives and reservations. And Thomas R. Donahue, the secretary-treasurer of the AFL-CIO, underscored labor's concerns.

The final session focused on the congressional politics of trade. Although formal congressional approval of a new GATT pact is not required (it is not a treaty), the agreement would require implementing legislation, which Congress would consider under a fast-track procedure that permits no amendments. Hence the Ways and Means members discussed how a GATT agreement might affect politically sensitive government farm subsidies and the controversial protections for the U.S. textile and apparel industries. They speculated on the provisions the accord would have to contain to enable the gainers—those whose congressional districts are likely to benefit—to offset the votes of the losers—those whose districts are likely to be hurt.

In the end, Ways and Means chairman Dan Rostenkowski, D-Ill., warned the negotiators that they would have the committee's full support only if they brought back a "good" agreement.

Because a Ways and Means endorsement will be pivotal to getting a pact

Trade consultant Harry L. Freeman
He wants the GATT to link services with goods.

through Congress, the North Carolina retreat is probably the first of many such "educational" gatherings for panel members. After nearly four years of negotiations in Geneva, the success of this multilateral round of trade talks may come down to a six-month campaign to convince a majority of Congress that the agreement is a good deal for the United States.

Prospects will depend largely on how key players in the U.S. economy line up. Their relative political leverage on Capitol Hill will ultimately decide how many Members vote on the implementing legislation. *(See table, this page.)* From here on in, trade experts say, the fate of a pact is likely to be determined not by the economics of trade in Geneva, but by the politics of trade in Washington.

Of course, the substance of the accord is important—the ultimate content will determine how people choose sides. And it is the very lack of progress on substance so far that worries many GATT observers.

"It is difficult at this stage to find points of real convergence" between the negotiating countries on key issues, GATT director general Arthur Dunkel said at the end of a meeting last month of the government officials who oversee the negotiations.

A meeting of the major industrial nations' trade ministers early this month in Napa, Calif., failed to close the gap.

The delay in service-sector talks poses particular complications for congressional approval because American services industries were the single most important driving force in launching this round of multilateral negotiations. Indeed, a new services trade regime was to be the cornerstone of any new agreement.

"I think we stand a pretty good chance of getting a services agreement that sets down principles," said Richard Self, deputy assistant USTR for services, "but I am concerned about the size of the down payment we may receive from other countries in the way of initial commitments to liberalize services trade barriers."

Services industry representatives have an even worse nightmare. They fear a weak framework agreement, riddled with reservations and exceptions, that does little to roll back barriers to services trade. In that case, warned Margaret S. Wigglesworth, executive director of a business group called the Coalition of Service Industries, "no agreement is far superior to a bad agreement."

With opposition already expected from some farm commodity groups, textile and apparel interests and unions, services industry antagonism toward the GATT accord would be its death knell.

"There is a certain amount of panic in these negotiations," Tran van Tinh, the chief EC negotiator, told journalists in Geneva recently. "But there is no need for pessimism."

With several months of hard bargaining still ahead, Jeffrey J. Schott, a research fellow at the Institute for International Economics in Washington, cautioned that "every public statement made from now on is part of the negotiating process." And that includes disaster scenarios from interested parties on all sides attempting to shape the final agreement through subtle intimidation.

Finally, cynical trade experts think that whatever the shape of the final accord, U.S. negotiators will declare victory and come home after the planned wrap-up GATT ministerial meeting in Brussels in December. It is very likely negotiators will then slink back to Geneva in January and February to hammer out a myriad of final details in time for a March 1 congressional deadline. An admission of failure, with all its negative consequences, is almost inconceivable, observers say, given the political capital spent by all parties to get this far.

Ultimately, however, Congress will be the final judge of success or failure. And special interests, from farmers to investment bankers, are likely to do their best to influence Congress's verdict

Battle of the Checkbooks

Congressional consideration of next year's multilateral trade agreement may turn into a battle of the checkbooks, with lobbyists calling in the chits they've built up over the years through campaign contributions. Following are campaign donations to Members of Congress and congressional election committees by the political action committees (PACs) of likely supporters and opponents of a new trade agreement. They are for 1989 and the first quarter of 1990, as compiled by the Federal Election Commission.

	PAC contributions (in thousands)
Probable supporters	
American Express Co.	$60
Arthur Andersen & Co.	128
Citicorp	358
Federal Express Corp.	601
Prudential Insurance Co. of America	165
Motion Picture Association of America	39
Recording Industry Association of America	52
RCA Inc.	147
Walt Disney Co.	65
Probable opponents	
Dairymen Inc.	$250
American Crystal Sugar Co.	292
American Sugar Cane League of the U.S.A.	148
American Sugarbeet Growers Association	196
Associated Milk Producers Inc.	407
Mid-American Dairymen Inc.	224
AFL-CIO Committee on Political Education	490
International Ladies' Garment Workers' Union	250
United Auto Workers	868
United Steelworkers of America	383

THE URUGUAY ROUND

The current multilateral trade talks were launched with much fanfare in September 1986 at a GATT meeting in Punta del Este, Uruguay (which is why the discussions are known as the Uruguay Round). They mark the eighth global tariff and trade-barrier-reducing negotiations since World War II.

The GATT has often been maligned as a slow-moving debating society whose rules fail to cover a large portion of world

Some Services at Stake

In the 1960s, the accounting and consulting firm of Arthur Andersen & Co. had little interest in that decade's Kennedy Round of international trade negotiations aimed at cutting tariffs. In the 1990s, the company is one of the U.S. Trade Representative's most active service-industry advisers.

The nature of trade has changed, and so has Arthur Andersen. Today, the firm is run as a type of cooperative that operates in 54 countries; in 1989, it did about 40 per cent of its $3.4 billion business overseas. About half its 51,000 employees work outside the United States. Trade difficulties come with the territory. "Most of our problems boil down to the transfer of money, people or technology," said Charles P. Heeter, a principal in Arthur Andersen's Washington office of federal services.

The firm has been hit, Heeter said, with discriminatory taxes and prohibitions against its practice of pulling money out of affiliates to pay for common expenses such as training. "We are now training specialty teams of 30-50 people with highly specific skills to go into a country to work with the local stock exchange," Heeter said. "Getting work permits for professionals such as these is very important."

Technology transfer laws also often undervalue software, brochures and training manuals that are part of the service Arthur Andersen sells abroad.

Finally, the firm can encounter country-specific trade problems. In South Korea, for example, the company is currently having trouble getting a license to provide telecommunications consulting services.

To head off similar problems in the future, Arthur Andersen, in the course of advising the Bush Administration on the services industry, is putting a high premium on winning a strong services agreement in the current round of talks.

trade. But over the years, it has succeeded in virtually eliminating tariffs worldwide. One could argue that the GATT must be doing something right because 97 nations are participating in the present round, and 12 more are waiting to join the GATT, among them the Soviet Union and Taiwan.

The Uruguay Round is the GATT's most ambitious undertaking. The agenda includes perennial issues involving agriculture, textiles, subsidies and government procurement. But trade-related investment, services trade and intellectual property rights are also being tackled, for the first time. Procedures for dispute settlement that have long slowed the functioning of the GATT system are set to be revamped.

After three and a half years of talking, negotiators have pledged by July to have framework agreements ready that outline the scope of what can be accomplished in 15 negotiating areas. That will leave them several months to fill in details before the December gathering of trade ministers, who will have the political authority to resolve any outstanding problems.

"There is a recognition that the July deadline has to be met," Dunkel said in April, "because if we don't meet it, we're in trouble."

On most topics, with the possible exception of agriculture, observers think a framework agreement is achievable. In the services negotiation, for example, the United States and the EC compromised on the structure of an agreement in mid-March. Both accepted basic principles: Services rules should be out in the open (no backdoor regulations), and all rules and dispute settlement procedures should apply to all GATT signatories. Countries must agree to grant the same market access and treatment to foreign firms as they do to their own nationals, except in cases where a government has "grandfathered in" an existing trade restriction. And nations may, before signing the accord, designate certain areas where they might want to impose trade constraints later.

Virtually all other industrial nations now support this compromise, and some of the newly industrial countries are willing to negotiate on it. But most developing countries still oppose it.

"We are very encouraged," said Charles P. Heeter, a principal in the federal services office of the accounting firm of Arthur Andersen & Co. "But there are still a lot of things that have to be accomplished by year's end." *(See box, this page.)*

LINKING TYPES OF TRADE

The first problem may be to tie any future services agreement firmly into the GATT. At the original Uruguay meeting, in a compromise to pacify representatives from developing countries who did not want to even talk about services, the services negotiation was put on a separate track from talks about trade in goods. American services industries want to tie the two together again to make it easier to punish countries that violate their services trade commitments.

For example, if Bangladesh would sign the services agreement and then put restrictions on American banks doing business in Dacca, the only recourse for the United States—without a link between services and goods—would be to ban Bangladeshi banks from operating in New York City, hardly a serious threat given that Bangladesh has no overseas banks. But by linking remedies for violation of services trade rules to the goods sector, the United States would have the option of forcing Bangladesh to keep its financial services sector open to foreign competition by threatening to halt U.S. imports of Bangladeshi jute.

"The remedies have to come together," said Harry L. Freeman, president of the Freeman Co., a Washington international trade consulting firm. He notes that the U.S. service industry already has the right under the 1984 Trade Remedies Reform Act to retaliate unilaterally against imported goods. Because foreign governments want the Bush Administration to forswear such unilateral actions in the future, "you would have to be crazy to give up the linkage under GATT," he said.

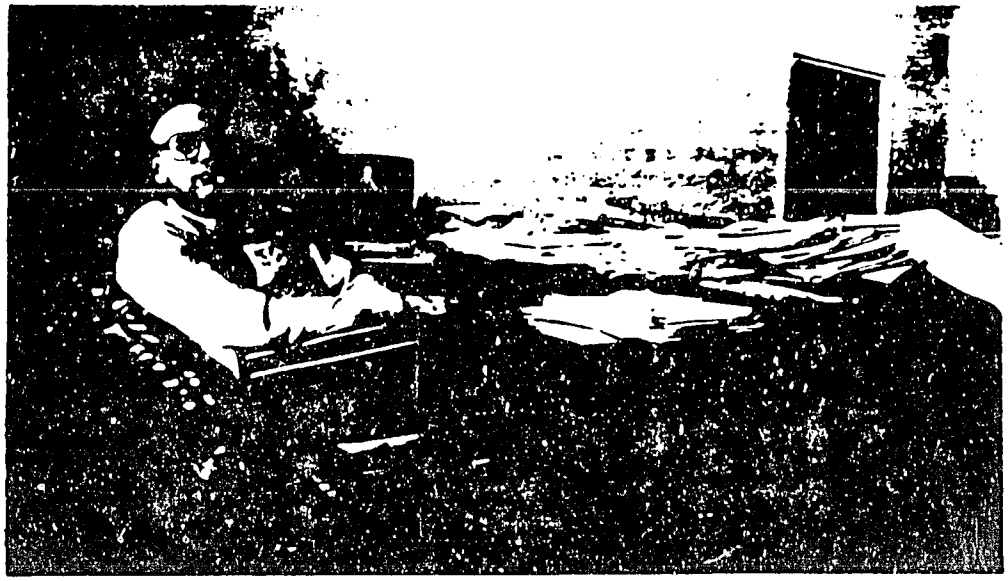
Privately, however, key services industry representatives say they might be willing to forgo linkage, because they doubt the United States will ever give up its unilateral right to retaliate. They say their final position on linkage depends on progress on an even more important issue: rollback of existing trade barriers.

In a meeting the week of May 7 in Geneva, the United States presented a list of requested rollbacks in foreign service trade barriers, along with offers of what it would do in return. Few experts expect this "request-offer" process to accomplish much by December. Self acknowledges there is not enough time. "We need rollback for this [services] agreement to fly," he said. "But I'm not ready to define what that rollback may be."

It may be minimal, given that developing countries are key to the process (the United States, the EC and Japan have already eliminated most of their formal ser-

vices trade barriers), and Third World countries are digging in their heels. Most developing nations are willing to freeze their existing level of protection but not reduce it.

Preservation of the status quo is out of the question, Americans say. "We are not willing to enter into a freeze that freezes our market open and foreign markets closed," said F. William Hawley, director of international government relations for Citicorp/Citibank. "We would be crazy to do that. One can see allowing some phasein in liberalization in a liberal time frame," he said. "But promises to some day liberalize is not what we are looking for."



Deputy assistant U.S. trade representative for services Richard Self
"We stand a pretty good chance of getting a services agreement that sets down principles."

The newly industrial countries such as South Korea and Thailand will play a pivotal role in resolving the freeze-versus-rollback debate. If these nations, which have the fastest-growing markets for American services, make significant concessions, U.S. service industries may be willing to let poorer countries off the hook.

"There is a need to find a balance between political reality and liberalization," said Joan E. Spero, senior vice president and treasurer of American Express. "Everybody is not going to be willing to give market access to everybody else's financial institutions."

An even trickier question for the United States, with ominous implications for the congressional approval process, is just which services industries will be covered by an eventual accord, and which will be excluded.

The official U.S. position has been to include as many services sectors as possible. "If it's rules without coverage, it's a hollow agreement," Schott said.

But the U.S. maritime industry and airlines want to be dropped from the talks. Under the 1920 Merchant Marine Act (the Jones Act), maritime shipment of goods from one U.S. port to another must be on an American boat. This protected market is the lifeblood of many shipping firms, and free trade that would open that business to foreign competition would threaten profits. Similarly, airlines are quite happy with existing bilateral agreements that grant foreign air carriers landing rights in the United States only on a one-for-one reciprocal basis.

John Eaele

Citicorp/Citibank international government relations director F. William Hawley
We will not agree to freeze our market open while foreign markets remain closed.

When this issue came up before, in the talks that led to the 1988 U.S.-Canadian free-trade agreement, the maritime industry had sufficient political clout to have the entire transportation sector dropped from the deal at the last minute. And most trade experts think this is inevitable again. Resolutions are already circulating in Congress to exclude transportation from GATT coverage, and the Administration clearly sees the handwriting on the wall. The question now is not whether, but when. For tactical reasons, the United States would like to delay pulling transportation off the table for as long as possible to avoid unraveling of the negotiations as other nations pull their favored industries.

"There is a very real danger that you pay a high price to exclude things," Hawley said. Most observers think the Europeans would demand exclusion for the motion picture industry, for example, so that they could continue their limitations on the showing of American programs on European television.

"The service-sector people would like to exempt transportation without having to pay that price," Spero admitted.

PAIN AND PLEASURE

Whatever the final shape of the agreement, history will judge it by Congress's willingness to approve GATT implementing legislation. And that will be determined by political dynamics.

"It's not that substance is not important," said Jeffrey M. Lang, the Senate Finance Committee's former chief international trade counsel and now counsel with the Washington office of the New York law firm of Winthrop, Stimson, Putnam & Roberts. "But it has to fit into the congressional process. The implementing

An Alternative to GATT

Faced with the prospect of a multilateral trade agreement that will fall far short of expectations, trade officials have begun casting about for a tangible, attractive alternative outcome for their four years of international effort.

Some think creating a world trade organization, one with more power and a larger staff than the existing General Agreement on Tariffs and Trade (GATT), would satisfy that political need.

The idea is not new. An International Trade Organization (ITO) was first considered in the late 1940s, as a companion to the World Bank and the International Monetary Fund. When the U.S. Senate refused to ratify the ITO treaty, the GATT was created as a temporary organization that did not require Senate approval.

This February, Italian Trade Minister Renato Ruggiero proposed reviving the ITO to oversee implementation of any new GATT agreement. In April, Canadian Trade Minister John Crosbie put meat on the idea by suggesting that a new world body would have powers to resolve trade disputes.

Opposition then reared its head. "I don't think the creation of a new institution is what this round is about," said Charles P. Heeter, a principal in the office of federal services of the accounting firm of Arthur Andersen & Co. "If that is what they come home with, it won't be satisfactory."

The Bush Administration appears to agree. "We must have the laws before we can build the courthouse," warned U.S. Trade Representative Carla A. Hills in a recent speech in Dallas, arguing that the first priority of negotiators should be to successfully complete the current talks.

A report, however, is circulating in trade circles that some in the Administration are arguing to make creation of a world trade organization a major topic at the economic summit in Houston in July.

Privately, U.S. negotiators worry that even flirting with the idea will create an "out" for trade ministers come December, when, with the clock ticking, they will be trying to reach a final agreement and will need to face the world's press with some sign of accomplishment. Stay tuned.

bill will have to be sent to a lot of committees because of the scope of the negotiation. Moreover, the 1988 Omnibus Trade and Competitiveness Act was so comprehensive, it gave them all a chance to play in the trade game, and they are not going to give that up."

Under those conditions, special interests will have a field day. With each member of Congress on two or three committees, a pain-pleasure matrix is inevitable, a lobbyist said, with each Member getting pushed and pulled in 15 directions.

This tug-of-war may be most evident on farm issues. The initial U.S. agricultural negotiating position called for complete elimination of all subsidies, in part because such a stance was the only one that all U.S. farm and commodity groups could agree on. *(See NJ, 5/5/90, p. 1082.)*

This solid support is expected to fragment if, as expected, U.S. negotiators come back with a compromise farm accord that helps some commodity groups and hurts others. The likeliest victims are dairy, sugar and peanut interests, most of which benefit from import protection that foreign producers are determined to strip away.

"We want to be treated fairly," said Dalton Yancey, executive vice president of the Florida Sugar Cane League and Washington representative of the Rio Grande Valley Sugar Growers. Dairy, sugar and peanut lobbyists have spread enough campaign contributions around Capitol Hill (the three largest dairy industry political action committees gave a total of $881,000 million to congressional candidates in 1989 and the first quarter of 1990) to ensure a hearing for their complaints about any GATT accord.

Though most congressional experts doubt that these commodity groups alone could block a GATT agreement, their past successes in fending off efforts to curb their benefits suggest that they could be formidable. To counterbalance sugar and dairy influence, "you have to have people who are vocally supportive of the agreement," said Paul Drazek, assistant director of the national affairs division of the American Farm Bureau Federation in Washington, "so you will have to have something in it for the major commodity groups," such as the wheat, corn and soybean growers.

"If you get an agricultural package in which the grain people think they have something real," said I.M. Destler, a public policy professor at the University of Maryland (College Park), "that more than offsets sugar and, I think, the dairy people, too." But such a balancing act won't be easy. The grain groups want better access to the European market and elimination of European export subsidies, which the Europeans refuse to concede.

The textile and apparel lobby is likely to be the second pocket of opposition to a new GATT agreement. The Administration has proposed replacing the current Multifiber Arrangement (MFA), which is outside the GATT and sets country-by-country textile and apparel import limits, with a global quota that caps only total imports and would be phased out over time. Only Canada supports such a comprehensive approach, and most trade experts think the United States will have to back off if it wants meaningful reform.

If it backs off, however, the Administration risks incurring the wrath of the big textile manufacturers. Carlos F.J. Moore, executive vice president of the American Textile Manufacturers Institute, the principal textile industry trade association, recently told the *Financial Times* that "there will be a lot of unhappy folk around" if the Administration gives up the global quota approach. And "we will be able to generate a lot of muscle," he said. To back up this threat, textile and apparel interests have already lined up 55 Senate and 229 House co-sponsors of a bill for global textile import controls.

But some observers question whether those votes could be mustered against a comprehensive GATT agreement that would contain a variety of benefits for individual states and congressional districts. Moreover, some trade experts detect the beginning of a rift over MFA reform among various textile and apparel interests. And if sentiment at the Ways and Means Committee retreat is any indicator, senior congressional leaders realize that in the words of a retreat participant, "some people will have to slowly be let slide overboard" if the GATT agreement is to succeed. On everyone's short list of potential victims is the textile industry.

Unions and some industries also see themselves as possible casualties. Their concern, Alan Wm. Wolff, a partner in the Washington office of the New York City law firm of Dewey, Ballantine, Bushby, Palmer & Wood who represents steel and semiconductor interests, told the Ways and Means retreat, is that in "the last 10 minutes of play in these negotiations, foreign countries will offer a deal to the United States. They will whisper, 'If you want these [rules] on new areas for the GATT, give us a few changes in your antidumping law.'"

Administration officials also talk openly of speeding up the GATT dispute

resolution mechanism to make it as fast as unilateral U.S. action is. If they achieve this, unions worry that U.S. negotiators might then be willing to compromise on some limits on U.S. freedom to use section 301 of the trade law to retaliate against unfair trade practices.

"What we are talking about is a change in a broad range of domestic U.S. laws," AFL-CIO international economist Mark A. Anderson said. "Is it in our interest to give up that degree of national sovereignty, especially given the kind of trade deficit situation we are in?"

Labor has some vocal allies in Congress, but the ebbing of union political influence in recent years suggests that labor may retain its favorite trade weapons only by choosing unusual bedfellows.

One may be the White House, which up until now has withstood the importuning of major American multinational corporations seeking changes in the dumping code. Many service providers have also decided they like having a 301 option, if only as a bargaining chip. Even the most free-trade-minded Ways and Means members at the retreat reportedly defended 301 as a huge success.

SERVICES' NEW CLOUT

When battle lines on the GATT agreement are finally drawn, service industries and businesses interested in intellectual property rights are likely to be in the vanguard of efforts to gain congressional approval for the implementing legislation.

In the world of Washington lobbying, these groups—financial and professional services companies, the entertainment industry and some high-technology firms—are the new kids on the block, but they already have an impressive track record. In the mid-1980s, the groups persuaded the Administration to make services and intellectual property the defining issues of the Uruguay Round. And they helped craft major portions of the 1988 trade law.

Because the services and intellectual property crowd will be pitted against some powerful traditional lobbies for the first time, the GATT approval fight could test whether those groups have arrived politically. "They really will have to be activated," a senior congressional staff aide said. "They can not afford to be lukewarm, or they will get clobbered."

Their motivation will depend, to a large extent, on the content of the GATT accord. "If you get a good intellectual property agreement," an international trade lawyer said, "this is real money to big business. It is inconceivable that they will let the textile people f--k it up."

Similarly, "services want a couple of sectors nailed down," said Claude E. Barfield, director of trade policy studies at the American Enterprise Institute for Public Policy Research. "The Administration will have to go to the mat on this or risk losing key support for the round."

In fact, foreign trade officials privately acknowledge that U.S. negotiators must bring home some goodies for American Express and Citicorp and others to ensure their wholehearted lobbying for congressional approval of a pact.

Whether these firms have sufficient clout in Congress is hard to judge. Their PACs are generally smaller than farm and union PACs. And motion picture industry lobbyists grouse that diverse members of the film community often spread money around with little regard to the industry's best interest. Nevertheless, it is now de rigueur for aspiring Senate candidates to make the pilgrimage to Hollywood to raise campaign funds. And more than one has come back with a newfound interest in patent and copyright protection.

So, the real possibility that Europe might exempt the motion picture industry from GATT coverage not only threatens the comprehensiveness of the agreement, it could also undermine political support for the pact in the United States.

"We sat back in the interest of the greater good when we were exempted from the Canadian free-trade agreement," a motion picture industry official said, "and we got burned badly. If we are left out again, I can't see us just sitting by. There would be enormous pressure to oppose the agreement."

To control these crosscurrents, Freeman, who as a former executive vice president of American Express has been a prime mover of the services agenda, has formed the MTN Coalition, made up of services and goods producing companies, to conduct a grass-roots educational campaign on multilateralism in preparation for a possible lobbying effort in support of the GATT accord.

That effort will have to start early next year because under the 1988 trade act, the Administration has to send Congress a copy of the new GATT agreement by March 1, 1991. Then, to retain the advantages of fast-track authority, the President must sign the accord by June 1. During that period, USTR will draft implementing legislation in consultation with Congress, trying to smooth the road for a vote, which must come within 90 congressional-session days after the implementing bill is submitted.

John Lucic

Coalition of Service Industries director Margaret S. Wigglesworth
"No agreement is far superior to a bad agreement" that perpetuates service barriers.

There is always the possibility the Uruguay Round could be extended, as happened with previous rounds, for a variety of reasons. The German national elections in December, for example, in which Bavarian farmers may hold the balance of power, may stall any European concessions on agriculture until early next year. If the GATT talks drag on for more than a month or two, the President has the right to ask for a two-year extension of his fast-track negotiating authority. Few trade experts, however, want to openly consider that possibility now for fear that it would let negotiators off the hook.

To avoid that, business groups, Congress and the Administration will soon have to begin assessing what they absolutely need to accomplish in this round. "The question is how will the endgame be played," Lang said, "how you decide what gets thrown off the back of the bus and what you absolutely have to have to have a done deal." The lobbying over that assessment has already begun. □

REPORT TO CONGRESS CONCERNING EXTENSION OF WAIVER AUTHORITY FOR THE PEOPLE'S REPUBLIC OF CHINA

Pursuant to Subsection 402 (d) (5) of the Trade Act of 1974 (hereinafter "the Act"), I have today determined that further extension of the waiver authority granted by Subsection 402 (c) of the Act for twelve months will substantially promote the objectives of Section 402, and that continuation of the waiver currently applicable to China will also substantially promote the objectives of Section 402 of the Act. My determination is attached and is incorporated herein.

GENERAL WAIVER AUTHORITY

The general waiver authority conferred by Section 402 of the Act is an important means for the strengthening of mutually beneficial relations between the United States and China. The waiver authority has permitted us to conclude and maintain in force a bilateral commercial agreement with China. The agreement continues to be a fundamental element in our political and economic relations with China, including important exchanges on emigration and human rights matters. The reciprocal granting of MFN trade treatment and other elements of this agreement enhance the ability of US companies to compete in the Chinese market. The continuation of the waiver authority will also permit future expansion of our bilateral relations with other countries now subject to Subsection 402 (a) and (b) of the Act, should circumstances permit. These considerations clearly warrant this renewal of the general waiver authority.

WAIVER FOR CHINA

Freedom of Emigration Determination

I believe that extending the current waiver applicable to China will substantially promote the objectives of Section 402 of the Act. China's relatively free emigration continues in the aftermath of the assault on Tiananmen Square. In FY 1989, 16,920 US immigrant visas were issued--a 9.5 percent increase. The US numerical limitation for immigrants from China was fully met. The principal restraint on increased emigration continues to be the capacity and willingness of other nations to absorb

Chinese immigrants, not Chinese policy. After considering all the relevant information, I have concluded that continuing the MFN waiver will preserve the gains already achieved on freedom of emigration and encourage further progress.

Commercial Importance of MFN

The granting of MFN tariff status to China was a key element in the package normalizing diplomatic relations and provided a framework for a major expansion of our economic/commercial relations. Maintaining most-favored-nation tariff status is fundamental for strong bilateral trade relations with China. In 1989, bilateral trade totaled $18 billion, with Chinese exports worth $12 billion and US exports worth $6 billion. The United States is China's largest export market, absorbing 25 percent of China's total exports.

If MFN were withdrawn, trade retaliation would be a certainty. China would apply its own higher non-MFN tariffs to US products and possibly erect other trade barriers as well. With US companies placed at a disadvantage, competitors from Japan and Europe would quickly move to replace US exports in our largest markets in China -- grain, aircraft and aerospace equipment, industrial machinery, steel products, chemicals, fertilizers and computers. The US could face losses in exports in the range of $2 billion to $3 billion, or about 33-50 percent of 1989 exports. US joint ventures in China would be forced to pay higher duties on imported components and their exports to the US would be subject to non-MFN tariffs, putting their continued operations in jeopardy. Withdrawing MFN would have a devastating impact on Hong Kong's free enterprise economy, which depends heavily on US-China trade and the health of export industries in South China Confidence in the territory's future would be further eroded. Finally, the loss of MFN would lead to higher prices for US consumers of products made in China.

Chinese Foreign Travel Policies

The record of non-immigrant visa applications received at US posts in China indicates that China continues to adhere to a relatively open foreign travel policy. In FY 1989, 63,269 non-immigrant visas were issued in China -- a two percent increase. Since late 1988, visa applications of government officials and state enterprise personnel travelling for business have declined. We believe this is due to the government's retrenchment policy and cutbacks in travel funds and not to political restrictions. Applications for private travel, which includes tourists, have increased sharply since last summer.

In February, China issued a new directive tightening controls over its citizens who wish to study abroad. These regulations require recent college graduates and fourth-year

undergraduates to work for five years before applying for overseas study. Some students may obtain a waiver of the work requirement by repaying the cost of their education. It is too soon to assess how the new rules will effect student applications, which peak in June, July and August. Nonetheless, we have protested this unpublished directive, and shall continue to press the Chinese authorities to relax or repeal it. We have also raised with Chinese authorities our serious concerns about allegations that Chinese students in this country have been subject to surveillance and harassment by Chinese diplomats and consular personnel. If there has been a "consistent pattern of acts of intimidation or harassment" of Chinese nationals in the US, it would be a violation of US law, and appropriate action would be taken.

Overall Human Rights Climate

The emigration-related objectives of Section 402 notwithstanding, the overall human rights climate in China remains unsatisfactory and a matter of serious concern. The situation described in the Human Rights Report for 1989 has not fundamentally changed. The Chinese Government has taken some limited steps to ease repression. Martial law was lifted in Beijing in January, and in Lhasa in May. After pressing the Chinese Government for some time, US diplomats once again have access to Tibet. Almost 800 people, detained after last year's protests, have been released, leaving an estimated few thousand of the 10,000-15,000 originally detained in prison. The Chinese Government, however, has yet to take decisive measures to demonstrate a commitment to internationally recognized human rights norms and a return to its earlier path of political and economic reform. In particular, we have the following concerns:

-- After the lifting of martial law in Beijing and Lhasa, new laws were enacted codifying and extending indefinitely many of the martial law restrictions on demonstrations.

-- Of the nearly 800 persons released from detention, only six individuals have been identified. Moreover, these people have not been released unconditionally. Many are required to report periodically to police stations. The Government has announced that 431 persons are still being regularly interrogated and monitored by public security departments in Beijing. We believe that as many as a few thousand remain in detention, as well as several hundred in Tibet in connection with pro-independence activities there.

-- Several criminal convictions for "counter-revolutionary crimes" -- charges connected with non-violent activities during last year's demonstration -- have been announced. Press reports claim that prosecution against at least the student leaders has begun, which could result in lengthy prison sentences. Administrative reprisals continue to occur. Participants in ongoing small-scale

pro-independence demonstrations in Tibet continue to be detained and punished.

-- Freedom of expression, the press, assembly, and association remain tightly constrained, and not all religious groups enjoy freedom to practice their believes. Security forces in Beijing have quickly suppressed most known instances of dissent. Monks and nuns identified as "troublemakers" have been expelled from monasteries and nunneries in Tibet.

-- Reports of mistreatment and torture of detainees are persistent. The UN committee on Torture has stated that reports of torture are too numerous to be merely isolated incidents.

-- A new law codifies and strengthens government control over the activities of foreign journalists. The government continues to jam the Voice of America. There has been no noticeable loosening of government control over the Chinese media.

-- Chinese students in America, as well as their families back in China, have been subject to surveillance.

Impact of MFN on US Interests Other Than Emigration

While US-China relations cannot return to normal under these circumstances, I have determined that withdrawing China's MFN status would do more to harm vital US interests and the interests of those Chinese who seek reform and an opening to the West than to help. MFN tariff status has given the Chinese the incentive to take into account US interests -- on fair trade practices globally, human rights, missile and arms sales, and cooperation on such regional issues as Cambodia and the Korean peninsula.

Without MFN, China would have little to lose in economic terms by failure to cooperate with the US. The commercial opportunities created by MFN also helps to promote market-oriented reform and provides opportunities for Chinese to maintain a wide range of contacts with Americans and American institutions. Withdrawing MFN would hurt those workers and enterprises in the export-oriented industries, particularly in South China, that have benefitted most from economic reform and have a stake in its further implementation. It would also undercut those in China who argue for closer relations with the US and want to see contacts with the US in all spheres continue and expand.

I wish to emphasize, however, that the US intends to press vigorously during the coming year for significant improvement in China's human rights practices. We want to see China's people have the same internationally recognized human rights that people elsewhere in the world enjoy. Until there is significant progress, the sanctions which I imposed on China last June will remain in force.

TRADE

Bush Renews MFN for China, Stirs Angry Hill Reaction

President Bush's decision to renew normal trade status for China, coming just shy of the one-year anniversary of the Tiananmen Square massacre, was broadly denounced in Congress the week of May 21 as yet another signal that the administration had turned its cheek to the country's human rights abuses.

"The president's repeated concessions to the Chinese government have been met with intransigence," Senate Majority Leader George J. Mitchell, D-Maine, said in a news conference shortly after Bush's announcement. "The answer is not more concessions."

Democratic wounds have been slow to heal since Bush vetoed legislation (HR 2712) both houses approved without opposition last year that would have allowed Chinese students in the United States to extend their visas until Beijing improved its human rights record. Bush said the visa requests would be reviewed on a case-by-case basis. *(Weekly Report, p. 245)*

The administration's decision to extend China's most-favored-nation (MFN) trade treatment for one year guarantees another showdown. Bush had until June 3 to extend MFN status, which entitles a country to standard U.S. tariff rates.

By acting early, he avoided making the announcement on the eve of the June 4 anniversary of the killings of Chinese student demonstrators and got it out of the way before his May 31-June 3 summit with Soviet leader Mikhail S. Gorbachev.

Earlier in the week, after a Republican meeting at the White House, Sens. John H. Chafee, R.I., and Alan K. Simpson, Wyo., and House Minority Leader Robert H. Michel, Ill., backed Bush's move as the best way to keep U.S. leverage in China and to encourage human rights improvements.

But after Bush's announcement, legislation was quickly introduced in both chambers to overturn the order. The bills are likely to gain substantial bipartisan support.

Among the Republicans denouncing the president's decision was Alfonse M. D'Amato of New York,

By Alyson Pytte

R. MICHAEL JENKINS

Solomon, Solarz talk before hearing.

who called it a "a short-sighted accommodation with a blood-stained and discredited regime."

Stephen J. Solarz, D-N.Y., chairman of the House Foreign Affairs Subcommittee on Asian and Pacific Affairs, offered the administration a middle road: less far-reaching legislation to tie next year's decision on MFN status to the release of political prisoners and other human rights gains.

If the administration did not support this approach, Solarz warned at a hearing before three House Foreign Affairs subcommittees May 24, the day of the president's announcement, it could "run the risk of immediate termination" of MFN. "I assure you, Congress will move forward," he said.

Impact on Human Rights

So far the administration has shown no interest in tying MFN to human rights conditions.

"Let me emphasize that granting MFN is in no sense an act of approval of a given country's policies," Richard H. Solomon, assistant secretary of State for East Asian and Pacific Affairs, said in the May 24 hearing. "It does not mean that the country in question is our most favorite nation."

There is also a fundamental division between the administration and a large bloc of critics in Congress over whether trade restrictions would improve, or worsen, the human rights situation in China.

Bush said renewing MFN status would further democratic reforms by keeping open channels of commerce and communication. "The people in China who trade with us are the engine of reform, an opening to the outside world," he said.

Revoking the trade treatment, he said, would mean lost jobs and revenue in China, Hong Kong and the United States. He said the price in Hong Kong, which has considerable investments in China and serves as a conduit in many trade and manufacturing ventures, could be as high as 20,000 jobs and $10 billion in revenue.

A punitive approach would also "play to the most xenophobic, reactionary elements" in China, Solomon said.

But critics, including Democrats Tom Lantos, Calif., Nancy Pelosi, Calif., and Sam Gejdenson, Conn., said there is ample evidence that the administration's conciliatory approach has failed. They cited testimony by human rights groups that 10,000 to 30,000 political prisoners are in custody and that torture and executions are continuing.

In the past, Congress has tied human rights to MFN status — by passing the Jackson-Vanik amendment to the 1974 trade act. That requires the president to ensure that countries with nonmarket economies are making substantial progress toward free emigration before granting MFN status.

The administration is withholding MFN treatment for the Soviet Union until it codifies recent improvements in emigration policy. *(Story, p. 1640)*

But since China is already meeting the improvements in emigration required by Jackson-Vanik, administration officials argue, there is no basis for denying MFN. Punishment, they said, is better meted out in the form of sanctions, such as a ban on military sales and restrictions on World Bank loans. However, some on the panel question whether China's emigration policies meet the Jackson-Vanik requirements.

The larger administration concern, however, is that imposing new restrictions would open a trade policy Pandora's box. Other countries with poor human rights records, including South Africa and Iraq, have MFN status.

"To broaden the terms of the [Jackson-Vanik] amendment is not the way to go," Solomon said.

Democrats countered that a double standard already exists between Beijing and Moscow. "It seems to me to boggle the mind that in the Soviet Union, where such dramatic changes have occurred, the president refuses to waive [Jackson-Vanik]," said Gejdenson, referring to increases in Soviet Jewish emigration. "But in China, where there are no changes, he waives it anyway." ■

House Foreign Affairs Subcommittees
Opening Remarks
Ambassador Winston Lord
May 16, 1990

Mr. Chairman, Members of the Subcommittees:

I am pleased to appear today to discuss American policy toward China.

For two decades through five Administrations, the United States enjoyed broad bipartisan consensus on dealing with that important, complex nation. But the slaughter of innocent patriots in Beijing last Spring and the subsequent repression have led to the first heated debate on China since the early 1970s. The Bush Administration and most policymakers of previous ones who worked on Sino-American relations are lined up on one side; the overwhelming majority of the Congress and the media are on the other. China experts -- that's an oxymoron -- are divided.

With the anniversary of the Tiananmen Square crackdown approaching, I hope this gap can be closed. A united American front is essential for fostering both Chinese human rights and American national interests.

The Chinese Scene

There is no debate on today's China. The regime has taken the nation on a Great Leap Backward -- executions, purges, imprisonment, surveillance, political indoctrination and the reversal of many economic reforms. All is cloaked in the Big Lie. Once again ideology reigns over expertise, Maoist slogans are in fashion and culture serves the State. Western values are attacked; America vilified; VOA jammed. Journalists posted to Beijing state: "There is no other place in the world today where foreign correspondents are subject to such intense, systematic harassment as we are in China."

The Chinese leaders blame their problems on everyone but themselves -- the Western press, American pressures, Gorbachev's policies, Hong Kong's impertinence. There is a siege mentality. This April it was forbidden even to stroll in Tiananmen Square during the traditional day of mourning. One man presented a single white flower and was immediately arrested.

Mr. Chairman, I need not elaborate here. The State Department's annual human rights report fully documented the abuses in China, confirming that the situation has deteriorated in virtually every area. Many observers, including Asia Watch, have given a specific accounting of political prisoners and other transgressions. Other witnesses will testify further.

I note some counter-trends that have kept the nightmare from getting worse. A degree of paralysis and porousness delays or prevents some repressive edicts from being enforced. Through subtle sabotage many party and provincial officials dilute or ignore hard-line instructions. The people -- unlike previous political campaigns -- are not jumping on the Party wagon by betraying others. They distrust the leadership. They protect one another. They share a widespread feeling that the political winds will soon shift again.

The number four student on the government's most wanted list, Chai Ling, recently escaped China after hiding for ten months. This would have been impossible before. I do not know the extent of the underground, but surely she was safeguarded in many parts of China not only by students, peasants, and workers but also by party officials, and perhaps public security personnel.

Given the events of the past year, it is hazardous indeed to predict the future anywhere in the world, never more so than for China. I firmly believe, however, that within a few years at most we will see a more moderate, humane, open regime in Beijing. In the discussion period I will be pleased to elaborate my reasons. When that bright day comes we can -- and should -- resume full cooperation with China.

United States Policy

Meanwhile America faces the practical policy problems of how to get from here to there. In previous testimony before Congress and in various publications I have set forth my positions. I submit for the record my December 19, 1989 article in the Washington Post. Until then I had supported the Bush Administration's general approach, although I was much more critical of the Chinese regime. The revelation of the Scowcroft missions to Beijing, which I considered a serious mistake, prompted me to speak out. I was reluctant to do so because of my admiration for the President, but I care deeply about a policy on which I have worked for twenty years.

There is a disturbing general pattern in Administration actions: waivers, vetoes and unrequited conciliatory moves -- and above all the double standard between China and support for democracy everywhere else, such as Eastern Europe, Latin America and South Africa.

The choice is not Administration policy versus isolating China, or promoting human rights versus protecting national interests. Instead the choice is between the distressing symbolism of fawning emissaries and a cool, working level conduct of necessary business. The choice is between toleration of egregious human rights violations and a principled approach consistent with our global posture. We should align ourselves with the Chinese people and future leaders rather than with a few

personalities who will shortly be swept from the stage.

In brief, we need a policy that blends condemnation and connection; features diverse approaches to various constituencies depending on symbolism and productivity; suspends certain programs while preserving foundations for better times; and encourages China in the direction of greater economic reform and political pluralism.

In specific terms this translates as follows:

-- Maintain a dialogue on international issues such as missile proliferation, Cambodia and Korea, but through Ambassadors and international forums rather than high level envoys.

-- Continue to suspend military ties.

-- Continue to suspend special economic privileges and World Bank loans.

-- Continue to suspend further liberalization of export controls on technology.

-- Allow our private business sector to make its decisions on economic grounds, i.e. Chinese policies on reforms, trade and investment.

-- Pursue those academic and cultural exchanges which are still fruitful despite the present climate.

Throughout, our rhetoric should affirm that the Chinese people are not different in their basic aspirations from Eastern Europeans and others around the globe. Let us discard the condescending attitude, reflecting unconscious bias, that somehow China, because of its size and traditions, cannot afford to move toward democracy.

The MFN Issue

Against this backdrop, we must consider the issue of maintaining most-favored-nation trade status for China. This is difficult as we weigh various factors -- the repression in China, the recent lines of our policy, American national interests, Chinese human rights, and future prospects.

I have wrestled for some time with this question, consulting American government officials, members of Congress, business people, academic experts, Chinese in this country, and citizens from Hong Kong. In the May 9, 1990 New York Times I set forth my conclusions and recommendations. I include this article for the record as well.

There are solid grounds for revoking MFN status. The preamble to the Jackson-Vanik Amendment and the legislative history underline the relevance of the general human rights situation. As I have stated, the record is clear. The Chinese landscape is bleak.

As for the specific criterion of free emigration, the

picture is somewhat mixed. In some categories the number of visitors is up, either through official toleration, the permeability of the system, or the benign connivance of officials and institutions. On the other hand, tough new requirements for graduating students and other scholars -- formalized after the President vetoed the Pelosi Bill -- prevent many others from leaving China. Thousands in jail, or those confined to our embassy, obviously cannot emigrate. Countless other Chinese cannot obtain exit papers or do not dare try.

The most serious argument for MFN revocation is that its extension could be misconstrued. The regime might portray this step to the Chinese people as business-as-usual with the United States. This risk is all the greater, unfortunately, because of the thrust of Administration policies.

For these reasons I strongly oppose the simple extension of MFN status without accompanying actions. The hardliners in Beijing could argue that their repression entails no international costs. They could conclude that there is no limit to our forbearance toward their abuses. So might President Gorbachev as he contemplates his treatment of the Baltic States and his summit with President Bush on the very eve of June 3.

On the other hand, there are several persuasive reasons to extend MFN, so long as this move is imbedded in a larger package.

Termination of the trade status would hurt the wrong people in China. These include entrepreneurs, business people, Chinese in the coastal areas and economic zones who are most dependent on foreign trade and investment and most committed to reforms and opening to the world. Meanwhile, the regime would use America as a handy scapegoat for the floundering Chinese economy.

We would severely damage the prosperity and morale of Hong Kong. Seventy percent of China's exports to us pass through there. Millions working in Hong Kong and southern China would be affected. As Hong Kong residents look toward 1997 with trepidation they can ill afford additional economic and psychological blows.

We would harm many Americans -- consumers, importers, exporters, business people in Hong Kong and China. The United States would lose many markets and investments, perhaps permanently. Others -- like Japan, Europe, South Korea, Taiwan -- would not follow our lead. They would profit at America's expense.

Finally, we would undercut our long term objectives. Certainly we should not grant any new privileges to China, and we should continue to halt various activities. But we should be careful about dismantling frameworks that we have labored over time to construct. Once commercial and personal ties with progressive elements in China are severed, they are difficult to

Congressional Quarterly
June 16, 1990

TRADE

Looking South for Agreement Suddenly Gains Currency

Chances for a free-trade pact with Mexico clouded by labor, immigration concerns

With visions of a North American trade bloc suddenly bright on the horizon, the thought of a U.S.-Mexico free-trade agreement is enjoying an overnight vogue in the White House and on Capitol Hill.

"When I first proposed this eight years ago I was laughed at," said Rep. Bill Richardson, D-N.M.

But the United States and Canada already have a free-trade agreement. A similar arrangement with Mexico could create a single North American market with a population soon to exceed 400 million.

And, as Mexican President Carlos Salinas de Gortari has noted, that would be larger than the European Community.

Nonetheless, the prospect of unlimited immigration, coupled with wage competition from workers remaining in Mexico, has raised doubts among some members.

The issue was aired June 14 by the House Ways and Means Subcommittee on Trade, which heard primarily from enthusiastic members and outside witnesses. Critics, including industry associations and labor unions, are scheduled to have their say June 28.

Although most of the talk on June 14 was hopeful, several members interrogated witnesses about obstacles.

"A well-paid [U.S.] industrial worker is bound to suffer," said Don J. Pease, D-Ohio, adding that an agreement would create "winners and losers" and saying he would want to know in advance "who would be in each category."

Charles B. Rangel, D-N.Y., said cocaine shipments across the Mexican border had more than doubled in the past two years. A free-trade agreement, he said, "would make it more difficult to keep contraband from entering the United States."

Moreover, the Canadian pact, which took effect in 1989, has left more than a few members grumbling about both the protracted negotiation and the results.

By Ronald D. Elving

"The Canadian agreement was not all that it could be," said Richard T. Schulze, R-Pa. "The Mexicans should know that we would not just come bearing gifts. We would also be bearing demands."

Hills on the Case

U.S. Trade Representative Carla A. Hills was on hand June 14 and said the Mexican government had "undergone a sea change since 1988" in its approach to trade and the economy.

She said Mexico had reduced its tariff rates from 100 percent to 20 percent or less. Moreover, she said, only goods representing about 7 percent of the total value of U.S. exports to Mexico are still subject to the previous import license requirements.

Hills said Mexico still had inadequate protection, such as patent laws, for intellectual property. But she said this and other issues might be successfully addressed in the continuing 97-nation talks under the General Agreement on Tariffs and Trade (GATT).

Mexico already is the third largest U.S. trading partner, after Canada and Japan. The United States accounts for two-thirds of Mexico's trade. The two countries exchanged goods worth about $52 billion in 1989, with U.S. exports to Mexico representing $25 billion of that amount.

Business spokesmen John E. Avery, company group chairman of Johnson & Johnson, and James D. Robinson III, chairman of American Express Co., stressed Mexico's importance, as well as its new economic orientation.

Avery, whose company has been doing business in Mexico since the 1930s, said a single North American market was inevitable.

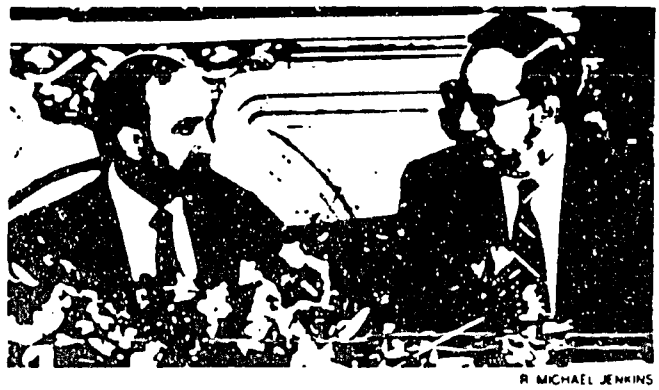
"It's just a matter of time before it happens," he said. "There is dramatic change happening in the world, and Mexico is in the forefront of it."

Robinson, who is also co-chairman of the influential Business Roundtable, said economic dislocations in the United States should be addressed "as part of any sensible agreement" be-

tween the two countries.

"Protectionism doesn't work," said Robinson. "Trade creates business opportunities, and business opportunities create jobs."

This was a theme that Salinas stressed during his visit to the United States, which included meetings June 11 with border-state members, Senate Majority Leader George J. Mitchell of Maine and other senators.



R MICHAEL JENKINS

Mexican President Carlos Salinas lunched with Majority Leader George J. Mitchell and several other senators June 11.

Salinas said the $10 billion increase in U.S. exports to Mexico in recent years had created "thousands of jobs" in the United States.

Moreover, he said, his ultimate aim was to "export products, not workers." He said the lack of a trade agreement might mean more unemployment in Mexico and force more workers to cross the border illegally.

Salinas said other nations with low-wage labor forces, such as in Asia, did not pose such a threat because their workers could not reach the United States as readily.

Man with a Mission

Reversing years of resistance in his country to the encompassing embrace of the U.S. economy, Salinas has pushed the trade pact as a response to the European economic unity scheduled for 1992.

He met on June 10 with President Bush at the White House, and the two endorsed the idea of a "comprehensive free-trade agreement" to be negotiated "in a timely manner."

The wording was significant, because it triggered only what are called "consultative talks" rather than true negotiations. These talks between Hills and Jaime Serra Puche, Mexico's commerce and industrial development minister, are likely to continue through the remainder of the year.

Existing law, updated by the 1988 trade act, provides expedited "fast-track" procedures for congressional approval of a bilateral free-trade agreement.

For the agreement to qualify for the fast track, the president must notify the Senate Finance and the House Ways and Means committees once he is ready to start formal negotiations.

The committees may disapprove within 60 days, thereby eliminating fast-track procedures, which limit the time the committees may take in considering such an agreement and also bar floor amendments.

The purpose of the fast-track authority is to allow negotiators the freedom to bargain with a guarantee that the deal they cut with the foreign country will be accepted or rejected in toto.

In the case of the Canadian pact, formal negotiations took three years. While somewhat controversial in the United States, that pact was the central issue for an entire national election in Canada.

At the June 14 hearing, Subcommittee Chairman Sam M. Gibbons, D-Fla., said he hoped the Mexican agreement could be negotiated "on a more compact schedule."

He also said he preferred a comprehensive agreement to a narrow one, somewhat of a contrast with Salinas' more circumscribed proposals. Salinas has said he does not expect to include oil as part of a free-trade agreement.

Mexico is one of the hemisphere's main exporters of oil, although its exploitation of that resource has not yet met earlier expectations.

Good Jobs, Good Wages

Gibbons said he did not favor building "huge trading blocs," except as a means toward "seeking free trade all over the world."

But several other members seemed at least as interested in the intermediate goal of a North American trading powerhouse. "A united North American continent would clearly increase our leverage [with] a united Europe and with the Pacific Rim," Schulze said.

Appearing as a witness with Richardson was Rep. Jim Kolbe, R-Ariz., who spoke glowingly of Salinas' market-oriented reforms: "They've moved so dramatically that it just boggles the mind down there." Kolbe said a Mexican trade agreement could be "the cornerstone of a comprehensive hemispheric trade policy."

Hills acknowledged interest in this kind of global trading clout but reiterated the administration's commitment to opening markets through GATT. She also reminded the members that much of Mexico's recent trade liberalization had followed that country's admission to GATT.

Also tempering enthusiasm about a prospective North American trading giant were concerns about the microeconomic effects.

Frank J. Guarini, D-N.J., said some labor experts had forecast a loss of 400,000 U.S. jobs as a result of a free-trade agreement. Richardson and Kolbe said such fears were misplaced. Some jobs would be lost, they said, but others would be created.

Pease said the promise of replacement jobs might be hollow if they paid little more than minimum wage. "Why should a congressman from northern Ohio vote for a free-trade agreement such as this?" he asked.

Said Kolbe: "Our ultimate goal is to raise the standard of living in both countries."

Avery said his company "faced that issue when we opened up down there . . . and we soon had more American jobs than we had before or than we would have had without our Mexican operations."

Bill Thomas, R-Calif., said he expected "the meatier fruit" of a Mexican trade agreement to involve agriculture. But he warned that moves designed to improve trade in fruit and vegetables could also create "some conflict with Argentina and, increasingly, Chile."

Guarini returned repeatedly to the problem of illegal immigration, noting that the Mexican border was being crossed not just by Mexicans but also by refugees from many other countries.

Both Guarini and Rangel, chairman of the Select Committee on Narcotics Abuse and Control, urged Hills to raise the issue of drug trafficking in her talks with Serra.

Hills said she preferred to focus her work on "licit trade." Rangel replied that the drug problem "should have the same sort of priority as legal trade."

Guarini then compared the issue to human rights concerns the United States routinely interjects into other trade negotiations. "It's such a great opportunity to bring all our problems to the table," he said.

"We're going to have quite a table," said Hills. ■

Richard S. Belous
Rebecca S. Hartley
Editors

National Planning Association, 1990

Executive Summary

Regional trading blocs appear to be a growing force in the global economy. The new U.S.-Canada Free Trade Agreement, plans to form a unified market in the European Community and a potential Asian yen trading zone are clear signs that the role of regional blocs is increasing. In addition, numerous regional agreements have been formed in Latin America, Africa, South Asia, and Southeast Asia.

This study is one of the first in-depth examinations of this international trend and its impact on corporations, workers and governments. As part of the study, the National Planning Association surveyed the members of its policy committees, many of whom are chairs, vice chairs, presidents, or CEOs of leading American corporations. The majority of these executives—88 percent—believe the world economy is shifting more in the direction of regional trading blocs. Roughly 75 percent think this trend will hurt the General Agreement on Tariffs and Trade, which has provided the international rules of the road for a vast portion of world trade since the late 1940s. Thus, a larger role for regional blocs could have a major impact on the international economy.

MULTILATERALISM VERSUS REGIONALISM

One way to understand regional trading blocs is to compare them with the GATT. As indicated in the following chart, the key principle behind the multilateral GATT system is nondiscrimination, while regional trading blocs are founded on the principle of preferences. Bloc members can practice discrimination in granting different preferences to various nations. The GATT system is open to all nations who are willing to follow certain basic rules, whereas a regional trading bloc may not be open to all who wish to join and agree to follow the bloc's basic rules.

Backers of multilateralism tend to base their views on concepts such as free trade, comparative advantage and economic liberalism. Backers of regional trading blocs—which often take the form of free trade areas, customs unions or sectorial agreements—favor free trade in certain cases but also often endorse what is called neomercantilism. They base their economic world view on concepts such as strategic trade theory, managed trade and economic nationalism rather than the traditional concept of comparative advantage.

As the hegemonic leader of the Western world after World War II, the United States was a major force behind the GATT,

A COMPARISON OF THE PRINCIPLES AND CHARACTERISTICS OF THE GATT AND THE REGIONAL TRADING BLOC MODEL

GATT Principles and Characteristics	Regional Trading Bloc Principles and Characteristics
(1) Trade is based on the principle of nondiscrimination.	(1) Trade is based on the principle of discrimination.
(2) All members are bound to grant as favorable treatment to each other as they give to any other member, i.e., most-favored-nation status.	(2) Nations within the bloc share special preferences not granted to nations outside the bloc.
(3) To the maximum extent possible, protection should be provided only through tariffs.	(3) Protection is often provided through quantitative restrictions as well as tariffs.
(4) Basic ideas include economic liberalism, multilateralism and free trade based on comparative advantage.	(4) Basic ideas include economic nationalism or regionalism, bilateralism, and trade often based on strategic trade theory and neomercantilism.
(5) The system is designed as a community open to all who are willing to follow membership rules.	(5) The bloc may not be open to all who wish to join and are willing to follow membership rules.
(6) The goal is to build a unified and integrated global system.	(6) The bloc may function as an exclusive club that generates a "them versus us" psychology.
(7) Under Article XXIV, the system provides a three-part test to determine if a regional trading bloc is consistent with the GATT.	(7) In the view of some advocates, blocs are a way of building a stronger multilateral system in the long run.

and many American government, business and labor leaders backed the multilateral trading system. However, because of the relatively declining U.S. share of the global economy, American leadership has been unable to push multilateralism with the same force it used prior to 1980, and a growing number of public and private sector leaders are now flirting with the notion of regional trading blocs. Furthermore, many U.S. leaders question the comparatively high cost to the United States under the multilateral trading system in relation to other GATT members, who, they argue, should be paying a larger share.

TWO-TIERED POLICIES

Outside the academic community, there are few advocates of either pure multilateralism or pure regional trading blocs. In most cases, political, business and labor leaders support policies that mix features of both systems. Under such a two-tiered policy, for example, economic liberalism and free trade may increase within a regional trading bloc; conversely, economic nationalism or economic regionalism may become a stronger force outside a bloc.

Implementation of a two-tiered policy could greatly alter the international trading system. If, through a policy mix, the United States makes a significant move away from multilateralism, the GATT will be seriously harmed. The hope is that a two-tiered policy for the United States can be constructed so as not to harm the GATT.

HUMAN RESOURCE IMPACTS

The growth of regional trading blocs also could substantially influence labor markets and labor-management relations. Increased dependence on blocs rather than on the GATT could present management with many new options concerning employment patterns, compensation structures and unionization levels.

In reaction to these new realities, labor is starting to strive for regional labor, health and safety standards. In the European Community, labor is currently playing a major role in the drafting of EC-wide labor market and social policy standards. In the United States, labor has shown a strong interest in trade policy and legislation.

DIVERSE VIEWS

This study presents a number of views on the issue. Chapter 1 is a basic introduction to regional trading blocs written by the editors. It traces the economic and political reasons behind the regional trading bloc trend. Chapter 2, by C. Michael Aho, Director of Economic Studies at the Council on Foreign Relations, presents the case against the growth of regional trading blocs. Chapter 3, by Richard Cooper, Director of Tax Economics, Price Waterhouse, details the points in favor of regional trading blocs. Dr. Cooper explains how to maximize the benefits and minimize the costs of regional trading blocs.

Mark Anderson, head of the Office of International Trade at the AFL-CIO, offers a view from labor in Chapter 4. He highlights the problems the GATT has created for American workers in recent years. In Chapter 5, Richard Belous, NPA Vice President of

International Affairs, explains how regional trading blocs may act as a new "wild card" in labor-management relations.

In Chapter 6, Herbert Weiner, a Consultant on labor matters to the Department of State and a former career Foreign Service Officer, discusses the philosophy underlying the United States' support of the Marshall Plan and of Europe's efforts to build a unified community. In Chapter 7, Michael Calingaert examines how EC 1992 could affect the European Community's trade policy and actions. Mr. Calingaert is the Director of European Operations for the Pharmaceutical Manufacturers Association and a former NPA Visiting Senior Fellow.

Maureen Farrow, former President of the C.D. Howe Institute and a Senior Economist with Coopers and Lybrand, and Robert York, a Policy Analyst at the C.D. Howe Institute and Canadian Research Director of the Canadian-American Committee, analyze the policy implications of the U.S.-Canada FTA and EC 1992 for Canada and the United States in Chapter 8.

Dick Nanto, a Senior Economist with the Congressional Research Service of the Library of Congress, focuses on the reactions of Japan and its neighbors to the growth of regional trading blocs in Chapter 9. Richard Tropp, the Chief Executive Officer of Washington Development Capital Corporation, takes a close look at U.S. government and business approaches to regional trading agreements in Latin America, Africa, South Asia, and Southeast Asia in Chapter 10. Rebecca Hartley, an NPA Fellow in the international program, examines in Chapter 11 the evolution of the Eastern European trading bloc, the Council for Mutual Economic Assistance. In Chapter 12, Peter Morici, Associate Professor of Government at the University of Maine and an NPA Senior Fellow, looks at the attractions and disadvantages of forming regional trading blocs.

UNDERSTANDING THE ALTERNATIVES

Changes in the international economy since the GATT was formed—the rise of important new trading sectors and the adjustment costs associated with losing, or failing to gain, significant international market shares—have been responsible for creating considerable unrest and disenchantment with the GATT's mechanisms for regulating international trade. Some GATT contracting parties and associated countries have created customs unions and free trade zones that have been inconsistent with the GATT system; the major industrialized nations, however, have generally continued to support the basic principles of the GATT.

We may now be seeing the rise of significant support for managed trade through the use of regional trading blocs as a way

to address problems that the GATT has been unable—up to now—to resolve. This study presents the important arguments for and against both regional and multilateral trading systems in an effort to understand the problems of the present system and the alternatives for its future.

USTR Issues Reports on Procurement And Intellectual Property Protection

As required by the Omnibus Trade and Competitiveness Act of 1988, the U.S. Trade Representative recently issued annual reports on other governments' policies on procurement and intellectual property protection. In government procurement, no countries were singled out as having discriminatory policies, but problems with a number of countries were outlined. Under the "Special 301" provision of the act, the USTR reported that several nations had strengthened intellectual property protection in the past year; the report highlighted remaining problems with several countries.

Government Procurement

Although the United States expressed concern about government procurement procedures that discriminate against U.S. goods and services in several countries, the U.S. Trade Representative (USTR) decided that none met the criteria for identification as a discriminating country.

Under the Omnibus Trade and Competitiveness Act of 1988 (Title VII—Buy American Act) the USTR is to identify, in a report to Congress by April 30 of each year, countries that violate the GATT Agreement on Government Procurement or meet three criteria for discrimination in areas not covered by the Code; the same criteria apply to countries that have not signed the Code. The criteria are: a significant pattern or practice of discrimination in government procurement againt U.S. goods and services; identifiable harm to U.S. business; and significant purchases by the U.S. Government of products or services from the country.

USTR Carla Hills emphasized that the Administration is giving top priority to a renegotiation of the Code that would expand its coverage to such currently excluded sectors as heavy electrical equipment and telecommunications. The Procurement Code talks have been timed to coincide with the Uruguay Round of the GATT, which is scheduled to conclude in December.

The USTR is providing Congress information on the following countries and regions, whose procurement markets are of particular significance, where substantial procurement problems have arisen:

- European Community. EC heavy electrical equipment and telecommunications markets are important to U.S. suppliers. The EC and the United States are engaged with other Code signatories in talks to expand the Code. Progress toward achieving nondiscriminatory procurement opportunities will be monitored closely over the next year.
- Germany. The United States is especially concerned about access to the heavy electrical equipment and telecommunications sectors.
- France. The United States is especially concerned about access to the heavy electrical equipment and telecommunications sectors.
- Italy. The United States is especially concerned about access to the heavy electrical equipment and telecommunications sectors.
- Greece. The United States seeks to have Greece establish overall non-discriminatory procurement policies.
- Japan. In the past, U.S. firms have encountered substantial procurement discrimination in the Japanese market. Recently, however, important progress has been made in several sectors, including satellites and supercomputers. The United States seeks a successful conclusion of the two-year review of the Major Projects Arrangement on construction, scheduled for May 1990.
- Australia. The United States is especially concerned about certain offsets policies. The United States encourages Australia to join the Code and to bring its policies and procedures in line with the obligations of the Code.

The USTR reported on recent procurement developments. A dispute settlement proceeding initiated by the United States under the Code involving procurement of electronic toll booth collection equipment by the Government of Norway was resolved successfully last month through cooperative negotiations. Norway has taken actions that offset the effect of this procurement on the U.S. bidder, and has agreed to take steps to ensure that future procurements are carried out in accordance with Code procedures. There are no other formal Code violations alleged at this time by the United States against any country.

The USTR expressed satisfaction with the decision made by Korea to seek accession to the Code. The Government of Korea announced in March its decision to accede to the Code, and will submit an initial entities list by June 30. In February, Korea agreed to include in its proposal to the Code Committee telecommunications contracts of major government entities procuring telecommunications equipment.

Intellectual Property Protection

The U.S. Trade Representative (USTR) reported a number of examples of strengthened intellectual property rules by foreign governments since the last statutorily mandated review a year ago. The USTR also cited several countries for continuing problems, including Indonesia, Turkey, the Philippines, and the Federal Republic of Germany.

On May 25, 1989, the USTR announced that under the Special 301 intellectual property provisions of the Omnibus Trade and Competitiveness Act of 1988, the Administration had singled out 25 trading partners whose practices deserved special attention. Of these, 17 were placed on the Watch List, while the remaining eight were placed on a Priority Watch List. (As reported in the May 7 issue of *Business America*, the USTR this year listed 23 countries whose intellectual property practices require special attention.)

The status of the eight trading partners placed on the Priority Watch List in 1989 was carefully reviewed last Nov. 1. Saudi Arabia, Korea and Taiwan were moved to the Watch List at that time because of significant progress in the protection of intellectual property rights. The Administration had expressed concern in November about certain intellectual property practices of two countries that remain on the Watch List: Malaysia and Turkey.

In January 1990, Mexico was removed from all lists after it published its "Industry and Trade Sectoral Plan" outlining the Mexican Government's intention to improve process and product patent protection, in addition to improving the enforcement of trademarks and providing enhanced protection for trade secrets.

Examples of strengthened intellectual property rules cited by the USTR include:

- In April 1990, the United States secured Malaysian Government commitments to amend its copyright law and accede to the Berne Convention by the end of this year.
- The United States signed an agreement in March 1989 with Indonesia establishing bilateral copyright relations, and in October 1989, Indonesia enacted its first patent law.
- In April 1990, the EC tabled a legal text in the Uruguay Round negotiations on the Trade Related Aspects of Intellectual Property Rights.
- The United States signed trade agreements with Poland and Czechoslovakia in March and April 1990 that include strong terms for intellectual property rights protection.
- In March 1990, Yugoslavia amended its patent law to extend the term of protection to 20 years from filing, among other improvements.
- Chile passed a new patent law in January 1990.
- In January 1990, the FRG increased penalties for intellectual property infringement.
- Saudi Arabia implemented a new copyright law in December 1989.
- The PRC submitted a draft copyright law to the National People's Congress Standing Committee and patent law amendments to the State Council in December 1989.
- Colombia passed a law defining computer software as a copyrightable material in June 1989.
- In November 1989, Portugal increased penalties for audio piracy.
- Italy introduced legislation to prevent computer software piracy in November 1989.
- Spain extended patent protection to U.S. plant varieties on a reciprocal basis in June 1989.

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INTERNATIONAL TRADE EFFECTS OF VALUE ADDED TAXATION

ABSTRACT

The actual value added tax systems used in many countries differ significantly from the completely general VAT that has been the focus of most economic analyses. In practice, VAT systems exempt broad classes of consumer goods and services. This has important implications for the effect of the VAT on international trade.

A value added tax is sometimes advocated as a way of improving a country's international competitiveness because GATT rules permit the tax to be levied on imports and rebated on exports. This leads to political support for the VAT among exporters and producers of import-competing products.

For a general VAT on all consumption, this argument is incorrect except in the very short run because exchange rates or domestic prices adjust to offset the effect of the tax on the relative prices of domestic and foreign goods. When prices or exchange rates have adjusted, a general value added tax will have no effect on imports and exports.

In practice, the value added tax frequently exempts housing and many personal services. The VAT thus raises the price of tradeables relative to nontradeables and induces a substitution of housing and services for tradeable goods. Since this implies a reduced consumption of imported goods, it also implies a decline in exports. The most likely effect of the introduction of a VAT would thus be a decline of exports.

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The Potential of Trade Expansion as a Generator of Added Employment in The Caribbean Basin

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Commission for the Study of International Migration and Cooperative Economic Development

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ABSTRACT

The existence of a relatively large pool of underemployed workers is an important factor to consider when looking for political and economic solutions to the current problems in Central America and the Caribbean. In Central America, the labor force is growing more rapidly than the economies can handle.

This paper provides estimates of export-employment linkages for manufacturing exports from Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras, Jamaica, Nicaragua and Panama in an effort to assess the potential of trade expansion to generate new jobs in the region. Reasonable trade expansion scenarios are then reviewed and the related employment is compared to expected labor force growth through the year 2000. This paper concludes with a section on the implications for public policy both in the United States and in Central America and the Caribbean.

In general, the expected new employment generated by manufactured exports will be rather small in comparison to the rapid increases taking place in the labor forces of Central American and Caribbean countries. Only in Costa Rica, and possibly in the Dominican Republic, can it be said that new manufacturing exports will contribute significantly to fulfilling employment needs in the rest of the century—and only if the export growth rate substantially exceeds 13 percent.

A large majority of new employment, even within Costa Rica and the Dominican Republic, must be generated by agricultural exports and by production (manufacturing as well as agricultural) for domestic consumption.

The region will continue to require the help of the external donor community. On the aid front, a broad-based development strategy should be adopted to generate the necessary employment. Domestic expansion must be seen as a complement, rather than a competitor with export growth. As for trade policy, industrial-country barriers to trade in labor-intensive products should be removed, especially in the apparel, textile, leather and fur, footwear, pottery, handbags and wood product industries.

THE WASHINGTON POST, May 1, 1990

Claude E. Barfield

The Grand Inquisitor on Trade

The second annual search for countries to be blamed for aggravating America's world trade problems is officially ended. This time it netted only one alleged offender, which might be a good sign that it's time to bring an early end to this peculiarly American ritual before it becomes any further established.

The search is conducted under "Super 301," the name informally given a section of the 1988 Trade Act. Super 301 mandates the indictment of a group of "priority" countries that allegedly maintain unfair trade practices which significantly inhibit U.S. exports. More than any other single provision, Super 301 symbolizes the perverse wrongheadedness of the 1988 act and the persistent refusal of Congress to acknowledge that our trade problems and deficit stem from internal macroeconomic failures and the emergence of new economic competitors, not from the unfair trade practices of our rivals.

Last year, after fierce internal debate, the administration singled out three countries for potential retaliation—Japan (superconductors, communications satellites and lumber), Brazil (restrictive import licenses) and India (foreign investment and insurance restrictions). For 1990, U.S. Trade Representative Carla Hills announced late last week that Japan and Brazil would be dropped from the list, but that India would be cited again.

Super 301 symbolizes the refusal of Congress to acknowledge that our trade problems stem from internal macroeconomic failures.

No other countries were added as alleged offenders.

The 1989 Super 301 actions by the United States resulted in a wave of protests from our major trading partners, who argued that we had arbitrarily assumed the role of prosecutor, judge and jury. This year's citation will undoubtedly produce the same result. Even conceding a sizable element of cynical hypocrisy in these criticisms, there are at least two reasons why—despite the adroit handling of the issue by the president and Ambassador Hills—Super 301 is a bad policy that does not advance U.S. trade interests and should be abandoned as a part of the Uruguay Round GATT negotiations.

First, the Super 301 process is at base arbitrary, capricious and ultimately ruled by the the kind of political judgments the United States argues against in the trade practices of other nations. Congress mandated action against those practices and those nations that *most heavily* restrict U.S. exports. The truth is, though, that it is virtually impossible (and the U.S. trade representative has never seriously attempted) to calculate with any accuracy the impact of individual trade barriers on U.S. exports. The National Trade Estimates Report, upon which such judgments are supposed to be made, is thus a document without economic or statistical foundation. It consists largely of self-serving industry estimates and disclaimers by the trade representative that it is "not possible to estimate the economic impact of [this barrier]."

Lacking an analytic base, the decisions regarding the Super 301 indictments become highly political and inevitably hostage to interest-group pressure. This was clearly the case last year with the naming of India and Brazil, and the remaining of India this year. Both India and Brazil maintain self-defeating trade policies that hurt their populations as well as U.S. economic interests. But they are no more destructive of U.S. exporting potential than the various combinations of tariffs, import licensing restrictions, investment barriers, export subsidies and other devices used by Egypt, Pakistan and Indonesia—to give just three illustrative examples.

The real reason for naming India and Brazil last year, as trade officials openly stated afterward, was in retaliation against their role as leaders of a bloc of developing countries that opposed U.S. goals in the Uruguay Round of GATT negotiations. (During the past year, President Bush and Ambassador Hills have stated repeatedly that successful completion of the Uruguay Round is the No. 1 priority of administration trade policy. Yet branding India, the leading recalcitrant nation, as an unfair trader two years running, seems particularly counterproductive to the achievement of real breakthroughs in Geneva.)

The treatment of the European Community under Super 301 also illustrates the lack of credible standards for judgments under that section of the law. Just as the 1989 Super 301 indictments were being handed down, the EC announced plans to institute domestic content quotas against U.S. television programs, an action that will cost U.S. companies hundreds of millions of dollars.

Yet in the face of this direct attack on U.S. exports, the administration supinely decided that it would pursue "other means" of redress. In recent months, despite repeated U.S. protests, the EC has moved steadily forward in the implementation of its television and movie restrictions. Yet once again this year the EC escaped citation under Super 301. Apparently, large trading blocs with economic clout and the capability to hurt the United States by retaliating enjoy immunity from the sting of Super 301.

The second reason that the Bush administration should act with greater boldness and offer to abandon the Super 301 process as a part of a successful GATT round package is that whatever nitpicking defense U.S. trade lawyers may advance, Super 301 violates the fundamental premises of the multilateral trading system embodied in the GATT. That system is based upon a negotiated reciprocal reduction of trade barriers, instituted on a multilateral basis across many industrial and service sectors. It would be destroyed if each of its members unilaterally redefined "unfair" trade practices and undertook separate bilateral negotiations to enforce those definitions.

As we enter the final months of the Uruguay Round negotiations, the United States is in many ways strategically positioned to provide crucial leadership to achieve unprecedented market-opening reforms. It has advanced a number of sensible, imaginative proposals on the central issues, and in Carla Hills and Clayton Yeutter it has an extraordinarily able negotiating team. The Bush administration should not jeopardize this multilateral leadership role by continuing to defend and pursue the destructive role of Grand Inquisitor for the entire international trading community.

The writer is director of trade policy studies at the American Enterprise Institute.

THE JOURNAL OF COMMERCE, June 25, 1990

Textile Thunder and Lightning

By MARC LEVINSON

A scandal soon may break on these pages. According to the Washington rumor mill, influential members of Congress are poised to unveil allegations of widespread fraud involving imported clothing. Garments made in China, they will claim, are being misidentified as products of Macao and Hong Kong to evade U.S. quotas. Look for investigations and speeches, and the predictable thunder and lightning.

The timing is not coincidental, for Congress is debating a textile bill once again. And the timing of that debate is not coincidental, either.

In Geneva, Switzerland, negotiators from the United States and 105 other countries are discussing ways to lower the restrictions that bem global trade in textiles. That's likely to mean that the United States will have to allow in more foreign-made fabric and clothing.

U.S. textile manufacturers don't like that. On their behalf, Sen. Ernest F. Hollings, D-S.C., has introduced legislation that would allow the total amount of textile products entering the country to rise by only 1% a year. Since U.S. consumption of textile products grows at about 2% a year, Mr. Hollings' bill assures that U.S. producers will gain market share year after year. His bill was voted out by the Senate Finance Committee last Thursday.

Mr. Hollings' bill doesn't stand much of a chance of becoming law; President Bush is sure to veto it. But that's not the point. The point is to send a message to those negotiators in Geneva that they should forget about opening up trade in textiles and apparel. If they don't, Mr. Hollings would have them know, the sweeping trade accord they are negotiating will face stiff opposition on Capitol Hill.

This isn't the first time the textile industry has sent such a message. Since the early 1960s, textile manufacturers in the United States and Europe have succeeded in wrapping trade in cotton, woolen, polyester and even linen products in a tangle of rules that restrict imports. The United States, Western Europe and, increasingly, Japan put tight quotas on imports of particular types of cloth and garments from particular countries.

At present, the United States has agreements with 42 countries limiting imports of cotton trousers, man-made-fiber brassieres and dozens of other products. Roughly 75% of all textile products coming into the United States are subject to quota limitations.

Were car parts or tape recorders at issue, those quotas would be illegal under the rules of the 97-nation General Agreement on Tariffs and Trade. But by the agreement of its members, GATT's rules don't apply to textiles. The current negotiations in Geneva would bring textile trade under the same rules as trade in other commodities. That's the last thing American textile producers want.

That's the last thing most foreign textile producers want, too. Quotas raise the price of clothing in the U.S. market, which means higher profits for foreign producers. And since the quotas are handed out on a country-by-country basis, manufacturers in high-wage countries like Taiwan and Hong Kong know they won't be driven out of the U.S. market by manufacturers from low-wage countries, like India and China.

To cut through this opposition, the United States has offered a rather imaginative proposal in Geneva.

Ten years from now, all barriers to textile trade, in other countries as well as in the United States, would disappear. In the meanwhile, country-specific quotas would remain in place where they already exist as a concession to exporters who don't want to lose their valuable access to the U.S. and European markets. No new quotas could be imposed. And the existing country-specific quotas would not grow; as the allowable amount of imports expands over the 10-year transition period, the entire amount of increase would be filled by whatever country could ship the goods at the lowest cost, not by some lucky holder of quota rights.

This would have a major impact on consumers in the United States. Textile and apparel quotas add billions to every American family's annual clothing bill. The burden is highest on low-income families, who spend a far greater share of their incomes on clothing than do the wealthy.

Some jobs in clothing manufacturing are preserved as a result. But economic studies place the cost of each job saved by the quotas at over $40,000 a year — several times the average annual pay of a sewing machine operator.

The U.S. textile industry, of course, profits handsomely from protection. Most of its members want to see trade barriers as high as they can get them.

If the textile manufacturers could put a stop to the negotiations in Geneva, they would. They can not. But they can count on their reliable allies on Capitol Hill to provide a little thunder and lightening at the appropriate time, just in case anyone in Geneva is watching.

Marc Levinson is editorial director of The Journal of Commerce.

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THE WASHINGTON TIMES, June 6, 1990

PAUL GREENBERG

Trading with the enemy

There was a time when the United States was not about to offer trade and comfort to an enemy of freedom. The time was the 1970s, and the enemy was a totalitarian power that refused to let its people go. Even now the Soviet Union cannot trade with the United States on the most favorable terms — although that is about to change because the Soviet Union is changing, if not evaporating.

To a generation that grew up with the Cold War, the changes in Russia have come with stunning speed. Yet they were long in the making. They spring not only from the weaknesses of communism but from the strengths of those who proposed to contain it. The strategy called Containment (1947-) took the long view, and it is finally paying off. With the exception of arms programs, perhaps no part of that strategy did more to pierce the Iron Curtain than the denial of trading rights embodied in the Jackson-Vanik Amendment. Its passage sent a strong message to a country that was eager, even desperate, to modernize: So long as the Soviet Union refused to recognize that most basic human right, the right to pick up and leave, it could not expect easy access to the American market.

The Soviets balked, they insisted that such a policy would never influence them, they huffed and puffed ... but in the end they changed. And the change in emigration policy was followed by change throughout the system. Jackson-Vanik worked. (I still miss Henry "Scoop" Jackson, late senator from the state of Washington and Cold Warrior of the first rank. He not only had principle but perseverance.)

Not all of Jackson-Vanik's detractors were in the Kremlin. During the false dawn called Detente, when Washington adopted a softer line toward Moscow without insisting on fundamental change within the communist system, the Nixon administration used various arguments against Jackson-Vanik, among them:

- Its repeal would help Russian businessmen and innovators — just the sort of Soviet subjects we wanted to encourage.
- Its repeal would also help Americans; trade would flourish and profits with it.

Sound familiar? Those are essentially the same arguments the Bush administration is using to rationalize its decision to let Communist China continue trading with this country on the most favorable terms. To quote the president: "The people who trade with us are the engine of reform opening to the outside world. Our responsibility to them is best met not by isolating those forces from contact with us ... but by keeping open the channels of commerce and communication." Also: "China buys about $6 billion a year of American aircraft and wheat and chemicals, lumber and other products. Lose this market and we lose American jobs."

Congress never bought those arguments when Detente was all the rage. It saw that granting the Soviets trading rights would let Brezhnev & Co. import American capital and technology without having to import American ideas — like freedom. Just as Josef Stalin once did.

In defending his China policy, President Bush noted that Beijing has made certain concessions of late. It has lifted martial law at least formally; it has been only semi-beastly to the Tibetans; and it has released a couple of hundred political prisoners. Doubtless such gestures will continue in return for trading rights with this country. But that is all they will be: gestures. There will be no tangible pressure to go beyond the occasional concession and change the system itself. Freedom doesn't spread just by osmosis.

It may take the diplomatic equivalent of a 2-by-4 (like Jackson-Vanik) to attract the attention of some regimes.

The glimmering benefits of the China trade are now being dangled before the American people. Oil-for-the-Lamps-of-China and all that. The China trade always has promised more than it delivered. Now it is being used to rationalize the appeasement of a regime that demonstrated its essential character a year ago in Tiananmen Square. The spirit that moved the students who were slaughtered there has not died. It has only gone underground. The free China it will inspire one day, perhaps one day soon, will not forget that America chose trade over human rights at a crucial time. Why appease the past when we could side with the future?

Washington has yet to learn the lesson of Jackson-Vanik's success. The president says he's been told that China's students approve of his policy. That will come as a surprise to Shen Tong, a leader of last year's demonstrations who fled to this country. "The president's action," he warns, "will serve only to undermine the efforts of those struggling for basic human rights in China." It is difficult to see how it could have any other effect. Someone like Shen Tong surely is closer to China's students than George Bush. Having spent a year or two in Beijing as the American ambassador, perhaps Mr. Bush thinks he knows better. If so, his is the old mistake of the Westerner who thinks he knows the East after the briefest of exposures.

By trading with the enemy, the president explains, we shall weaken it. Once upon a time Americans knew better. The most effective way to stand by our principles is simply to stand by them. Alas, that may strike the experts in Washington as unspeakably simple. So did the Jackson-Vanik Amendment.

Paul Greenberg is editorial page editor of the Pine Bluff (Ark.) Commercial and a nationally syndicated columnist.

LOS ANGELES TIMES, April 2, 1990

A 'Deal' to Give Away the Store

■ Mexico: A free-trade agreement with the U.S. would be a travesty of history and economics. Even talking about it is an act of political desperation.

By JORGE G. CASTAÑEDA

MEXICO CITY—Leaks in Washington and rumors in Mexico about the beginning of talks on a free-trade agreement are both surprising and expected.

The move toward a common market is surprising because Mexico has always questioned whether full economic integration with the United States would benefit Mexico; the present administration has constantly restated Mexico's position that across-the-board free trade was not in our best interest. Just two weeks ago, President Carlos Salinas de Gortari, speaking in Chile, stressed the need for Mexico to strengthen its ties to Latin America, rejecting the notion of joining any one trading bloc.

So it was a surprise, to say the least, to learn that at the same time, Salinas' top aides were secretly meeting in Washington with the secretaries of State and Commerce, James A. Baker III and Robert A. Mosbacher, and Trade Representative Carla A. Hills, along with National Security Council Director Brent Scowcroft. The subject: possible negotiations on fully open trade between the two countries.

At the same time, these developments cannot be considered entirely unexpected. For months, many careful observers of the Mexican economy have been warning that, under existing conditions, and despite its apparent, superficial success, Salinas' economic reform program faced nearly insurmountable obstacles. Herein lies the explanation for the Mexican move toward an agreement with Washington, as well as its accelerated pace and secrecy. Herein also lie the reasons for doubting the wisdom of this bold—or reckless—step.

The problem is relatively simple. The initial drastic trade opening abruptly imposed on Mexico two years ago has had foreseeable consequences. Even with a barely growing economy, but thanks to a politically indispensable appreciating exchange rate, imports have skyrocketed and exports have stagnated. Purchases abroad rose 57% in 1988, nearly 30% in 1989, yet the economy grew only at an average of 1.5% per year, and investment in infrastructure, capital goods and retooling remained low (even though these are all import-intensive areas). Exports grew only 15% in 1989, and half of that growth represented a rise in oil prices. Non-oil exports increased only by 8%. During the fourth quarter of 1989, the annualized figure for the trade deficit was $3.5 billion—higher than at any time since 1981.

The meaning of this was evident. If the economy were ever to reach even a 4% sustained yearly growth, it would require enormous external funding—roughly $5 billion a year—for a considerable period of time.

Given the country's foreign debt and the trade opening, for Mexico to grow it had to drastically reduce its debt service or obtain money some other way. The Salinas-Brady debt package ended up providing only marginal relief—outstanding debt remaining more or less stable, and yearly debt service dropping by 15%, at most.

That left only three possibilities for easing the deficit: a recession, which in fact happened early this year; or the return of Mexican capital from abroad, quickly and in droves; or a rush of direct foreign investment into Mexico. Some money has trickled back, but even in small amounts, repatriation of capital requires exorbitant domestic real interest rates, and the process does not seem likely to become lasting or substantial.

More important, foreign investment is not forthcoming, despite changes in regulations and the government's efforts to woo investors. During the first nine months of last year, the net flow, according to Mexico's respected financial daily, El Financiero, reached only $1.337 billion, down 45% from the previous year. Prospects are even less encouraging as European and Japanese investment is diverted to Eastern Europe.

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Beyond the immediate problems, analysts of the Mexican economy see a broader obstacle to a significant rise in direct foreign investment. In the past, investors were attracted by Mexico's growing, protected internal market. But since 1982 the domestic market in Mexico has been stagnant or shrinking, and since 1987 it has been totally unprotected. U.S. investment will flow to the Mexican export sector—which is directed essentially at the U.S. market—or not at all. But export investment requires guaranteed product access to export markets as well as full, unrestricted, across-the-board investor access to the host-country banks, insurance companies, communications, consultants and so on. This is where the free-trade agreement comes into play.

If Mexico is to receive the amount of foreign investment that the Salinas program requires, a full-fledged open trade agreement with the United States seems to be a necessary condition. It is also an urgent one. Salinas faces congressional elections next year and a presidential election in 1994. If things do not come together quickly on the economic front, his entire presidency may unravel. But the solution—economic integration with the United States—may prove more costly and more dangerous than the problem. This explains the secrecy and the government's waffling on the issue.

It is not an easy issue to deal with. Mexicans' fears and doubts about a common market are not groundless. While parts of the country and society would benefit—the north, and the upper-middle class—others could be permanently condemned to the humiliation of the underpaid, under-skilled underclass. Political autonomy might be sacrificed for prosperity for certain regions and sectors but not for the whole country.

Mexican nationalism would not easily acquiesce to this state of affairs. And tying the Mexican economy's future to that of the U.S. economy at a time of great uncertainty is not necessarily the most prudent course to follow.

On the other hand, Latin American economic integration seems illusory, and Mexico's economic links to the north are already extraordinarily tight. Indeed, the question of closer economic ties with the United States appears increasingly less relevant than that of how to establish them in a way that reduces their negative potential and enhances their benefits for Mexico. In this case, the issue changes, and Salinas' rush toward integration becomes open to criticism for different reasons.

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If Mexico must consider the prospect of a common market, or even a limited free-trade agreement, with the United States and possibly Canada, it should do so only under certain conditions. The first one, of course, has to do with openness and democracy: Such a major change in the country's history cannot be carried out behind the Mexican people's backs, or without their informed and democratically expressed consent. Nothing of the sort is taking place.

The process should be undertaken as part of a patient, long-term, well-thought-out political and economic strategy. It cannot and will not work as a quick fix undertaken for reasons of political survival or expediency. Countries that negotiate in a hurry generally give away the store, and Mexico's store has been given away far too many times.

Also, Mexico should press, and hold out as long as is necessary, for access for its main export to the United States, now and in the foreseeable future: people. Freedom of entry for Mexican labor is obviously something Washington will not accept willingly overnight.

But this is what real negotiations as opposed to unilateral concessions, are all about: accepting the previously unacceptable. Bold strokes and historic changes should come about on both sides of the border, in American policy toward Mexico and in the Mexican government's policy toward Mexican society. Otherwise they are simply desperate shots in the dark, which a proud and worthy people will not countenance.

Jorge G. Castañeda is a graduate professor of political science at the National University of Mexico.

EDITORIAL/OPINION

Mexico Ponders Free Trade Pact

For Salinas, Program Offers Political Boost

By M. DELAL BAER and BEN TONRA

Mexico's quiet affair with North American free trade has been publicized before the formal engagement. In seeking talks with the United States on a free trade agreement, Mexican President Carlos Salinas de Gortari may have concluded that his domestic restructuring program needed a boost. The objective now is to marry the Mexican economy with a North American free trade area, hoping that such a match will bring renewed prosperity.

Mr. Salinas launched his economic modernization drive upon taking office in 1988. This program has included liberalized foreign investment regulations, the privatization of state-owned companies, trade liberalization and deregulation. This opening has taken the Mexican economy from stagnation in 1988 to a predicted 3% growth rate in 1990, and reduced the official inflation rate from 180% in 1988 to an average rate of less than 18% over the past 12 months.

This economic upturn, however, is built on fragile foundations. Mexico faces a 1989 balance of payments deficit estimated to be $5 billion. Observers are also forecasting a 12-month trade deficit of $500 million. These trends prompt speculation about a peso devaluation in 1990.

New foreign investment has yet to become the promised motor of growth. In 1989, despite the relaxation of foreign investment regulations in May of that year, foreign investment actually fell to about $2.2 billion from $2.6 billion in 1988. Current estimates for 1990 show only a modest improvement on these figures.

Investors worry that while the regulations have been relaxed, an unfriendly foreign investment law is still on the books. Similarly, while the headlong flight of capital seen in the mid-1980s has ended, investors are still cautious about repatriating their overseas capital. The government's wage and price freeze, due to expire in July 1990, has reduced inflation but at the cost of building up pressures for wage and price increases.

Mr. Salinas has invested much political capital in his restructuring program and needs a high economic return. So far he hasn't gotten it. Competition for foreign investment has heightened since the Eastern European revolutions of 1989. Some believe that Mr. Salinas underwent a conversion to the North American concept after his January European visit convinced him that Mexico would not be able to attract the attention of investors without secure access to the U.S. market.

Global trading blocs are emerging as the bipolar security world disintegrates. 1992 will mark the economic integration of the European Community. It is also likely that Japan will turn greater attention to its Pacific Rim strategy to build markets, trade and investment. Mexico, Canada and the United States must deal with this reality, either separately or together.

Mexico's North American strategy has been carefully to include Canada. In January nearly half the Mexican cabinet flew to Ottawa for talks on expanding economic relations. On March 19 Canadian Prime Minister Brian Mulroney returned the compliment in Mexico City, signing 10 accords, including a framework agreement designed to substantially increase bilateral trade, currently valued at nearly $1.5 billion. Mexico has taken note of the estimated quarter million new jobs and increased foreign investment that may be partially related to the year-old U.S.-Canadian free trade agreement.

A North American free trade agreement would provide all three partners — Mexico, Canada and the United States — with the tools to compete successfully in a tightly structured world economy. The United States and Canada would provide Mexico with much-needed markets, capital and technology. In turn, Mexico can offer its own market of nearly 100 million consumers by the year 2000, inexpensive labor and abundant natural resources. A North American entity could thus be a strong and balanced player in a global economic arena.

Mr. Salinas' political style is that of a gambler willing to take big risks in search of big payoffs. Playing the North American card could be a political plus for him and his embattled party, the Institutional Revolutionary Party. As Mexico moves toward 1991 midterm elections, Mr. Salinas needs to extend his coattails. Public sentiment may be far less anti-Yankee than Mexico's intellectual caste would have us believe.

"I told you, amigos — it will finally have to open its doors to us!"

A North American free trade agreement will not be a panacea for Mexico. Trade restraints related to environmental, health, anti-dumping and Super 301 trade restrictions will not disappear. Still, significant benefits are likely to accrue. Many existing quotas and tariff barriers will be eliminated in important sectoral areas. An agreement would also guarantee market access, an important issue if Mexico's benefits under the Generalized System of Preferences were to be phased out.

The North American courtship is at a delicate stage. Too enthusiastic a U.S. embrace could raise Mexican suspicions as to motive. Too aloof a U.S. response will send Mexico away in search of other opportunities. A lack of adequate consultation could inflame Canadian sensitivities. With rational expectations and sensitive handling, however, Mexico can approach a North American relationship with confidence.

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For N. America, Issue Is Blocs Vs. Globalism

By MURRAY G. SMITH

Should the United States (oh yes, and Canada as well) start preparing for a world of trading blocs by negotiating bilateral free trade agreements with Mexico or by drawing Mexico into the recently launched Canada-U.S. Free Trade Agreement? Not at the expense of multilateral efforts to liberalize trade worldwide.

There are parallels between the recent proposal by Mexico's President Carlos Salinas de Gortari to explore closer economic ties with the United States and the sectoral approach proposed by Canada in 1983. The Canadian sectoral proposals encountered two problems. First, sectoral approaches were incompatible with the General Agreement on Tariffs and Trade. Second, the lists of sectors proposed by the two countries did not overlap, which made negotiations difficult. A combination of these two problems limit the prospects for the sectoral approach to bilateral or trilateral negotiations for Mexico as they did for Canada.

Pursuing the comprehensive approach permitted under the GATT rules poses some problems for all three nations. Although the liberalization of trade and payments regime has been dramatic and bold, since tariffs remain high many Mexican industries may oppose a full free trade agreement. Moreover, Mr. Salinas may discover that free trade with the United States reawakens nationalist sentiment in Mexico, just as Canadian sensitivities were stirred in Canada's 1988 free trade debate.

In the United States and Canada, industries such as textiles and apparel and auto parts, which were cautious about the free trade agreement, will be hostile to a similar arrangement with Mexico. U.S. opposition is likely to be more pronounced than nationalist concerns in Mexico or Canada, but could be very tough to dislodge. However, opposition in the United States would become more strident against a full-scale common market with unrestricted immigration.

There is a current economic trend toward greater regional trade and investment in Europe, North America and the Asia-Pacific region. However, governments should not necessarily pursue regional trading arrangements. If the global trading system starts to fracture along hemispheric fault lines, the world will be poorer. The emergence of such monolithic blocs could lead to rising trade conflicts with repercussions that no company or country could avoid.

The strengthening of economic linkages among the Western Pacific and European economies poses particular challenges for the North American economies. These challenges can be addressed by further macroeconomic adjustment and through achieving a successful outcome in the Uruguay Round of GATT negotiations.

Eventually, macroeconomic pressures will unwind the massive trade imbalances of the 1980s. With macroeconomic pressures to reduce the U.S. trade deficit, generating the trade surplus needed to service the substantial foreign debts of the three North American economies implies that collectively they will have to look to offshore markets for export growth prospect.

Some have expressed concern about a "Fortress Europe." Yet, the items on the 1992 agenda that may have adverse impacts on third countries are concentrated in agriculture, technical barriers, safeguards and anti-dumping duties, public procurement practices and rules for services. GATT rules in these areas are either inadequate, incomplete or non-existent. Thus the outcome of the Uruguay Round could be very significant in containing the adverse consequences of Europe's 1992 agenda as well as the emerging links between Western and Eastern Europe.

Although trade and investment links are expanding among the Western Pacific economies, there is no reason to fear the emergence of a Japan-centered trade bloc. The United States and Canada are full participants in the new Asia-Pacific Economic Cooperation, or APEC, process and they might encourage Mexican participation. But Asian nations involved in the process have stressed that substantial progress in the Uruguay Round is a high priority. Their overall goal is to strengthen the multilateral system. Some of the issues in the U.S.-Japan bilateral talks, such as tariffs on forest products, could be dealt with constructively in the Uruguay Round.

Next week Mexico is hosting an important meeting of trade ministers from developed and developing economies. Building on its own liberalization, Mexico can play an important role by bringing developing countries into effective participation in the contentious GATT agreements on services and intellectual property rights. Canada and the United States can demonstrate leadership by a willingness to liberalize gradually sensitive industries, such as textiles and apparel.

To respond to events in Europe and the competition from dynamic Asian economies, the North American economies must make rebuilding and strengthening the multilateral trading system a priority. The liberalization of trade and investment brought by the Canada-U.S. Free trade Agreement and by Mexico's liberalization will expand trade and investment links between these North American economies.

However, as debtor economies with current account deficits, Canada, the United States and Mexico must expand their exports of goods and services to offshore markets in the 1990s. All three will face common challenges as they attempt to do so. They have a strong interest in a successful outcome of the Uruguay Round, one that will promote the liberalization of commerce among North American economies and provide enhanced and more stable access to offshore markets.

Murray G. Smith is editor of "Canada, the Pacific & Global Trade," published by the Institute for Research on Public Policy in Ottawa.

THE WASHINGTON POST

THURSDAY, MAY 31, 1990 A23

Hobart Rowen

Are Food Imports Safe?

Over the years, politicians have put down environmentalists as fuzzy-thinking theorists uncommitted to the Almighty God of the Gross National Product. But the public, as it has been exposed to polluted water, air and land, has learned to pay attention.

Now, a coalition of environmentally aware and consumer organizations is sounding a new warning and—typically—is being ignored by large segments of the press. The coalition charges that in pressing for completion of the current round of multilateral trade negotiations under the aegis of the General Agreement on Tariffs and Trade, the Bush administration is willing to weaken existing American standards governing the safety of food.

The GATT accords cover about 80 percent of $3 trillion in annual trade among 96 nations. Negotiations are now underway, in what is known as the "Uruguay Round," to revise and extend them, especially in trade in services and agriculture.

The GATT system has been the umbrella under which global trade boomed since World War II. It is widely supported as a main bulwark against protectionism, and its benefits are eagerly sought by developing countries—and more recently by the Soviet Union.

But the largely positive results of the GATT should not be used as a cover-up for deflating environmental protection—and that is precisely what is being charged by the coalition. It says that the Bush administration is ready to accept international standards that often are not as protective as our own.

Two congressional resolutions have been introduced in support of this new environmental crusade. One, by Rep. Al Swift (D-Wash.), would block imports that do not meet minimal environmental, consumer and worker safety standards. That could be too broad a brush used by protectionists more interested in shutting off imports than in environmental safety.

The other resolution, offered by Rep. James H. Scheuer (D-N.Y.), goes more directly to the specific issue. It calls on Congress to withhold approval of the Uruguay Round until an environmental assessment of the whole package has been made. And then the Scheuer proposal would require that international environmental standards "become a floor, not a ceiling" for state and national standards.

There is an impressive array of groups supporting these resolutions, including the National Wildlife Federation, the National Family Farm Coalition, the Ralph Nader organization, Greenpeace, Friends of the Earth, the Natural Resources Defense Council and the National Toxics Campaign.

They challenge the Bush administration proposal to "harmonize" food-safety standards. For example, Scheuer charges, the United States is willing to accept a United Nations food code known as Codex Alimentarius as a major benchmark to determine whether any individual country's pesticide standard is really a disguised trade barrier.

But according to the coalition, the Codex is weaker in many cases than existing Food and Drug Administration or Environmental Protection Agency standards. The National Family Farm Coalition says that if Codex standards were applied in the United States, imported foods could avoid FDA restrictions on DDT, Alar, sulfa antibiotics or bovine growth hormone (BGH), which is used to boost milk production in cows.

For example, the use of DDT to treat apples is now banned in the United States. But under the Bush proposal, DDT-treated apples, grown overseas, could be imported and sold without restriction. According to the protesting groups, the Codex allows 50 times the amount of pesticide residue in bananas and peaches set by the FDA code.

If such weaker international standards were to apply, it's conceivable that America would be driven to lower its own higher safety standards to avoid charges of protectionism. "U.S. consumers and exporters should not be asked to pay ransom to other countries if they wish to set standards higher than the rest of the world's," said Alex Hittle of Friends of the Earth. "Nor should the United States try to force foreign consumers, who might choose higher standards, to accept more poisons in their food as we try to 'open up' foreign markets for our exports. We owe it to ourselves and to our friends abroad to scrutinize the GATT's environmental efforts."

An administration source told me that the environmental groups are "not well informed," and that if the Codex were adopted, the United States could still insist "on a higher standard, if we can defend it scientifically." But the source added: "It may be that some of our standards are too high."

The National Resources Defense Council says that in contested cases, the decision would be made "by a panel of experts, who may be consultants to the pesticide industry, meeting behind closed doors at the GATT secretariat in Geneva."

This is an issue that needs a full airing. At a minimum, the coalition's demands for public debate and media attention are justified.

TREASURY NEWS
Department of the Treasury • Washington, D.C. • Telephone 566-2041

Statement of
John M. Niehuss
Senior Deputy Assistant Secretary
for International Economic Policy
U.S. Department of the Treasury
as delivered by
Mark T. Cox, IV
U.S. Alternate Executive Director
World Bank
at the Afternoon Session
of the Development Committee
of the World Bank and the International Monetary Fund
May 8, 1990
Washington, D.C.

This morning, Secretary Brady stressed the need to maximize the contribution of the private sector to development. He also noted the importance of foreign direct investment and the repatriation of flight capital to help finance privately led growth.

The World Bank Group is well positioned to take the lead in helping developing countries undertake the reforms needed to foster vigorous and competitive private sectors. As a main source of adjustment lending, the Bank can guide developing countries in implementing macroeconomic, structural, and institutional changes needed to maximize the contribution of the private sector. To do this, however, the Bank must increase the priority given to private sector objectives and integrate them into the entire range of its operations.

Last year, the Bank launched a Private Sector Action Program with the objective of strengthening and coordinating its private sector development operations. We have had some concerns with the implementation of this action program, as private sector activities do not appear to have been fully integrated into the Bank's lending operations. We believe that Bank's country lending strategies should give adequate attention to private sector development and that private sector issues should be systematically addressed across the range of Bank Group programs.

NB-802

An essential element of private sector development is helping developing countries mobilize and compete for capital. It is a harsh reality that official financing is becoming increasingly scarce at a time when there are growing demands for financing to support private sector growth. It is also a fact that commercial bank lending, which helped finance development efforts in the 1970s and early 1980s, is well below historical levels. There is no indication that this situation will change significantly in the near future. The inescapable conclusion is that developing countries, in addition to mobilizing domestic savings, must look increasingly toward foreign direct investment and domestic capital held abroad to help finance their development needs.

These sources of capital have some unique benefits. They can contribute to the adjustment process and supplement domestic savings without increasing the stock of debt. Foreign direct investment can also contribute managerial and technical skills, invigorate business competition, create employment and increase exports.

The ability of developing countries to attract foreign private investment and repatriate flight capital depends primarily on the policies which they themselves adopt and implement. A sound macroeconomic policy environment is an essential precondition for attracting foreign capital, including flight capital. But, this alone may not be sufficient. Also needed are measures to improve the environment for private sector activity and to eliminate specific impediments to foreign direct investment, including measures to reduce unnecessary government intrusion in the economy and the establishment of a legal and institutional framework that will ensure business confidence and nurture entrepreneurship. This framework must provide for transparent and stable government procedures; for non-discriminatory treatment for foreign investment; for free transfers of capital and returns related to foreign investment; for fair procedures for resolving investment disputes; for the elimination of screening and performance requirements.

We recognize that the restoration of business confidence can take time. Yet increasing foreign investment and repatriating flight capital are the only practical avenues for increasing the resources available to developing countries without increasing their indebtedness.

The Bank has an appropriate role to play in helping developing countries compete for capital. We strongly endorse the Bank's efforts to promote macroeconomic and structural adjustment in borrowing countries. Nevertheless, we feel that much more remains to be done to promote the flow of private foreign direct investment, and the contribution it can make to development.

In this regard private sector development and investment policy reform should be explicit conditions of the Bank's adjustment operations. Private sector considerations must be introduced at early stages of lending operations. There are compelling, practical reasons for this approach. The Bank cannot provide balance of payments support indefinitely where borrowing countries preserve impediments to foreign private capital and private sector growth.

As part of project and sector lending operations, the Bank needs to do more to develop investment sector loans and promote investment policy reforms. The Bank should also consider new approaches and instruments for promoting private sector development. For instance, we wonder whether slower disbursing adjustment loans could be used to support longer term institutional and regulatory reforms. Could pilot projects on investment reform in certain sectors be introduced in strategies for countries that are not ready for overall reform?

These are just a few ideas. What is needed is a vigorous examination of the impediments to private sector development and ways the Bank can strengthen its efforts to address them. This morning, Secretary Brady asked that this matter be taken up at the next Development Committee meeting in September. More specifically, we suggest that the Bank review this issue over the coming months and prepare a progress report and action plan for the Bank's contribution to private sector development for consideration at the fall session of the Development Committee. The issue is of such importance to the development process that the Committee should keep the issue on the agenda until we are convinced that real progress is being made.

TREASURY NEWS
Department of the Treasury • Washington, D.C. • Telephone 566-204

STATEMENT BY
THE HONORABLE DAVID C. MULFORD
UNDER SECRETARY OF TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE
HOUSE BANKING COMMITTEE
SUBCOMMITTEE ON INTERNATIONAL DEVELOPMENT
FINANCE, TRADE AND MONETARY POLICY
MAY 9, 1990

Mr. Chairman and Members of the Committee,

I welcome this opportunity to present the Administration's views on the European Bank For Reconstruction and Development (EBRD). The EBRD was conceived and negotiated to serve as a major vehicle for fostering and promoting the dramatic and historic changes that are occurring in East and Central Europe. The Administration will submit to you proposed authorizing legislation for U.S. participation in the EBRD.

Bilateral Initiatives

The United States, and other Western democratic countries, have responded to the changes in Eastern Europe with strong offers of political and economic support. The Administration and the Congress moved quickly, during the last session of Congress, to develop a bilateral aid package for Poland and Hungary.

In December, 1989, the United States took the lead in organizing a $500 million multilateral bridge loan for Poland. We contributed $200 million of our own funds from the ESF to that financing package, which has now been fully repaid.

In January, the Treasury Department again led the effort to provide funding to a $1 billion currency stabilization fund to support the launching of Poland's economic reform program. The United States contributed $200 million to the fund in the form of a grant. It is a measure of Polish success and courage that in the period since its creation in January, the government has not had to draw on the fund, and that instead Polish net reserves have increased by about $1.5 billion.

Other countries, for example, the Western European countries, Japan and Canada have made pledges of bilateral support for

the countries of Eastern Europe. Both the IMF and World Bank also have moved to develop programs to support much needed economic reform for those East and Central European member countries undergoing transition. The IMF has provided assistance to Poland, Hungary, and Yugoslavia; and the World Bank has pledged a $5 billion, 3-year lending effort in support of economic reforms in Eastern Europe -- with about half to go to Poland.

A Multilateral Initiative -- The EBRD

At the European Summit in Strausbourg, in December 1989, France proposed that the European Community take the lead in creating a multilateral development bank dedicated to fostering and promoting necessary and fundamental reforms in East and Central European countries. Creation of such a bank would demonstrate the political and economic commitment of Western Europe to the countries of East and Central Europe and would assure that there is a dedicated pool of resources solely for the use of those countries. A multilateral bank also could, through its borrowing in capital markets, leverage its contributed funds into a larger pool of loanable resources.

Status of the EBRD

The negotiations which began in mid-January and included 40 countries, the European Community (EC), and the European Investment Bank (EIB), concluded in early April with agreement on a Charter. This is an extremely short time in which to develop the basic document for an institution of this type. This speed demonstrates, however, the commitment of participants to the establishment of the Bank.

When the charter is ratified, the EBRD, with a capitalization of ECU 10 billion, will have the capability of lending as much as $12 billion in its first five years of operations.

European governments would like the EBRD to begin operations by the end of 1990. The Charter provides that it will become effective and enter into force when members representing not less than two-thirds of the EBRD's total subscriptions, and including at least two countries from Central and Eastern Europe, have deposited the necessary instruments.

Major Elements of the EBRD

The United States has supported from the outset of the negotiations the concept of a multilateral bank that would facilitate the transition of borrowing countries in East and Central Europe to democracy and pluralism and a market-oriented economy. The EBRD will be a unique institution for several reasons. Compared to other MDBs, it will have a small number of potential borrowing countries. The per capita income of its borrowers is higher than those of other MDBs. Its mission, therefore, is not to provide concessional loans or loans for broad development purposes. Instead, it should provide financial support and incentives that promote the transition of its borrowing countries to market-oriented economies with strong private sector development.

We believe we have succeeded in laying the basis for this essential mission in the new Articles of Agreement. We must now ensure that the Charter is implemented effectively. I would like to summarize the key elements of the Charter provisions.

Capital -- The capitalization of the EBRD will be ECU 10 billion (approximately $12 billion) subscribed over five years. Thirty percent of the capital will be paid-in capital, with the remainder callable capital. With this capital base the EBRD theoretically could support approximately $2.4 billion of lending annually for each of its first five years of operation.

Shareholding Schedule -- The U.S. will take a 10 percent share and be the largest single shareholder. Our purpose in seeking the largest shareholding position was to underline the importance we attach to the objectives of this bank and our strong sense of partnership and kinship with both Eastern and Western Europe. While our ties to Western Europe and our current political and economic relationships are strong and visible, we also have a very large Eastern European population in the United States with strong ties to Eastern Europe. While the U.S. will have the largest individual shareholding, the EC members will, together, hold a majority of the EBRD's shares.

Supporting Political and Economic Reform -- The purpose of the Bank is to: "... foster the transition towards open market-oriented economies and to promote private and entrepreneurial initiative in the Central and Eastern European countries committed to and applying the principles of multiparty democracy, pluralism, and market economics."

Backsliding -- The charter also has specific provisions to address countries that retreat from these commitments. In exceptional circumstances, or in cases where a member is implementing policies not consistent with the Bank's purpose, the Board of Directors may recommend that Governors suspend or modify the member's access to Bank resources. Any decision on such a recommendation will require a majority of not less than two-thirds of Governors representing at least three fourths of the total voting power.

Private Sector -- The development of the private sector is fundamental to the development of open, market-oriented economic systems in East and Central European countries. Largely at our insistence the EBRD will have a private sector orientation. By charter at least 60 percent of the EBRD's aggregate annual lending must be to the private sector. In addition, at least 60 percent of the EBRD's lending by country over the first five years must be to the private sector or to state-owned enterprises that are privatizing to private ownership and control. The remaining resources can be lent to infrastructure and environmental projects that support the development of the private sector or to state-owned enterprises that operate competitively, i.e. are autonomous of their governments and subject to bankruptcy laws.

Subscription Payment -- Payments on subscriptions can be made in European Currency Units (ECU), the U.S. dollar or the Japanese yen. The United States will have a fixed dollar funding commitment to the EBRD, as it does in other MDBs. The dollar valuation will be set at average dollar-ECU exchange rates for the period September 30, 1989, to March 31, 1990, i.e., $1.16701 to the ECU. With a 10 percent share of the EBRD, the U.S. will have a funding commitment fixed in dollars over five years of $350 million for paid-in capital. The callable capital portion of our subscription is also fixed at $817 million. This translates into an annual commitment of $70 million of budget authority for paid-in capital and $163.4 million of program limitations for subscriptions to callable capital.

This $70 million for paid-in capital for FY 1991 is part of the Administration's proposed $300 million Special Assistance Initiative for Eastern Europe.

Environment -- The environment is a serious issue in East and Central Europe and a major concern of all EBRD members. The EBRD is the only multilateral development bank which has environmental provisions in its charter. Under the charter the EBRD will: "promote in the full range of its activities

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environmentally sound and sustainable development"; and shall, "report annually on the environmental impact of its activities."

The U.S. plans to follow-up in the development of EBRD regulations and operational guidelines to ensure that these commitments are translated into strong, effective operational policies and practices. Key issues we plan to press are adequate staffing and the development of environmental impact assessment procedures.

Soviet Borrowing -- A key issue for the United States was borrowing by the Soviet Union. We argued strongly for limitations on Soviet access to the EBRD's approximately $12 billion in resources. Agreement was reached ultimately to limit for the first three years any Soviet borrowing to the level of their paid-in capital to the EBRD. Lending to the Soviet Union also will be confined to the private sector (including privatization) or to help enterprises operating competitively and moving to a market orientation.

What this means is that if the Soviets made all their paid-in contribution in the first three years vs. a five year payment schedule they could borrow a maximum of $216 million. With EBRD capital of approximately $12 billion, total lending to all potential borrowers over the first three year period could reach $7.2 billion. Thus, Soviet borrowing will represent a relatively small proportion of possible EBRD lending.

In addition, any change in USSR's borrowing status at the end of the three-year period will require the agreement of three quarters of the members representing at least 85 percent of the voting power.

Restricting Soviet borrowing to their own paid-in capital for the first three years means that U.S. taxpayer funds will not be used for Soviet borrowing during this period.

Board of Directors -- There will be a resident Board of 23 Executive Directors, 11 representing the European Community and 12 representing the non-EC member countries. Of those 12, there will be four Directors each representing the East and Central European members, the non-European members, and other European countries that are not members of the EC. The United States will have a separate seat on the Board.

Conclusion

Mr. Chairman and Members of the Committee, as you can see the major issues surrounding the creation of the EBRD have been agreed. Charter members of the Bank are preparing to sign the Charter in Paris on May 29. Between now and May 29 we

expect decisions will be made regarding a President for the EBRD and the location.

The Administration believes strongly that it is in the United States' interest to join the EBRD as a charter member. It will demonstrate our solidarity with Europe, our support for the reforms now being made in Eastern Europe and will give us more influence over the structure and operations of the Bank. The Administration hopes that the Congress shares our opinion and will support legislation for the U.S. to become a charter member of the EBRD.

Report on International Economic and Exchange Rate Policy

Mr. Chairman, you had asked me to summarize the main conclusions of the Department of the Treasury's April Report to the Congress on International Economic and Exchange Rate Policy. As you know, the report primarily addressed economic policy coordination among the major countries and developments in Korea and Taiwan.

Regarding economic policy coordination, the report notes the important role played by G-7 coordination in putting into place the policies necessary for sustained global growth, low inflation and reduced external imbalances. The economic expansion is now being sustained into its eighth consecutive year, growth prospects remain favorable, and external imbalances have been substantially reduced, particularly in the United States and Japan. Our current account deficit fell a further $21 billion in 1989 to $106 billion.

We cannot be complacent, however. External imbalances remain large and the external adjustment process slowed over the course of 1989. Current account trends are difficult to project with certainty, but it would appear that any further improvement in the U.S. current account position in 1990 will at best be very modest, and the possibility of a deterioration cannot be excluded. Also, significant changes are occurring in Eastern European political life and we have witnessed important developments in global financial markets this year, particularly in Japan.

These issues were reviewed at last weekend's meeting of the G-7. While there was satisfaction with recent exchange market stability and the continued growth in industrial countries, the G-7 also agreed that price pressures warrant continued vigilance. We also remained of the view that the present level of the Japanese yen may have undesirable consequences for the global adjustment process. Furthermore, we agreed that German economic and monetary union would contribute to improved non-inflationary global growth and to a reduction of external imbalances, developments that we would most welcome given Germany's substantial surpluses.

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Regarding Taiwan and Korea, our bilateral negotiations with these economies have achieved progress. More market-based systems for determining the exchange rate have been implemented by both. Their external surpluses have also been declining. We do, however, have some remaining concerns that will require us to continue to monitor exchange rate and trade developments in Taiwan and Korea,

Since our report to Congress in October 1988, the New Taiwan (NT) dollar has appreciated by 10 percent against the U.S. dollar, more than that of any major trading partner. The NT dollar has moved within a narrow band over the past year.

Last April, Taiwan implemented an exchange rate system that allowed for most foreign exchange transactions to be freely determined. In addition, since our October 1989 report, further steps have been taken to liberalize the system.

Taiwan's current account surplus and its trade surplus with the United States rose in 1989. If one-time purchases of gold from the United States by Taiwan's Central Bank in 1988 are excluded, however, these surpluses fell by 15 percent to $11.2 billion and by 14 percent to $13 billion, respectively, last year.

Given these developments, our view remains that there are no clear indications that Taiwan is "manipulating" the exchange rate for competitive advantage. Taiwan's external surpluses, nonetheless, remain at an unsustainable level. There is a need, thus, for liberalization of remaining capital and exchange controls and exchange rate adjustment to advance the adjustment process.

The Korean won has strengthened only 0.7 percent since our October 1988 report. Since the won's strongest point, shortly following the April 1989 report, it has depreciated by about six percent. Korea instituted a new "market average rate" system of exchange rate determination on March 2.

Of additional significance, the Treasury and Korea's Ministry of Finance initiated Financial Policy Talks in late February. We aim to achieve progress in these talks on market access problems facing U.S. banks and securities firms in Korea, as well as further liberalization of Korea's capital and exchange markets. We expect a second round of discussions will be held this summer.

Korea's external surpluses have fallen considerably in the past year. The current account surplus decreased by 64 percent in 1989 to $5.1 billion. The U.S. bilateral trade deficit with Korea declined by 30 percent to $6.3 billion.

There is no evidence that the authorities are directly "manipulating" the exchange rate at this time. The government's pervasive controls on capital flows, however, allow it to indirectly influence supply and demand for foreign exchange and, thus, the exchange rate itself. Recent policy measures which aim to increase exports and the won's nominal depreciation against the dollar are also cause for concern.

Thank you.

Washington Development Capital Corporation

May 24, 1990

TESTIMONY BEFORE THE SUBCOMMITTEE ON
INTERNATIONAL DEVELOPMENT, FINANCE, TRADE AND MONETARY POLICY
of the COMMITTEE ON BANKING FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

on the INTERNATIONAL FINANCE CORPORATION'S AFRICA PROGRAM

by RICHARD A. TROPP, PRESIDENT
WASHINGTON DEVELOPMENT CAPITAL CORPORATION

Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to testify on the Africa program of the International Finance Corporation ("IFC"), and in particular on the Africa Project Development Facility ("APDF"). I am here this morning in my capacity as the United States private sector member of the APDF Advisory Board.

As some of you know, I was for six years the Special Assistant to the Administrator of the U. S. Agency for International Development ("AID"), under first Peter McPherson and then, briefly, Alan Woods. In that capacity, and in connection with the investment company which I have been running for the last two years, I have had extensive opportunity to observe, to assess, and to work with the IFC and with its parent institution, the World Bank.

Proceeding on the assumption that you have had the chance to go through the briefing materials presented to you before this hearing by the IFC, I will briefly summarize the points about the APDF and about the IFC more generally which seem particularly worth your attention, and then await your questions.

IFC in General: By contrast with the World Bank, which lends to Less Developed Country ("LDC") governments pursuant to its charter, the IFC is the primary multilateral financing source for the LDC private sector--the entrepreneurs whose combined activities are the moving force in LDC development. While the Bank focuses on the whole economy of LDCs, and on using its financial leverage to encourage the economic policy reforms which are the prerequisites to LDC development, the IFC focuses on transactions--on making individual private sector projects happen.

IFC aspires to be a minority shareholder generally financing not more than 25% of the cost of a project, with the majority of the financing, the entrepreneurial business concept, the management,

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and the shareholder control expected to be in the local private sector. One measure of IFC's efficiency is that it has, over the last half-dozen years, mobilized between five and seven dollars for every dollar which it has invested--both from LDC entrepreneurs and from developed country businesses and donor agencies.

It was generally our sense at AID that IFC has been--in financing transactions, in its financial advisory services, and in its technical assistance for the development of LDC capital markets--on the cutting edge of private sector development in the LDCs.

APDF in Particular: APDF was established on the theory that notwithstanding the popular business stereotype of Africa, there are many investment opportunities on which an investor--whether corporate or individual--can earn a satisfactory return. Given the stereotype, however, a potential U.S. or European investor is not going to spend the $50,000 to $200,000 which it takes to do the financial analysis, the accounting and audit, the engineering and other technical work, the legal analysis and drafting, and all of the other pieces which one has to have in hand in order to assess whether or not an investment is worth making.

When approached by an African entrepreneur with a promising business idea, APDF's staff in the field works with him--and APDF spends that money--to produce the business analysis, which an investor can then assess without having had to spend the up-front money and time on it. APDF's field staff is composed of financial people capable of taking what the entrepreneur presents and working with him to translate it into terms which developed country corporations and millionaire investors can understand.

APDF's pipeline of projects on which they are working with African entrepreneurs stands at 267 this month. They have received over 1600 project proposals from Africans since APDF's startup, and their work has assisted in securing investments of around $113 million. They are doing this with a budget of approximately $31 million for their second five years, $4.0 of it from the U. S. As word of their effectiveness spreads through Africa, hundreds of entrepreneurs are beginning to come to them for help in turning their business dreams into actual financed businesses.

The numbers and the formal description do not adequately communicate the main point that I want to make to you: after the difficult work that Kim Jaycox's people at the World Bank are doing to encourage African governments to implement economic policy reforms which will create a positive investment climate for business, THE single most useful thing that anyone in the multilateral banks--or anyone in this country--is doing for Africa is APDF.

There are a lot of people in this country and in Europe, and a lot of organizations both public and private, which are holding

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hundreds of meetings and issuing dozens of papers on "private sector development" in Africa. APDF, quietly, is just doing it.

Someone like me, running a company on behalf of investors, cannot justify spending $50,000-$200,000 on each of several projects in Africa before finding one which is worth the investors' taking a risk with their capital. It just costs too much to do the preliminary financial analysis and screening, and to negotiate the terms of an investment, by comparison with the relatively small size of the actual business investment itself.

When Alex Keyserlingk's people do that work, however, they make it possible for a company like mine to take serious investor money--potentially dozens of times the size of APDF's investment in preparing a project paper--and to allocate it toward entrepreneurs in Africa, on whom otherwise I could not justify encouraging serious investors to spend time or to take a risk. The long-run result of APDF's work is bound to be that millions of dollars in U.S. and European capital will be invested in businesses in Africa which otherwise would not have any hope of getting that capital, or even of engaging serious investors' attention.

What APDF is doing is making it possible for this thing that the aid agencies and the private voluntary organizations call "private sector development" really to happen in Africa. They are making it possible for entrepreneurs to act on their dreams, and by the magic of Adam Smith's "invisible hand", cumulatively to turn those dreams into that phenomenon which we call "economic developkment".

Mr. Chairman and Members, I am privileged to be here to testify on their behalf, because I believe that what they are doing really will make a difference in Africa. I am happy to answer your questions about them, or more broadly about other elements of IFC.

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Congressional Staff Forum
on
International Development

Director
William E. Hellert

May 24, 1990

MEMORANDUM

To: ODC Staff
From: Anastasia Primbas

SUBJECT: HEARING ON THE INTERNATIONAL FINANCE CORPORATION
House Banking Subcommittee on International Development, Finance, Trade and Monetary Policy

Members in Attendance: Chair Walter Fauntroy (D-DC), Nancy Pelosi (D-CA), Doug Bereuter (R-NE),

Testimonies:
Panel I - S. Melvin Rines, Kidder, Peabody & Company, Inc.
- David Levey, Moody's Investors Service
Panel II - David Gill, Batterymarch Financial Investment, Former IFC Official
Richard Tropp, Washington Development Capital Corp.

Background:

The IFC is an arm of the World Bank which was established in 1956 for the purpose of promoting economic growth in its developing member countries by promoting productive private investment. It does this through the provision of technical assistance and loan and equity capital. The IFC is distinctive in the World Bank group in that it does not provide government guarantees or have callable capital; the IFC's capital is fully paid in.

According to Chairman Fauntroy, today's hearing was called for a number of reasons:

* Many Subcommittee members have indicated that they are unfamiliar with the institution, since it operates at a low level of visibility and receives minimum oversight of its activities.
* The IFC might be seeking a capital increase in the foreseeable future
* The Treasury Department has notified Congress that the IFC wishes to enter the U.S. capital market to raise funds and that a waiver was being requested for it with respect to certain reporting requirements under SEC regulations.

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Summary:

Panel I:
S. Melvine Rines stated that the IFC is more conservative than other multilateral development banks (MDBs). He discussed the significance of the IFC's Triple A ratings, the highest credit rating given to the bonds of financial institutions by Moody's and Standard and Poor's. Rines also explained exemptions from SEC registration requirements have already been granted to all of the MDBs in which the U.S. is a member; to exclude IFC would make some investors hesitant.

David Levey discussed the IFC's favorable position in the Moody's Sovereign Credit Report. According to Levey, the IFC's Triple A rating is based on:

* the quality and performance of its loans and investments
* its preferred creditor status which greatly reduces transfer risk on its loan and equity investments
* its status as an arm of the World Bank
* its strong support from member countries

Panel II:
According to David Gill, the IFC is the largest entity of its kind involved with the promotion and finance of private enterprise in developing countries; by the end of 1989, the IFC had made loans to almost 500 enterprises in 79 developing countries. Gill described that an ideal enterprise in a developing country would involve 20-40% of foreign investment.

Richard Tropp explained that the IFC's success is due to several factors:

* Whereas most MDBs work with governments, the IFC works with the private sector
* The IFC's role as an intermediary between the investor and the business people in developing countries

Furthermore, the Inter-American Development Bank and the Asian and African Development Banks are paying the IFC the compliment of imitation.

Discussion:
Fauntroy questioned the witnesses on whether the IFC's profitability and conservative description, according to Moody's and Standard and Poor's criteria, were a result of the institution's reluctance to take on riskier, or more "marginal" candidates. Evading the actual question, the witnesses maintained that any profits generated by the private sector investments are recycled back into their respective developing countries.

EXECUTIVE SUMMARY

Improving the Official Debt Strategy: Arrears are not the Way

The Institute of International Finance, Inc.
May, 1990

It is now clear that Secretary Brady's proposals generated a dramatic shift in the official strategy dealing with international debt by postulating that bank debt and debt service would have to be reduced if sustained progress towards creditworthiness was to occur. The resources of the IMF and the World Bank could be used to support this process. This change in official policy has had far-reaching consequences and may yet produce unintended effects, particularly if the alarming increase in interest arrears is not reversed.

There have been some notable achievements: The IMF and the World Bank now provide some support for bank debt and debt service reduction; several deals or agreements in principle have been struck; the countries involved have tackled major macroeconomic problems and implemented difficult structural reforms; the approach has proven a flexible one, confirming the case-by-case principle.

However, to conclude that all was well with the current official debt strategy would be premature. Other developments do not bode well for future progress in resolving debt and development problems: There was a marked deterioration in discipline within the international system, including a sharp buildup of interest arrears to all creditors; loan-loss provisions were raised to new heights and large numbers of banks exited from the process; debt-for-equity swaps, local currency conversions or payments and private sector restructurings fell drastically after March 1989, and secondary market prices of existing debts remained depressed; and, finally, new lending by banks declined.

These developments have far-reaching consequences and indicate problems with the new strategy which will block progress if it were applied to countries which lack a record of economic adjustment, a demonstrated will to service debt and a commitment to implement and sustain structural reforms.

Debt and debt service reduction has not been voluntary as it was initially billed. Debt-for-equity swap programs, which had been one of the most important vehicles for debt reduction during the preceding years, have been suspended or truncated in several large countries. The current official debt strategy is underfunded. The enhancements available from third parties are not available on a timely basis and insufficient for large-scale debt and debt service reduction.

The loss of discipline in the system and the buildup of payments arrears indicate a strong element of moral hazard in the official debt

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strategy. The approach encourages countries to view debt reduction as an entitlement. The problem is being seriously compounded by the IMF's new policy of tolerating payments arrears to banks, because it undermines the sanctity of contracts on which the international financial system is based.

A final concern is the link between debt reduction and renewed investment and growth. There is no empirical evidence to support such a link, i.e., there is no assurance that debt reduction will increase investment and growth.

Modifications to the strategy are needed now because we are about to enter a difficult new phase. The major new element in 1990 is the need to cope with countries whose track record is clearly one of nonperformance. In such circumstances, debt reduction would actually be counterproductive. In addition, substantial numbers of banks have already made the decision to exit.

It will be important to recognize that the commitment of a number of debtor countries to adjustment and reform will need to be tested. It is essential for such countries to agree to programs with the IMF and meet a series of half-yearly performance targets. Countries will have to stop adding to arrears and agree to eliminate them by a fixed date. Subsequently, debt reduction transactions will have to be phased in and made conditional.

IMF toleration of interest arrears to commercial banks undermines implementation of the official debt strategy. Toleration of arrears to banks not only erodes standards of conduct and discipline towards all creditors, it serves as a warning to other would-be investors. In order to maintain the integrity of the international financial system, the IMF should require that arrears to banks be settled just as arrears to the IMF are paid before countries can resume borrowing. The IMF should also insist that a country seeking debt or debt service reduction reveal fully its direct and indirect holdings of its own bank debt.

It should be recognized, too, that the "overhang" argument provides no reason to distinguish debt to banks from debt to official agencies or from domestic debts. Because the purported benefits of debt reduction are unproven, creditor banks require substantial financial support to accept the measurable costs of debt and debt service reduction. This means that there is need for a sharp increase in official funding to support the debt strategy.

Finally, a number of other issues that are impeding progress must be resolved:

- Debt and debt service reduction must be truly voluntary. Banks cannot submit to forced sale of claims at arbitrary prices and then be expected to make new loans.

- Official sector support for new lending where appropriate will improve substantially the prospects for an eventual return to the market.

- Increased flexibility is needed in applying existing resources. Negotiations between countries and their banks are needlessly complicated by segregating enhancements into nonfungible pools for support of debt reduction and debt service reduction.

- Official enhancements should also be available fully at the outset of a program. Otherwise, debt reduction will have to be phased in as official support becomes available.

- Specific measures to encourage savings, to attract foreign equity investment, and to bring back flight capital must be a part of the conditions for official support of debt and debt service reduction.

- Expectations of debtor countries must be moderated.

Growing arrears to banks and official agencies threaten the key objectives in the present debt strategy, e.g., restoring sustainable growth and voluntary access to capital markets. They also warn other would-be investors, domestic and foreign, that their claims, too, could one day be at risk. In addition, they pose a major threat to the international financial system and have seriously damaged the cooperative approach on which the official debt strategy must be based if it is to succeed. For these reasons, the official sector, as a matter of urgency, must deal with the current arrears crisis and restore the conditions for effective creditor cooperation.

Economic Policy Institute

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BUSH/IMF POLICIES WORSEN LATIN DEBT CRISIS BY ENCOURAGING CAPITAL FLIGHT FROM LATIN AMERICA

Report: $151 Billion Capital Flight from Region From 1973-87 Represents 43 Percent of Total New Debt Burden During Period

Washington, DC -- A new study released today finds that the flight of private capital from Latin American countries to banks and investments outside the region is actually being made worse by the conditions imposed on debtor nations by Bush Administration and International Monetary Fund debt policies -- whose stated aim is to reduce capital flight and increase investment in Latin economies.

The study, *Capital Flight and the Latin American Debt Crisis*, written by economist Manuel Pastor, Jr., finds that the requirement that debtor nations remove controls over capital -- a basic condition of the IMF and the Bush Administration's "Brady Plan" -- makes it easier for wealthy elites in those nations to export capital to foreign countries, thus worsening the capital shortage at home and further crippling economic growth.

Pastor also finds that redistributive measures -- the sort of wage cutting often imposed on debtor nations by the U.S. and other international lending agencies -- have no impact on the transfer of money abroad. This means the poorest citizens in Latin countries are unnecessarily being put through great economic hardship while the wealthy transfer capital abroad which could be used to finance development and economic growth, according to Pastor.

The report, published today by the Economic Policy Institute (EPI), uses an econometric analysis of capital flows in eight major Latin American countries over the past two decades. It finds that while these nations were running up huge foreign debts, their wealthiest citizens were investing heavily abroad. Pastor estimates that from 1973 to 1987, **this capital flight from Latin America totaled $151 billion -- almost half (43 percent) of the total external debt**

acquired by these countries during the same period.

At a press conference to release the study, author Manuel Pastor called for greater and more comprehensive efforts to achieve debt reduction and new investment in Latin American economies, but he warned that "without controls over flight capital, debt relief will result in more money leaking out of Latin nations into banks in the U.S., Switzerland and Japan, with little investment in the debtor countries which desperately need economic development."

The study demonstrates that if private assets held abroad by Latin Americans could be mobilized for investment in Latin America, the debt burden in many countries would be either eliminated or substantially reduced, and economic growth could be revived in the region.

The conclusions of the Pastor study directly challenge the IMF/Bush Administration prescriptions for debtor nations: forced reduction of capital costs, and removal of controls on capital movement. Pastor writes that the study's results "are profoundly upsetting to conventional thinking about capital flight, and undermine the orthodox remedies prescribed by the U.S. government and the IMF. While the harsh medicine of cutting wages and other austerity measures does not help to stem the capital flight, outright capital controls do -- and they also help to lessen the impact of other factors that induce flight."

Pastor's analysis found that "U.S. opposition to capital controls flies in the face of historical and empirical evidence." For example, Pastor discovered that the Latin countries free of capital controls -- Argentina, Mexico and Venezuela -- "literally hemorrhaged resources over the years of debt accumulation." Pastor found that "the only time IMF agreements slow capital flight is when countries have capital controls -- a policy the IMF tends to discourage!"

In evaluating future policies, Pastor's econometric analysis revealed that extending new foreign loans to countries <u>with</u> controls will produce **less than 15 percent of the capital flight** that such new flows would yield in countries lacking such controls.

Thus, Pastor recommends that "the IMF's ideological objection to capital controls should be put aside in favor of a pragmatic realization that controls can help give countries breathing space to engage in necessary policy shifts."

Pastor warns that the recent turn to democracy in many Latin American countries is jeopardized by the debt crisis and the austerity policies adopted in

response to the demands of international lenders. In this context, he outlines the serious consequences of continued capital flight: drastic reductions in investment and growth, erosion of the tax base, and a redistribution of income from the poor to the rich.

The EPI report also demonstrates that the U.S. economy and U.S. workers and communities have been harmed by the ongoing debt crisis which has crippled the ability of Latin American countries to import U.S. consumer goods, equipment and machinery. He cites cumulative estimates that by 1985 the U.S. had lost 1.6 million jobs from the debt-induced Third World recession. And Pastor calculates that as many as 400,000 new jobs could be created in the U.S. if Latin America could achieve a 50 percent reduction in current debt service, thus freeing up investment funds that would stimulate growth and demand for U.S. goods.

Pastor concludes: "The Brady-IMF requirement of policies for promoting the return of flight capital as a condition for extending debt reduction puts the cart before the horse. An alternative approach would be to provide debt relief first, and accompany such relief with a pragmatic use of capital controls, progressive redistribution of income, and a more efficient tax system. Otherwise the application of austerity and deregulation policies might kill the patient before the medicine of debt relief takes effect."

Among the other findings of the report:

* Contrary to the conventional view that labor costs must be reduced to bring about a return of flight capital, neither the level nor the growth of labor costs has a statistically significant effect on capital flight.

* Contrary to the presumption that IMF stabilization programs create a more attractive environment for domestic investment, such programs do not in fact reduce capital flight -- except when accompanied by capital controls.

* Most of the vast wealth held by Latin elites in North American banks earns income which is tax-exempt. (Latin tax laws exempt income earned outside the country and the U.S. exempts income earned by non-residents.)

* "What really counts for resolving the Latin American debt crisis is the extent of assets held abroad, and the possibility of mobilizing those resources," writes Pastor. For Argentina, Mexico and Venezuela, if private assets abroad could be mobilized, the debt burden would be either eliminated or substantially

reduced. For several countries, interest earnings could pay for a substantial portion of the import bill. "In the Argentine case, for example, the repatriation of just one-fourth of the earnings could raise import capacity by nearly 20 percent -- and lift the potential growth rate from, say 1 percent to more than 3.5 percent," says Pastor.

Manuel Pastor Jr., a widely-published expert on international economics, is Associate Professor of Economics at Occidental College in Los Angeles.

The Economic Policy Institute is a Washington, DC-based nonprofit, nonpartisan economic think tank.

Capital Flight and the Latin American Debt Crisis is available from the Economic Policy Institute for $8.00 ($10.00 for first class mail delivery).

CONGRESSIONAL STAFF FORUM
ON INTERNATIONAL DEVELOPMENT

DEBT NEGOTIATIONS: THE COSTA RICAN PERSPECTIVE

Speaker: Sylvia Saborio, Senior Fellow
Overseas Development Council

June 8, 1990

	1980	1985	1988
DEBT OUTSTANDING	**$2.1 bil.**	**$3.8 bil.**	**$3.9 bil.**
Public/Publicly Guaranteed	**$1.7 bil.**	**$3.5 bil.**	**$3.5 bil.**
Official Creditors	$776 mil.	$1.7 bil.	$2.0 bil.
Multilateral	$435 mil.	$748 mil.	$992 mil.
Concessional	$132 mil.	$227 mil.	$244 mil.
Nonconcessional	$303 mil.	$521 mil.	$748 mil.
Bilateral	$341 mil.	$962 mil.	$988 mil.
Concessional	$128 mil.	$457 mil.	$684 mil.
Private Creditors	$916 mil.	$1.8 bil.	$1.6 bil.
Bonds	$146 mil.	$221 mil.	$65 mil.
Commercial banks	$719 mil.	$1.5 bil.	$1.5 bil.
Other private	$51 mil.	$28 mil.	$22 mil.
Private Nonguaranteed	**$112 mil.**	**$302 mil.**	**$317 mil.**

ECONOMIC BACKGROUND

Costa Rica has long been considered a model country, especially in comparison to its Central American neighbors. It is educated, boasting a literacy rate of 93%; it is democratic, having had only brief interruptions in constitutional changes of power since declaring its independence from Spain in 1821; it is well-off, with a 1988 GNP of $4.5 billion, the equivalent of $1,700 per capita; and it is peaceful, having given up its army in 1948. Yet, even this exemplary country found itself embroiled in the debt quagmire that has enveloped much of Latin America for over a decade.

In the 1970's Costa Rica over-borrowed from abroad to finance rising oil prices and other public spending. In the early 1980's, Costa Rica's small, open economy found itself increasingly affected by external shocks, including rising international interest rates and declining terms of trade. The

country plunged into its worst recession in 30 years, characterized by: rampant inflation (which hit over 90% annually in 1982), rising public fiscal and current account deficits, declining GDP, and diminishing public sector expenditures on education, health, nutrition and sanitation.

By late 1981, with its coffers nearly depleted, Costa Rica declared a moratorium on all external payments. In 1982, the new administration began negotiations with external creditors on its foreign debt and instituted a series of internal structural adjustment measures. Yet, Costa Rica's debt continued to rise, from $2.1 billion in 1980 to $3.9 billion by 1988. Whereas in absolute terms this debt is quite small, in relative terms the debt was roughly equivalent to GDP or three and one-half times total annual exports. By comparison, Brazil's debt is equivalent to a little over one-half of its GNP.

DEBT PACKAGE

On May 5, 1990, Costa Rica and a group of 220 creditor banks signed an agreement restructuring the $1.8 billion commercial debt, making this the latest debt refinancing package reached within the framework of the Brady Plan. Costa Rica's particular situation was distinguished by its significant arrears problem. Arrears accounted for $366 million of the $1.8 billion owed to commercial banks.

The package itself is a debt/debt service reduction package, with no new money option, and contained two pre-conditions, both of which were met: 1) that at least 95% of the banks participate, thus ensuring against free-riders, and 2) that at least 60 % of the debt be tendered in the cash repurchase option.

The package offered banks a choice between two options:

1) a cash repurchase by Costa Rica at 16 cents/$1.00.
   ***63% of outstanding claims were repurchased**

2) a debt exchange of unrepurchased claims, as follows:
   i. banks tendering at least 60% of their total individual claims could exchange the rest for "A" bonds, at face value, 6.25% interest, with a 20 year maturity, and a 10 year grace period. These bonds are unsecured but have an 18 month rolling interest guarantee (in case of default, payment is guaranteed for 18 months).
   ***17% of outstanding claims were exchanged for "A" bonds**

   ii. other banks could acquire "B" bonds, at par, 6.25% interest, with a 25 year maturity, and a 15 year grace period. These bonds have no collateral or interest guarantee.
   ***18% of outstanding claims were exchanged for "B" bonds**

Arrears are treated as separate claims: a downpayment of 20% was

made when the deal was closed, and the rest was exchanged for 15 year bonds, at market rates, with a 36 month interest guarantee and a mortgage-style repayment schedule. The agreement also includes a debt conversion provision and a value recovery clause that essentially allows the banks to cash in on Costa Rica's future prosperity.

According to the Wall Street Journal, the deal will save Costa Rica an estimated $150 million a year. However, as Sylvia Saborio, one of Costa Rica's chief debt negotiators points out, the deal does not provide significant additional financing relief, given that Costa Rica had only paid about one-third of its debt-servicing obligations over the past four years. Therefore, Saborio argues, the agreement is a de jure acknowledgement of a de facto condition.

In sum, the agreement will allow Costa Rica to retire 60% of its bank debt and reduce debt service payments by 73% annually. It is expected that, with the relief, Costa Rica will be able to resume pre-crisis growth rates of around 6% a year by 1991.

Some questions that need discussing include whether this agreement holds any lessons for other debtor countries, and the future of Costa Rica relationship with foreign commercial banks.

-Laura B. Rawlings

The Forum is made possible with the help of Bechtel Group Inc., the Boeing Company, the Carnegie Corporation of New York, Chase Manhattan Bank, N.A., and Dow Chemical, U.S.A.

The Evaluation of Debt Exchanges --IMF Working Paper

Prepared by John Clark
February 1990

Summary

An approach is presented for analyzing debt-for-debt exchanges from the perspective of the exchange's impact on a country's contractual obligations and from the perspective of the creditors whose participation is sought. It is argued that a distinction must be maintained between guarantee structures which involve a onetime outflow on the part of the debtor on the lines of an insurance premium and those which allow for a possible refund to the debtor of escrowed resources. In cases where, following the discharge of the new contractual obligations, the resources used to fund any associated enhancements are returned to the debtor, the difference in debt stocks before and after the transaction (including any debt incurred to fund any associated enhancements) understates the relief the country has obtained. A meaningful comparison with buybacks must be based on a formulation that recognizes the net burden of completely repaying partially collateralized debt is lower than its absolute level.

In the section on valuation, claims on a sovereign debtor are presented as entitlements to share in the aggregate payments which the debtor is willing to make. In periods when the debtor's aggregate payments are insufficient to discharge all the contractual obligations falling due, it is assumed that holders of unguaranteed claims receive new claims which may be used to attempt to share in subsequent aggregate payments. The valuation of guarantees needs to contemplate not only the probability of the guarantee being triggered, but also, once the guarantee is triggered, the value of the new claim foregone in return for the full contractual payment. It is argued that the secondary market price does not provide sufficient information to value guaranteed debt instruments. The paper presents some rule of thumb valuation formulas previously suggested in the literature. To provide an indication as to the relative optimism or conservatism of these formulations, boundaries are presented for the highest and lowest possible valuations, consistent with the observable secondary market price and a very general model of creditors' expectations, of partially enhanced instruments.

Taken together, the two sections demonstrate that debt-for-debt exchanges are not necessarily equivalent to buybacks. Exchanges involving refundable guarantees are shown to be functionally equivalent to targeted buybacks where in addition to lowering obligations across the board as in a conventional buyback, certain obligations, e.g. the final principal payment, are effectively eliminated. Given that payment claims falling due later in time might be serviced less fully than claims falling due earlier, discounts may vary across claims. Since the debt relief obtained through a buyback is only a function of the average value of claims while that obtained through an exchange may also involve the value of claims at specific times (which may differ from the average), the amount of present discounted contractual relief per dollar of precommitted resources achievable through a debt exchange may be more or less than that achievable through a buyback.

Appendix to Testimony Presented by Nancy Alexander
to the House Committee on Banking, March 28, 1990.

CONSENSUS NGO POSITION OF THE DEVELOPMENT BANK ASSESSMENT NETWORK ON THE IDA9 REPLENISHMENT

March 1990

The International Development Association (IDA) was established as a "soft-loan" window of the World Bank in 1960 in order to make concessionary financing available to countries which were too poor, or whose creditworthiness was too precarious, to qualify them for the Bank's regular loans.

Through the years, many in the U.S. NGO community have supported IDA in the belief that the poor in recipient countries were being directly assisted by its loans. If this were true, the community would continue to be largely supportive of such financing on below-market terms, particularly in light of the current drain of financial resources from the South to the North.

It is increasingly clear, however, that the overwhelming majority of IDA credits have supported projects and programs which have, at best, only indirectly, benefitted the poor. Today, there is in fact growing concern about, and often outright opposition to, many of the large-scale, environmentally questionable investments being made with IDA funds that can also cause extensive dislocations and great suffering among local populations.

Furthermore, many NGOs have been critical of the use of IDA financing to leverage and support economic policy reforms which have not served the interests of the poor and which have had a particularly negative impact on the lives of women and children. These structural adjustment programs have placed great pressure on NGOs engaged in grassroots development programs to utilize their limited resources and energies in relief and compensatory efforts designed to help protect the poor from the worst aspects of imposed austerity. Neither do these adjustment measures appear to be improving the economic performance of the Bank's borrowers. This fact was recently reinforced by the Bank's decision to begin a retreat from its adjustment lending in order to protect its triple-A rating on global bond markets.

The Development Bank Assessment Network, which includes among its participants some 15 non-governmental organizations, has been active over the past two years in discussing with members of Congress and representatives of the Treasury and the World Bank the need for constructive changes in Bank operations. The group has set forth various concrete proposals for reform, drawing on the experience of its members at grassroots levels overseas and within the Bank itself. Today, due to a lack of significant progress in such areas as poverty reduction,

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environmental reform, access to information and the participation of local populations, we feel an increased urgency to press forward with an agenda for change so that taxpayers' money can be utilized constructively in the future.

Accordingly, we urge the Congress and the U.S. Executive Director to promote vigorously several proposed changes already under consideration at the World Bank, as well as a number of other fundamental changes in IDA's operations and loan portfolio described below. These we feel would provide the basis for a critical three-year effort to develop an IDA lending program more appropriate and responsive to the needs of the world's poor and of a healthy environment.

We believe that these modifications of the policies and practices of the IDA program will strengthen its work in its appropriate role as a provider of assistance to the activities of the world's poorest people, will increase its relevance to the attack on world poverty and environmental degradation, and will significantly improve its performance in all respects.

These proposed reforms can be placed in three major categories:

Poverty

1. by January 1991, all appraised IDA loans made in support of economic policy reform in borrower countries should be presented to the Bank's Executive Directors with supporting documentation indicating the short- and medium-term impact of the reforms on --

a. the real incomes of the poor,
b. the level of national food production (for local consumption) and food security,
c. the access of the poor to land and other productive assets,
d. the integration of local and regional economies, in particular the development of domestic and inter-regional systems of trade,
e. the diversification of industrial and agricultural production that expands the use of local raw materials, goods and services,
f. the access by women to productive resources and services, and
g. the quality and delivery of essential social and technical services, including programs of primary health care, nutrition, credit and training,

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and immediate steps should be taken to change the reform program in light of projected negative trends in any or all of these areas;

2. by July 1991, the Bank should initiate, in collaboration with local governments and independent parties, the implementation of publicly available, social-impact assessments in all IDA and blend countries of a representative cross-section of IDA-supported projects and programs collectively utilizing at least 50 percent of the IDA funds disbursed in each of those countries;

3. by July 1991, the Bank should relocate its Women and Development unit to the Office of the Senior Vice-President for Operations and reallocate sufficient staff to that unit so that it is able to participate in institutional decision-making related to the planning and supervision of all projects and programs supported with IDA funds and to help prepare, on an annual basis, disaggregated statistics that indicate, by gender, the effects of adjustment and other programs on local populations;

4. by January 1992, at least 50 percent of IDA recipient governments should have national poverty eradication strategies developed through open and thorough consultation with a broad range of popular groups and other non-governmental organizations in their respective countries, and at least two-thirds of IDA's projected lending to these countries should be designed to support aspects of these plans; and

5. by January 1992, IDA's financing of adjustment programs should be sharply decreased in all borrower countries and a plan developed for lowering the percentage of adjustment lending by the end of the year to less than ten percent of each country's borrowing, consistent with the Bank's original mandate.

The Environment

1. by July 1991, a comprehensive review chaired by the U.S. Executive Director should be conducted of the Tropical Forest Action Plan to ensure that the implementation of that plan has a positive rather than a deleterious environmental impact before any projects under that plan are financed with IDA9 funds;

2. an environmental impact assessment reflecting the views of affected groups and local NGOs must be submitted to, and approved by, IDA/Bank staff for any prospective project or program (including sector and structural adjustment programs) that has potentially significant environmental consequences before IDA9 funds are allocated to that project or program, and by July 1991 borrower governments must be carrying out

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assessments for all relevant projects and programs in order to receive IDA funds;

3. by January 1992 and in accordance with Bank plans, Environmental Action Plans for tackling priority issues in borrower countries should be completed for all IDA recipients, and the Energy Sector Management Assistance Program should be fully integrated into IDA lending operations as part of expanded efforts in support of programs of renewable energy and energy efficiency and conservation; and

4. by January 1993, IDA guidelines currently under development should be completed for operations that involve tropical rainforests, tropical dry forests, wetlands, mountain regions and coastal resources.

Consultation and Information Access

1. by July 1991, the Bank should develop a Grassroots Collaboration Program, originally proposed in 1987 by the United States, under which mechanisms are established in all IDA and blend countries for comprehensive consultation with popular groups and other non-governmental organizations in order to involve local populations in the conceptualization, design, implementation and monitoring of development projects and programs, including structural and sector adjustment programs;

2. by January 1991, the Bank must implement a policy on public access to information that makes publicly available all IDA documents and final country-generated documents required by IDA, excepting those sections of documents that contain information that falls within pre-determined categories and the release of which would seriously compromise a relationship with a borrower government; under no circumstances should information concerning fundamental physical, institutional and economic elements of IDA-supported operations, such as information related to loan design, loan conditionality, economic analysis and environmental, public-health and sociocultural impacts, be treated as confidential; and

3. by July 1991, the Bank should assign a senior staff person to each Country Department, as well as to each Resident Mission, who has the responsibility for responding to public requests for information and for initiating contact with the public and concerned NGOs about specific projects and programs, so as to be able to respond to requests for information within twenty working days of their receipt by the institution.

NGOs working on multilateral aid issues look forward to being able to support an IDA program that incorporates these or similar changes in its operations. We therefore urge the Congress and the Administration to press for such reforms and to ensure that reports on progress in the above areas are made available on a regular basis to the Congress and the American public so that informed decisions regarding U.S. financing of IDA can be made.

THE JOURNAL OF COMMERCE, May 19, 1990

Capital Lessons for East Europe

By LAURA RANDALL
and DEBORAH MILENKOVITCH

East Europeans from Warsaw to Bucharest agree that their economies must be transformed. The new leaderships in many countries are already preparing to privatize their economies. There are several motives for privatization:

- To eliminate the monetary overhang that will fuel inflation when prices are freed.
- To cover budgetary deficits without the inflationary printing of new money.
- To promote efficiency through competitive markets and private ownership of factors of production.
- To placate the nomenklatura and the workers by allowing them to acquire shares of their corporations.
- To provide an independent assessment of enterprise management through the valuation of shares on a capital market.
- To encourage foreign investment and international lending.

All these reasons point to privatizing the formerly state sector and to establishing capital markets.

One cannot privatize an entire economy overnight. If this were done, either it would result in depressing the value of all assets, or selling them off in too great measure to foreigners, or in selling them on concessionary terms to some citizens (say, workers in the factory) but not to others (private farmers, civil servants). Also, reducing government control of strategic industries would be unreasonable until viable product and factor markets have been developed.

The experience of Latin America shows that there are ways of building capital markets that allow some privatization while retaining some government control.

In order to build capital markets, investors need to have a reasonable belief that the value of their investment will not be lost. In Mexico, the government strengthened capital markets by use of a financial intermediary, the Nacional Financiera.

This government body received its initial capital from the government. It first made loans and later provided other banking services to selected private firms in sectors which the government had targeted for economic development, in return for seats on the boards of directors.

The Nacional Financiera raised additional capital from the public and the banks by selling certificates of participation. It guaranteed the repurchase of the certificates on sight at par plus a stipulated interest rate. In inflationary periods, the certificates could be denominated in dollars. After some years of operation, the certificates were entirely subscribed by the public and banks, without inflationary government participation.

For strategic industries, Eastern Europe could use the Brazilian approach to the nationalized oil industry.

The government is the majority shareholder in Petrobras, the state oil company. The remaining shares are sold on the stock exchange and can be owned only by Brazilian nationals. This maintains government control while obtaining private funding and providing a market test of the firm's financial performance. Since workers, both directly and through their social security corporation, own shares, it also provides for the motivation of workers through ownership of the firms in which they work.

In less sensitive areas of the oil industry, such as petrochemicals, the government, private domestic and foreign capital jointly own firms. This permits the government, as an owner, to influence corporate strategies while obtaining private finance, access to foreign technology and marketing skills and an international market test of the firm's performance.

Schemes such as those in Mexico and Brazil have widened and deepened the capital markets and aided in establishing sufficient public confidence in the markets. This left private firms better able to float their shares. The experience of the Latin American governments may suggest some intermediate institutional solutions helpful to the East European governments as they confront the challenges of privatizing their economies.

Laura Randall is professor of economics, Hunter College, New York. Deborah Milenkovitch is director of the Institute on East Central Europe, Columbia University.

THE JOURNAL OF COMMERCE, MAY 19, 1990

No Loans for Eastern Europe

By HORST SCHULMANN

The enormous economic potential of Central and Eastern Europe intrigues Western businessmen and financiers. But many of them do not consider the dismal reality that casts its long shadow across the region.

Significant new lending to the governments of the area by Western commercial banks, at this time, would be no more than a profound act of faith. It would be stimulated by nothing more than the great hope that the reform process now being launched will be successful and make the countries more creditworthy.

In economic terms, these are small countries. The combined economic output of Bulgaria, Czechoslovakia, East Germany, Hungary, Poland, Romania and Yugoslavia is just 2% of global production. These countries trade mostly with each other and the Soviet Union. Their combined convertible currency exports are just 80% of the exports of South Korea alone.

But with good management and training and a dynamic economic policy environment, the 136 million inhabitants of these countries could increase production dramatically. Living standards in some of these countries could double in the 1980s.

The economic machine of the region is so run-down that it is near collapse. Savings and investment have slumped in recent years. Returning to the levels and growth rates achieved in the 1970s would produce major increases in living standards.

Far-reaching economic policy reforms are required to unleash the productive potential of the East European people. There must also be a profound change in the attitudes of their governments toward economic management: Deeply entrenched interventionist habits must be replaced by providing genuine freedom and support to the entrepreneurial spirit.

There also must be substantial Western finance to encourage and stimulate the difficult and testing transition to free-market economies. Official finance from the major Western governments and the multilateral agencies is clearly vital, and the planned European Bank for Reconstruction and Development can play a constructive role.

The scale of such official finance and the speed with which the bank becomes operational will serve as important signals to Western investors as they make determinations about the region's prospects.

But what can one expect from private sources of foreign funds?

Newspapers are full of stories of Western businessmen dashing into Central and Eastern Europe, but for the most part these are missions of inspection, not investment. These are businessmen making contacts, not signing contracts.

The notable exception is East Germany, with its future firmly tied to West Germany. Foreign direct business investment needs to become the prime source of Western finance to the region.

To achieve this, however, crucial obstacles must be overcome. The lack of currency convertibility limits the flexibility of manufacturers and their ability to transfer profits.

Manufacturers requiring intermediate inputs may well experience supply shortages. And even if materials can be supplied, they could well prove to be of shoddy quality. Communications and transportation systems are poor, and legal systems tend to be ill-equipped to protect the interests of foreign investors.

On the positive side, at least, are the determined statements by political leaders of their intention to secure reforms, plus indications of popular support for foreign investment. Each country in the area must be regarded as distinct and the sharp differences between them must be stressed.

Implementing swift policy changes is difficult in the current period of transition from old to new forms of government. Predicting the pace of change is impossible.

Creditworthiness in Central and Eastern Europe is deteriorating. To some extent this reflects short-term output losses resulting from the political upheavals of recent months. Further, countries such as Bulgaria, Hungary and Poland already have reached high levels of indebtedness.

For the most part, the banks, all too aware of the frustrations in recent years with outstanding sovereign liabilities to developing countries, will steer clear of new sovereign debt engagements. So too, in all probability, will most institutional investors in public and private placements of sovereign backed bonds.

The banks will play a crucial role in the revival of Central and Eastern Europe, but for the most part this will be driven by the needs of their prime business clients. Banks will be looking for clear "bankable business" in the form of trade and project financing, especially with significant cash flow and foreign exchange earning potential.

The situation in Central and Eastern Europe today is one of rapid political and social change, which provides major opportunities to ease international political tensions and to invigorate the whole European economy. The political and economic changes that have occurred and those that will take place are revolutionary ones and deserve forceful support from Western governments.

Active participation by banks and other foreign private investors depends on the success of the region's new leaders in mobilizing public support behind far-reaching economic reforms that can unleash the great human and economic potential of their countries.

Horst Schulmann is the managing director of the Institute of International Finance, Washington.

The Scorecard on Reform

	Price Reform	Privatization	Capital Market	Trade Liberalization	Exchange Rate
Hungary	+	+	+	+	+
Poland	++	+	+	+	++
Czechoslovakia	0	0	0	0	+
Yugoslavia	+	+	0	+	++
Romania	0	0	0	0	0
Bulgaria	0	0	0	+	+

++ substantial reform.
+ some reform.
0 no significant change
Source: The Institute of International Finance Inc.

THE WALL STREET JOURNAL, May 3, 1990

A Common-Sense IMF Needed for a Repentant Third World

By MICHAEL MANLEY

The exhilarating political transformation in Eastern Europe has removed a major threat to democracy. But threats outside Eastern Europe to countries which have been in the "trenches of democracy" for generations remain.

Some of those countries, like Jamaica today, stand at the threshold of economic growth. In the past, many leaders, myself included, placed too much reliance on government involvement in the production of goods and services. Now we are part of a general agreement that private sectors operating in market conditions provide the best means to economic growth and development. We have developed strong private sectors, have for years attempted to implement International Monetary Fund stabilization programs and World Bank structural adjustment programs – but find our economies burdened by debt.

At the same time, the intractable rules of lending agencies frustrate rather than stimulate economic growth. Without that growth, the social progress that is both the implied promise of the democratic system and the expectation of its practitioners, is impossible to sustain.

Third World debt has tripled in the past nine years, from $600 billion to $1.8 trillion. There are three main kinds of international debt. First, there is debt owed to commercial banks. Second, there is government-to-government, or bilateral debt. Third, there is debt owed to multilateral lending agencies such as the IMF, the World Bank and the Inter-American Development Bank. This is the type of debt that makes up a large portion of the loans owed by the English-speaking nations of the Caribbean.

Multilateral debt has two distinct disadvantages: No rescheduling whatsoever is permitted. And the Brady Plan's debt relief applies only to commercial debt, not IMF and other agencies' loans.

In the case of Jamaica, only 8% of our debt is commercial, while 45% is owed to multilateral agencies. Clearly, in our case a Brady Plan has little relevance. Further, our total debt of $4.5 billion represents some 189% of the island's gross national product, and debt servicing requires 40% of our annual export receipts. Jamaica is one of the most indebted nations on a per-capita basis.

Obviously, the island's capacity for sustained growth is severely constrained by this burden, despite a confident and aggressive private sector that enjoys both the confidence and backing of the government and the cooperation of the trade union movement. Expansion plans are constantly frustrated by the shortage of foreign exchange and even private foreign capital, which we solicit and encourage vigorously, tends to be apprehensive.

Finally, Jamaica is burdened by the fact that no rescheduling of any loan from a multilateral agency is permitted. Every single dollar of interest and principal repayment must be met, in terms of the original agreement, on the due date – or we face the prospect of the suspension of all disbursements under existing programs. In 1988-89, the net flow of capital from Jamaica to the IMF and the World Bank was – incredibly – $208 million. During this period, the island borrowed $70 million.

Normally, one would not have any quarrel with these strict arrangements, which would be the normal and proper obligations of a commercial debtor. But these are not normal times, nor is this a normal situation. The whole world shares responsibility for the debt crisis. The inflationary explosion following the Vietnam War and the OPEC oil price hikes, the ensuing stagnation, rising interest rates and tightening money market, the careless lending of commercial banks, the inexperience or in some cases shortsighted borrowing by developing countries together with many other factors contributed to the crisis in which we are all now trapped.

Ironically, there have been great advances in debtor-country management capabilities and understanding of strict financial prudence. And there is now general reliance upon market-driven strategies of private-sector-led growth. However, all these incalculable advantages garnered from experience to provide the basis for a new maturity in today's debtor countries are negated by the sheer weight of the debt burden.

The lending agencies exert pressure to force debtor countries to implement immediately policies that may be justified in strict economic theory but that are impossible to attain overnight. Import duties and internal interest policies are good examples. High duties encourage inefficiency but their immediate removal can kill off industries that could become competitive if given time to adjust. In the area of interest rates one lending agency is proposing policies that would require Jamaican small farmers to pay 22% on development loans. No business can hope to expand successfully at that interest rate.

Third World debtor countries represent more than half of humanity, that is to say, more than half of the potential market for the exports of creditor nations. The debt crisis restricts the capacity of developing countries to buy the exports of developed countries – which, in turn, hurts developed nations.

I am not advocating a retreat from the sanctity of contract, nor do I expect Jamaica to be permitted to walk away from its debt obligations. However, common sense and conscience surely demand that the major powers that determine the policies of the multilateral lending agencies take an urgent look at these agencies' inflexible rules, rules that have long since outgrown justification and now add to the strangling burdens of countries like Jamaica.

Surely the time has also come to take a new look at bilateral debts. Canada's recent unilateral cancellation of all debts held by English-speaking Caribbean countries is a powerful example. The sum involved – $183 million – might be small in the context of total Third World debt, but it is relatively large in the context of the Canadian economy.

Could not the reduced military expenditures accompanying the end of the Cold War be recycled into a new facility to supplement IMF/World Banks funds? This new pool of money could be used to reschedule debts due to the multilateral lending agencies, restricted to those nations undergoing the effects of structural adjustment.

A significant first step would be the creation of a small expert group at the Group of Seven's Houston Summit in June. The group's mission would be to come up with practical recommendations in, say, three months, to ease the debt crisis. The menu of remedies to deal with the problem is adequate. What we need now is the vision and the will to act in response to common sense as much as conscience, and that will safeguard democracy in my part of the world.

Mr. Manley is prime minister of Jamaica.

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THE WALL STREET JOURNAL, June 12, 1990

Fatter IMF Purse Won't Fatten Third World

By ALAN STOGA

After several years of debate, the U.S. and other members of the International Monetary Fund agreed in May to increase the fund's financial resources by $88 billion, to $180 billion. When ratified by the U.S. Congress and other national legislatures in the next year or so, this is supposed to enable the IMF to help meet the financial needs of Eastern Europe and the developing countries. Unfortunately, the quota increase is the wrong solution to the right problem.

First, the problem. Almost a decade after the onset of the Third World debt crisis, most of the Latin American and African economies remain stagnant, pushed out of the world economy by their own mismanagement, the scarcity of risk capital, and industrial-country protectionism. Democratic leaders throughout the developing world are struggling to adopt free-market reforms and to sustain economic stabilization programs. These efforts are understandably impeded by the reluctance of creditors and investors to provide much new financing, at least until the debtors establish credible track records of reform.

The circumstances are similar in Eastern Europe. While there is a lot of sympathy in the West for the dramatic changes that have occurred since the Berlin Wall came down, the capital needed to support the structural reforms that lie ahead does not appear to be readily available.

This is where the IMF and the new quota increase come in. In almost any analysis the developing world and Eastern Europe will need fresh capital to achieve reasonable economic growth if structural reform continues. But private investors demand higher returns and more security than these countries can afford. The logic is straightforward: If the private markets will not provide the capital, then the IMF, along with the World Bank, should fill the gap.

Unfortunately, the shoe may not fit the foot. The IMF was designed to manage the overall direction of the international monetary system and to provide short-term financial support to countries with temporary balance-of-payments problems. The fund is not a particularly good vehicle to mediate between reluctant creditors and needy borrowers, nor to provide the kind of long-term development finance that is required to support structural economic reform. Argentina and the Philippines do not have short-term payments imbalances: They have chronic payments imbalances.

Indeed, during the past decade the IMF has wandered far from its original mission. Under the leadership of Jacques de Larosiere, the fund played a major role during the early 1980s in preventing the Third World debt crisis from becoming a systemic crisis that could have threatened the integrity of international financial markets. But the IMF's stopgap efforts failed to resolve the underlying problems of debtor country insolvency and stagnation. This was because IMF advice was sometimes misdirected and sometimes not followed.

Stabilization programs were constantly renegotiated, and short-term loans effectively became long-term loans. The whole process undermined the credibility that the IMF's "seal of approval" used to have for private investors, so the fund's ability to mobilize private capital – which in the past had magnified the impact of its lending – disintegrated.

In addition, the reluctance of the U.S., the IMF's most powerful member, to accept the same kind of economic policy criticism and guidance that are routinely imposed on other countries undermined the credibility of the fund in its role as guardian of international monetary arrangements among the major industrial countries.

With currency negotiations largely conducted among the major industrial countries, outside the context of the IMF, the fund is now a sideshow when it comes to core exchange-rate issues. The irrelevance of the IMF on monetary questions has been furthered by the unfortunate U.S. preference for bilateralism (especially when dealing with the Japanese) and economic summitry. The annual summits of the seven industrial country leaders have become far more important monetary venues than the periodic meetings of IMF directors and governors.

The consequence has been that there has been a significant blurring of the roles of the IMF and the World Bank. Both have, essentially, the same clients – developing countries. Both tie their lending to structural economic reforms as well as to progress in achieving short-term financial stabilization. Both are privileged creditors that insist on the seniority of their loans over those of other creditors. And both are staffed by overzealous but quite talented economists whose starting premise is that they know more about governing any particular country than its own government does.

Do we need both institutions? As currently operating, probably not. In today's circumstances more money – the $60 billion IMF quota increase – is not enough of a solution. No more than $20 billion of that money would, in any case, be paid in hard currency.

There is, however, an urgent need to make more risk capital available to Eastern Europe, Latin America, and the rest of the developing world, without which the reform process in many countries will falter. But there is also a need to rethink the IMF and World Bank, to bring the institutional framework created at Bretton Woods more than 40 years ago in line with dramatically changed economic and political conditions – and the realities of the Bretton Woods institutions themselves.

The U.S. and its partners should do both: fix the fund and spend the money.

Mr. Stoga is managing director of Kissinger Associates, based in New York.

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STATEMENT OF RONALD W. ROSKENS

ADMINISTRATOR

AGENCY FOR INTERNATIONAL DEVELOPMENT

BEFORE THE

FOREIGN OPERATIONS SUBCOMMITTEE

OF THE

SENATE APPROPRIATIONS COMMITTEE

APRIL 3, 1990

Mr. Chairman, members of the Committee, thank you for this opportunity to introduce myself and provide my perspective on the future directions which should be taken by A.I.D. I also want to comment on A.I.D.'s budget request for the coming fiscal year. The resources we will need to accomplish the ambitious goals we have set for ourselves need to be discussed in some detail.

Secretary Baker has already commented about the astounding changes that have taken place in Eastern Europe -- in Panama and Nicaragua -- in Namibia -- and in some ways in South Africa as well. I need not repeat what you already know.

What I want to suggest is that the era of great change is not over -- it is merely beginning.

The explosion of democracy and the drive toward free market systems which we are witnessing today cannot help but impact other nations. I doubt that governments that avow communist principles will long survive in the face of today's turbulence. Even socialist systems may find it hard to compete with the success that comes to ntions that rely on open markets.

The implications of these changes -- both today's and tomorrow's -- are quite considerable for the U.S. government and the U.S. private sector. As a nation, we are applauding the expansion of democracy and the desire on the part of many of these emerging democracies to pursue principles that foster individual and entrepreneurial initiative. Yet it has become obvious to many of us, including many of you in the Senate, that we are not prepared to support these newly emerging

democracies in as timely a manner as we would like. We seem to be playing "catch-up" -- writing supplemental bills that will allow us to provide needed assistance to Panama and Nicaragua and to refugees. Even a newcomer such as myself can see that this method of operating makes us somewhat slow and less than fully effective.

That is why Secretary Baker and I have both asked for greater flexibility in the foreign affairs accounts. Such flexibility has always made sense. History shows that the international scene is never perfectly stable for long. The rapid pace at which the world is changing makes that flexibility more than desirable -- it makes it imperative. I hope to work with you to find a way to put the flexibility we need back into the foreign assistance program, so that we might run with, not behind, the fast moving forces of change in the world.

It is important that we be an effective force for democracy and human progress in the world. It is important because we -- as humanitarians -- have a moral obligation to offer some of our wealth and know-how to those who dream of a brighter future for themselves and their families.

At the same time, we have an obligation to the American taxpayer -- to take advantage of expanding international economic opportunities for the U.S. We already know that developing countries buy more than a third of all U.S. exports. Those developing nations that pursue market-oriented policies can grow at phenomenal rates -- and countries on a fast growth track are the markets of our future. Flourishing economic relationships translate into greater demand for U.S. goods and services.

This point was made by Peter Drucker in the March 20 edition of the Wall Street Journal when he flatly asserted that:

> "America could do more to solve its trade deficit by helping to bring about economic growth in Latin America -- and reestablishing that hemisphere as a major U.S. customer -- than it could do by removing all of Japan's barriers to U.S. imports."

If we can successfully foster economic and human progress -- multiplying its impact across continents -- the U.S. could look forward to more rapid and beneficial two-way trade with developing countries.

Readying ourselves to meet emerging needs in the developing nations and in emerging democracies is only half the battle. The tremendous reserves of talent and skills the U.S. can bring to bear on the problems developing nations face will be

misplaced if we believe that a formula -- or even a common set of programs -- can be applied in every country that needs our help. To my mind, such approaches are naive because they fail to recognize the cultural, economic, political and other differences that distinguish countries and societies. Two countries commanding much attention at present serve as good examples: Panama is reinstating the democratic and free market principles which they know well; Poland, on the other hand, has not relied on a market-based economic system for over fifty years. In Poland, we need to erect -- in Panama, we can simply renovate. The differences here are not simply cultural -- these countries have different needs.

As we organize ourselves to help these nations we will rely heavily on the force and vigor of the private sector -- U.S. businesses, private and voluntary organizations and U.S. universities -- to help us in our pursuits. For our part, we must help to pave the way for the financial and technological investments which only the U.S. private sector can provide. A.I.D. -- with its on-the-ground knowledge of developing countries' potential and problems -- must continue to build policy environments which are conducive to private sector investment. It also needs to be emphasized that this partnership between the public and private sectors will not be entirely productive if one party is constrained.

While we must recognize the differences among nations and the unique nature of their needs, our assistance program should not be simply reactive. History has shown that economic growth and development advance and become permanent when people are free and where market-oriented economic policies make it possible for all citizens to participate in and benefit from economic progress.

In its FY 1991 Congressional Presentation, A.I.D. presented these basic ideas as three fundamental goals that serve as a framework for A.I.D.'s programs -- in all of the countries in which it works. These intertwined goals present a clear and solid beginning for the kind of coherent focus I am encouraging at A.I.D.

The three fundamental goals are:

-- Economic growth that is broad-based and sustainable, in both economic and environmental terms.

  * Let me note here that this is not an abstract goal -- what we are talking about is real increases in people's incomes. Broad-based growth means thousands of start-up businesses and millions of new jobs in these countries.

-- Human capacity development -- the growth of people -- with particular emphasis on achieving health and education levels sufficient to enable all citizens to contribute to and benefit from economic progress, and

-- Pluralism, including the promotion of democracy, freedom and competition in the political, economic and social institutions of a nation.

These broad goals do not tell us exactly what we should do in a country -- nor should they. They do, however, provide appropriate guideposts for developing programs that fit the unique characteristics and needs of countries all around the world.

a) Economic Growth: With respect to broad-based and sustainable economic growth, a consensus is emerging concerning its central importance in the development process. When economies are growing and are open to full participation, individual and family incomes rise and enable people to obtain adequate food, health care, education and shelter. Where there is no significant economic growth, improvements in living standards are tenuous at best.

For growth and its benefits to be broad-based, economies must be open. Private firms must compete in the provision of services and in all aspects of industrial and agricultural production and distribution. Similarly, entrepreneurs, including the smallest entrepreneurs, must have easy access to the market and individuals must have a fair chance to compete for each new job that emerges as the economic growth process takes hold.

By way of illustration, one of A.I.D.'s microenterprise programs in Indonesia provides working capital loans to small entrepreneurs wishing to enter the marketplace. One such loan was extended to a widow in North Bali who wanted to buy scrap cloth from clothing shops. She sews these scraps into children's clothing and sells them at local markets. Her business has so expanded that she is now looking to hire additional workers to help with the marketing of her apparel. As a result of this one small loan, this woman's income has increased enough to provide adequate food for herself and her four children and employment is being provided to family members and outside workers.

The sustainability of development progress depends in large part on a long-term commitment to sound economic policies. All too often we see governments promote inappropriate economic policies that choke off trade, stifle external investment and smother individual initiative. These policies serve to:

- Hinder the ability of low income groups to better themselves, by keeping prices artificially depressed and maintaining a subsidy for the elite;

- Encourage the squandering of natural resources, and actually subsidize short-term exploitation for short term gain;

- Ignore individual property rights of citizens and actively discourage new business and competition through harshly unrealistic licensing procedures.

It is in recognition of the key role of sound economic policies that we are proposing increased attention to performance-based budgeting of our development resources as a means of fostering policy change which is conducive to broadly-based growth.

b) Human Capacity Development: A.I.D. remains committed to assisting developing country governments and private sector service providers to reach the poor with food, essential health and family planning services and to provide them with a basic education. Without these investments in human capital, overall economic growth is neither attainable nor meaningful.

One means of promoting human capacity development is through education and training: A.I.D. funds basic education projects in developing nations around the world and has provided opportunities for more than a quarter of a million people from developing countries to receive academic and technical training in the United States.

Education and training programs can serve a variety of development objectives. As an example, A.I.D. is assisting some recipient countries to trim expensive government payrolls by helping civil servants make the transition from public to private employment. It has been difficult to get new graduates and current civil service employees to explore job opportunities in the private sector. But the Mali Economic Policy Reform Program supported by A.I.D. has helped the Malian Government to undertake a pilot voluntary early retirement program. One mid-level Malian Government civil servant who opted for early departure -- Sara Maiga Sidibe -- received a lump-sum severance payment and entrepreneurial training. Armed with these resources, she opened a successful pharmacy that now employs several people. Her income has probably tripled in the process. Her story may be an exception, but it is encouraging.

We are also at the forefront of worldwide population and natural family planning programs. A.I.D. is by far the world's

largest donor to family planning projects and supplies over three-fourths of the contraceptives donated to the developing world.

Health care, particularly for children, has been one of our principle areas of investment and success over the years. A.I.D. helped support pioneering research into Oral Rehydration Therapy, whch is now helping millions of babies and children suffering from the effects of dehydration due to diarrhea.

c) Pluralism: The final ingredient that is integral to the success of any society is political, social and economic pluralism, based upon a rule of law which provides equal protection for all. A.I.D.'s promotion of pluralism is at the apex of the Agency's goals overall: to promote economic development which fosters human dignity and to promote foreign policies which encourage human freedom. In simple terms, pluralism means the right to choose -- to make all of the daily choices that add up to control of one's own destiny. Pluralism and the policies that promote openness, fairness and opportunity are natural in societies where individual responsibility is valued.

By and large, economic development and political freedom throughout the world have been mutually reinforcing in modern times. Open societies, through legally guaranteed freedoms of speech, press and association, as well as through free elections and a system governed by the rule of law, allow the unrestricted flow of ideas and the expansion of a private sector that is an important counterweight to state power. Open markets, in turn, promote political diversity by providing employment outside of government, allowing individuals to maintain their livelihood independent of the state. Thus, A.I.D. attempts to strengthen institutions which promote the openness and transparency of markets, fair and efficient adjudication of disputes, and the promotion of the rights of individuals to associate for economic purposes, to hold property and to retain the profits from their labor.

A.I.D. has encouraged the development of pluralistic societies by providing support for labor unions, cooperatives, credit unions, and local organizations, as well as special initiatives that promote human rights, strengthen legislative bodies and judicial administrations, and support free and fair elections. These types of development assistance not only enhance the lives of those affected, but simultaneously reinforce democratic principles.

Through all of these initiatives, A.I.D. is fostering the "infrastructure of democracy", not only through its mainstream programs, but also by means of activities which support

opportunities to build institutional capacity and increase citizen awareness of and participation in the political process, irrespective of that form of participation.

Before turning from A.I.D.'s broad goals to management issues, I want to point out that our commitment to sound environmental practices permeates everything A.I.D. does. A.I.D. recognized the importance of the environment to sustainable development early on and became active in this area more than a decade ago. Until recently, the careful protection of the environment was not considered to be a problem that required the attention of development agencies. Awareness of the fragility of the world's environment, and how critical protecting the precious natural resources of developing nations is to their future and, indeed, to the future of all the world's inhabitants, has become more widespread.

Protecting the environment and formulating development policies and programs that are environmentally sound have been and are absolute priorities at A.I.D. We are committed to working with developing nations and other donors to hasten the day when environmental degradation is a thing of the past. A.I.D.'s efforts to combat global climate change are reflected through forest management, reforestation, renewable energy and energy conservation activities. For FY 1990, A.I.D. is committing an additional $15 million from FY 1989 levels to ensure an increasing commitment to global climate change activities.

A.I.D. has also been a leader in the effort to train farmers in alternative methods to the environmentally unsound practices of slash-and-burn cultivation. We have also sought to protect vulnerable rain forests and preserve genetic biological diversity -- while at the same time relieving heavy debt burdens -- by sponsoring debt-for-nature swaps. These types of environmental programs are highly effective in many of the Latin American countries, but cannot easily be replicated in other countries or regions. In Africa, we are racing against the spread of desertification. In Thailand, industrial pollution is the most critical environmental challenge. In Egypt, inadequate sewage disposal poses both ecological and health hazards. Simply put, "all purpose" environmental projects do not exist.

Consistent with our congressional mandate, A.I.D. is an active participant in U.S. efforts to encourage environmental reforms in the Multilateral Development Banks (MDBs). We monitor MDB projects for potential environmental problems, seeking improvements in design early in the project cycle and providing recommendations to U.S. Executive Directors to the MDBs.

In addition to focusing on results, I am committed to the highest management standards for A.I.D. It is essential that A.I.D. employ management approaches that will ensure that the funds appropriated for foreign assistance are used efficiently -- a concern this Committee shares. In tight budgetary times, the need for efficiency is particularly great. To reiterate Secretary Baker's suggestion, closer consultation about mutual objectives could achieve essentially the same outcome as earmarking, but at a lesser cost to overall programming efficiency.

Each year the attention of the public and Congress focuses on new issues, and new expectations are continually being imposed on the foreign assistance program. New directives are imposed without reference to existing requirements or to the cumulative effects of this process. This system hinders the efficient allocation of resources in response to changing needs, and actually inhibits our ability to achieve development goals. While no one questions the appropriate role of Congress in fashioning the budget of the Federal Government, everyone should be aware that our concerns over excessive restrictions are a function of their negative practical consequences.

Specifically, the combination of functional accounts, earmarks and directives complicates A.I.D.'s budget process in several ways depending on the kind of earmark.

One type of complication arises when relatively small accounts are earmarked, like the Education account -- 52% of which was earmarked this past year. The effects of such earmarking -- often invisible to Congress -- are forced cuts in projects without regard for their intrinsic merits, their importance to country programs or their track record. This particular earmark also underscores a message I keep coming back to: there is no such thing as a universal anecdote for development problems. Concentrating on primary and secondary education programs, as the basic education earmark does, distorts our overall education efforts. Combined with the cut in the account, about $20 million worth of planned education and training activities cannot be funded this year.

Earmarks for specific activities which usually have merit in isolation but for which there is no demand in our programs are likewise problematic. Those which require us to mount new, unanticipated programs -- within a single year -- and especially those in which we have little prior experience -- force us to short-cut the planning process, divert resources from other uses, and often lead to sub-optimal projects. Last year's earmark of $2 million for African elephant preservation is an example of this type of problem.

The increase in such earmarking of DA has compounded the constraints already imposed by the functional accounts, and has made it increasingly difficult to program funds properly to

respond to those critical impediments to growth which I cited earlier. It is for this reason that we are submitting a budget request which proposes no functional account divisions.

These examples provide insight into the extraordinary problems caused by earmarking and the restrictiveness of functional accounts. These constraints have made it increasingly difficult in recent years to program funds to respond to the most critical impediments to economic growth in the countries A.I.D. assists.

Fixing Foreign Aid

With the end of the Cold War, America's much-criticized foreign aid program may be reoriented to help U.S. businesses compete in the emerging global marketplace.

BY ROCHELLE L. STANFIELD

The end of the Cold War may finally force Washington to do something about foreign aid.

For years, Members of Congress and successive Administrations grumbled and blamed each other for the aid program's shortcomings, misdirection, politicization and administrative incomprehensibility, but took no action to correct them.

They still haven't done very much. Spending on foreign aid that would be permitted under the fiscal 1991 budget resolution adopted by the House just about matches the Bush Administration's $14.8 billion foreign aid request, which in turn looks a lot like the $14.6 billion foreign aid appropriation for fiscal 1990, which was not all that different from the $13 billion spent in 1989.

Senate Majority Leader George J. Mitchell, D-Maine, complained in an April 2 statement on the floor: "The Administration does not have a five-year plan or a three-year or a two-year plan for foreign aid; indeed, they offer no plan at all. They have not explained how any plan would be affordable in relation to their other spending plans; they have not outlined the relationship of any plan to our national security objectives."

Ronald W. Roskens, the new administrator of the Agency for International Development (AID), took note in an interview of "the remarkable, cataclysmic, if not stunning, changes that have occurred in the world," and said they are driving his agency "to reorder our internal operation to enable us to more responsibly and responsively deal with conditions that are unfolding."

AID officials say they are working on a new plan but haven't been able to put it down on paper because events keep overtaking them.

"Foreign aid has to change with the times. It's just that you have to get the times to stabilize long enough for us to be able to prepare legislation," said Richard Bissell, assistant AID administrator for science and technology and formerly the agency's planning chief. "We have to have a movie camera to capture things. You can't do it with a still camera."

For that reason, and because this is an election year, serious work on a complete foreign aid overhaul isn't likely before next spring. But a combination of factors has provided what many believe is the necessary momentum for change:

- frustration with the current system's inflexibility at a time of swift and dramatic change in the world;
- the end of the Cold War and the perceived need to redirect foreign aid away from Cold War political objectives and toward making American business more competitive in global markets;
- a new chief for an agency that had been headed by an acting administrator since the death of M. Alan Woods a year ago.

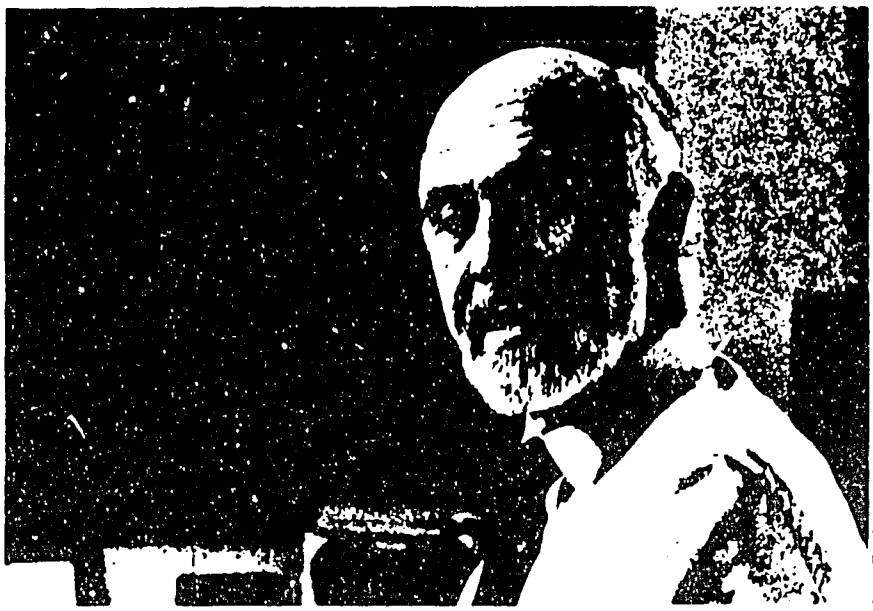
So there is an air of expectation that something will happen this time. "There are certain times when an issue moves from being a problem that people know is there but don't want to worry about to one they want to do something about," said John W. Sewell, president of the Overseas Development Council, a Washington think tank devoted to international economic development. "In the last two or three months, we have moved into that time with foreign aid. It is now both imperative and possible to think about drastic reforms in this area of policy."

REVOLUTIONARY CALL

The democratic revolution across Eastern Europe and in parts of Central America raised the level of frustration of sup-

Richard A. Bloom

Agency for International Development administrator Ronald W. Roskens
Recent dramatic events are driving AID "to reorder our internal operation."



John Eisele

John W. Sewell, president of the Overseas Development Council
To cope with changes in the world, a new, broader-gauged agency must replace AID.

porters of U.S. foreign aid and triggered the calls for a revolution in the program.

The Administration and Congress alike say they want to help out the emerging democracies on both continents. But budget constraints preclude any significant increase in aid, and congressional "earmarks" (guarded by zealous supporters) lock in the biggest aid recipients and prevent any major shifts in aid allocations.

This year, Congress has agreed to carve out $300 million in aid for Eastern Europe and $720 million for Nicaragua and Panama, but those are one-shot deals that lawmakers are unlikely to be able to repeat year after year.

Rationalizing the country-by-country allocations and retrieving some flexiblity for the process is probably the most politically divisive part of the foreign aid reform problem. Last year, a House Foreign Affairs Committee task force headed by Lee H. Hamilton, D-Ind., and Benjamin A. Gilman, R-N.Y., came up with a foreign aid reform package that was gutted before it passed the House. Even Gilman rejected the recommendation to remove earmarks. The Senate didn't hold hearings on the subject. *(See NJ, 4/8/89, p. 846.)*

But the frustration level has grown considerably since then. Sen. Minority Leader Robert Dole, R-Kan., expressed it in a controversial Jan. 16 op-ed piece in *The New York Times* in which he argued for cutting aid to the top five recipients by 5 per cent to support a fund for new democracies.

The response was predictably immediate and hostile, especially from supporters of aid to Israel (the top aid recipient), vividly demonstrating the issue's political sensitivity. That's one reason a complete foreign aid overhaul is unlikely before the November elections.

World events have changed faster than the ability of the creaking budget process to react to them. "The budget that came up this last time [President Bush's January proposal for fiscal 1991] was, to that extent, business as usual," Secretary of State James A. Baker III conceded to the Senate Appropriations Subcommittee on Foreign Operations on May 1. But Baker promised, "That won't be the case again."

A growing chorus in Congress, within the Administration and in the community of foreign policy experts are calling for a much more sweeping redirection of foreign aid, stimulated by the end of the Cold War and what they see as the beginning of an era of global economic warfare.

"The next war will indeed be economic, and the competitors will be the same people, frankly, we had to deal with 50 years ago, the Japanese and the Germans," Rep. David E. Bonior, D-Mich., the deputy whip, said in a recent interview. "I think we need a strategy to make us more competitive with them in trade, and that has got to be part of the equation in foreign aid."

The Hamilton-Gilman report counted 33 objectives in the 1973 Foreign Assistance Act (the last time foreign aid was overhauled), but a Cold War rationale has justified most aid spending over the past 10 years. The overwhelming majority of aid goes to Israel ($3 billion obligated in fiscal 1990), Egypt ($2.4 billion), Pakistan ($588 million) and three countries hosting U.S. military bases: Greece ($349 million), the Philippines ($350 million) and Turkey ($516 million).

About 18 months ago, Woods issued a report concluding that foreign aid works best when it helps to develop the private sector in Third World countries. The report, however, made no recommendations and was generally ignored at the State Department and in Congress.

Now, some policy makers want to use foreign aid to develop and promote markets for the United States in Eastern Europe and the Third World, a tactic the Japanese have employed with great success in Asia. Though support for this is widespread, however, there is profound disagreement on how to do it.

Sen. David L. Boren, D-Okla., for example, suggested in a Jan. 2 *New York Times* op-ed piece that "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." But there's a lot of opposition to that in Congress, in the Administration and among foreign policy analysts.

There is also substantial unease among supporters of current foreign aid allocations, both of the humanitarian and the military variety.

"With the changes taking place in Eastern Europe, the problem and concern is that Africa will be left out. Africa will be forgotten," said Joseph C. Kennedy, director of international development for Africare, a Washington-based nonprofit organization that supports development projects in Africa.

Many military planners say the end of the Cold War will increase hostilities in the Third World. U.S. arms suppliers insist that decreasing military aid won't reduce arms purchases by these countries but just direct the market elsewhere.

"You can do all of the moral posturing you want, and all you are going to do is convert the market to the British, French, Soviets, Israelis and Brazilians and encourage indigenous arms production if [Third World nations] feel threatened," said Joel L. Johnson, vice president of the Aerospace Industries Association of America Inc. in Washington.

An economic orientation also would give foreign aid a new constituency: the business community. Foreign aid supporters acknowledge that the program needs friends, but some question the propriety of corporate support.

Foreign aid has never been very popular, and is even less so now. In a recent poll by Louis Harris and Associates Inc., for example, only 47 per cent of those asked about foreign aid said they favored it, down from 59 per cent in 1986.

"We have done a very bad job of telling the American people why foreign aid is in the self-interest of the United States," said Mark L. Edelman, AID's deputy administrator, who had been acting agency chief until Roskens was sworn in on April 23.

Roskens said a personal high priority is selling foreign aid "and the values that accrue to our national interests" to the American people and Congress.

MIXING AID AND CREDITS

Just about everyone agrees that the United States has to compete more effectively for potential Eastern European and Third World markets. And more and more analysts see a role for foreign aid in that competition. But there's no consensus on specific mechanisms to accomplish that goal.

"I don't want to see [foreign aid] money spent not so much based on which countries need the most development assistance but which companies need the most subsidies to compete in the market place," said Rep. Matthew F. McHugh, D-N.Y., a senior member of the Foreign Affairs Committee. "Those are two separate considerations, and I don't want economic development money used for the other purpose."

Committee chairman Dante B. Fascell, D-Fla., doesn't agree. "The fact is, American business needs some kind of assistance, although I'm not saying it has to be dollars or a legislative program," he said. "For all the years I've been in Congress—35 years—American business has had to struggle uphill against both subsidies and other competitive measures used for business by other countries, making it very difficult for the U.S. businessman."

Fascell supports—and McHugh adamantly opposes—linking foreign aid to export credits. AID would provide assistance to cover part of the cost of a project—a power plant, say—and the Export-Import Bank of the United States would extend a credit for the balance of the cost on the condition that purchases with the aid and with the credit are made in the United States.

That's what most other donor countries do, but the United States has objected to that practice. As much as $12 billion in commercially sensitive projects are financed in this way by other donor countries, according to *The Tied Aid Credit Issue: U.S. Export Competitiveness in Developing Countries* (Center for Strategic and International Studies, 1989), by Ernest H. Preeg, an expert in international business at the Washington center and formerly AID's chief economist and deputy assistant administrator.

"We don't do it as a matter of principle," Preeg said in an interview. "We may be losing on the order of $4 billion a year in exports in the most important high-tech industries because of what others do with their aid program."

Conservatives don't like tied aid because, they argue, it amounts to government interference with the free market. The Reagan Administration, in its early years, even tried to abolish the Eximbank, though the Bush Administration is relying on the bank to stimulate private-sector deals in Eastern Europe.

Supporters of traditional foreign aid programs, such as McHugh, say they fear the power of the corporate lobby and worry that U.S. business objectives, not foreign country development needs, would end up driving the program.

Preeg and other advocates of tied aid insist that this won't happen if AID makes sure that each project financed has sound development prospects. "A lot of work has been done on development criteria—what is the cost of return, the impact on population and the environment, which technologies to use," he said. "That can be worked out from the start."

Others oppose this approach, recalling the horror stories that abound about AID's white elephant infrastructure projects in the 1950s and 1960s.

"I think we moved away from that for some pretty good reasons," said an aide to Sen. Patrick J. Leahy, D-Vt., chairman of the Appropriations Subcommittee on Foreign Operations. "We built a lot of roads that went from nowhere to nowhere and power plant projects that turned out to cause huge environmental problems."

Since then, others contend, the United States has pioneered environmentally sound infrastructure projects. "The United States does well, and our equipment is very good, and it is possible that they will work environmentally because we've learned a hell of a lot in the last 10-20 years, thanks to the environmental movement," Sewell of the Overseas Development Council said.

The Administration has decided to experiment with a few mixed credit deals in Asia. In Indonesia, for example, AID and the Eximbank have proposed a package of assistance and credit for a telecommunications system.

"I truly believe our influence in Indonesia in the time to come is going to be enhanced as much by our selling them a telephone system as almost anything else we can do," Eximbank chairman-president John D. Macomber said. "It's not to say our military position is not important, but looming much larger on the horizon is the ability to have large market shares for U.S.-made products around the world."

Macomber acknowledged, however, that the bank is participating only reluctantly in mixed aid-credit projects. "We think it's uneconomic and it's costing everybody a hell of a lot of money," he said. "We're telling our allies: 'Let's cut it out. You're forcing us to play this game.' This is a way of getting them to the bargaining table."

AID's Edelman, who also doesn't like mixed credits, said that foreign aid can enhance U.S. trade without such added financial inducements by providing emerging democracies with the technical assistance that will enable them to participate in the global market. "I don't think we [should] beef up incentives," he said. "I think where we spend money in Eastern Europe is on those things that help them attract the private sector."

THE LOSERS

In the absence of additional money, spending foreign aid to develop potential markets in Eastern Europe and the Third World means not spending it on some other form of aid. The likely losers appear to be military and political aid.

"The kind of thing we should be looking at is military assistance to countries that have been getting it because of their presumed role in NATO," McHugh said. "If the threat in Europe is significantly diminished and we're strapped for foreign aid funds—and we are—then that seems one area we could be looking toward adjusting downward."

No matter how military assistance is calculated—and it is figured differently depending upon the outcome desired—it is a big portion of foreign aid. Counting only military equipment, training and re-

John Fiscle

Former AID chief economist Ernest H. Preeg
The United States must mix aid and export credits.

lated purposes, it amounts to about $5.5 billion, or 37 per cent of the total foreign aid allocation.

That excludes the $3.4 billion requested for 1991 for the Economic Support Fund, which is not used for military equipment but is used to support Cold War strategic purposes. (Because of its geostrategic-political nature and its fewer strings, Rep. Hamilton has called it "the Secretary's walking-around money.")

Not surprisingly, supporters of the major recipient countries can find new arguments for sustaining their share. Israel and Egypt (whose aid is linked by the 1979 Camp David Accords) are really not part of the Cold War equation, advocates say. Irritation with Israel stems from its government's recalcitrance in participating in the peace process.

"Israel is still faced with all the same problems. The military threat continues to haunt Israel," said Thomas A. Dine, executive director of the American Israel Public Affairs Committee (AIPAC), the principal lobby group for Israel.

Others argue—with less confidence of the outcome—that Pakistan, the Philippines and Turkey are emerging democracies that require continued U.S. aid if they are to become important markets for American goods. It is harder to make that argument for Greece and Portugal, which are members of the European Community and will benefit from the community's economic integration.

"With the exception of Israel, I think the will is generally there to look at the pie and make more sense out of it," Bonior said.

The military equipment industry views military assistance in economic terms and argues for maintaining the U.S. share of what it predicts will be a lively market.

Military planners predict increased regional conflicts in the Third World as the superpowers reduce their influence over client states. "People who expect to see a peace dividend worldwide may be somewhat surprised in that, ironically, the very act of cutting back on our own defense expenditures may result in increases in defense expenditures by many Third World countries," Johnson of the Aerospace Industries Association said.

Third World countries are spending a lot on arms, but not necessarily those countries that are fighting wars. From 1983-87, Third World countries imported $188 billion in arms. But the 15 countries then at war spent less than a third of the total, and the bulk of that was spent by Iran and Iraq, according to Jo L. Husbands, a senior research associate at the National Research Council who made the calculations for an article in the May issue of *The Bulletin of the Atomic Scientists*.

The other potential losers if foreign aid is redirected toward U.S. trade purposes, ironically, could be the poorest countries, which are the least likely to provide big markets for U.S. goods. AID's development assistance fund amounts to just $2.4 billion, but it is frequently eyed when money is sought for an emergency. Funds reserved for several African countries were transferred to help Panama and Nicaragua, for example.

"Right now, Africa as a continent gets less in foreign assistance than any other part of the world, $520 million for 53 countries out of $14 billion plus," Africare's Kennedy said. He said he fears that the total for Africa is more likely to go down than up when aid is restructured. "It's very difficult, because Africa really doesn't have a constituency here in the United States."

John Tuckle

Rep. Matthew F. McHugh, D-N.Y.
Aid and credits shouldn't be linked.

As part of his job of selling foreign aid to the American people, AID chief Roskens said, he plans to appeal "to the humanitarian instinct. There is an element of charitability that is inherent in our culture, in the nature of our country. That can't be forgotten."

A MATTER OF TRUST

Election-year politics and the exigencies of the budget cycle are likely to prevent dramatic changes in foreign aid spending this year. But the politics of the budget deficit could force a restructuring of the program next year.

Emergency financing for aid to Central America and Eastern Europe came from the defense budget, but that is probably the last Pentagon money the foreign aid program is likely to see. "In 1991, the peace dividend is not shifting to the extent that many people thought it might from defense to foreign policy and domestic. It is shifting from defense to domestic," said Larry Q. Nowels, a foreign aid specialist at the Congressional Research Service.

Advocates of a foreign aid overhaul favor rewriting the 1973 Foreign Assistance Act. Sewell and others say it would mean setting up a new kind of agency that would have broader capability to deal with economic aid, trade and debt. Fascell and Hamilton are set to push through the legislation they worked on last year, but it isn't likely to reduce earmarked funds dramatically.

The Senate Foreign Relations Committee, however, might remain the obstacle it has been for years, especially if chairman Claiborne Pell, D-R.I., wins a tough reelection bid in November. Even with a new chairman, observers predict, the committee is likely to remain sharply divided and thus paralyzed on foreign aid.

The Administration's position is also obscure. Neither Bush, Baker nor Roskens has committed himself to recasting the foreign aid law.

Many see another, somewhat less satisfactory, approach by means of informal agreements between the Administration and Congress on appropriations measures. Sen. Leahy and Rep. David R. Obey, D-Wis., chairman of the House Appropriations Subcommittee on Foreign Operations, Export Financing and Related Programs, both enthusiastic supporters of change, say substantial revisions can be made by switching money around under the current legislative framework.

That will require trust between Congress and the Administration. Congress imposed much of the earmarking of foreign aid funds during the Reagan Administration as a consequence of a lack of consultation and diminished trust.

"My own personal feeling is that there will never be a deal struck as such on earmarking," AID's Bissell said. "What can occur is an emerging consensus on a growing number of foreign policy issues between the Administration and Congress such that earmarks become irrelevant."

Baker, who already spends a lot of time on Capitol Hill, has promised accelerated consultation. Fascell, who has expressed some skepticism about how much this Administration really listens to Members of Congress, says he is willing to give the executive branch the benefit of the doubt.

"I want to give the Administration more flexibility than they have, but accountability and consultation has to be part of the process," he said. "It's a constant struggle that's gone on for 200 years on how to work together and will probably continue for a while longer." □

APPROPRIATIONS

House Panel Acts To Shift Foreign Aid Priorities

Democrats shuffle funds from military to development, citing 'the new realities' as communism wanes

Rep. David R. Obey of Wisconsin and many of his fellow Democrats want to use foreign aid to help close the books on the Cold War. But the Bush administration and some Republicans hesitate to abandon some overseas commitments left over from the height of the U.S.-Soviet confrontation.

In the opening shot of what could be many partisan battles this year over post-Cold War priorities, a key House Appropriations subcommittee on June 13 approved a $15.8 billion spending bill that begins to cut back military aid to foreign countries. The bill may go to the full Appropriations Committee the week of June 18 and to the House floor a week later.

Obey, chairman of the Foreign Operations Subcommittee, drafted the bill to start shifting priorities to reflect what he called "the new realities" following the collapse of communism in Eastern Europe. The subcommittee-approved bill would cut $526 million from President Bush's request for military aid to U.S. allies and allocate the money instead for development in Eastern Europe, Africa and elsewhere.

Republicans and the Bush administration opposed Obey's bill, approved on a party-line vote of 8-4. But that vote disguised the fact that disagreements on foreign aid cross party lines. One conservative Democrat, Charles Wilson of Texas, reserved the right to vote with Republicans when the bill reaches the floor. And one Republican, John Porter of Illinois, said he voted with his colleagues only out of party loyalty.

When it reaches the full House, the measure will be buffeted by debates over two politically hot issues: aid to El Salvador and support for family planning programs overseas.

Obey's subcommittee included in the bill a provision to suspend half of U.S. military aid to El Salvador in fiscal 1991. The House on May 22 had voted to include that provision in a foreign aid authorization bill, but the bill subsequently was defeated.

Mickey Edwards, Okla., ranking subcommittee Republican, said the administration will wage an all-out fight on the House floor to kill the Salvadoran aid provision. Bush sought $85 million for military aid to El Salvador in fiscal 1991.

Another floor battle will be over an expected proposal by Porter and others to ease restrictions on U.S. support for international organizations that provide family planning services overseas. Current law bars support for the U.N. Population Fund because of its activities in China and for the International Planned Parenthood Federation because some of its affiliates offer abortion services.

While reducing the president's overall request for military aid, the bill would give the administration unusually broad discretion to determine how much to give to individual countries. Obey said he tried to avoid the popular congressional practice of earmarking precise amounts of aid for particular countries — a practice the Bush administration staunchly opposes.

The bill includes full-scale earmarks for only four countries: Israel ($3 billion in economic and military aid), Egypt ($2.1 billion in economic and military aid), Jordan ($35 million in economic aid) and Cyprus ($15 million in economic aid).

Shifting Priorities

As a symbolic step away from Cold War priorities — and also to find money for programs favored by most Democrats on the subcommittee — Obey reduced Bush's request for the main military aid program by $526 million. Foreign Military Financing (formerly Foreign Military Sales) helps allies buy U.S. weapons and defense services. It is budgeted for $4.7 billion in fiscal 1990, and Bush sought $5 billion for fiscal 1991. Obey proposed just less than $4.5 billion.

To drive home the point that Washington needs to re-examine its security commitments overseas, Obey also proposed limits on military aid to three NATO countries that host U.S. bases.

Portugal would be limited to $90 million (a slight boost over the $84.6 million budgeted for fiscal 1990), Greece would be limited to $280 million (compared with $348.5 million in fiscal 1990) and Turkey's aid would be capped at $400 million (compared with $497.9 million in fiscal 1990). The figures for Greece and Turkey represent the traditional 7:10 aid ratio, intended by Congress to hold down Turkey's aid in comparison with that given Greece.

Obey found three uses for the money he suggested trimming from military aid. Eastern Europe programs would get $200 million above Bush's request, development efforts in sub-Saharan Africa would get another $200 million, and programs aiding ref-

BOXSCORE

Obey

Bill: Fiscal 1991 foreign aid appropriations (unnumbered).

Latest action: House Appropriations Foreign Operations Subcommittee markup June 13.

Next likely action: Full committee markup.

Reference: Authorization bill, Weekly Report, p. 1670; China, p. 1781; El Salvador, pp. 1670, 1370; Nicaragua bill, p. 1630.

By John Felton

ugees and children in the Third World would be boosted by $150 million.

A longtime critic of military aid overseas, Obey called his proposals "painfully modest" and said the bill "does not represent the priorities that I would like to see. I would give a lot more to the poorest countries in the world."

Just as cutting th defense budget will be a slow process, Obey said, "it takes a little while to go in a new direction" with foreign aid.

When Edwards offered an amendment that would have restored $270 million of the military aid that Obey wanted to cut, Obey noted that his bill would reduce military aid spending by less than 5 percent.

"If we can't do that much, we might as well all quit," Obey said.

Edwards said he, too, would like to see more aid in the bill for the countries of Eastern Europe and Africa. But Obey's proposal for shifting money directly to those countries from the military aid program "is so far off base" that it makes the bill unacceptable to most Republicans and to the Bush administration, he said.

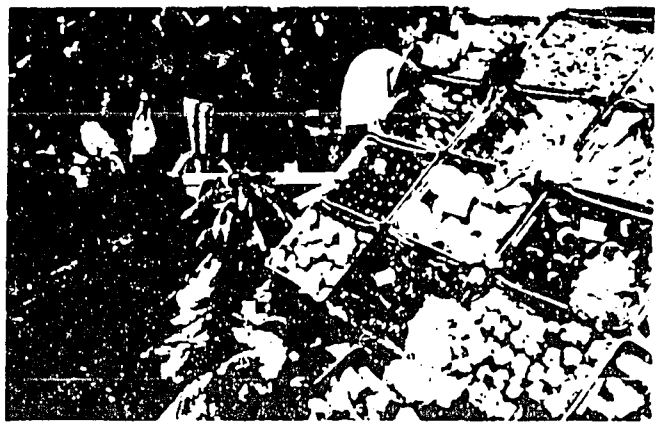
Even so, Edwards voiced frustration with the administration, saying he found "no one at home" when he tried to get a clear position from the White House on how much military aid it would demand. Edwards and Obey both said representatives of the White House, the State Department and the Defense Department gave conflicting views on some issues.

Jerry Lewis, R-Calif., said he could not support any bill making the military aid cuts proposed by Obey.

"I just don't think I'm ready to say the Cold War is over," Lewis said.

Lewis and Wilson noted that Obey's proposal would have an impact greater than the nominal 5 percent the chairman claimed. That is because the bill also protects the military aid budgets for Israel ($1.8 billion) and Egypt ($1.3 billion). After the $3.1 billion for those two countries is set aside, Obey's bill would leave about $1.4 billion for all other countries — a cut of about 27 percent from what Bush had budgeted.

Edwards' amendment to restore some of the military aid failed on a voice vote, with Wilson joining the Republicans in voting "yes." The subcommittee also rejected, by voice vote, an Edwards amendment to repeal the limits that Obey placed on military aid to Greece, Turkey and Portugal.



EMBASSY OF POLAND

Poland's efforts to move to a free-market economy need a boost from the country's creditors, Obey argued.

Protesting China Loans

As a signal of continuing unhappiness with Bush's policy toward China, the subcommittee approved a provision to withhold some donations to the World Bank if that agency makes new loans to China. But the provision would give the president broad discretion to provide the money anyway.

The bank's International Development Association (IDA), which aids the world's poorest countries, on May 29 approved a $300 million loan for the reforestation of rural areas in China. The United States had joined other industrialized countries in supporting the loan on the grounds that it will help China meet "basic human needs," such as jobs and housing.

Because of Beijing's June 1989 crackdown on political dissent, the Bush administration had opposed international financial aid for China except for humanitarian needs.

Protesting the administration's support of the China loan, Obey included in his draft of the bill a provision to curtail the fiscal 1991 U.S. contribution of $1.064 billion to IDA. Obey's draft would have withheld from IDA the amount of any loans that it makes to China for projects that do not meet U.S. criteria for "basic human needs." However, Obey's draft would give the president the authority to give IDA the money anyway by certifying to Congress that it is in the U.S. national interest to do so.

At the suggestion of Matthew F. McHugh, D-N.Y., the subcommittee adopted a less sweeping proposal to withhold from IDA only the proportionate U.S. share of any loans to China not for basic human needs. The United States provides about 20 percent of IDA's funds overall, so the McHugh amendment would restrict that percentage of the value of some IDA loans to China.

As with Obey's original proposal, the McHugh amendment would allow the president to give the money if he finds it in the national interest.

Focus on Poland Debt

In the latest chapter of his long-running dispute with the world's major commercial banks, Obey insisted on withholding the entire U.S. contribution in fiscal 1991 for the main agency of the World Bank.

Bush had requested $110.6 million in direct contributions and $2.9 billion in non-budget "callable capital" subscriptions for the International Bank for Reconstruction and Development. That bank makes loans to "middle-income" developing countries, such as Mexico and Brazil.

Obey for several years has used U.S. support for the World Bank as his lever to protest the refusal of large commercial banks to write off bad loans they made in the 1970s to developing countries. He has accused the World Bank and its sister institution, the International Monetary Fund, of making loans to those countries that essentially are used to repay commercial banks.

This year, Obey focused on Poland, which owes about $40 billion to commercial banks and foreign governments. The refusal of those banks and governments to forgive that debt "is a very big example of unreality" and is hampering the efforts of the Solidarity-led government to make the difficult transformation from communism to a free-market economy, Obey said.

Obey said he was withholding this year's contribution to the World Bank in hope of pressuring the Bush administration into negotiating an agreement with other industrialized countries to reduce Poland's debt burden. Obey acknowledged that "we don't have a lot of leverage" to force the banks and other countries to forgive bad loans, but he said his refusal to supply the World Bank money "may get the administration's attention."

Obey also linked the initial $70 million U.S. contribution to the new European Bank for Reconstruction and Development to the Polish debt issue. The money is in the bill but

cannot be given to the bank until the administration makes progress in international negotiations to ease Poland's debt burden.

During the subcommittee markup, Dean A. Gallo, R-N.J., offered an amendment to provide the full World Bank funding requested by Bush. "We're either going to be players or we're not going to be players" in World Bank decisions, he said.

The subcommittee rejected that amendment 3-9, however, with only Lewis and Porter supporting Gallo.

Administration officials said the White House probably will oppose the Obey bill simply because of the World Bank cut — even if all other provisions opposed by the administration are settled by compromise.

The panel approved nearly all of Bush's requests for other international development banks.

Eastern Europe

Repeating another political battle from 1989, Congress is moving to provide more aid money for Eastern Europe's emerging democracies than Bush sought. Obey's panel voted $500 million for programs in Eastern Europe; Bush had requested only $300 million.

> **"I would give a lot more to the poorest countries in the world."**
>
> **—Rep. David R. Obey, D-Wis.**

The bulk of the money in the subcommittee's bill — $430 million — would go to bilateral aid programs directly run by, or funded by, the U.S. government. The remaining $70 million would be the first U.S. contribution to the new European development bank.

In one significant change from 1989 legislation providing aid to Poland and Hungary, the Obey subcommittee bill would give the administration broad discretion to determine which Eastern European countries get U.S. aid. Congress last year earmarked precise amounts for specific programs in Poland and Hungary, prompting the administration to complain that it did not have enough leeway to adapt to changes.

The House subcommittee bill divides the $430 million by category but generally allows Bush to determine which countries get which types of aid. One exception is a $125 million earmark for quasi-governmental "enterprise funds" that invest in private businesses in Poland and Hungary.

Other aid categories in the bill are $100 million for private enterprise investments other than the Polish and Hungarian funds, $80 million for scholarships and technical training, $75 million for environmental cleanup, $30 million for technical advice on housing, and $20 million to bolster labor unions, political parties and other "democratic" institutions.

The subcommittee also called for increased activity in Eastern Europe by the Export-Import Bank, which provides loans and guarantees to finance exports of U.S. products. The subcommittee added $250 million to Bush's $500 million request for direct loans by the bank, and Obey urged the bank to use much of the extra money for exports to Eastern Europe.

Other Issues

Other major issues in the fiscal 1991 foreign aid spending bill were:

- **Nicaragua.** As part of Obey's campaign to avoid earmarks, the subcommittee took no position on Bush's request for $200 million in economic aid for Nicaragua. That would be in addition to the $300 million Congress recently appropriated for Nicaragua in fiscal 1990.
- **Philippines.** Despite Obey's oft-stated skepticism about the program, the panel approved $160 million in fiscal 1991 as the second U.S. contribution to an international aid program for the Philippines. Bush had requested $200 million. Obey has criticized the program as wasteful, noting that Manila has not spent millions of dollars in previous aid.

The subcommittee took no position on Bush's request for $200 million in military aid and $160 million in the regular U.S. bilateral economic aid program for the Philippines.

- **Cyprus.** The subcommittee directly rebuffed Obey only once during its June 13 markup. The issue was a perennial one: assistance to Cyprus.

As part of his campaign to avoid earmarks, Obey's draft of the bill recommended, but did not require, that the administration give Cyprus $15 million in economic aid — the amount approved routinely by Congress.

On a 7-5 vote, the subcommittee accepted an amendment by Porter to earmark the customary $15 million. Obey at first resisted the amendment but relented when it became clear that a majority favored it.

- **Pakistan.** At Wilson's request, the panel included a provision to extend for one year a waiver for Pakistan from a law barring aid to countries that appear to be trying to develop atomic weapons. Because of Pakistan's strategic location, Congress has allowed aid there until April 1, 1991 — despite strong evidence that Pakistan is developing nuclear bombs.

Obey's draft bill was silent on the issue, thus allowing the current waiver to expire and requiring an aid cutoff halfway through fiscal 1991. Wilson, a longtime advocate of aid to Pakistan, said the government in Islamabad would consider that a "hostile act." Obey eventually relented and agreed to insert in the bill another waiver for Pakistan until April 1992. ■

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FOREIGN AID

Panama-Nicaragua Legislation Helps Other Nations, Too

Little pieces of the pie will go for development programs, plus a big chunk for Israel housing guarantees

Congress loaded up the recently enacted supplemental appropriations bill (HR 4404) with more than a dozen foreign aid programs — in addition to the billions of dollars in domestic spending that attracted widespread attention.

President Bush had intended the fiscal 1990 supplemental to aid primarily the new governments in Nicaragua and Panama. But by the time Congress finished with it early May 25, the bill topped $4 billion. Foreign affairs items will cost nearly $900 million, not counting more than $2 billion in off-budget programs.

Bush on Jan. 25 had asked Congress to appropriate $500 million in "emergency" aid to the new government of Panama. After the Feb. 25 elections that ousted the Sandinistas from power in Nicaragua, Bush sought $300 million in aid to that country.

Aside from grousing by some Democratic senators, there never was serious opposition on Capitol Hill to either request. But the supplemental encountered numerous procedural and political delays, causing Bush to complain that Congress was dragging its feet while the two new Latin democracies desperately needed assistance.

Both houses approved Bush's full $300 million request for Nicaragua but pared $80 million from his $500 million Panama amount. Under a previous agreement with the administration, they shifted $30 million of Panama's funds to programs in Africa; the remaining $50 million was transferred to other Hill priorities, such as aid for Haiti, the Caribbean and Soviet Armenia.

In the supplemental, Congress imposed few conditions on how the Nicaragua and Panama aid can be spent. Instead, a companion authorization bill, facing a conference committee, contains numerous conditions and specifies how much can be used for various programs in each country.

BOXSCORE

Obey

Bills: Fiscal 1990 supplemental foreign aid — appropriations (HR 4404), authorization (S 2364).

Latest action: Congress cleared HR 4404 May 29; President Bush signed it May 25 (PL 101-302).

Next likely action: House-Senate conference on S 2364.

Reference: Spending bill, Weekly Report, p. 1630; authorization bill, pp. 1737, 1670; Israel housing, p. 539; USIA spending, 1989 Weekly Report, p. 3066.

In their report, conferees on the appropriations bill did "strongly urge" the administration to condition 80 percent of Panama's aid on such steps as that government's reaching agreement to disclose to U.S. narcotics agencies information on current international transactions.

The supplemental limits to $30 million the amount that can be provided for the "repatriation" and "resettlement" of the U.S.-backed contra guerrillas who had battled the Sandinistas in Nicaragua.

The bill also specifies that aid could be given only to those contras who agree to lay down their arms, as provided in an April 19 agreement between contra leaders and the Nicaraguan government.

The bill also sets aside $2 million to support a U.N. observer mission monitoring the contras' demobilization.

Conferees accepted a Senate provision to allow up to $8 million in Nicaragua's aid to be used for unspecified environmental projects. The final bill also bars use of U.S. aid for projects that would result in the "significant loss" of tropical forests in Nicaragua or Panama.

Bush also has requested a follow-up appropriation of $200 million for Nicaragua in fiscal 1991, which begins Oct. 1.

Soviet Refugees in Israel

With little fanfare, conferees approved $400 million in loan guarantees to enable Israel to build housing for thousands of Jewish refugees from the Soviet Union. Israel will be able to use the guarantees to get privately financed 30-year loans at interest rates substantially below the market level.

The bill also includes $5 million for direct aid to Israel's overall refugee program. That is in addition to $25 million appropriated by Congress last fall in the fiscal 1990 foreign aid bill.

The $400 million housing program is the largest single such effort ever financed overseas by the United States. Previous housing loan guarantees averaged about $25 million, U.S. officials say. The loan guarantees are "off budget" and thus would not contribute directly to the budget deficit. If Israel defaults on its loans, however, U.S. taxpayers will pick up the tab.

At the insistence of David R. Obey, D-Wis., chairman of the House Appropriations Subcommittee on Foreign Operations, Israel will have to pay an initial upfront fee to the United States of $2.8 million in exchange for the loan guarantees.

Under standard procedures, Israel would have to pay a fee of $4 million — 1 percent of the principal amount of the guarantees. But at the request of the Israeli government and pro-Israel lobbyists, both chambers had voted a concession for Israel. The Senate bill had required Israel to pay only $1 million; the House version was silent on the issue, in effect allowing the

By John Felton

Authorizer Sees Relevance Slip

According to the civics textbooks, Congress passes authorization bills before it passes appropriations bills. But Congress rarely follows the textbooks, and its handling this year of supplemental spending on foreign aid had even less than usual to do with standard procedures.

Just before it left for its Memorial Day recess, Congress on May 25 sent President Bush a bill (HR 4404) to make more than $4.3 billion in supplemental appropriations for fiscal 1990 — including about $900 million for foreign aid. Some time after it returns from its recess, Congress likely will give final approval to another bill (S 2364) to authorize the foreign aid programs included in the appropriations bill.

Fascell

The appropriations bill included provisions waiving the legal requirement for an authorization bill, thus making the latter bill technically unnecessary. And because the authorization bill contains several provisions opposed by the Bush administration, it is possible that it will never be enacted into law.

The principal purpose of even considering the authorization bill is to assert the jurisdictional authority of the two committees that write such legislation: House Foreign Affairs and Senate Foreign Relations. In recent years, the two panels have watched in frustration as their annual or biennial foreign aid authorization bills died for one reason or another — only to be supplanted by foreign aid appropriations bills.

Foreign Affairs Chairman Dante B. Fascell, D-Fla., complained May 24 that the need for action by the authorizing panels "has been less and less and less. It has made our work almost irrelevant."

While many members voiced sympathy for Fascell's plight, only a minority appeared moved enough to do anything about it. By 277-126, the House rejected a motion that would have stripped from the spending bill several provisions that had the effect of making the authorization bill unnecessary. *(Vote 142, Weekly Report, p. 1692)*

Even so, Fascell pressed ahead with his measure and later that evening got the House to approve it with little debate. Averting a floor fight, Fascell deleted from his bill controversial provisions cutting in half U.S. military aid to El Salvador. The House had approved those provisions the week before while acting on the authorizing bill but immediately turned around and defeated the bill itself when voting on final passage. *(Weekly Report, p. 1670)*

The Senate had passed its version on April 5, so the measure goes to a conference committee, where a small number of differences likely will be quickly resolved.

Both pending versions of the authorization bill would formally approve aid funds for Nicaragua and Panama, as well as several other programs contained in the appropriations bill.

Unlike the spending bill, however, both versions of the authorizing bill contain numerous restrictions on how much money the administration could spend in Nicaragua and Panama on particular types of programs, such as development aid and import subsidies. The two bills also would condition the aid for Panama on that country's willingness to negotiate an agreement allowing the United States access to bank records needed for investigations into narcotics trafficking.

The administration has opposed such restrictions, insisting that they unnecessarily limit the president's flexibility in conducting foreign affairs.

—John Felton

administration to require Israel to pay the full $4 million fee.

In conference, Obey demanded that the fee be set at $2.8 million, pointedly saying that the $1.8 million increase over the Senate-approved amount was the same figure that Israel recently spent to subsidize the purchase of housing for Jews in the Christian quarter of Jerusalem. That purchase caused an international outcry, especially among Christians and Arabs who feared that it signaled a new Israeli policy of settling Jews in parts of the city that previously had been set aside for other faiths.

Obey said he was upset that the Israeli government initially denied involvement in the housing purchase.

In addition, the bill requires Israel to pay an annual service fee of $125,000 during the life of the loan. That also is a concession from the fee normally charged housing-guarantee recipients; the customary fee is one-half percent of the outstanding principal, or $2 million in the first year.

The bill places no conditions on where housing financed by the loans could be built. However, conferees said it was congressional intent that none of the money be used in the territories occupied by Israel during and after the 1967 war. Under longstanding U.S. policy, Israel will have to agree not to use its aid in the occupied territories.

Conferees also urged, but did not require, Israel to make "extensive" use of U.S. technology and contractors in building the housing.

Latin and Caribbean Aid

In recognition of tentative steps toward democracy in Haiti, the supplemental allows $13 million in additional aid there. That includes $10 million for development and $3 million to support free elections.

The administration had planned to give Haiti $42 million in fiscal 1990.

Conferees said Haiti's potential for democracy "may be greater than [at] any time in recent history" because of a recent turnover of power in which Gen. Prosper Avril gave way to Ertha Pascal-Trouillot, who stepped down from the Supreme Court to take the presidency.

The $3 million for the democratic process in Haiti is contingent on several conditions, such as the appointment by the government of a "genuinely independent" electoral council.

The bill also provides the following:

- **Chile.** $10 million for primary health-care programs in Chile targeted for the poor, as proposed by the Senate. Under standard rules, Chile would not qualify for such aid because its per capita income is too high. However, conferees said the aid is justified be-

cause the military government that ruled Chile from 1973 until this year ignored the needs of the poor.

• **Bolivia, Peru.** $25 million for Bolivia and $20 million for Peru for development aid programs intended to lure farmers and others away from the production of coca and marijuana.

• **Caribbean.** $8.75 million in economic aid for Jamaica and $3.25 million for other countries in the Caribbean. The bill also provides $5 million in development aid for countries of the eastern Caribbean.

INTERNATIONAL RED CROSS

Congress included $10 million for sub-Saharan Africa but did not specify amounts for any particular countries.

Namibia, Southern Africa

One little-noticed but potentially significant provision of the supplemental will open a U.S. aid program in Namibia, the former South African colony that gained independence this year under an international agreement brokered in 1988 by U.S. diplomats.

Bush had not requested the aid for Namibia, but the administration accepted the $10 million earmark once it became clear that committees in both chambers strongly favored it.

The supplemental provides another $10 million to promote democracy in South Africa. That money is to be administered by the National Endowment for Democracy, a quasi-governmental agency that advocates democratic reform overseas. None of the money is to be used by the South African government, and conferees stipulated that the aid must be directed toward "victims of apartheid."

Conferees deleted House language earmarking $5 million for Mozambique and Zambia; instead, they encouraged the administration to provide added development aid to those two countries.

The bill includes another $10 million for development in sub-Saharan Africa, with no specified amounts for any particular countries.

State Department Funding

In the concluding chapter of a dispute that began last fall, the supplemental gives the State Department the authority to spend $312 million that was appropriated but withheld by Congress for fiscal 1990. The U.S. Information Agency (USIA), which runs the Voice of America and other programs, will get an additional $52.5 million.

In its regular spending bill (PL 101-162) for the State Department and other agencies, Congress last year appropriated $3 billion for the department in fiscal 1990 but limited its actual spending to the $2.7 billion figure allowed in fiscal 1989. The USIA was allowed to spend only $882 million of its $934 million appropriation.

Those spending caps were the result of a complicated jurisdictional dispute between the Senate Appropriations and Foreign Relations committees. The two committees settled their differences early this year, but Congress delayed action to lift the cap.

The supplemental repeals that cap, allowing the State Department to spend the full amount appropriated to it in fiscal 1990. Among other things, that step eventually will enable the department to expand its diplomatic posts in Eastern Europe.

Conferees deleted a Senate-passed provision that would have given the State Department $10 million to open diplomatic facilities in Lithuania, in the event that the United States decided to accord formal recognition to the government there.

The Lithuanian parliament on March 11 declared independence from the Soviet Union, but the Bush administration has refused to recognize the government, noting that the United States never officially acknowledged Soviet sovereignty over Lithuania and the other Baltic republics of Estonia and Latvia. The conferees also killed a Senate provision granting up to $5 million in emergency aid to Lithuania.

Other Provisions

Other foreign aid provisions in the supplemental are the following:

• **World Bank.** $1.6 billion in off-budget "callable capital" for the World Bank. In all likelihood, the money will not be spent; it is similar to a loan guarantee the bank uses to borrow money on world markets.

Congress had deleted the $1.6 billion from the regular fiscal 1990 foreign aid appropriations bill (PL 101-167), at Obey's insistence. Obey demanded the withholding of the money as a protest against what he called the Bush administration's failure to develop a sound policy for dealing with Third World debt problems. Obey relented this year, however, and agreed to support the $1.6 billion.

• **Cambodia.** Breaking with longstanding U.S. policy, the bill will allow — but not require — the administration to provide up to $5 million for aid to children in Cambodia. The aid would be provided through international relief agencies, and only in areas of Cambodia controlled by the government in Phnom Penh. Under the bill, none of the money could be used directly or indirectly to aid the Khmer Rouge, the communist faction that ruled Cambodia in the late 1970s and was responsible for the deaths of hundreds of thousands of people.

• **Armenia.** $5 million for relief for Soviet Armenia, which was stricken by a powerful earthquake in December 1988. That aid is in addition to $5 million that Congress already has appropriated for Armenia in fiscal 1990. Both aid items were sponsored by Senate Minority Leader Bob Dole, R-Kan.

• **Romania.** $4 million for health-care needs of children in Romania. Conferees designated that $2 million be channeled through UNICEF and $2 million through the International Red Cross.

• **Environment.** $5 million for a supplemental contribution to the U.N. Environment Program.

• **Refugees.** $75 million for the State Department's migration and refugee program, most of which will be used to help support refugees from the Soviet Union and elsewhere who come to the United States. Of the total, $5 million is earmarked for aid to Soviet refugees in Israel, in addition to the $400 million U.S.-financed housing program. The bill also includes $25 million for an "emergency" refugee aid program aimed at selected categories of overseas refugees, such as Afghans living in Pakistan. ■

EL SALVADOR

Collapse of Hill Negotiations Sets Stage for Aid Fight

Partisan politics, differences over substance stall bid to craft a bipartisan compromise on policy

Efforts in the House to negotiate a bipartisan compromise on aid to El Salvador collapsed in mid-May, setting the stage for a partisan floor battle the week of May 21.

The collapse of the talks made it likely that the House will adopt a modified version of a Democratic-sponsored plan that would suspend 50 percent of El Salvador's military aid in fiscal 1990 and 1991. Republicans will offer a counterproposal to allow President Bush to suspend 25 percent of El Salvador's fiscal 1991 military aid if the Salvadoran government fails to take certain actions.

Democrats said they are confident that they have a majority for their position, and some GOP strategists agreed.

The House will debate the matter when it acts on a bill (HR 4636) to authorize Bush's request for aid to the new governments of Nicaragua and Panama, as well as other foreign aid. The bill may reach the floor on May 22.

Republicans and Bush administration officials pulled out of the talks because House Democrats insisted on linking the El Salvador issue to the Nicaragua and Panama aid. Bush for weeks has complained that Congress is needlessly holding up the aid request.

But once the talks on El Salvador failed and House approval of the Democratic-sponsored amendment seemed likely, the Democrats agreed to drop their demand that the issues be linked.

Members of both parties said they hoped House adoption of the Democrats' provision on El Salvador would trigger new negotiations, possibly leading to the bipartisan policy agreement that nearly everyone on Capitol Hill said is needed. Secretary of State James A. Baker III had wanted a consensus, similar to last year's accord on policy toward Nicaragua.

After House action, the Salvadoran aid question will move formally to a House-Senate conference committee on conflicting versions of the authorization bill. The Senate passed its version (S 2364) in April. However, the dispute probably will be resolved at a higher level — renewed negotiations among top Hill leaders, Baker and other administration officials.

By John Felton

Joe Moakley

William S. Broomfield

"This is only the first step. There's still a lot of talking to be done," said Rep. Joe Moakley, D-Mass., chairman of the Rules Committee and a leading advocate of curtailing Salvadoran aid.

After years on the political back burner in Washington, El Salvador has returned as a major issue, primarily because of widespread outrage over the murders last Nov. 16 of six Jesuit priests and two women at a university campus in San Salvador. Nine military personnel have been charged in the case. But a House Democratic task force chaired by Moakley reported on April 30 that the Salvadoran government's inquiry into the case has come to a "virtual standstill." *(Background, Weekly Report, pp 1368, 1370)*

The Salvadoran government and representatives of leftist guerrillas on May 16 opened peace talks in Caracas, Venezuela, under United Nations supervision. Those talks are given the best chance of any recent attempt to negotiate an end to El Salvador's civil conflict, which has lasted more than 10 years and claimed more than 70,000 lives.

Leverage and Linkage

As often happens on Capitol Hill, the first round of talks on El Salvador fell victim to a combination of partisan politics, procedural arguments and differences over substance. Republicans, showing their unhappiness over their perpetual minority status in the House, reacted sharply to what they perceived as strong-arm tactics by the Democratic leadership.

They complained that Democrats were unwilling to make any concessions on El Salvador — an accusation the Democrats rejected and threw back at the Republicans.

Party leaders also differed over procedure: linking the El Salvador matter to Nicaragua-Panama aid.

Democrats were using Bush's request for aid to Nicaragua and Panama as their leverage to force the administration to negotiate on El Salvador. The source of their leverage was the fact that none of the aid money contained in a fiscal 1990 supplemental appropriations bill (HR 4404) could be spent until Congress enacted a companion authorization bill.

Republicans and Bush administration officials objected to the Democrats' linking of the El Salvador and Nicaragua-Panama issues. Newt Gingrich, R-Ga., interrupted a May 10 meeting between Democrats and administration officials to announce that House Republicans would refuse to participate in any talks on El Salvador until the Democrats dropped the linkage.

Mickey Edwards, R-Okla., said the GOP position was. "We're not going to talk to them [Democrats] until they let the money go for Panama and Nicaragua."

Confident of a House vote rebuffing Bush's policy toward El Salvador, House Democrats agreed on May 17 to

remove the link between that issue and the Nicaragua-Panama aid. With the approval of House Speaker Thomas S. Foley, D-Wash., conferees on the aid supplemental bill inserted language to allow the money to be spent without the authorization legislation.

However, David R. Obey, D-Wis., chairman of the Foreign Operations Subcommittee, said that if there is no deal on El Salvador, the Rules Committee could delete the waivers in the Nicaragua-Panama bill and retain Democrats' leverage.

Questions of substance also proved troublesome in the negotiations on El Salvador, but most participants predicted that an agreement is possible.

House Democrats staked out a position demanding an immediate 50 percent cut in El Salvador's military aid, contingent on actions by either the Salvadoran government or the leftist anti-government guerrillas.

The administration rejected an immediate aid cut but accepted the notion of suspending some of El Salvador's assistance beginning in fiscal 1991, which starts Oct. 1. Foley said he would be willing to limit aid cuts to fiscal 1991 — but only as part of a negotiated agreement with the administration.

Rep. Dave McCurdy, D-Okla., who said he tried in vain to negotiate a compromise between the Democrats and the administration, predicted that Congress eventually will adopt a proposal he floated in early May. McCurdy's plan called for the United States to withhold half of the $85 million planned for arms aid to El Salvador in fiscal 1991. The president could restore the aid if the Salvadoran government had taken steps to carry out reforms or if the rebels refused to negotiate peace with the government and stepped up attacks on the government.

Republican, Democratic Plans

When it takes up HR 4636, the foreign aid supplemental authorization bill, the House essentially will be faced with two competing proposals on aid to El Salvador:

- A GOP-backed amendment, sponsored by William S. Broomfield, Mich., senior Republican on the Foreign Affairs Committee. The Broomfield amendment would require the president this November to withhold one-fourth of El Salvador's military aid if he reports to Congress that the Salvadoran government is not making progress in respecting human rights, is not conducting a serious investigation into the Jesuits' murder, is not moving to separate police forces from the military, is not reforming its judicial system or is not making plans to reduce the military's role after the war ends. Under this proposal, the president could restore El Salvador's aid if the guerrillas take any one of four steps, such as refusing to negotiate in good faith or continuing to receive military aid from outside El Salvador.

Edwards said that the Broomfield proposal would impose more conditions on El Salvador than many Republicans would like but that it was crafted in an attempt to win some Democratic votes.

- A provision, endorsed by the Democratic leadership, to suspend half of El Salvador's military aid in fiscal 1990 and 1991. That provision is based on an amendment to HR 4636 adopted by the Foreign Affairs Committee. Moakley and John P. Murtha, D-Pa., will offer a floor amendment to the Foreign Affairs provision incorporating suggestions made by Republicans and the Bush administration. The vote on adoption of the Moakley-Murtha amendment likely will be the House's key action on El Salvador.

The Moakley-Murtha amendment should have broad appeal among House Democrats. Moakley is a leader of liberals who have sought to impose more conditions on — or cut off — aid to El Salvador. Murtha throughout the 1980s backed U.S. policy toward El Salvador.

Conspicuously absent from sponsorship of the Moakley-Murtha amendment is McCurdy, a self-described "moderate" who has been at the center of Hill debates over Central America since the mid-1980s. Democratic leaders negotiated at length with McCurdy in mid-May in hope of getting his support for their aid cut-off plan. But those negotiations failed on May 16, minutes before Moakley's Rules Committee went into session to write the rule providing for House consideration of the foreign aid bill.

McCurdy said he was "surprised and disappointed" that his fellow Democrats decided to press ahead with the Moakley-Murtha plan. But other Democrats who met with McCurdy said he refused to make the necessary concessions to get an intra-party agreement.

"I frankly don't think, whether he misread us or not, that he was willing to reach an accommodation," David E. Bonior, D-Mich., said of McCurdy. Bonior chairs the House Democratic task force on Central America. ■

WALL STREET JOURNAL, April 17, 1990

State Department Still Says No to UNESCO

The State Department is reporting to Congress today on the advisability of rejoining UNESCO, the United Nations cultural organization from which the U.S. and Britain withdrew in 1984. The following is an excerpt from the report's conclusion.

It is obvious that the time is not yet ripe to reopen the question of renewing United States membership in UNESCO. United States strategy since our withdrawal has been clear and consistent – we have sought to work actively from outside the organization with those who share our objective of restoring UNESCO as a well-run international organization with an effective program of work, limited to its fields of competence. While United States nonmembership has spurred some reform activity at UNESCO, there is much more that needs to be accomplished in order for UNESCO to be considered as the organization intended by its founders. The recently announced decision of the United Kingdom not to seek reentry demonstrates that their thinking on the subject remains essentially the same as ours.

A renewal of United States membership at this time would require that we accept promises of change in lieu of real reform. . . . The following issues are illustrative of our continuing concerns with respect to activities at UNESCO:

Communications. We remain deeply concerned about the palpable similarities which exist between the current text on communications and those which preceded it over the last fifteen years. Despite the additional references which have been inserted regarding freedom and independence of the press, it is undeniable that the critical elements to which the United States most strongly objected in the past are still present. The program remains one in which freedom of the press and freedom of expression are "balanced" against the desires of governments to control the flow of information to and from their citizens. Moreover, the so-called New World Information and Communication Order is still perceived by Third World UNESCO delegates as an "article of faith" with them and as "a continuous and evolving process."

The PLO. In UNESCO, resolutions heavily biased against Israel, and often based on false accusations, have continued to be adopted up to the present. Although the PLO membership question has been deferred until 1991, the PLO observer will be able to make direct requests for UNESCO participation program assistance, thereby possibly gaining increased control of aid flows to people in the occupied territories. The Director General's recent appointment in UNESCO of a high-level "Coordinator for Cooperation with Palestine" also gives the PLO a special status in UNESCO's program of work exceeding that of any member state.

Management and personnel. Despite the recommendations received from two independent consulting groups (the Hammarskjold Commission and the Wilenski Panel) which urged that "critical reforms" be instituted "as a matter of urgency," Director General Mayor has proposed a restructuring plan which has generated enormous controversy at UNESCO and plunged the organization into its worst crisis since the departure of the United States, the United Kingdom, and Singapore. Rather than the cuts which the Director General had led us to expect, his proposal would create, by our count, some 33 new posts (which could cost as much as $6 million according to one Secretariat estimate). There was no open recruitment of the persons named to fill any of the newly-created posts, nor did Director General Mayor consult with the Executive Board, as required by UNESCO's rules.

Budgetary restraint. There has been no progress at UNESCO in moving towards the formal establishment of a budgetary decision-making process which would give adequate weight to the views of major donors. The Director General himself has demonstrated a reluctance to propose efficiency measures or concentration of the program. While he has often indicated that his hands are tied by the lack of resources at UNESCO, he has been able to find in every budgetary period substantial sums for travel, consultants, and a variety of activities not specifically authorized by the General Conference. And although the Director General has boasted of reducing the number of pages in the Medium-Term Plan and Program and Budget, our concern is that this simply reduces the amount of information available to member governments.

Decentralization and program concentration. Unesco's newly adopted program of work retains virtually all the activities undertaken in the past. The organization's programs remain diffuse and unfocused. Concentration in a few key areas as urged by the United States and major donors has eluded the Director General. Although Director General Mayor has pledged to increase the portion of his budget spent in the field instead of at headquarters, it is unclear how he will do this. His proposal for an across the board "decentralization" of the budget at a fixed percentage without reference to the content of specific programs represents an abdication of responsible management rather than a redress for a long-standing problem at UNESCO.

Finally, the United States must assess what it stands to gain through renewed membership in UNESCO and what it stands to lose. Our withdrawal did not alter our policy of strong support for international cooperation in educational, scientific and cultural and communication activities. Our ability to protect important political interests within UNESCO remains substantial, as evidenced by the deferral of consideration of the PLO request for membership in UNESCO. The leverage we retain as a sought-after non-member in some instances is greater than we would wield simply by being one vote among 161 others.

Membership in UNESCO would cost the United States about $50 million annually. Before being able to advocate reentry, the President would have to able to assure the United States Congress and the American taxpayers that this would be money spent on programs within UNESCO's mandate which bring direct benefit to mankind. Regrettably, UNESCO at this stage does not possess the characteristics of a well-managed and focused organization that would enable the President to give such assurances.

Congressional Staff Forum
on
International Development

March 29, 1990

MEMORANDUM

Director
William E. Hellert

To: ODC Staff
From: Anastasia Primbas

SUBJECT: HEARING ON MISUSE OF FOREIGN AID
House Committee on Appropriations Subcommittee on Foreign Operations, Export Financing, and Related Programs

Testimonies: Sherman Funk, State Department; Herbert Beckington, AID; Frank Conahan, GAO; Stephen Trodden, Defense Department

Members in Attendance: Robert Mrazek (D-NY), Jerry Lewis (R-CA)

Summary:
Sherman Funk identified two areas of major management and program weaknesses that should receive priority attention from the State Department:

* Security of US personnel, information and facilities overseas
-The overseas posts do not have the resources to meet the security needs. The real threats are technical and intelligence intrusions, as opposed to physical or terrorist attacks which have largely been avoided.

* International narcotics control
-More cooperation is needed between the State Department and AID to develop strategies for proper eradication and alternative crops
-The embassies must do a more effective job of monitoring the equipment that has been brought in for the host countries' anti-narcotics efforts
-Narcotics assistance units (NAUs) must do more field work instead of limiting their work to the embassy

Herbert Beckington pointed out that the following factors "diminish effectiveness" and "increase the vulnerability" for the management of AID programs:

* The environment under which AID operates is a very difficult one for economic aid to be carried out
* AID relies heavily on third parties to carry out the delivery of aid
* AID must share the costs of various programs and a host country cannot often meet its share
* There remain problems of control and accountability in the handling of local currency
* Since AID's programs are centrally funded, it is often difficult to carry them out from Washington

Frank Conahan noted that there are still many long-standing

problems for foreign economic and military aid.
AID's economic aid programs include the following problems:

* A primary accounting system that has not been fully integrated with subsidiary and program systems
* Inadequate audit coverage of overseas mission programs
* Insufficient number of direct-hire staff
* Inadequate assessments of host-country capability to manage AID-financed host country contracts
* Inadequate procedures for tracking host country-owned local currency

Conahan also reviewed the accountability and management problems of foreign military aid:

* Limitations on US monitoring of military grant aid
* The unauthorized use of technology
* Inadequate accounting systems for management of military aid
* Difficulties in auditing covert aid operations

Stephen Trodden testified that DoD's FY91 audit plan will focus on:

* Streamlining cumbersome accounting systems
* Improving pricing and billing procedures
* Strengthening the planning process
* Developing a more responsive equipment ordering and delivery system

Congressional Staff Forum
on
International Development

Director
William E. Hellert

April 18, 1990

MEMORANDUM

To: ODC Staff
From: Anastasia Primbas

SUBJECT: HEARING ON P.L. 480 - FOOD FOR PEACE
House Foreign Affairs Subcommittee on International Economic Policy and Trade

Testimonies:
Panel I - Raymond Hopkins, Swarthmore College
Panel II - Harold Johnson, GAO
Panel III - John Swenson, Catholic Relief Services
Steven McCoy, North American Export Grain Association

Members in Attendance: Sam Gejdenson, D-CT; Doug Bereuter, R-NE

The Senate Agriculture Committee has approved a revision of PL480 that addresses several controversial issues of the food aid program. Today's hearing examined the effectiveness of Titles I and II of PL480 Food for Peace. Title I of PL480 is administered by the U.S. Department of Agriculture and provides for concessional sales of food. Local currencies generated through Title I sales are to be used to carry out programs of agricultural development, rural development, nutrition, and population planning. Title II, a food grant program administered by AID, relies on the participation of private voluntary organizations (PVOs).

Panel I
Summary:

Doug Bereuter commended Raymond Hopkins and ODC for their thorough Policy Focus on "U.S. Food Aid in the 1990s."

Raymond Hopkins testified that donor countries will have to generate a greater supply of food in the 1990s in order to fill the "gap" in low income "food-deficit" countries. According to the estimates of the National Academy of Sciences, a doubling or tripling of present food aid efforts will be needed. Furthermore, he suggested that it is necessary to change allocation criteria so that food aid better addresses the problem of hunger. According to Hopkins, if food security based on poverty were the central allocative criterion, then clearly more food aid would go to particularly vulnerable poor countries, such as those in Sub-Saharan Africa, and less to Egypt with its 3000 calories per-capita diet. Moreover, Hopkins stressed that the present PL480 program is "anachronistic" and must be better managed.

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Panel II
Summary:
Harold Johnson testified on GAO findings pertaining to local currency generated by PL480, Title I for development purposes. In general, whereas local currencies were programmed for purposes consistent with development goals, AID's monitoring was insufficient to provide reasonable assurance that the funds were actually used as intended. Johnson stressed that the accountability of local currencies will not be better accomplished by changing the ownership of the currencies from the host governments to the U.S. He suggested that the proper focus for local currency accountability should be on assessing and improving the financial management systems of host country agencies.

Panel III
Summary:
John Swenson testified that Catholic Relief Services and other PVOs feel hindered by inadequate funding to pay project expenses and outdated, excessive and unrealistic regulations under the PL480 food programs. According to Swenson, it is essential that Congress amend PL480 to make 2% of the Title II budget available to support the administration of food distribution. The funding made available for these "field operational costs" would be used for logistics such as inland transportation and warehousing. Furthermore, Swenson stressed the need for greater programmatic flexibility, while maintaining adequate accountability.

Steven McCoy stated that many of the agricultural organizations have expressed support for the recent PL480 reforms proposed by the Senate. However, he stressed additional measures:

* greater flexibility with respect to repayment terms required under Title I
* greater assurance of private agribusiness participation in non-emergency food assistance programs
* more exact definition of resources available under the proposal to support market development activities

LOS ANGELES TIMES, April 24, 1990

Tell Every Nation It's Democracy or Isolation

■ **Change:** Think of it happening: Humanity fixes politics to make peace, freedom and justice really work.

By JAMES DAVID BARBER

History's most challenging moment is right now. From Taiwan to Namibia, from Poland to Brazil, from the Soviet Union to South Korea, the revolution for democracy rises to overthrow tyrants and to build peace and justice through government by consent of the governed. The pace of political change is amazing. The exciting reform movements in 1989 have shifted into antiquity, replaced this year by mass demands for democracy now.

Think of it happening: Humanity fixes politics to make peace, freedom and justice really work. Think of it failing: The revolution becomes a disaster, and democracy dies.

In 1947, the United States faced an analogous challenge in Europe. Then, as now, the immediate result of the overthrow of the tyrant is chaos. The looming threat is the temptation to get a new tyrant to restore order. But thanks to the vision of the then-secretary of state and President, we came forth with a plan to bring a new Europe into existence by offering major aid to the European countries, in common, if they could join one another and plan democratically. The Marshall Plan succeeded—a true, historical feat, contrasted with the various ideological fantasies still sprawling about.

Today, the movement for democracy can win if we join together and create a common federation of genuine democracies linked by political, military and economic support.

This effort should reach out to every real democracy, not just to those in the neighborhood. As our minds have moved from the gradual to the immediate, they should move from the continental to the worldly. Not that long ago, geography was a most important factor in the organization of human society. Less so today. Developments in military technology, economic trade, transportation and communications have transcended localities, creating a new arena of international activities that engage everything and are governed by nothing. That is dangerous business—anarchy plus interdependence. But the solution is to transcend the presently restricted political institutions by inventing new ones to encompass the powerful reality of the emerging international relationships.

Like the Marshall Plan, democratic federation worked. Not perfectly: In the United States, ours broke down in the Civil War. Since then, however, the history of American democratic federation, along with that of Canada and Australia and India, stands out as a relative success compared to totalitarian nationalism in the Soviet Union or scattered anarchy among the nations in Africa. Federation and democracy share the recognition that differing communities can maintain political distinctions within the commonality of commitment to fundamental principles of procedures and rights. The establishment of federation is essential to the success of the new democratic revolution, because major cultural and political differences will prevail, as democracy's mutually respecting discourse defines and amends the relationships.

Differences among communities need not destroy federal democracy. One of the most interesting historical observations is that democracy has emerged and persisted in wildly different nations. Who would have thought it could happen not only in Great Britain and the United States, but in Costa Rica, India, Germany, Australia, Japan and Venezuela? The facts imply that democracy is not dependent on culture, in its deep sense, but that it can be born and stay alive in nations with strikingly different religions, ethnicities and histories. Democracy demands nonviolence, rule of law, deliberative discourse, human rights for all—and representative government. It does not demand that citizens love one another, but that they commit conflicts to a democratic federation and live with the results.

Thus, today's federation of democracy should move beyond the concern over the unification of East and West Germany, the composition of NATO and the Warsaw Pact, the Europe of 1992, or even a rebirth of the Atlantic Alliance. Every nation that succeeds in establishing democracy—real democracy—should join and receive the strongly supportive economic and social advantage. Every nation struggling to establish its democracy should be helped by the federation. Every nation that rejects democracy should be cut out and vigorously pressed for reform by the federation.

"DAMN!"

Rejecters of democracy should never receive support from a government committed to democratic principles. The scandals by which tyrants in Turkey, El Salvador, Libya, China and Mozambique and other brutal, corrupt, inhuman butcheries receive aid from democracies should be stopped—now. But that is not enough, either. It is immoral and unjust for democracies to tolerate totalitarians—not only in our house or next door but wherever they are butchering our human brothers and sisters. So the new federation of democracy is not to be a United Nations—not an all-inclusive, loose-jointed organization that includes fake national Mafias. If it is brought across to democratic voters that their tax money is buying the tools that Turks use to torture children, they will agree to shift such payments to the cause of stopping Turks from torturing children. The demand that admission to the federation of democracy requires democracy is essential.

Equally essential is the demand to help burgeoning democracy. Think of Hungary, Poland and Czechoslovakia. More than four decades of experience under a political system in which one has virtually no motive or opportunity to participate in democratic-type activities. Systems in which one is dominated and manipulated by force and its threat, by lies, by money corruption, by hunger and humiliation. Think of Namibia, thrilled with the new hope of democracy but surrounded by nations where the hope was killed. Think of the Soviet Union, whose surrender of despotism may trigger secessions that can tear it apart.

To suppose that democracy will happen just because an alternative is rejected is tragically naive. Implementing democracy takes major, concentrated political action far beyond the publication of a written constitution. That is why democracies like the United States and Japan—and all the other real democracies—should be investing much talent and money into the emergency rooms where potential democracies are coming to life.

Before our states were united, there were those who found it an odd idea, a bizarre outreach from a here to there. They were wrong. So are those today who think all will turn out for the best if we just let it go on. The time to federate democracy is now, because whatever it is that made the revolution happen, this is the day it stands a chance to rescue the human race.

James David Barber is James B. Duke professor of political science and policy studies at Duke University, Durham, N.C.

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LOS ANGELES TIMES, May 15, 1990

Salvadoran Foot-Dragging Wears Out the Welcome Mat on Capitol Hill

■ El Salvador: U.S. support of the civil war has slipped from steadfast to debatable in six short months. What changed Congress' mind?

By KENNETH E. SHARPE

Last fall, Sen. Christopher Dodd helped block efforts to put serious conditions on military aid to El Salvador. Today, the Connecticut Democrat argues that fully half of that aid should be cut, starting now.

Dodd's change of mind reflects the first major shift in thinking among liberals and moderates on El Salvador since 1984, when the election of reformist President José Napoleon Duarte all but ended four years of acrimonious debate on the U.S. counter-insurgency policy. Since then, the central questions in Washington have been: How can the guerrillas be defeated, and how can the government be encouraged to promote reform so as to remove the roots of revolution?

Today a new debate in Washington is shaping much different questions: How can we shed our responsibility for a corrupt and murderous military, and how can we encourage a negotiated end to this unwinnable war?

Why the change?

In November, the guerrillas mounted a surprise offensive and held large areas of the capital city while simultaneously attacking important provincial centers. Like the 1968 Tet offensive in Vietnam, it was beaten back, but like Tet, it gave the lie to U.S. tales of the guerrillas' demise and convinced all but the most stubborn observers that 10 years of U.S. counterinsurgency strategy had failed. The FMLN remains a powerful military force that can veto U.S. attempts to exclude them from sharing political power.

Throughout the 10 years of war, the Salvadoran military has accused religious workers of fomenting revolutionary sentiment among the poor. On the fifth night of the FMLN November offensive, nine soldiers from the elite U.S.-trained Atlacatl battalion broke into the Jesuit-run university in San Salvador and murdered six priests, their housekeeper and her daughter.

The killing of the Jesuits dramatized the failure of the U.S. strategy. Despite the success in promoting periodic elections, U.S. policy was seen as failing to foster the basic conditions for democracy—protection of human rights, the freedom to organize, an independent judiciary.

Last month, a task force of 19 House Democrats looked into the status of investigations into the Jesuit killings. Among its conclusions: The army had no intention of submitting to civilian judicial control; the justice system was unable to investigate thousands of other crimes linked to the military, and military repression makes little distinction between those who advocate nonviolent change and those who take up arms with the guerrillas. The good intentions of an elected president who holds office but no power no longer seemed a justification for aiding his brutal army. Also, it was clear that "conditionality"—tying release of U.S. aid to Salvadoran reforms—hasn't worked.

In February, two major justifications for supporting the Salvadoran military on a grand scale fell apart with the electoral defeat of the Sandinistas in Nicaragua. It has now become much more difficult to claim that the Sandinistas are the cause and sustenance of the insurgency in El Salvador. And after the Sandinistas' willingness to accept the results of free and fair elections, it will be difficult to claim that allowing the guerrilla left to share power will spell the end of democracy in El Salvador.

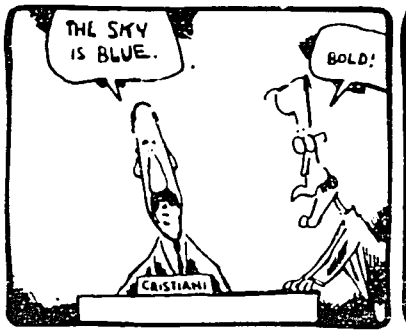
The changes in Eastern Europe, too, have undermined the justification that the aim in El Salvador is to prevent a "Soviet beachhead" in Central America. Further, the new demands on scarce foreign aid being made by Eastern European countries have put budgetary pressures on the $1 million a day we're giving to El Salvador. Some in Congress simply want to wash their hands of the whole mess and turn their attention to Europe.

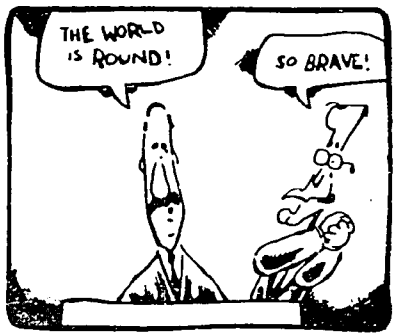
The more realistic perceptions of the Salvadoran and global situation have led pragmatists on Capitol Hill to favor a new aid strategy. Instead of "give aid, with conditions," they favor "cut aid, and condition its renewal." This week, the House is considering legislation that calls for a 50% military aid cut now, with the threat to cut the rest if Alfredo Cristiani is overthrown, or if the military and government don't negotiate in good faith, or if the Jesuits' murders are not adequately prosecuted. To answer critics who say such cuts will encourage the guerrillas, the legislation adopts Dodd's creative solution: If the guerrillas launch a major offensive, the 50% cut can be restored. That gives both sides an incentive to negotiate seriously.

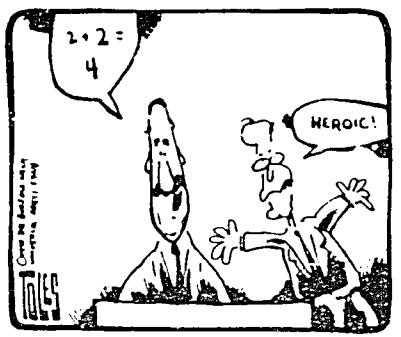
The new debate in Washington, however, does not yet signal a change in course. First, the loopholes in the aid cutback are big enough to drive a truck through. For example, it allows the President to renew the aid if he certifies that the guerrillas are not negotiating in good faith, or if he has proof that the guerrillas are receiving significant shipments of lethal aid from outside of El Salvador. The willingness of the Bush and Reagan administrations to distort reality to keep the aid flowing in the past does not bode well here.

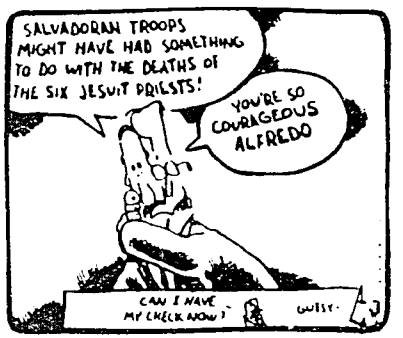
The Bush Administration is anxious to forestall congressional restrictions and will push to defeat or significantly weaken the legislation. Until the Administration itself faces the reality that current policy will continue to fail, and that the only viable alternative is serious negotiations that recognize the power of the guerrillas, the changed debate in Washington will not lead to the needed change in course.

Kenneth E. Sharpe is a professor of political science at Swarthmore College and co-author of "Confronting Revolution: Security Through Diplomacy in Central America" (Pantheon, 1986).









Paul Conrad is on vacation.

EDITORIAL/OPINION

Even the Field for Tied Aid

By ERNEST H. PREEG

Tied aid credits, whereby loans to assist economic development are tied to the exports of the aid donor country, inevitably link export competitiveness to development assistance. This is especially so for commercially sensitive infrastructure projects in telecommunications, electrical power generation, transportation and computer systems.

The United States, as a matter of policy, has done very little in this area. Other aid donors provide a large share of their economic aid for capital project assistance. Some, most notably Japan, simply offer low-interest loans for capital projects; almost half of Japanese bilateral aid is used in this way.

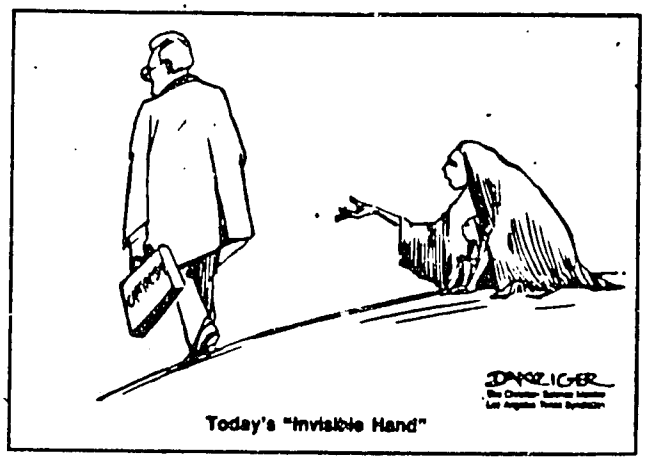
Major European countries blend aid and export-import bank loans to provide a "mixed credit." The result is the same: concessionary financing that cannot be matched by U.S. exporters.

As a consequence, capital projects worth $10 billion to $12 billion a year are inaccessible to U.S. exporters because of the tied aid credit practices of other governments. This results in an estimated annual loss of $2.4 billion to $4.8 billion in U.S. exports. The loss will be far greater in the future, since their inability to establish market position now will inhibit U.S. companies from taking advantage of the high growth potential of these markets.

A forceful and forward-looking U.S. policy response is urgently needed. The response needs to be comprehensive, integrating export competitiveness, development assistance and foreign policy objectives. It should consist of three mutually supportive elements.

First, the U.S. Export-Import Bank's "war chest," which permits soft loans to meet mixed credit bids by others, should be funded adequately. This is an immediate response to prevent further loss of U.S. market share in high-technology exports in high-growth developing country markets, particularly in Asia. It also would make clear to other donor countries that a more balanced approach for capital project assistance is needed.

Second, a new capital projects program should be created within the U.S. Agency for International Development. U.S. companies can provide the best technology at the lowest cost for necessary telecommunications, power generation and infrastructure, and should be permitted to do so.



Today's "Invisible Hand"

Third, a coordinated strategy for capital project assistance should be negotiated within the Organization for Economic Cooperation and Development to limit the use of tied aid credits.

The Bush administration has been developing a policy for tied aid credits along these lines, but its content is weak and its objectives have not been articulated clearly. For example, the Ex-Im Bank war chest authority was renewed in 1989, but with maximum funding of only $114 million — and even this came from a reduction in direct Ex-Im Bank loans.

An innovative joint Ex-Im Bank/AID program was announced on May 15, in which $500 million of capital project assistance will be provided over the next two years to the Philippines, Indonesia, Thailand and Pakistan. The announcement, however, is ambiguous as to whether this represents a lasting shift in AID priorities to include capital project assistance or a temporary effort to help exporters.

As for a negotiated OECD accord, the current U.S. objective is to convince others to stop providing tied aid credits in the most important sectors, such as telecommunications and power generation. Unfortunately, this is unlikely to succeed, since the support for economic aid in Europe rests largely on the benefits firms derive from tied aid credit projects.

Tied aid credits for Eastern Europe are in prospect. Spain reportedly is considering at least one tied aid credit, and other West European nations may follow. If such a proliferation occurs, the United States should provide comparable financing for U.S. companies, but this would be a purely reactive policy. It would be better for the U.S. government to develop its own assessment and conclusions about assistance for East European economic recovery.

There needs to be a level playing field for export finance if U.S. exporters are to be competitive in fast-growing developing country markets. A revised policy framework for economic assistance programs also is needed as U.S.-Soviet rivalry in the Third World recedes. A central objective in both respects is to build mutually beneficial trade relations over the longer term.

Such an integrated trade/aid relationship with developing countries does not fit the mold of existing programs, partly for bureaucratic reasons. Ex-Im Bank provides export finance while AID helps poor people. Their respective programs are viewed as separate and incompatible, while they should be mutually reinforcing.

A useful point of departure is the March 21 congressional testimony of AID Assistant Administrator Reginald Brown. He cited the fact that some foreign aid recipients would prefer U.S. assistance in the form of capital equipment and technical assistance as a reason to rethink economic assistance priorities.

He also commended the success of other countries in combining successful development with promoting commercial advantage: "I particularly believe, even as the Japanese can learn from us, we have much to learn from the Japanese."

Ernest H. Preeg is a fellow in international business at the Center for Strategic and International Studies in Washington, and is author of "The Tied Aid Credit Issue: U.S. Competitiveness in Developing Countries."

JOURNAL OF COMMERCE, May 7, 1990

making a change

Still Mired in the Cold War

By MARC LEVINSON

By all evidence, the Cold War is over. The most fundamental implication of that fact is widely understood: the great challenges facing the United States today are economic, not military. Recognizing that implication is one thing. Accepting it, however, is something else altogether.

Americans' inability to draw useful conclusions from the collapse of communism seems particularly acute with regard to Latin America, where perestroika may well have an impact almost as great as in Eastern Europe.

The threat of communist subversion has been the glue holding U.S.-Latin American relations together since the 1950s. Economic ties with most Latin countries save Mexico are weak and growing weaker; U.S. investment presence, which once drove Washington's policy toward Latin America, is in decline. Without the communist threat to keep things together, U.S. interest and influence in the region are likely to wane.

Unfortunately, the small group of specialists who shape American attitudes toward Latin America haven't done much thinking about that. Ask them about the implications of warmer U.S.-Soviet relations on the hemisphere and they'll immediately mount their hardy war horses, Cuba and Nicaragua.

Since he came to power in 1959, Cuban leader Fidel Castro has been the pivotal figure in hemispheric relations. Latin America's leaders, be they populist presidents looking for food aid or military dictators looking for tanks, quickly figured out that the bearded *líder máximo* could serve as a useful bell to ring to get Washington's attention.

Mr. Castro and his island really aren't of much concern to Latin Americans and never have been; for almost all of them, Cuba is a little place that's very far away. Even those Mexicans and Peruvians and Brazilians who cheer him for standing up to Uncle Sam recognize that his ideas don't offer much to a nation seeking to modernize. By any realistic appraisal of U.S. interests, Mr. Castro long since has passed from being a nuisance to being an irrelevance. Nicaragua, another U.S. obsession, falls into the same category.

Yet put a bunch of professional Latin Americanists in a room and watch the discussion turn to Fidel Castro and his Nicaraguan protege, Daniel Ortega. Bolivia's sweeping fiscal reforms hardly merit a mention; Argentina's struggle to modernize its decrepit economy gets five minutes. The talk about whether Nicaragua's new president, Violetta Chamorro, should leave a Sandinista leader in charge of the army can go on for hours.

The fact is, however, that the decline in East-West tensions has important economic ramifications south of the Rio Grande. Without a communist threat, the stability of Latin American governments, aside from Mexico, will be of far less interest to the United States, except perhaps where drugs are concerned. That means Washington is likely to devote even less time to the economic problems that could destabilize the region.

For all the attention the Bush administration is paying it, for example, one would think Latin America's foreign debt crisis was over. As far as most U.S. banks are concerned, it is over, but heavy debt service obligations continue to burden the economies of every Latin American country. Such potential manifestations as civil war in Peru, military coups in Argentina and endless economic turmoil in Brazil, however, elicit precious little interest in Washington.

A number of Latin American countries have taken major steps to open their economies to foreign trade and investment. While the United States has applauded those steps, it has done little to reciprocate. Latin American exports, from Brazilian ethanol to Argentine steel to Colombian suits, still face major barriers in the United States.

Unable to get Washington's attention with new tactics, Latin governments are falling back on tried-and-true methods. With considerable hullabaloo, Brazil and the Soviet Union have been talking about closer trade ties, although the Soviets have nothing to sell to the Brazilians and neither country has hard currency with which to buy. Argentina is still seeking Soviet help to upgrade its rail system, a field in which the Soviets demonstrably lack expertise. The Soviet Union and Mexico established a joint trading company in March, and are planning to increase industrial and agricultural ties.

Economically, none of this is likely to have much consequence for decades to come. But then again, that isn't really the purpose. If Washington notices, then all of this frenzied friendship with the Soviets will have proven worthwhile.

Marc Levinson is editorial director of The Journal of Commerce

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NEW YORK TIMES, May 8, 1990

FOREIGN AFFAIRS | Flora Lewis

The Weight of Mexico

MEXICO CITY

One local paper said 10 million people had come to the capital to see the Pope, who arrived Sunday. It's conceivable. Some Mexicans say the country's population is now 90 million. Nobody can be sure.

When I lived here in the 1950's, the population of the capital was 2.5 million, and of the country 25 million. The rate of growth approached the limit but nobody was particularly worried. The country's only demographer told me that development would soon bring a balance, and he cited the U.S. as proof that rising living standards brought a lowered birth rate.

Now at last the rate is dropping, but the population is still soaring, and standards are falling. Mexico will enter the 21st century with 100 million or more. Population is like a supertanker: it goes a long way before attempts to slow it take effect.

There have been huge efforts to expand education, health services, roads and such, but human misery is spreading much faster with the deluge of children, many abandoned.

The writer Carlos Fuentes, who refuses to live in Mexico City, has written a book called "Christopher Unborn," about a child whose birth date will coincide with the 500th anniversary of Columbus's discovery in 1492. He will breathe fecal dust because only a third of the city's sewage is treated, and have a high level of toxic lead in his blood, which can cause mental retardation.

Thirty-five years ago you could ride a horse through scattered villages in the valley or up the empty hillsides, with the majestic volcanos on the horizon as the guiding landmark. Now the volcanos have disappeared into the acrid, slurpy air.

These are the key problems underlying Mexican-U.S. relations. There's no place to go but north, and no matter how stringent the border controls, the human tide will overwhelm them unless this country becomes livable for more of its people.

According to an opposition politician, Mexico has to import 10 million tons of grain a year for survival, at $3 billion, consuming two-thirds of the value of its oil exports. Jesus Gonzalez Schmal, a moderate in the right-wing party PAN, argues that the country could feed itself again with proper agricultural policies and better cooperation with U.S. industry.

It needs us as a partner, not a boss.

Like everybody else, he is indignant at the abduction for trial in the U.S. of a doctor charged with involvement in the torture-murder of an American drug enforcement agent here. But like many, he is worried about the drug traffic's impact on the society and says the doctor should have been arrested here and extradited.

Mexico is changing, with the rest of the world, but painfully, perhaps catastrophically slowly. President Carlos Salinas de Gortari is moving to liberalize the government-dominated economy and encourage investment. He is popular. But officials don't have much of an answer to the question why foreigners should have confidence to invest when Mexicans send their money abroad, more than enough to cover the whole debt.

The Pope's visit reflects some of the change. When he last came, 11 years ago, the Government refused a reception and he convoked a church conclave where he denounced liberation theology. This time President Salinas welcomed him formally at the airport, and the Pope's message was solidarity and social justice. But still nothing about population.

This country is another example of shifting perceptions about creating a society that offers its people a fair chance, and how much harder it is to repair the damage of bad government than to recognize it. The tendency to blame Yanqui imperialists is waning, but sensitivities about the weight and arrogance of gringo neighbors remain acute. The invasion of Panama reopened old wounds.

The U.S. cannot escape the fallout of Mexico's desperation. Neither can it intervene in the clumsy, short-sighted ways it has in Central America. The opposition leader on the left, Cuauhtemoc Cardenas, says the country has the resources and capacity to pull itself up if it had rule of law and honest government.

He is a nationalist who rejects U.S. hegemony, but he doesn't want to isolate Mexico or go for central planning. He hasn't quite got the message from Eastern Europe, but he does oppose authoritarian government and puts democracy first.

In this part of the world, it seems the U.S. hasn't quite got the message from E. .. Europe either. It's freedom, to be sure, but also out from under big brother. Mexico is in a bad way, too, and needs a sympathetic partner, not a neighborhood boss. □

TREASURY NEWS
Department of the Treasury • Washington, D.C. • Telephone 566-2041

STATEMENT OF
SECRETARY OF THE TREASURY
NICHOLAS F. BRADY
AT THE MORNING SESSION
OF THE DEVELOPMENT COMMITTEE
OF THE WORLD BANK AND
THE INTERNATIONAL MONETARY FUND
WASHINGTON, D.C.
MAY 8, 1990

This morning, I want to review three topics:

1) progress under the strengthened debt strategy, including the importance of foreign investment and the return of flight capital;

2) the role of the private sector in development; and

3) the treatment of environmental issues within the World Bank.

The Strengthened Debt Strategy

I welcome the progress that has been made under the strengthened debt strategy. Six heavily-indebted countries have reached agreements with the commercial banks. The international institutions, creditor governments and commercial banks have all contributed to support debtor reform efforts under the new approach.

Debtor countries, are already gaining benefits. Debt burdens have been reduced, flight capital is returning and investor confidence is growing. However, to ensure that these benefits are lasting, reform efforts must be sustained. Policies for promoting foreign investment and capital repatriation, privatizing public enterprises, and developing competitive economies are an essential part of these reforms.

NB-796

Debtors need to liberalize regulations relating to investment and create efficient domestic capital markets in order to develop competitive economies and attract foreign capital. The international financial institutions should complement those efforts and assume a more active role in the reform of investment regimes. They should, for example, develop investment sector loans and incorporate measures to liberalize direct investment policies in both structural and sectoral adjustment loans. Debt/equity swap programs can also be an important element of adjustment programs while also contributing to overall debt reduction.

The Role of the Private Sector

A related and broader issue is the importance of enhancing the contribution of the private sector to development. Developing countries have begun to recognize that a dynamic private sector is the key to sustainable development and economic well-being. The United States welcomes this change and is working through many channels to support and encourage it.

The World Bank Group is well positioned to promote private sector growth in its borrowing members. The Bank, should pay greater attention to the role of the private sector in the development process.

Since the World Bank is a key source of adjustment lending, it is able to help developing countries implement needed macroeconomic, structural and institutional changes. The Bank should give higher priority to private sector development and institutionalize this priority across the entire range of Bank operations. Failure to stimulate private sector growth and mobilize private capital could undermine sustainable growth.

We will be discussing this issue this afternoon. However, given its critical importance, and the presence of other issues on the afternoon agenda, I suggest that the Committee revisit the issue of private sector development, including the mobilization of private capital, as a primary topic of discussion at the next meeting in September.

The Environment

I would like to conclude with a few remarks on the environment. This is an issue of great importance to the United States. At last September's annual meeting of the World Bank, President Bush called for more emphasis on the environment in national policy making, especially in promoting energy efficiency and conservation and greater protection of tropical forests. With respect to the World Bank, the United States has sought to promote the integration of environmental considerations into its lending programs and has encouraged the use of environmental impact assessments and environmental action plans.

The United States has supported the use of debt-for-nature swaps to help preserve forests and wetlands. In the recent past, such swaps have been signed in a number of countries. While the dollar amounts involved in these swaps have been small, an important principle has been established. We believe this mechanism can be used more innovatively and encourage the World Bank to play a more active role in facilitating swaps. For example, a portion of either project or sector loans could be used by the Bank to help finance debt-for-nature swaps.

An environmental report has been prepared by the Bank for our meeting today. However, it focuses on the proposed Green Fund and does not address a number of important issues relating to the Bank's existing environmental programs as was requested at the meeting of this Committee last September. Significant progress has been made by the Bank in the environmental area, but a great deal more needs to be done. We suggest that the information requested last Fall be provided to the Committee for our next meeting in September so that the Bank's progress can be reviewed, and further progress encouraged.

Human Development Report--United Nations, 1990

Oxford University Press

Overview

This Report is about people — and about how development enlarges their choices. It is about more than GNP growth, more than income and wealth and more than producing commodities and accumulating capital. A person's access to income may be one of the choices, but it is not the sum total of human endeavour.

Human development is a process of enlarging people's choices. The most critical of these wide-ranging choices are to live a long and healthy life, to be educated and to have access to resources needed for a decent standard of living. Additional choices include political freedom, guaranteed human rights and personal self-respect.

Development enables people to have these choices. No one can guarantee human happiness, and the choices people make are their own concern. But the process of development should at least create a conducive environment for people, individually and collectively, to develop their full potential and to have a reasonable chance of leading productive and creative lives in accord with their needs and interests.

Human development thus concerns more than the formation of human capabilities, such as improved health or knowledge. It also concerns the use of these capabilities, be it for work, leisure or political and cultural activities. And if the scales of human development fail to balance the formation and use of human capabilities, much human potential will be frustrated.

Human freedom is vital for human development. People must be free to exercise their choices in properly functioning markets, and they must have a decisive voice in shaping their political frameworks.

Starting with this perspective, human development is measured in this Report not by the yardstick of income alone but by a more comprehensive index — called the human development index — reflecting life expectancy, literacy and command over the resources to enjoy a decent standard of living. At this stage, the index is an approximation for capturing the many dimensions of human choices. It also carries some of the same shortcomings as income measures. Its national averages conceal regional and local distribution. And a quantitative measure of human freedom has yet to be designed.

The index does, however, have the virtue of incorporating human choices other than income, and consequently is a move in the right direction. It also has the potential for refinement as more aspects of human choice and development are quantified. This Report lays out a concrete priority agenda for better data collection that will enable the human development index to be used increasingly as a more genuine measure of socioeconomic progress.

The Report analyses the record of human development for the last three decades and the experience of 14 countries in managing economic growth and human development. Several policy conclusions from this experience underpin a detailed analysis of human development strategies during the 1990s. The Report ends with a special focus on the problems of human development in an increasingly urban setting. The orientation of the Report is practical, looking not just at what is to be done — but also at how.

The Report's central conclusions and policy messages are clear, and some of their salient features are summarised here.

1. The developing countries have made significant progress towards human development in the last three decades.

Life expectancy in the South rose from 46 years in 1960 to 62 years in 1987. The adult literacy rate increased from 43% to 60%. The under-five mortality rate was halved. Primary health care was extended to 61% of the population, and safe drinking water to 55%. And despite the addition of 2 billion people in developing countries, the rise in food production exceeded the rise in population by about 20%.

Never before have so many people seen such significant improvement in their lives. But this progress should not generate complacency. Removing the immense backlog of human deprivation remains the challenge for the 1990s. There still are more than a billion people in absolute poverty, nearly 900 million adults unable to read and write, 1.75 billion without safe drinking water, around 100 million completely homeless, some 800 million who go hungry every day, 150 million children under five (one in three) who are malnourished and 14 million children who die each year before their fifth birthday. In many countries in Africa and Latin America, the 1980s have witnessed stagnation or even reversal in human achievements.

2. North-South gaps in basic human development have narrowed considerably in the last three decades, even while income gaps have widened.

In 1987 the average per capita income in the South was still only 6% of that in the North. But its average life expectancy was 80% of the northern average and its average literacy rate 66%.

Developing countries reduced their average infant mortality from nearly 200 deaths per 1,000 live births to about 80 in about four decades (1950-88), a feat that took the industrial countries nearly a century to accomplish. This is clearly a message of hope. The essential task of taking the developing world to an acceptable threshold of human development can be accomplished in a fairly manageable period and at a modest cost — if national development efforts and international assistance are properly directed.

But this promising trend must be seen in its proper perspective. While North-South gaps have narrowed in basic human survival, they continue to widen in advanced knowledge and high technology.

3. Averages of progress in human development conceal large disparities within developing countries — between urban and rural areas, between men and women, between rich and poor.

Rural areas in the developing countries have on the average half the access to health services and safe drinking water that urban areas have, and only a quarter of the access to sanitation services.

Literacy rates for women are still only two-thirds of those for men. And the maternal mortality rate in the South is 12 times that in the North — the largest gap in any social indicator and a sad symbol of the deprived status of women in the Third World.

High-income groups often preempt many of the benefits of social services. Levels of health, education and nutrition among higher income groups far exceed those of the poor in many countries. There is thus considerable room for improvement to ensure that the benefits of social expenditures are more evenly distributed, flowing to the very poor. The rationale for government intervention greatly weakens if social spending, rather than improving the distribution of income, makes it worse.

4. Fairly respectable levels of human development are possible even at fairly modest levels of income.

Life does not begin at $11,000, the average per capita income in the industrial world. Sri Lanka managed a life expectancy of 71 years and an adult literacy rate of 87% with a per capita income of $400.

By contrast, Brazil has a life expectancy of only 65 years, and its adult literacy rate is 78% at a per capita income of $2,020. In

Saudi Arabia, where the per capita income is $6,200, life expectancy is only 64 years and the adult literacy rate is an estimated 55%.

What matters is how economic growth is managed and distributed for the benefit of the people. The contrast is most vivid in rankings of developing countries by their human development index and by their GNP per capita. Sri Lanka, Chile, Costa Rica, Jamaica, Tanzania and Thailand, among others, do far better in human development than in income, showing that they have directed more of their economic resources towards human progress. Oman, Gabon, Saudi Arabia, Algeria, Mauritania, Senegal, Cameroon and the United Arab Emirates, among others, do considerably worse, showing that they have not yet translated their income into human progress.

The valuation given to similar human development achievements is quite different depending on whether they were accomplished in a democratic or an authoritarian framework. A simple quantitative measure to reflect the many aspects of human freedom — such as free elections, multiparty political systems, an uncensored press, adherence to the rule of law, guarantees of free speech, personal security and so on — will be designed over time and incorporated in the human development index. Meanwhile, the Report lists the top 15 countries that have achieved relatively high levels of human development within a reasonably democratic political and social framework: Costa Rica, Uruguay, Trinidad and Tobago, Mexico, Venezuela, Jamaica, Colombia, Malaysia, Sri Lanka, Thailand, Turkey, Tunisia, Mauritius, Botswana and Zimbabwe.

5. The link between economic growth and human progress is not automatic.

GNP growth accompanied by reasonably equitable distribution of income is generally the most effective path to sustained human development. The Republic of Korea shows what is possible. But if the distribution of income is unequal and if social expenditures are low (Pakistan and Nigeria) or distributed unevenly (Brazil), human development may not improve much, despite rapid GNP growth.

Even in the absence of satisfactory economic growth or a relatively even income distribution, countries can achieve significant improvements in human development through well-structured public expenditures. For example, during the last three decades, Sri Lanka experienced relatively slow growth, rather equally distributed, and Botswana and Malaysia had adequate growth, unequally distributed. Yet all these countries have made impressive achievements in their human development levels because they have had well-structured social policies and expenditures.

Costa Rica and Chile, too, have demonstrated that dramatic human progress can be achieved — in a short time and even without rapid GNP growth.

But distributive policies can compensate for the effects of low GNP growth or unequal income distribution only in the short and medium run. These policy interventions do not work indefinitely without the nourishment that well-distributed growth provides. In the long run, economic growth is crucial for determining whether countries can sustain progress in human development or whether initial progress is disrupted or reversed (as in Chile, Colombia, Jamaica, Kenya and Zimbabwe).

6. Social subsidies are absolutely necessary for poorer income groups.

The distribution of income is fairly uneven in most of the Third World. Simply stated, economic growth seldom trickles down to the masses. Free market mechanisms may be vital for allocative efficiency, but they do not ensure distributive justice. That is why added policy actions are often necessary to transfer income and other economic opportunities to the very poor.

Food and health subsidies serve that purpose — as long as they are properly targetted to low-income beneficiaries and efficiently administered. They establish an essential safety net in poor societies that generally do not have the social security schemes that are familiar in the industrial nations. Generally amounting to less than

3% of GNP, these subsidies have not been too costly. And when they are removed without an alternative safety net, the ensuing political and social disturbance has cost far more than the subsidies themselves.

Social subsidies will serve the interest of developing countries much better if more effort is devoted to designing them as efficient tools of income redistribution, without hurting the efficiency of resource allocation. Such effort is far preferable to the usual acrimonious debate supporting or rejecting all subsidies arbitrarily and across the board.

7. Developing countries are not too poor to pay for human development *and* take care of economic growth.

The view that human development can be promoted only at the expense of economic growth poses a false tradeoff. It misstates the purpose of development and underestimates the returns on investment in health and education. These returns can be high, indeed. Private returns to primary education are as high as 43% in Africa, 31% in Asia and 32% in Latin America. Social returns from female literacy are even higher — in terms of reduced fertility, reduced infant mortality, lower school dropout rates, improved family nutrition and lower population growth.

Most budgets can, moreover, accommodate additional spending on human development by reorienting national priorities. In many instances, more than half the spending is swallowed by the military, debt repayments, inefficient parastatals, unnecessary government controls and mistargetted social subsidies. Since other resource possibilities remain limited, restructuring budget priorities to balance economic and social spending should move to the top of the policy agenda for development in the 1990s.

Special attention should go to reducing military spending in the Third World — it has risen three times as fast as that in the industrial nations in the last 30 years, and is now approaching $200 billion a year. Developing countries as a group spend more on the military (5.5% of their combined GNP) than on education and health (5.3%). In many developing countries, current military spending is sometimes two or three times greater than spending on education and health. There are eight times more soldiers than physicians in the Third World.

Governments can also do much to improve the efficiency of social spending by creating a policy and budgetary framework that would achieve a more desirable mix between various social expenditures, particularly by reallocating resources:

- from curative medical facilities to primary health care programmes,
- from highly trained doctors to paramedical personnel,
- from urban to rural services,
- from general to vocational education,
- from subsidising tertiary education to subsidising primary and secondary education,
- from expensive housing for the privileged groups to sites and services projects for the poor,
- from subsidies for vocal and powerful groups to subsidies for inarticulate and weaker groups and
- from the formal sector to the informal sector and the programmes for the unemployed and the underemployed.

Such a restructuring of budget priorities will require tremendous political courage. But the alternatives are limited, and the payoffs can be enormous.

8. The human costs of adjustment are often a matter of choice, not of compulsion.

Since there is considerable room for reallocating expenditures within existing budgets, the human costs of adjustment are often a matter of choice, not compulsion. When there is a sudden squeeze on resources, it is for policymakers to decide whether budgetary cuts will fall on military spending, parastatals and social subsidies for the privileged groups — or on essential health, education and well-targetted food subsidies. The evidence of the 1980s shows

that some countries (such as Indonesia and Zimbabwe) protected their human development programmes during the process of adjustment by reorienting their budgets. Yet in some countries where education and health expenditures were cut, military expenditures actually rose. Obviously, the poverty of their economies was no barrier to the affluence of their armies.

External donors can help protect human development by providing additional resources to ease the pain of adjustment and by agreeing with developing countries on new and benign conditions for adjustment assistance — conditions that would make it clear that external assistance will be reduced if a country insists on spending more on its army than on its people. They could stress the right of the recipient country — indeed its obligation — not to cut social expenditures and subsidies that benefit poorer income groups and other vulnerable segments of the population. And they could specify that human development programmes should be the last, not the first, to be reduced in an adjustment period after all other options have been explored and exhausted.

9. A favourable external environment is vital to support human development strategies in the 1990s.

The outlook is not good. The net transfer of resources to the developing countries has been reversed — from a positive flow of $42.6 billion in 1981 to a negative flow of $32.5 billion in 1988. Primary commodity prices have reached their lowest level since the Great Depression of the 1930s. The foreign debts of developing countries, more than $1.3 trillion, now require nearly $200 billion a year in debt servicing alone.

In the 1990s the rich nations must start transferring resources to the poor nations once again. For this to happen, there must be a satisfactory solution to the lingering debt crisis — with debts written down drastically, and a debt refinancing facility created, within the existing structures of the IMF and the World Bank, to foster an orderly resolution of the debt problem.

10. Some developing countries, especially in Africa, need external assistance a lot more than others.

The least developed countries, particularly those south of the Sahara, suffer the greatest human deprivation. Africa has the lowest life expectancy of all the developing regions, the highest infant mortality rates and the lowest literacy rates. Its average per capita income fell by a quarter in the 1980s.

There is thus a growing trend towards a concentration of poverty in Africa. Between 1979 and 1985 the number of African people below the poverty line increased by almost two-thirds, compared with an average increase of one-fifth in the entire developing world. That number is projected to rise rapidly in the next few years — from around 250 million in 1985 to more than 400 million by the end of the century.

In any concerted international effort to improve human development in the Third World, priority must go to Africa. The concept of short-term adjustment is inappropriate there. Required, instead, is long-term development restructuring. Also required is a perspective of at least 25 years for Africa to strengthen its human potential, its national institutions and the momentum of its growth. The international community should earmark an overwhelming share of its concessional resources for Africa and display the understanding and patience needed to rebuild African economies and societies in an orderly and graduated way.

11. Technical cooperation must be restructured if it is to help build human capabilities and national capacities in the developing countries.

The record is not reassuring. In many developing countries the amount of technical assistance flowing each year into the salaries and travel of foreign experts exceeds by far the national civil service budget. Unemployment of trained personnel and a national civil service demoralised by low salary levels often exist side by side with large numbers of foreign, high-priced experts and consultants. In some countries, there

continues to be an acute lack of trained national personnel. Technical assistance to Africa amounts to $4 billion a year — as much as $7 a person. But institution-building and the expansion of human capabilities has been grossly inadequate in most of the region.

More successful technical cooperation in the 1990s requires that programmes focus more on human development issues. This will broaden the basis for more effective national capacity-building — through the exchange of experience, the transfer of competence and expertise and the fuller mobilisation and use of national development capacities. Emphasis must be placed on improving the availability of relevant social indicators and on assisting developing countries in formulating their own human development plans. The yardstick for measuring the success and impact of technical assistance programmes must be the speed with which they phase themselves out.

12. A participatory approach — including the involvement of NGOs — is crucial to any strategy for successful human development.

Many overplanned, overregulated economies are now embracing greater market competition. Increasingly, the role of the state is being redefined: it should provide an enabling policy environment for efficient production and equitable distribution, but it should not intervene unnecessarily in the workings of the market mechanism.

The movement of nongovernmental organisations (NGOs) and other self-help organisations has gained considerable momentum and proven its effectiveness in enabling people to help themselves. NGOs are generally small, flexible and cost-effective, and most of them aim at building self-reliant development. They recognise that when people set their own goals, develop their own approaches and take their own decisions, human creativity and local problem-solving skills are released, and the resulting development is more likely to be self-sustaining. A comprehensive policy for the participation of NGOs is essential for any viable strategy of human development.

13. A significant reduction in population growth rates is absolutely essential for visible improvements in human development levels.

The number of people in developing countries — having increased from 2 billion in 1960 to an estimated 4 billion in 1990 — will probably reach 5 billion in 2000. The decline in the population growth rate — from 2.3% a year during 1960-88 to an estimated 2.0% during 1988-2000 — is insufficient to make a dent in the overall demographic picture. More vigorous efforts are required to reduce population growth in the developing world, above all in Africa and South Asia. There is an urgent need to strengthen programmes of family planning, female literacy, fertility reduction and maternal and child health care.

The world's demographic balance is shifting fast. The share of the developing countries in world population is expected to grow from 69% in 1960 to 84% by 2025, and that of the industrial nations to shrink from 31% to 16%. Even more telling, 87% of all new births are in the Third World, and only 13% in the industrial nations.

If the developing world's new generations cannot improve their conditions through liberal access to international assistance, capital markets and the opportunities for trade, the compulsion to migrate in search of better economic opportunities will be overwhelming — a sobering thought for the 1990s, one that spotlights the urgent need for a better global distribution of development opportunities.

14. The very rapid population growth in the developing world is becoming concentrated in cities.

Between 1950 and 1987 the number of urban dwellers in developing countries more than quadrupled, from 285 million to one and a quarter billion. Their number is likely to increase to nearly 2 billion by 2000, when eight of the 10 largest mega-cities (each with 13 million people or more) will be in the Third World. This process of urbanisation seems to be inevitable, as various attempts to discourage urban migration have

for the most part failed.

The urban challenge for planners and policymakers in developing countries during the 1990s will be to identify and implement innovative programmes to deal with four critical issues.

- Decentralising power and resources from the central government to municipalities.
- Mobilising municipal revenue from local sources with the active participation of private and community organisations.
- Emphasising "enabling" strategies for shelter and infrastructure, including assistance targeted to weaker groups.
- Improving the urban environment, especially for the vast majority of urban poor in slums and squatter settlements.

The effectiveness of government responses to these issues will largely determine human development in the urban setting.

15. Sustainable development strategies should meet the needs of the present generation without compromising the ability of future generations to meet their needs.

On this, the consensus is growing. But the concept of sustainable development is much broader than the protection of natural resources and the physical environment. After all, it is people, not trees, whose future choices have to be protected. Sustainable development therefore must also include the protection of future economic growth and future human development. Any form of debt — financial debt, the debt of human neglect or the debt of environmental degradation — is like borrowing from the next generations. Sustainable development should aim at limiting all these debts.

Poverty is one of the greatest threats to the environment. In poor countries, poverty often causes deforestation, desertification, salination, poor sanitation and polluted and unsafe water. And this environmental damage reinforces poverty. Many choices that degrade the environment are made in the developing countries because of the imperative of immediate survival, not because of a lack of concern for the future. Any plans of action for environmental improvement must therefore include programmes to reduce poverty in the developing world.

If environmental problems are seen in the above perspective, it will help ensure that global ecological security is viewed as a unifying link, not a divisive issue, between the North and the South. Further, the additional costs of environmental protection must come largely from the rich nations since they are responsible for a major part of environmental degradation. With 20% of the world's population, they emit more than half the greenhouse gases that warm our planet. It is mainly the willingness of the rich nations to change their environmental policies, to transfer environmentally sound technologies and to provide additional resources that can ensure the protection of our global commons.

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These, then, are the main policy conclusions and policy messages of this first *Human Development Report*. Far from answering all questions in this first effort, the findings and conclusions often point to issues requiring deeper analysis and more meticulous research: What are the essential elements of strategies for planning, managing, and financing human development? What are the requirements of a practical framework for participatory development? What is a conducive external environment for human development? These and related questions will set the agenda for future Human Development Reports.

Executive Summary

U.S. Participation in the U.N. Development Program

United States General Accounting Office
Report to Congressional Requesters
February, 1990

Purpose

The United Nations (U.N.) Development Program spends about $1 billion a year and is the world's single largest program for providing technical assistance to developing countries. Over the years, the United States has contributed about $3 billion to the Program and its predecessor agencies. The Chairman of the House Committee on Foreign Affairs; the Chairman of the Subcommittee on Human Rights and International Organizations; and Congressman Gerald Solomon asked GAO to review selected issues concerning the Program. Specifically, GAO was asked to assess (1) the Program's efficiency and effectiveness, (2) other major donors' views of the Program, (3) the level of U.S. influence, and (4) the Program's accounting practices and financial status.

Background

The U.N. General Assembly established the Development Program in 1966 and assigned it the central funding and coordinating role in technical assistance within the U.N. system. Technical assistance includes the provision of advisory services, training, and equipment to developing countries. The Program channels money through about 30 other U.N. agencies which implement about 6,000 projects in 152 developing countries in such diverse fields as agriculture, industry, and communications.

Using five-year country plans, Program officials are supposed to work with the recipient governments and the U.N. system agencies to ensure that U.N. technical assistance projects are designed and implemented to support the recipient government's development priorities. The Program is headed by an Administrator, governed by a 48-member Governing Council, and funded by voluntary contributions.

Results in Brief

The Program is not fulfilling its designated role as the central funding channel and coordinating body for U.N. technical assistance. It only finances about 30 percent of U.N. system technical assistance, and primarily coordinates the projects it funds. For the most part, other U.N. projects are not coordinated or integrated into an overall country plan.

Member nations believe that the Program performs a number of useful functions. However, U.S. and other donor officials have expressed concern about the overall impact of the large number of small, diverse projects. U.S. officials also believe that more evaluation of project results is needed and that a greater percentage of Program funds should be used to meet the priority needs of the least developed countries and should be concentrated on activities where the Program offers advantages over other funding sources.

The United States has played a major role in the Program since it was established. The Administrator of the Program has always been an American, and the United States is a member of the Program's Governing Council.

The Program's reported fund balance of over $1 billion as of December 31, 1988, was high compared to previous years, but Program officials expected it to decrease rapidly as planned projects are implemented. The U.N. Board of Auditors issued qualified audit opinions on the Program's last two annual financial statements because a substantial portion of the expenditures reported by U.N. implementing agencies had not been independently audited each year.

Principal Findings

The Program Does Not Coordinate All U.N. Technical Assistance

Under a U.N. General Assembly resolution, a five-year country program should be used to help plan all U.N. technical assistance. GAO found that the Program funded and coordinated only about 30 percent of U.N. technical assistance activities. The Program generally does not coordinate the technical assistance funded by other U.N. agencies from their regular budgets and special contributions for specific projects or activities. Other U.N. agencies operate independently and have their own mandates, programs, and procedures. The Program primarily coordinates the projects it funds in its country programs.

Problems With Program-Funded Projects

About 4,700 Program-funded projects have budgets under $400,000. The projects cover a broad spectrum of activities. In general, U.S. and other donor officials believe that, because the projects are small and scattered, they have limited impact on the priority development needs of recipient countries. Moreover, they place an administrative burden on the recipients, Program field offices, and U.N. implementing agencies. U.S. officials believe that more evaluative information on the impact of Program-funded projects is needed.

Other Nations' Views

Major donor representatives believe the Program performs a number of useful functions. Some, however, have concerns about the impact of Program-funded projects. Also, member nations, through U.N. General

Assembly resolutions, have expressed their belief that increased coordination through the Program would improve the effectiveness of U.N. technical assistance activities by ensuring that they meet the priority needs of the recipient country and by simplifying the diverse project management procedures of the various U.N. agencies.

Major U.S. Role

The United States has played a major role in the program since it was established and is the largest donor. However, its contributions have decreased from 24 percent of total contributions in 1985 to about 12 percent in 1988.

The Program makes extensive use of U.S. expertise, training facilities, and equipment. A relatively high number of the Program's professional employees, especially those in key positions, are U.S. citizens. Also, the Program's development policies coincide with U.S. priorities in such areas as protecting the environment, increasing agricultural production, and promoting private initiative.

Unaudited Expenditures

The U.N. Board of Auditors, which audits the Program annually, issued qualified opinions on the Program's 1986 and 1987 financial statements, primarily because it felt it could not comment on the unaudited expenditures of Program funds reported by some U.N. implementing agencies with biennial audit cycles. To resolve this problem, the Program's Budgetary and Finance Committee recommended that the Program's financial statements also be audited biennially to coincide with the audit cycles of the major U.N. implementing agencies.

High Fund Balances

The accounts that fund the Program's projects and operating costs had a balance of about $1 billion on December 31, 1988. Of this amount, $581 million was for general resources (compared to $184 million in 1985), $225 million was for required financial reserves, and $196 million was contributed for specific activities and cannot be used for other purposes. The Program also administered 57 separate trust funds which account for an additional $257 million, of which $46 million was for operational reserves. Exchange rate gains, required financial reserves, and the Program's requirement that some types of activities be funded a year in advance help account for the high fund balances. Program officials said that total commitments, with respect to unspent budgets of approved projects, exceeded $1 billion and that the balance is expected to sharply decline in 1989 and 1990 because of increased program expenditures.

Recommendations

GAO recommends that the Secretary of State seek the support of other major donor countries to (1) strengthen the Program representatives' role in coordinating all U.N. system technical assistance activities at the country level, (2) increase the evaluation of project results to determine their impact on the priority needs of the recipient countries, and (3) ensure that the Program concentrates on the priority needs of the least developed countries and on activities where the Program offers advantages compared to other funding sources.

Agency Comments

The Department of State agreed with GAO's findings and recommendations.

ANNUAL MEETING

MONTREAL

An IDB for the 1990s

A crucial period for Latin America

The 1990s will be critical years for Latin America and the Caribbean, a time of wrenching economic change that will test the abilities of the region's new democratic governments to create modern and just societies.

The IDB today finds itself in a strong position to help the region in its drive toward modernization and social justice, IDB President Enrique V. Iglesias told delegates to the annual meeting of the Bank's Board of Governors in Montreal, Canada, on April 2.

The Bank's immediate priority is to quickly and efficiently allocate the $22.5 billion in lending provided by the seventh increase in its resources, Mr. Iglesias stated. The Bank is increasing its dialogue and consultation with national authorities and is helping countries to prepare projects more rapidly. Plans are being made to delegate greater responsibilities in this regard to the field offices.

A second major aim will be to direct special attention to priority areas, especially to make up for unmet social needs. An enormous "social debt" has accumulated during the years of economic crisis, said the IDB president. The Bank will help reduce this debt by lending for urban and agricultural development, large-scale credit programs for microentrepreneurs and increased participation of women in the development process.

Mr. Iglesias called promoting investment a "fundamental task," particularly in light of the investment decline during the past decade. He also urged more support for the private sector in view of the growing responsibilities assigned to it in the Latin American countries. The recent initiation of the Inter-American Investment Corporation's activities was "an auspicious event," said Mr. Iglesias, "which complements the Bank's own objectives."

IDB President Iglesias and Canadian Secretary of State for External Affairs Joe Clark

The Bank will increase its efforts in helping the countries to develop their export capacities. The countries, he said, "cannot afford the luxury of. . . living isolated from the international economy." The region must adapt quickly to changing circumstances and new opportunities. "We have to be in the forefront of technological change, not bringing up the rear," he said.

Finally, Mr. Iglesias declared that the development of human resources, particularly to support scientific and technological progress, will receive the IDB's highest priority.

Once again the president stressed the Bank's commitment to natural resource conservation and environmental protection.

"Rational use of the vast and rich natural resource endowment. . . and concern for the environmental effects of population growth and urban concentrations. . . must be central issues in the Bank's dialogue with and cooperation for our countries," he said.

Reforming the state. Another focus of IDB support in the 1990s will be Latin America's process of economic and social reforms. The Bank will support moves to modernize the State, particularly by helping to transform State enterprises from permanent sources of public deficits into net contributors of funds for development. The Bank's support will include technical assistance, funding for investment projects and sector loans.

The president acknowledged that although the external debt problem is not a direct IDB responsibility, the institution can make a contribution by helping to turn net resource flows back into the region. The Bank's fast-disbursing sector loans, for example, will support reforms leading to debt reduction and restructuring. In addition, Mr. Iglesias proposed that the

The bitter experiences of the 1980's have prepared Latin America for the next decade.

Bank help the Latin American countries find ways to reduce debt owed among themselves.

Other IDB contributions to Latin America's reform effort will be to increase cofinancing with international commercial banks and support regional integration and cooperation.

These are the kinds of cooperative relationships the Bank will seek to establish with its member countries, concluded Mr. Iglesias. Doing so will expand the "traditional Bank," he said, and pave the way for a truly "innovative Bank."

Lessons from the '80s. In the same address, the IDB president presented his view of Latin America as a region which has lost a great deal, but which has also achieved some noteworthy successes.

The restoration of democracy in the vast majority of Latin American countries was a "net gain of tremendous importance," he said. Other gains have been fiscal reforms, macroeconomic adjustment programs, measures to reform the State, and the development of an "export culture."

The 1980s also have taught Latin America some valuable lessons.

First, the countries learned that periodic economic adjustments are essential for increasing efficiency and competitiveness, and for resolving the debt problem. "There can be no solution to the problem of indebtedness without profound internal adjustments," said the IDB president.

The region has also learned that sustained, efficient development can be achieved by deregulating markets and allowing them to work.

Another lesson is that Latin America needs a profound reform of the State. "There must be a State," said Mr. Iglesias, "but it has to be efficient." The State should focus on improving market mechanisms and establishing clear, equitable rules.

New pragmatism. The bitter but instructive experiences of the past have prepared Latin America for the next decade, said Mr. Iglesias.

"I sincerely believe that a new realism has taken root in Latin America," said Mr. Iglesias. "Virtually the entire region is in the midst of a process of profound and painful changes, which are being introduced by dynamic and reinvigorated political leadership, with a large measure of pragmatism and political courage." The critical factor in all of the adjustment processes, he continued, is to secure credibility in public action.

"That credibility, based on consistency of policy and perseverance in implementation, is essential for encouraging public and private domestic savings and preventing capital flight, while promoting the return of capital and encouraging private investment to flow in from abroad."

Throughout Latin America, he said, enlightened public opinion has concluded that macroeconomic balances are fundamental, that realistic policies on prices, interest rates and exchange rates are essential for stabilization and development, and that Latin America is irrevocably committed to being a full-fledged participant in an increasingly competitive international market.

World Bank OECD

NOT FOR PUBLICATION BEFORE
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Paris, 10th May 1990

"AGRICULTURAL TRADE LIBERALIZATION:
Implications for Developing Countries"

Some, but not all, developing countries will gain if agricultural trade barriers are dismantled and subsidies withdrawn, warns a new joint study by the World Bank and the OECD Development Centre.

Prepared to coincide with the beginning of the final phase of the Uruguay Round, the study is based on analytic models containing agricultural price and trade projections leading international agricultural trade experts first presented at an OECD Development Centre and World Bank symposium last October.

Given the crucial role of agriculture in the Third World, the study stresses that "the developing countries will be among the most affected - positively or negatively - by the outcome of the GATT negotiations on agricultural trade liberalization".

In projecting the potential effects of liberalization on prices, production, consumption and welfare, the models developed in the studies provide valuable perspectives and insights for the negotiations and have important policy implications. An urgent message of the study is that what will actually happen will depend on policy measures both developed and developing countries take now within the context of the Uruguay Round.

An outcome of almost all the projections is that food grain prices will rise following agricultural trade liberalization in developed countries. Though many food-importing developing countries - some of them among the poorest - could be adversely affected, at least in the short run, the overall effects could be cushioned if developing countries also liberalize their trade and reduce the distorsions inhibiting their agricultural production.

Another strong conclusion of the study is that agricultural trade needs to be completely liberalized across-the-board, with no commodities excluded. A "worst case scenario" would be if support for food grains is withdrawn while protection and subsidies for livestock production remain. The result would be an even sharper increase in food prices than anticipated from complete liberalization.

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Finally, the study stresses that although there will be losers, the world as a whole, and particularly developing countries in the long term will gain from trade liberalization. The challenge is to develop appropriate transitional arrangements to buffer possible short-term losses of large food importers in the developing world so that the long-term objectives will not be frustrated.

Journalists are invited to a press briefing
at the OECD Development Centre, 94 rue Chardon Lagache, 75016 Paris,
on Friday 18th May 1990, at 11.00 a.m.

Press copies of the report are available from the OECD Press Division, 2 rue André Pascal, 75775 Paris cedex 16 (tel. 45 24 80 88 or 80 89).

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Concluding Assessment

By Uma Lele

This paper has demonstrated the complexity of agricultural development in Africa, the number of variables that impinge on the outcomes, and in particular the extent of variability in national endowments as well as in policy responses and outcomes.

In terms of initial conditions, Kenya and Nigeria were the best endowed, followed by Cameroon and Tanzania. Senegal and Malawi inherited by far the least favorable initial conditions. Nigeria and Cameroon had favorable external shocks, due primarily to the dominance of oil. In Senegal, while changes in external terms of trade were favorable, mainly due to the role of phosphates, other external shocks relating to agriculture turned out to be unfavorable (i.e., as regards the terms of trade for groundnuts and the climate).

In this respect, the fortunes of the more agriculturally based economies in the East were less favorable than in the West. Terms of trade losses were the greatest for Kenya, although both Malawi and Tanzania also suffered major losses.

Only Kenya among the MADIA countries made the most of its initial conditions and pursued a combination of macroeconomic and sectoral policies that achieved rapid agricultural growth while also promoting equity.

Malawi's growth record was good in the 1970s, primarily reflecting its good macroeconomic policies, but land and price policies swamped the effects of other favorable policies in smallholder agriculture.

Nigeria's adverse policies and "luck" in terms of internal shocks to the system meant that it did not make good use of the resources at its disposal for laying the foundations of long-term growth, although much physical infrastructure was developed and social indicators improved. Political problems have been enormous in Nigeria, and the nature of its policy responses were in many ways symptomatic of those political and institutional problems. Cameroon followed more moderate policies than Nigeria, although with highly variable performance as between cotton and other subsectors of the agricultural economy.

Tanzania and Senegal performed least well. Whereas adverse policies played a part in both countries, Tanzania's more favorable resource endowments relative to Senegal's underline the role of policies in explaining its performance. In Tanzania's case, genuine strides were made on the equity front, but could not be sustained because too little attention was paid to agriculturally-led growth.

While favorable price incentives based on appropriate macroeconomic and sectoral policies played a key role in explaining performance, the quality of natural resources and of technological, institutional, political, and human and physical investments critically determined the ability of small farmers to mobilize land and labor, the two most important factors explaining growth. There was relatively little technical change in the agricultural sectors of MADIA countries.

Important physical and human capital foundations were laid in all countries, but the record of successes and failures in MADIA countries highlights the amount of time needed for learning-by-doing, and therefore how important it is to exploit initial conditions, as well as how difficult it is to create a new market niche through diversification. Ironically, the countries that moved least rapidly to diversify their economies did the best.

The growing population pressure on limited land resources in Kenya, Malawi, and Senegal confronts these countries with exceptionally difficult problems. Now that Kenya has developed a sound smallholder agricultural base, productivity increases will be crucial for growth. In Malawi and Senegal, smallholder agriculture faces far more complex problems, partly because of the policies pursued in the 1970s. Tanzania and Cameroon, and to a lesser extent Nigeria, have better prospects, if only because of their favorable resource endowments.

This paper has noted the relatively small role that donor assistance has played in the growth that has occurred in MADIA countries. Large amounts of aid have been allocated with the best of intentions but to types of activities that have had little effect on growth. Nonetheless, there are some outstanding examples of the catalytic role that well-conceived donor assistance can play. They include smallholder tea and coffee development in Kenya, cotton in Cameroon, and maize and small-scale irrigation in northern Nigeria and elsewhere. The success with which donors have contributed to the growth process seems fundamentally to depend on the extent to which they understand the myriad micro-level constraints on growth prospects in individual projects and subsectors. Not surprisingly, therefore, those donors with a prior colonial connection with Africa have had a relatively greater share of the successes achieved. The importance of the "colonial" donors has been declining in Africa, however, and their ability to create sustainable indigenous systems has been limited. This decline in external expertise and knowledge about Africa is especially worrying in relation to the amount of external financial resources being devoted to alleviating the continent's crises. Equally worrying is the fact that with the major exception of the U.S. record in Africa (as in Asia), and the singular contribution of the Nordic Cooperative Project in strengthening the managerial capabilities of the Kenyan cooperatives, "new" donors have tended to underemphasize the importance of human and institutional capacity, while overestimating the utility of aid in the form of physical plant and expatriate technical assistance.

It is important to stress that the findings here reflect the donor studies carried out for the wider MADIA program. The official studies contributed by donors themselves emphasize the extent to which the effectiveness of external assistance has been undermined by the donors' limited ability to tailor their assistance to important aspects of the local conditions under which their programs operate, and to take adequate account of the impact of micro-level constraints. Donors also note the tendency to respond to such problems by falling back on technological and organizational solutions arising from their own particular backgrounds and expectations, which may have relatively little connection in practice with recipients' needs or organizational and manpower capabilities. Time and again, studies by MADIA's collaborating donors stress the problems associated with lack of country-specific knowledge, including historical and situation-specific constraints. They also emphasize the pressing need for a greater institutional

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memory in the donor community and a better understanding of the sociopolitical and technological factors operating in recipient countries, if the current focus of reform programs on the removal of price distortions is to be appropriately complemented by the institutional and other nonprice changes needed to give the pricing reforms a chance to work. There also needs to be greater emphasis on the longer-term "superstructural constraints" that persist even while SAL-type programs are being completed, constraints that only Africans themselves can remove with increased political will and improved human and institutional capital.

The MADIA study also stresses the imperfect understanding of the real sources and causes of growth and the methods used to promote them—which means that donors and governments do not always agree on means or even on specific ends. An objective diagnosis of a particular development problem (or definition of a particular policy goal) can only be built up through data-based analysis, in which donors and recipients need to share. This should enable donors and recipients to reach a consensus about the steps needed to solve the problem or achieve the goal. A second broad consensus then needs to be built within the recipient country (based on the involvement of individual recipient country policymakers in the previous two stages), so that there is a sustained indigenous commitment to the reform process.

Finally, if the MADIA study has one observation to offer in addition to that of the need for greater depth in framing and implementing agricultural development strategies, it is the extent to which the swinging pendulum of donor concerns—from a preoccupation with equity in the 1970s to emphasis on efficiency in the 1980s—has tended to divert attention from more basic, long-run problems. The emphasis on "quick" poverty alleviation during the 1970s gave priority to helping low income regions and populations, and to raising food crop production. The present tendency to emphasize equally "quick" solutions based on correction of price incentives and markets, can lead to inadequate attention being paid to an appropriate balance between food and export crop development, between growth and equity objectives (regionally and nationally), between short-term macropolicy adjustments and long-term capacity building, and between physical and human capital development.

The problems associated with framing and maintaining agricultural development strategies based on specificity and balance are very real. If such strategies are to become successfully institutionalized, fundamental changes in approach will be needed. This entails a new focus, by donors and recipients alike, on a more comprehensive, data-based, systematic, and comparative understanding of specific development issues and constraints on a *continuous* basis, perhaps using much broader-based programs of analysis of the kind attempted in the MADIA study. As a part of the aid coordination process, donors need to specialize and concentrate their resources on their respective comparative advantages, while the process of knowledge acquisition and utilization by African governments themselves needs to be supported, so as to improve their ability to address their own development needs successfully. This process should include establishing and fostering centers of excellence on African issues, in both African and donor countries.

Executive Summary

Poverty and the Social Dimensions of Structural Adjustment in Cote d'Ivoire

Social Dimensions of Adjustment in Sub-Saharan Africa Policy Analysis

By Ravi Kanbur, The World Bank, March 1990

During the 1980s, many developing countries have entered into an explicit process of structural adjustment. The need for such adjustment has been brought about through combinations of external and internal shocks which have led to unsustainable external deficits. These deficits have had to be dealt with during a period in which concessional capital flows, and even non-concessional ones, have dried up. In their absence, adjustment to the new realities is called for. But adjustment is not costless. Since it calls for changes in the composition of output, with more emphasis being placed on exports and an outward looking strategy, it follows that there will be distributional effects with both gainers and losers. Who are likely to be the losers? Are they those already in poverty? If so, how can the adjustment process be managed so as to protect them? These are the questions to which this paper is addressed. It puts forward a conceptual framework for answering these questions, and implements it for the specific case of Côte d'Ivoire.

The paper is divided into five sections. Section 1 lays out the conceptual framework of analysis at the macro and at the micro level. Section 2 reviews the structural adjustment program in Côte d'Ivoire in order to highlight salient features that relate to poverty alleviation. Section 3 develops an empirical poverty profile of Côte d'Ivoire in 1985 along dimensions suggested by the discussion in Sections 1 and 2. Section 4 attempts to link the macroeconomic developments of 1980–85 to poverty. Finally, Section 5 looks ahead and draws out some policy conclusions for the future design of SALs.

Conceptual Framework

The centre piece of the conceptual framework is the need to link macro level policy changes to their micro level distributional consequences through a *policy relevant poverty profile* of the country in question. The macroeconomic analysis of various structural adjustment policies will suggest the dimensions along which the profile should be constructed. Thus a major component of many adjustment programs is the imperative of making activities which produce internationally tradeable goods more profitable, and to reduce the profitability of activities which produce non-tradeables. In order to quantify the impact of this on poverty, we need to know how the poor relate to these two types of activities. In other words, we need a disaggregation of poverty by tradeable and domestic goods sectors.

Given the central role of a poverty profile, it is important that we use a measure of poverty which is convenient in an operational context, capable of representing disaggregations along different dimensions simply, and yet capable of capturing commonly held views on poverty and the depth of poverty. Much of the analysis of this paper is done on the basis of such a decomposable measure of poverty, and its success in this application is likely to have implications for whether this measure should be used in other contexts and for other countries. However, a basic argument in this paper is that it is not sufficient to look at income based measures of poverty alone. Basic needs achievements are an important component of the standard of living and impacts on these should be an integral part of any poverty focussed strategy of structural adjustment.

Section 2 of the paper moves from the general conceptual framework to the details of the structural adjustment process in Côte d'Ivoire, from 1980 to the present. It gives an account of the structural adjustment program from 1981 through 1986, in order to highlight the key policy instruments used during the process. This discussion, with the background of the conceptual framework in Section 1, then suggests the dimensions along which the poverty profile of Côte d'Ivoire should be constructed. A review of the three SAL agreements for Côte d'Ivoire reveals several important features. Firstly, the structural adjustment measures in these agreements have become progressively more specific and intensive. The measures in SAL I were largely to do with institutional reform whose effects are intangible and whose direct effects upon the poor are not easily quantifiable. Some pricing measures were taken, and these were intensified over time. By the time of SAL III, the pricing measures

were extended to export subsidy schemes for manufactured exports. However, SAL III only became effective in 1987, so that there is little scope for discovering and isolating effects in the historical data, which at the time of writing (late 1987) is available only up to 1986.

Secondly, the social sectors receive very little mention in the three SALs. The major exception to this is the urban housing sector, from which the government announced its intention to begin disengaging, in SAL II. Moreover, the historical record shows that this policy was indeed implemented to a considerable extent. The likely impact of this on the poor is thus a question of some importance, and the paper addresses this in Section 5. However, education and health receive only a brief mention, or no mention at all, in the three SALs. It is with this neglect as background that Section 3 introduces achievements along these basic needs dimensions as an important part of the poverty profile, and Section 5 suggests conditionality to protect government expenditure on these sectors, in an era of general retrenchment in total expenditure.

Poverty and Basic Needs in Côte d'Ivoire

Following on from the discussion of the structural adjustment process in Côte d'Ivoire, Section 3 takes up the important task of constructing a policy relevant poverty profile for Côte d'Ivoire. It introduces the data base, the Living Standards Survey for 1985, which provides a snapshot of the income distribution for the year in question. Unfortunately, although the Living Standards Survey for 1986 has recently become available, we do not have comparable household surveys for the period before 1985 and crucially before the adjustment process started. In view of this we have to use the mid-1980s picture to project backwards historically, and to project forwards the effects of adjustment policies.

Section 3 begins by constructing a poverty profile along conventional regional lines, but using a family of poverty measures which allows national poverty to be decomposed into its regional components. We disaggregate into five regions—Abidjan, Other Urban, West Forest, East Forest, and Savannah. Further disaggregation may be desirable but, given the sample size of the survey (1,600 households), we will quickly run into the "small cell" problem. We find that the poverty ranking of the regions is as stated above—with Abidjan showing least poverty and Savannah showing very high levels of poverty. This holds true for a range of poverty indices which emphasize the depth of poverty to different degrees. Indeed, with the measure which emphasizes depth of poverty most, poverty in the Savannah accounts for more than 50 percent of national poverty, even though the regions population is less than 20 percent of the national total. The above exercise is repeated for an even lower poverty line which defines for us what might be termed "hard core" poverty. The Savannah now accounts for over 60 percent of the Côte d'Ivoire poverty. We also calculate various "targeting indicators" which help rank regions according to which should be favored most in terms of government activities which increase incomes. Again, the same ranking is maintained, with Savannah top of the list for government intervention, and Abidjan at the bottom. We seem then to have a regional ranking which is very robust indeed, and to the extent that policy has a regional dimension it gives very clearly guidelines for a poverty focussed strategy.

While the regional dimensions of poverty are important for analyzing structural adjustment and poverty, it is important to have a socio-economic disaggregation which corresponds more closely to policy concerns and instruments in adjustment programs. With this objective, we disaggregate households into five types—export croppers, food croppers, government sector, formal private sector, and informal sector. Again, this disaggregation would ideally be finer but for the data limitations.

The poverty profile for the five "socio-economic" groups reveals that food crop farmers are the poorest of the five while government sector households are the least poor. Indeed, for the poverty measure which emphasizes depth of poverty most, the food crop group accounts for around two thirds of Côte d'Ivoire's poverty while the government sector group accounts for less than one percent. Export croppers are the next poorest to food croppers, followed by informal sector households, formal private sector households and then government sector households. This ranking is robust to the different measures of poverty used and to an analysis of hard core poverty. The rankings that emerge from targeting indicators also mirror this ranking exactly. The policy implications of this are taken up in subsequent sections. But obviously the policy of raising export crop prices is one which is not inconsistent with a poverty focus—export croppers are poorer than Ivorians on average.

Section 3 now moves on to basic needs aspects of poverty, focussing on education, health, and housing. It presents profiles of basic needs achievements by region, poverty-group, and socio-economic group. An immediate point of interest is that the income poverty rankings of region and socio-economic groups are more or less maintained in the rankings of basic needs achievements. In terms of the basic needs achievements of the poor in education and health, the analysis shows serious shortfalls when compared to the Côte d'Ivoire average. Thus the literacy rate for the poor is around half that for all Côte d'Ivoire while the school

attendance rate for primary school age children among poor households is three quarters its value for all Côte d'Ivoire. In addition, the poor have systematically lower achievement of educational grade for age, even restricting attention only to those who attend school. On health, a similar picture emerges. The percentage of ill individuals who consulted health personnel is significantly lower for the poor than for the non-poor. Moreover, the use of hospitals by the non-poor is proportionately greater than that by the poor, which has policy implications for retargeting expenditure within the health sector.

Housing presents some interesting contrasts in Côte d'Ivoire. For the country as a whole, renting is not a sign of poverty. On the contrary, a larger percentage of the poor live in their own homes than do Ivorians on average. The contrast appears for Abidjan, where this is reversed—here, a larger percentage of the poor live in rental accommodation. However, very few of the poor live in subsidized public rented accommodation. The household survey shows this very clearly, and it sheds light on the possible poverty effect of the reduction of such subsidies, as envisaged in SAL II and as implemented in the next two years.

Macroeconomic Trends and Poverty

After establishing the poverty profile, the paper moves on in Section 4 to an analysis of macroeconomic developments during the 1980s and their possible effects on poverty. The analysis combines the input-output accounts on the productive structure of the economy for 1980–85, and the patterns of income distribution as revealed in the poverty profiles of Section 3. During this period, real per capita household income declined at an average annual rate of around 2.6 percent per annum. This is a remarkable decline by any standards, but we argue that it is likely to understate the corresponding increase in poverty. Assuming that the pattern of income distribution in 1985 was maintained throughout 1980–85, we find that the incidence of poverty would have increased at 4.8 percent per annum and the incidence of hard core poverty would have increased at 7.9 percent per annum. The section goes on to conduct a more refined analysis taking into account differing income distributions within the five socio-economic groups discussed in Section 3, and also taking into account changes in the sectoral composition of output over this period, as revealed through a detailed analysis of the input-output accounts.

Policy Analysis and SAL Design

After the historical account of Section 4, Section 5 moves on to a discussion of policy and future SAL design, taking up a number of current and emerging policy issues as discussed in Section 2, and in light of the conceptual framework in Section 1 and the poverty profiles in Section 3. We summarize here the major policy conclusions:

- Proposals to cut producer prices for export crops in order to augment government revenue have to be viewed with extreme caution, at least if the adjustment strategy is poverty focussed. The analysis of Section 3 shows that redistribution away from export croppers to the average Ivorian will tend to increase national poverty.
- Within the export crop category, cotton farmers have a staggeringly high incidence of poverty and should be a target group of extra special concern.
- So far as policies to effect a general increase in the price of tradeable goods relative to non-tradeable goods is concerned, the verdict is mixed. Export croppers benefit, and they are poorer than average. But so do formal private sector households who draw their incomes from processing and manufacturing activities, and these are richer than average.
- Rice price policy emerges as a persistent concern in the three SALs, with the final SAL proposing bringing producer and consumer prices in line with world prices. Using a poverty profile disaggregated by producers and consumers of rice, we show that rice producers are poorer than rice consumers, that rice producers are poorer than coffee and cocoa farmers, and that rice is consumed more by the non-poor compared to food in general. Thus the producer price of rice should not be lowered dramatically. Similarly, there does not appear to be a poverty alleviation based argument in favor of subsidizing rice in relation to food in general.
- From the poverty analysis it is clear that government subsidized public housing does not benefit the poor. A poverty focussed strategy would not be unduly concerned about removal of these subsidies. However, the poverty analysis also shows that the poor suffer from a lack of basic amenities, and government projects to provide these should be encouraged.

Beyond relief

Vol. 5 No. 1 APRIL 1990

The United States Congress authorized the African Development Foundation (ADF) in 1980. ADF opened its doors in 1984 as an independent public corporation that focuses on the expansion of direct economic assistance to indigenous African groups in such areas as food production, education, husbandry, water management, manufacturing and health. BEYOND RELIEF emphasizes long-term development in Africa ... fertilization of the soil in which the African people can sow the seeds for the future.

"All that the African people seek to achieve is to be able to face their own problems themselves rather than have things done for them."
Sobhuza II, King of Swaziland, 1963

CREDIT !

by Percy C. Wilson

(Mr. Wilson is the former Vice President of ADF)

Credit Funding

For some time now development specialists have carefully examined problems associated with credit projects at the micro level. I have been privileged to participate as a principal investigator in several analyses, and I have reached the conclusion that the only problem with credit for African small-scale enterprise development at the grassroots level is that there is too little of it available. The limited amount that exists is mainly in the informal sector, a system comprised of family members, kinship networks and/or moneylenders. Credit funds from family members is often likely to be insufficient, while funds available from local moneylenders is apt to be too expensive because of high user rates. Obviously, this situation hinders business development. While an individual or a group may have enough start-up capital to launch an

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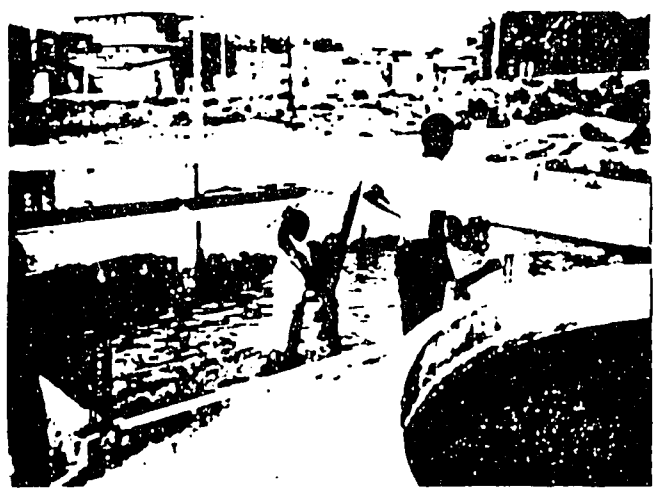

Leonard Floyd

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enterprise, they are likely to have too little or no capital available for unforeseen contingencies. The need to increase the availability of such funds to individuals and groups at the grassroots level forms the ethos of the African Development Foundation's strategy to place credit within the reach of Africa's poor, yet aspiring entrepreneurs.

Servicing Loan Funds

For donors such as ADF who are trying to fill the micro-credit gap, it is imperative to understand the cultural context of groups requesting funds for small-scale enterprises. This understanding is important in determining terms and conditions under which loans should be made, as well as how repayment schedules should be structured to create incentives for the recipient groups to manage funds received. In other words, servicing of loan funds is critical. The monitoring of activities for which loan funds will be applied and an individual's ability to repay loan funds are part of this servicing.

At ADF, we believe that special awareness and understanding of the prevailing socio/cultural circumstances are critical to successful loan servicing programs. To achieve this end, ADF has established an African professional field support system. This system consists of African development field staff ... individuals who are indigenous to the countries and sub-regions in which ADF provides project assistance. This group of experts significantly enhances the Foundation's capacity to analyze proposals and to relate to local cultural factors in making recommendations about funding credit projects.

Filling The "Credit Gap"

Within the context of its mandate to support grassroots development through the funding of small-scale enterprises, ADF tries to fill the "credit gap" by supporting the establishment of revolving loan funds of village and community groups, and making funds available for credit activities as well as through credit that can be drawn upon by entities interested in private initiatives. Such funding may go to grassroots groups through intermediary organizations or to national credit union leagues to be made available to members of affiliated local credit unions. Through the Foundation's loan guarantee authority, credit projects are initiated with traditional financial institutions. The long-term goal of this type of project is to create a productive relationship between traditional financial institutions and business persons in the informal sector.

Khalu

VEA Agricultural Project, Sierra Leone: Members bag harvested rice.

Achieving Accountability

Whatever the case and irrespective of the cultural context (nomadic communities, urban dwellers or small-scale farmers) of a particular project, the methods of achieving accountability in the management of credit projects funded by ADF is established internally by groups and organizations themselves. ADF tries to avoid regulating such arrangements because they are more effectively structured and managed by the groups themselves, as a result of social pressures generated by the community and/or organizational membership. Thus, accountability tends to be built into the type of grassroots credit projects funded by ADF as a result of the social context of the project, which generates a stake in its success.

Christine Fowles

Coffee and Tea Project, Zimbabwe: The family compound in the Eastern Highlands.

As long as a project is seen to have the desired impact on the end user(s) of the funds, it is left up to the group ... in consultation with ADF ... to establish the methods of operating and the rates of loan repayment. This approach allows for local creativity in devising practical credit arrangements, rather than automatically imposing foreign models to extend and manage credit programs. The attractiveness of this approach is that it allows local communities to upgrade age-old methods of trading, and to do business with each other, while retaining their own standards of traditional accountability.

Attracting ADF's Support

In assessing the suitability of a credit proposal for funding, the Foundation looks for projects that are market-driven in terms of seeking to support an activity or set of activities that are revenue generating. This, in turn, is likely to enhance the sustainability of the project or the group being funded. As a general rule, situations in which the people are trading among themselves or have a desire to promote such transactions using money, are situations that are most likely to attract ADF's support. *continued on page 4*

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ADF's Goals

Through its mandated approach of supporting grassroots development, ADF hopes to achieve the following through funding credit projects:

- To expand local capacity for management at the grassroots level, where the responsibility for successfully managing credit projects rests with the recipient organization or community; and
- To increase the level of funds available to people at the grassroots level at a cost that does not create a burden on the end user(s) of credit.

One of the advantages of credit projects at the grassroots level is that, to the extent that user fees are charged, project participants tend to be more realistic about what is achievable, thereby reinforcing the internal accountability of such projects. As a result, there is an increased sense of worth and group pride.

Farmer clients inspect cow pen with Kenyan FSK Project Director, Paul Maina.

ADF Funded Projects

The following ADF-funded projects reflect the diversity of its credit activities:

ZIMBABWE

The Zimbabwe Coffee and Tea Project
Agricultural Finance Corporation
$101,537 for three years (1985)

The Agricultural Finance Corporation (AFC) is a parastatal organization which provides agricultural credit in Zimbabwe. Credit is provided to farmers from AFC's own resources and through guarantee of overdrafts from commercial banks to principal cooperatives, including cooperative unions which serve small-scale and low-income farmers. AFC is the primary institutional source of credit to small farmers. ADF funds were used to establish a revolving loan fund which provided loans to 144 small farmers for coffee and tea production. Loans averaging US $700 enabled farmers to establish from one-half to three hectares of coffee or tea enterprises.

Since independence, the government of Zimbabwe has expanded agricultural extension services, storage, and marketing opportunities to farmers. However, insufficient funds have limited its ability to extend credit to its small farmers, estimated to be about 800,000 in the region. The major impediment to increasing the number of rural farmers engaged in coffee and tea production, which are lucrative cash crops, has been the lack of financing.

ADF funds were requested to create a permanent revolving loan fund for the small scale farmer. It was planned to initially support 100 new coffee growers and 50 tea growers. It was estimated that over the long term, the fund would be able to service 4,500 producers.

The three-year loan program allowed the farmer to place one-half hectare of land under cultivation. The total loan amount was $700 US dollars, to be repaid over a seven-year period. Interest ran about 13 percent, one point less than the going bank rate. The crop was estimated to be productive over a 20-25 year period.

The strengths of this project were that it:

- Provided, through a loan fund, an enabling mechanism for small scale farmers to undertake a high value cash crop which had the potential to significantly increase family income;
- Extended the services of an established institution to small scale farmers;
- Ensured implementation by a well-organized and experienced lending institution; and
- Guaranteed that all project funds went directly to rural Africans, with management and supervisory costs absorbed by others ... ADF funds were, therefore, leveraged by revolving from one farmer to another.

KENYA

Mobile Management Service to Rural Women Project
Kenya Women's Financial Trust (KWFT)
$152,625 for three years (1985)

The Kenya Women's Financial Trust (KWFT) was founded in 1981. It is the only national intermediary credit mechanism available exclusively to women in Kenya. KWFT provides technical advice as well as loans and loan guarantees to women entrepreneurs. The ADF grant enabled KWFT to develop a mobile training unit which provided management and credit training to rural women entrepreneurs outside of Nakuru. During the first year, KWFT visited 45 villages, trained 276 women, and loaned (US) $12,000 to nine women entrepreneurial groups. Because of KWFT's success, ADF provided a second year grant, including (US) $30,000 for an expanded revolving loan fund.

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Integrated Food Production Systems Project
Farming Systems Kenya, Ltd.
US $250,000 for three years

Farming Systems Kenya, Ltd. (FSK) is a local non-governmental, non-profit company which was established in 1981, to train small-scale farmers in farm management, particularly double-entry bookkeeping, extension and credit services. The goals of the Integrated Food Production Systems Project over the three years were to: provide farm management training to 1,764 farmers; extend credit to 882 farmers; continue extension services to the 400 farmers to whom FSK had already provided training and credit; and ensure the self-sustainability of FSK and its client farmers after final construction of a factory for processing potatoes, which were then converted into a flour product for marketing in Kenya.

SOMALIA

Extension of Vegetable Farming to Resident Nomads Project - HAQABTIR
$55,989 for one year (1986)

HAQABTIR is the first officially registered, voluntary non-profit Somali agency. It was founded in 1984, to assist groups of displaced persons, especially refugees, in improving their living conditions by providing training in appropriate marketable skills. Based on their years of service to refugee nomadic families, they sought to extend their service to Somalia's least served people ... the resident nomads ... by assisting 60 residential nomadic families in developing a farm. As the farmers harvested their crops, they were to repay most of the initial capital inputs in several installments. The accumulated funds were then used as a revolving loan fund to assist other rural women in refugee-affected areas.

ADF funds enabled HAQABTIR to assign an agricultural technician and two farm assistants to the rural nomadic families, most of whose farmers were women. They assisted in selecting the participant farmers from all those who applied; clearing and leveling land; constructing canals; plowing and dividing land into individual family plots; and training farmers in seed preparation, planting, harvesting and marketing.

TOGO

UNICOOPEMA Pilot Credit Program
Union of Maritime Fishing Cooperatives,
$250,000 for three years (1987)

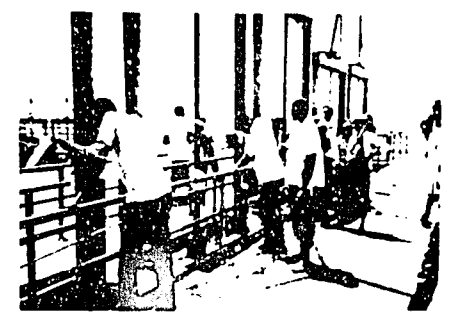
The Union of Maritime Fishing Cooperatives is a fisherman's association and an economic development organization. Currently, the cooperative has 65 fishermen and producers of fish products as members. The traditional fishing sector in Togo has long been dependent on the traditional system of credit -- moneylenders who charge exorbitant rates of interest.

In order to reduce the dependence on moneylenders, UNICOOPEMA has established a credit program for its members. Loans are provided at a rate of interest of eight percent to three target groups: the women who process the fish; the "master" fishermen; and the youths. Seasonal and long term (three-year) loans are made available to qualifying applicants.

SENEGAL

Revolving Loan Fund for Grassroots Initiatives,
Federation of Non-Governmental Organizations of Senegal
$221,760 for two years (1987)

The Federation of Non-Governmental Organizations of Senegal (FONGS) was created in 1976, with an objective of strengthening village development associations in Senegal, and encouraging and promoting village-based development activities. Since its creation, FONGS has grown to include nine Regional Village Development Associations, which represent 7,000 villages in Senegal.


Tom Katus

The Haqabtir Project, Somalia: Interested observers watch project intake for gravity fed irrigation system.

ADF funds have enabled FONGS to establish a revolving loan fund which provides credit to individuals and groups to undertake community-based production projects. FONGS has set aside approximately (US) $205,000 for the loan fund, with loans ranging from (US) $300 to $10,000, depending on whether the borrower is an individual or a village group. Loans are made for a period of two years.

By funding such projects as those described above, ADF has demonstrated to other donors and lending institutions that grassroots groups in Africa represent a solid market base for credit funds. Within these market bases are to be found the African entrepreneurs who will ultimately prove instrumental in helping to generate dynamic, indigenous private sectors throughout the continent. If, through lessons learned from our funding of credit activities, the Foundation can serve as a beacon for other institutions to create their own micro-credit programs with significant grassroots outreach, then the Foundation will be achieving much of what it was established to accomplish in supporting grassroots development.

■ ■ ■

Economic Development Institute Seminar
Report 21

Summary

The World Bank
December, 1989

Both the francophone and anglophone groups, with only minor differences, endorsed the need to promote decentralization, and both fully agreed on the need to enhance the performance of local authorities. In addition, they concluded the following:

- The concept of decentralization, though widely discussed, is interpreted differently and the distinctions between deconcentration, field administration, and the devolution of power must be clarified.
- Decentralization of planning and decision-making from national to regional and local levels is underway (to some extent) in all countries with the aim of improving effectiveness and gaining a broader involvement and commitment from the communities being served (the "bottom-up" approach to decision making, management and accountability). However, the process *must rest on real devolution of power to the local levels*, rather than the more illusory practice inherent in deconcentration or field administration of central government.
- The concept of decentralization presupposes a sharing of political power and responsibilities between levels of government, which, in turn, requires political commitment. At present, the level of commitment varies greatly across the region and is not yet fully developed in many countries.
- Along with sharing power with the local governments, central authorities must provide them with the financial, legal, institutional and managerial resources they need to fulfill their duties. This involves greater freedom to set the rates and types of taxes and fees. It also involves improved capacity to collect revenues. To this end, staff and institutions must be developed. This can be achieved through: (1) training at all levels; (2) identifying and applying incentives to attract and retain experienced and qualified staff; (3) clearly defining responsibilities between levels of government; and (4) coordinating their activities.
- Decentralization, properly applied, has a democratizing effect, as it can be an essential tool for identifying and responding to local priorities, delivering certain services and mobilizing resources.
- The decentralization process in Africa can have a double impact. First, it offers a way to include communities in the decision making process. Second, it is essential for the general rehabilitation of national public finances—and thus, as a means to attain sustainable growth.
- More innovative ways must be developed to build the capabilities of local authorities, emphasizing neglected areas such as training, human resource development and revenue generation. To this end, various forms of follow-up activities should be planned, including additional workshops.
- Local officials must be accountable to both central governments and to the communities they serve. The lack of accountability at the local level is linked, among other reasons, to the inefficiencies that stem from centralized control. Thus, local officials are anxious to work with central government authorities to set policies and monitor performance. With regard to their constituencies, local officials must demonstrate their responsiveness to local needs. Also, in many countries, public confidence has been eroded due to a rather endemic corruption, which can result from the lack of institutional oversights or a system for public review of accounts. Therefore, local officials must identify and eliminate corrupt practices.
- Local officials will need to develop the political will to increase revenues and use them in a manner that will guarantee access by all to at least the basic infrastructure.
- If strengthened, local governments, can play an important role in mitigating the negative effects of structural adjustment on the poor. They are in a better position to recognize the precise impact of various adjustment policies and to allocate scarce resources where they will help the most (and consequently provide the poor with better access to services and infrastructure). And this, in turn, will reduce the burden on the central government.
- To reduce the gap between the supply of and demand for services, local governments should do the following: (1) re-examine the service and design standards using criteria of appropriateness, affordability, equity and sustainability; (2) encourage the involvement of the private sector (including NGOs and their constituent communities) in providing services and infrastructure; and (3) acquire greater autonomy in mobilizing resources.
- The international donor community should be aware of the various countries'

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changing circumstances, revising and adapting policies when necessary. Further, when promoting decentralization, donors should be sensitive to each countries' unique conditions and history—rather than adopting a single approach or model. In the same vein, assistance should be seen as a long-term endeavor, because short-term solutions are unrealistic.

- SSA countries want to develop, as partners with the donor community, appropriate ways to foster decentralization and enhance the capacity of local government.
- Follow-up workshops should be held to assure that the dialogue continues.

Some delegates were concerned that rapid decentralization would be inappropriate for their particular realities, given recent political conflicts and economic strains. All stress that the donor community should not present monolithic approaches nor push decentralization too fast in these cases. This follows the idea that it will take some time for local governments to gear up to fully assume all the functions expected of them.

The local government delegates noted they were encouraged that for the first time, it was apparent that the international donor community, as well as their central governments, recognize the importance of local government. All participants were gratified that opportunities are now available to promote local government. Moreover, it was evident that the delegates found it important to share their experiences, frustrations and approaches. In Chapter III, some of the concepts discussed in the sessions have been translated into recommendations for action.

Comparing the two sessions

It was interesting to note that due to the greater diversity among anglophone countries (with regard to their political-economic-cultural experiences), delegates from these nations formed a more heterogeneous group than their counterparts from the francophone nations. In addition, they seemed more accustomed and willing to test various approaches to administration. Local officials from these countries are also more involved with managing day-to-day operations and are relatively more open to with the communities, the private sector and the NGOs. Officials from the francophone countries form a more homogeneous group, operate from a highly centralized structure, and consequently are more accustomed to negotiating local decisions and pressuring for necessary resources, rather than dealing with alternative structures.

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How Adjustment Programs Can Help the Poor: The World Bank's Experience

World Bank Discussion Paper 71
January, 1990

Abstract

Little is known about the overall impact of adjustment programs on poverty. To a large extent, this is because it is difficult to distinguish the effects of externally induced recession from the effects of the policies and programs designed to offset them. Nevertheless, one clear lesson from experience has been that an orderly adjustment process designed to establish a new equilibrium growth path is indispensable for improving the longer-term position of the poor.

Some adjustment measures can affect the poor adversely. This adverse impact may result from reductions in public expenditures, increases in prices of goods and services consumed by the poor, and declines in employment or real wages in sectors in which they work.

Appropriate social and economic measures can help to reduce the adverse impact on the poor and create opportunities for stronger poverty reduction in the future. The most common way of addressing the adverse impact of adjustment has been the implementation of targeted compensatory programs. Such programs can compensate those affected directly by adjustment (for example laid-off public sector employees) or provide temporary employment or relief to the chronically poor. But these programs have often been too complex and have faced serious shortcomings such as insufficient political commitment, institutional weaknesses, shortages of funding and poorly trained staff. Greater attention should be given in the future to identifying the most appropriate interventions as well as to their design and implementation.

Changes in the design of adjustment programs can promote the longer-run interests of the poor, but have received relatively little attention. Appropriate design changes can help to foster pro-poor growth by, for example, removing biases that favor capital-intensive production or other impediments to employment growth. They can also enable reallocations of public expenditures in ways that support, or improve the efficiency of, programs that help the poor to take advantage of the emerging economic opportunities (by developing skills or providing the necessary complementary infrastructure). Finally, appropriate design changes can help mitigate the possible adverse impact on the poor, for example, by targeting subsidies more effectively. Subsidies that have a large impact on the incomes of the poor (even if only a small proportion of the subsidy reaches them), should not be reduced or eliminated unless alternative means of reaching the poor are introduced.

Does Education Pay in the Labor Market?

World Bank Living Standards Measurement Study
Working Paper No. 67, January, 1990

ABSTRACT

The paper examines how education and postschool vocational training affect the type and extent of labor market participation of women in Peru. It also estimates monetary returns to different levels of schooling, to formal general and technical schooling, and to training. The sample, which comprises more than 5,600 women in urban and rural Peru, was drawn from the Peruvian Living Standard Survey. More than 70 percent of these women were in the labor force at the time of the survey, about 35 percent of them working in paid jobs.

The overall level of female labor force participation in Peru is 72 percent, and this percentage is higher in rural areas than in urban areas. The majority--60 percent--of paid female workers are self-employed, but these jobs tend to be very lowpaying. Women holding jobs in the public sector (either in state corporations or the government) are the best paid.

In general, education and training enhance the contribution of women in the labor market. Although education does not increase the participation of Peruvian women in the labor force (and may in fact decrease it), it alters the occupational distribution of female workers by increasing the proportion of women in paid employment. Among paid employees, education is positively related to hourly earnings; the relationship is nonlinear, with primary education showing higher returns than secondary education. The return to postsecondary education appears low and negative, except for the small fraction of women who have earned a diploma. The poor performance of the Peruvian economy since the early 1970s has influenced this result.

Uncle Sam's Bitter Pill

The dose of free-market reforms that Washington strategists recommend for prostrate South American economies may provoke a political backlash. Still, success stories exist.

BY ROCHELLE L. STANFIELD

"Nothing's easy, Lituma," Lt. Silva, the Peruvian police detective in Mario Vargas Llosa's 1986 mystery novel *Who Killed Polomino Molero?*, tells his young partner. "The truths that seem most truthful, if you look at them from all sides, if you look at them close up, turn out either to be half-truths or lies."

Silva eventually solves the murder but remains baffled by the mysteries of Peru's caste-dominated, power-craving, socially divisive politics and economics. The author might be baffled as well. As he runs for president of Peru in a campaign packed with more bizarre twists and turns than many of his fictional plots, Vargas Llosa might recall this novel and the aptness of that bit of dialogue.

The first apparent truth that turned out to be a lie was Vargas Llosa's "inevitable" clear victory in the April 8 presidential elections. After months as the dominant candidate, with a 60 per cent majority in the polls, he ended up with barely 33 per cent. From out of nowhere had come Alberto Fujimori, who won 30 per cent of the vote on April 8 and has become the favorite in the runoff to be held by June 3.

The April upset in Peru might cast doubt on another seeming truth: that drastic economic reforms are needed to save the chaotic economies of Peru and its neighbors. A reexamination of that truth could prove worrisome to many onlookers, from Vargas Llosa and leaders of other South American countries to the U.S. Treasury and State Department and the multilateral financial institutions.

The United States has a lot at stake in the economic recovery of South America. For the first time in many decades, all South American countries have democratically elected governments, a trend that U.S. foreign policy seeks to preserve. But these democracies are fragile, and their new leaders lack the clout of their predecessors, mainly military dictators. Critics question whether the new leaders can—or should—implement the drastic measures demanded by U.S. and world finance officials sitting in Washington.

The current version of the truth as seen from Washington is that the typical Latin American economy—dominated by state-owned enterprises, huge government bureaucracies, large budget deficits and protectionist trading policies—has failed as decisively as the Communist model in Eastern Europe. The salvation of these countries, the reasoning goes, can be found in a free-market system that employs fiscal discipline at home and open trade and financial policies abroad. Democratically elected governments will be able to install these reforms once the people understand it is in their best interest, according to the wisdom.

To encourage South American leaders to accept these truths, U.S. Treasury Secretary Nicholas F. Brady a year ago offered what is called the Brady plan, under which the U.S. government promises to facilitate debt relief agreements between debtor countries, U.S. commercial banks and the multilateral financial bodies if the countries adopt free-market strategies. Under the plan's terms, commercial banks provide debt relief that is backed by collateral from the World Bank and the International Monetary Fund (IMF). Unlike an earlier plan named for former Treasury Secretary James A. Baker III, the Brady plan does not offer new money to the debtor countries.

John Eisele

Inter-American Development Bank's Juan S. Cariaga
Anti-inflation plans must be comprehensive and coherent.

That the economies in South America are in trouble is not in dispute. During the 1980s, per capita income in Latin America declined by 10-20 per cent, aggregate foreign debt soared to $434 billion and inflation reached quadruple or quintuple digits in many countries. There is a growing consensus across South America for some kind of economic reform.

But many South American voters are rejecting the Washington solution and are making that point clear to their governments. Vargas Llosa's now-faltering campaign was built on a platform of drastic free-market reform; Fujimori was the candidate who promised to introduce changes more slowly.

Institute for Policy Studies fellow John Cavanagh
South Americans accept reforms with a pistol to their heads.

Brady announced his plan in March 1989 in response to riots in Venezuela, where President Carlos Andres Perez, a former populist president who had just returned to power, had imposed free-market reforms. Argentinian President Carlos Saul Menem, who won election last year on a populist ticket, has tried to impose Washington-approved reforms and has encountered such resistance that many specialists fear a military coup in Buenos Aires.

Brazilian economic reformer Fernando Collor de Mello, declared that he had a mandate to impose dramatic austerity measures when he won the presidency in December (by a mere 4 percentage points). So far, he has encountered little opposition to a far-reaching 40-point plan he announced on March 16, but many specialists question how long his honeymoon will last.

As critics see it, the Washington solution ignores the tremendous disparity between rich and poor throughout South America and lacks a social cushion for workers, the poor and the unemployed, whom the reforms hit the hardest. But, Washington policy makers reply, to provide a safety net would dilute the efficiency of the reforms and thus, perhaps, prevent certain countries from participating in debt relief programs such as the Bredy plan.

So far, only Mexico has signed a debt relief agreement under the Brady plan, and critics contend that the $7 billion in debt that Mexico has been forgiven under the pact is inadequate. Costa Rica and Venezuela have concluded preliminary agreements.

"The people here at Treasury from the Secretary on down who have been involved in [the Brady plan] are well aware that this places a burden on the [Latin American] societies," a spokesman for the Treasury Department said. "But it is something that we believe has to be done in order for them to get out of this difficulty."

PISTOLS AND CHILE

The untenable economic situation across South America is pushing the new democratic governments toward reforms regardless of political consequences. The final straw seems to be hyperinflation. Peru and Brazil experienced 2,700 per cent inflation during the past year. In Argentina, inflation has been running at 100 per cent a month, and some reports put it as high as 20,000 per cent during 1989.

"Inflation is something you have to be very careful of, it is so destructive," said Juan S. Cariaga, the executive director for Bolivia, Paraguay and Uruguay at the Inter-American Development Bank (IDB) in Washington who helped stem 24,000 per cent inflation in Bolivia as that country's finance minister in the mid-1980s. "When you reach such a level of inflation, this is a total chaotic and anarchical situation," he said of Bolivia. "Nothing works. It is total disorder."

In the view of some analysts, this crisis marks the end for the old Latin American economic model. "The economic ideology of Latin America has collapsed—not as dramatically and visibly as the Marxist-Leninist ideology of Eastern Europe, which is not the same—but it has collapsed," said Stephen Dachi, a U.S. foreign service officer who served as consul general in Sao Paulo, Brazil, until 1988 and who is currently a visiting fellow at the Center for Strategic and International Studies in Washington. "The central issue now is, can the democratic governments in power solve this economic crisis?"

The so-called official Washington consensus of the U.S. government, the World Bank, the IMF and regional development banks such as the IDB urges these countries to combat hyperinflation through comprehensive reforms: reduce the size of their governments, privatize state-owned industries, deregulate, balance their budgets and open their economies to foreign trade and investment.

"But there's no simple model that can be plugged in, no simple set of rules that [these countries] can sign on the bottom line," warned John Williamson, a senior fellow at the Institute for International Economics in Washington who specializes in Latin American and other Third World debt problems. "It always has to be adapted to the economic and political circumstances of the country in question. I suspect that one of the problems of the past was that the IMF did tend to have too much of a standard approach rather than regarding itself as an ally of the local politicians and technocrats in putting together something which both makes technical sense and fits the local political circumstances."

Critics often don't see the flexibility and tailoring that are in the Washington approach. The South American countries "are going along with this because they have no options," said John Cavanagh, a fellow at the Institute for Policy Studies, a left-leaning think tank in Washington. "They are being told that any rescheduling of their debt and any new money that is desperately needed to repay old money is contingent upon their accepting these reforms. So they are accepting them with a pistol to their heads."

Several countries that instituted reforms on their own over the past 15 years are cited as examples of what can be done. But they may be more illustrative as exceptions than as models for the rest of South America.

The first and most comprehensive reforms were undertaken in the 1970s by Chile under the military dictatorship of Gen. Augusto Pinochet. He trimmed the budget (cutting spending for health and education, not for defense), slashed the

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size of the bureaucracy, ended much government regulation, sold off state enterprises (at bargain rates to the wealthy, it turned out), reduced government subsidies to local industry, reformed the tax system (actually making it more regressive, critics say), liberalized trade policy, welcomed foreign investment, freed up interest rates and devalued the currency.

Taking advantage also of a favorable world price for copper (Chile's major export commodity), these reforms have given Chile one of the only growing South American economies. The drawback is that they were accomplished under a repressive dictatorship.

"For a long time, the adoption of those policies by the Chilean government threatened to give them the kiss of death, partly because of the political odium the Chilean regime had earned by its ruthless seizure of power and by the authoritarian way in which it subsequently governed," Williamson wrote in *The Progress of Policy Reform in Latin America* (Institute for International Economics, 1990).

In a recent interview, he added, "The reforms were so unpopular there in the early years, I think a democratic government would have to go about it a different way."

Now that Chile has inaugurated Patricio Aylwin, its first president to be democratically elected in 20 years, and time has softened the harshness of the Pinochet years, the Chilean approach to economic reform has won greater appeal.

"Today, Washington defines performance in terms of economic efficiency, and its model is Pinochet's Chile," said Jerome I. Levinson, senior special adviser to the IDB president, who explained that his views don't necessarily reflect bank policy and, indeed, are in the minority in official Washington. "If that's the criterion, [the democracies] will inevitably fail, because they cannot do what Pinochet did, which was any time a union leader reared his head, he chopped it off."

BOLIVIA'S BOLDNESS

In 1985, Bolivia accomplished similarly sweeping reforms under democratically elected President Victor Paz Estenssoro. As Williamson describes them in his book, they were "the equivalent of about five [General Agreement on Tariffs and Trade] rounds, six Gramm-Rudmans and more deregulation than had been accomplished by the Carter and Reagan Administrations together, all overnight."

Cariaga was a member of the economic team that planned these reforms. He recalled that Paz was able to act boldly because "there was a consensus that this [hyperinflation] couldn't go on." The program was accepted because it was "credible, comprehensive and coherent," he said. "This is very important. You have to have an idea in mind and act coherently." In Cariaga's view, a lot depended upon Paz's leadership abilities. He was an experienced politician and a trusted leader in Bolivia who imposed the reforms at the beginning of his fourth term.

John Eisele

Institute for International Economics fellow John Williamson
Reforms should be adapted to political circumstances.

"Amazingly, he did get public support," Cariaga said. "Bolivia is a nation known for decades for its political and social unrest. But when these draconian measures took place and were put into effect, nobody was dead on the street."

Bolivia's troubles weren't over. On the heels of the reform program, the world price for tin, Bolivia's chief legal export, hit bottom. Soon after, the world price for natural gas (Bolivia's second most important legal export) dropped, and Argentina stopped payment on its purchases of Bolivian gas.

Nonetheless, as a result of the reform program, Bolivia's inflation dropped to 2.4 per cent by the first six months of last year, the lowest rate in Latin America. The country was able to negotiate a deal to buy back its foreign debt at a bargain price. The tax base was broadened, and taxes were collected. Per capita income, which had declined by 20 per cent from 1980-85, began to inch back up, averaging about a 2.5 per cent increase per year.

Despite this turnaround, Bolivia is cited as a success story far less frequently than Chile is. It is a very small economy—eking out a gross national product in 1986 of $3.7 billion, compared with Chile's $18.4 billion or Argentina's $72.9 billion—and is still very poor and unindustrialized. Critics contend that the poor suffered disproportionately from the austerity measures and that efforts to diversify exports by growing cotton and soybeans are destroying the environment.

In addition, Bolivia did not delve into privatization, one of the favorite goals of official Washington. And its growth rate is meager. Bolivia's gross domestic product actually declined by 0.4 per cent per capita in 1988-89, compared with 12 per cent growth in Chile.

It is this way of measuring performance solely in terms of economic efficiency that raises concerns of critics such as IDB adviser Levinson. Others object to linking economic reform with the type of government that carries it out.

"I don't like to push the theme that you have to be an authoritarian government to make structural changes," said Richard E. Feinberg, executive vice president of the Overseas Development Council in Washington. "A lot [of reform] has been done under very democratic conditions in Britain, Jamaica and Costa Rica, for example. I think what you need is strong, coherent leadership, which you can have in a democracy. You need a chief executive with vision."

STAYING POWER

So far, the new democratic South American leaders, notwithstanding the vision they initially appeared to possess, have shown little staying power.

Democracy returned to Argentina with the election of President Raul Alfonsin and the Radical Civic Union in 1983, and he took office amid great enthusiasm. By 1989, hyperinflation and civil unrest had so shaken his government that he turned power over to his elected successor, the Peronist Menem, several months early. "The biggest victim has been the credibility of a new government," said Shafiqul Islam, a senior fellow in international economics at the Council on Foreign Rela-

tions in New York City. "In the latter part of his regime, Alfonsin could never have fought hyperinflation because he lost credibility. Menem had the credibility in the beginning and now that he has failed, he has been 'Alfonsinized.' "

In Peru, high hopes also accompanied the 1985 election of President Alan Garcia. Maoist guerrilla warfare, strikes and hyperinflation so dogged his heels that by 1988-89, he publicly questioned whether he would live out his term. His party was trounced in the April 8 election.

"Virtually every democratic government [in South America] has ended its term in office weakened," said Peter Hakim, staff director of Inter-American Dialogue, a hemispheric affairs forum in Washington. "Indeed, in every case that there has been an election, the incumbent [party] has lost the election, in some cases by humiliating margins."

The ultimate threat to the new democracies has been the specter of a takeover by military men bent on avoiding economic chaos. But not even the military wants to confront the kinds of problems presented across the continent. "Paradoxically, the economic ruin of South America is helping to keep the democratic governments in power," said Mark Falcoff, a resident scholar at the American Enterprise Institute for Public Policy Research. "The military don't want to take over because they don't have any answers and they know they don't. They [also] know today, as they did not know 20 years ago, that they might not even be recognized by the United States."

As the regional specialists see it, a few of the new leaders might find the vision and political agility to survive the economic crisis. One is Mexican President Carlos Salinas de Gortari. (Mexico is in North America, and its relationship with the United States makes it unique in the hemisphere, but it is often discussed along with South America because its economy is similar in size and scope and because of its Spanish heritage.) But the validity of Salinas's 1988 election remains under a cloud; some critics do not consider him a democratically elected president.

Salinas, who has an economics degree from Harvard University, has implemented a broad set of reforms of the kind official Washington likes. He deregulated, reformed the tax code and opened the economy to foreign trade. He is also in the process of selling off public enterprises, but instead of using the savings to cut the cost of government, he has promised to invest the proceeds in housing, education, health centers and rural roads.

In Brazil, Collor has promised to follow a similar strategy of reinvesting some proceeds from economic reforms in a national social program.

Washington critics such as Levinson hail these strategies as constructive moves that could save Salinas's and Collor's political futures but that are risky in terms of winning Washington approval. "For the first time, they are making the social question an integral part of the strategy rather than a residual," he said. "But what this means is that the claim upon the public-sector resources is going to continue to be high. It is not going to be a declining factor," which is what Washington demands.

Richard A. Bloom

Development Council's Richard E. Feinberg
Authoritarian leaders aren't needed for reforms.

The most important role that the United States can play in preserving the new South American democracies, in the view of some analysts, is to provide those leaders with sufficient breathing space to tackle the economic reforms and meet some of the backlog of social needs.

This could be accomplished within the framework of the Brady plan, although most specialists say the plan needs beefing up. They complain that the debt service required of these countries constitutes a reverse foreign aid program from developing countries to industrialized countries. For Latin America as a whole, these so-called net transfers—the difference between aid and loans flowing into these countries and payments flowing out—amounted to $27.6 billion in 1989 alone, and topped $100 billion over the past four years. "The real issue is the very, very large transfer of resources from Latin America," Feinberg said. "We shouldn't be talking about increasing aid but sucking less money out of these countries."

Islam complained that the plan didn't give Mexico sufficient relief, in part because the collateral for the relief—which is put up by the World Bank and IMF—is too high. Author Williamson suggested that those institutions make more cash available for the purpose. Others predict that if they do so and then come to Congress asking for more money—as the IMF is likely to do next year—Congress will call it a bank bailout and say no.

The commercial banks participate in the Brady plan voluntarily. Hakim said it should be mandatory. Levinson said bank regulations should be rewritten to make it easier for the banks to write off a lot of this debt.

Though debt relief is the main role for the United States, it is not the only avenue for help. By redirecting military aid, for example, the United States could discourage high defense spending.

"The obvious thing for these countries to do is cut back military expenditures, but nobody is pushing them to do that," Cavanagh said. "At the same time, the U.S. military aid program is encouraging them to buy more arms. However, as the internal violence grows [in these countries] because their economies are collapsing, there is a sort of logic to buying more arms to put down your own people. It's a vicious cycle."

In the long run, what would help these countries the most is greater access to U.S. markets, a gift they are unlikely to get despite talk of a U.S. free-trade zone with Mexico. "If one really wanted to say what is the easiest way the United States could help, it would be to reduce trade barriers," Williamson said. "Scrap sugar quotas, increase textile imports or increase steel imports."

In Vargas Llosa's 1986 Peruvian mystery novel, Lt. Silva's murder investigation was delayed because he had no official car and had to wait on a hot highway to flag down a truck. "There wasn't a vehicle of any kind in sight," Vargas Llosa wrote. "The lieutenant shrugged his shoulders in a gesture of resignation: 'We'll have to be patient.' " So, most likely, will his countrymen. □

JOURNAL OF COMMERCE, April 26, 1990

Politics Key to Africa's Future

By MILTON ALLIMADI

The press has been saturated with stories about the fear of African leaders that the West is poised to abandon them in favor of investment opportunities in the emerging democracies in Eastern Europe. Judging by the pronouncements from the World Bank, the International Monetary Fund, the White House and private business circles, these fears may be justified.

This is scary, considering the dismal economic situation prevalent in most African countries. But instead of wasting time appealing to the conscience of the Western countries for help, African leaders should take the initiative and prepare the continent to mitigate the adverse impact when capital dries up.

The first thing African leaders must do is discard myopic agendas in favor of farsighted ones. There are no two ways of doing it: Personalized power must be replaced by democratic and enduring institutions of governance. This begins with the rule of law and constitutions that guarantee free elections, freedom of speech and a fundamental bill of rights.

The constitutions should permit proportional representation in the armed forces in order to ensure against tribal domination, an endemic problem in several countries. The size of standing armies should be reduced. National security can best be provided by well-trained militias that are mobilized only during hostilities, which also would ensure civilian control of the security force.

What does all this have to do with capital movements? A democratic political environment would make African countries hospitable to their greatest resource, human capital.

When people know that they can redress their political grievances by replacing leaders through the ballot at regular intervals, and that they are free to lead their lives without fear of coercion or terror from armies, they will work hard and reinvest their resources. Entrepreneurs and even politicians would begin to invest in Africa instead of funneling resources to foreign bank accounts. Indeed, a healthy political climate would encourage Africans working abroad to remit foreign exchange to their home countries, augmenting domestic capital formation.

Democratic systems of electing leaders within each country will pave the way to cooperation between countries and among groups of countries in Africa. This would open the way for economic cooperation and the attainment of economies of scale through joint projects. Integration would also create viable markets to support the growth of light industries initially and heavy industries eventually.

Recently, the Organization of African Unity unveiled a plan for a common market within a decade. This is a commendable start, but the dynamics of world events require expeditious action if further economic decline is to be averted.

The austerity programs that have been pursued by several African countries have not succeeded, partly because this has not been accompanied by political liberalization. On the contrary, even as the countries formerly under command economies collapse throughout Europe, the political climate continues to be repressive in much of Africa.

The rest of the world is increasingly combining into economic blocs to pool regional resources and ensure market shares. Africa cannot expect the Western countries to solve its problems; they have their own agendas. African leaders should muster the political will necessary to affect the fundamental changes required: More often than not, their own policies have been the major hindrances to the continent's development.

Only a committed African initiative, based on farsightedness, democratic participation and a regional approach, can reverse the horrendous trend. Otherwise, Africa will continue to suffer economic retrogression and its accompanying social malaise.

Africa has no more room for suffering. A political environment that permits democratic participation and the security of life and property is a prerequisite for Africa's economic development.

Milton Allimadi, a native of Uganda, is an economist living in New York.

THE JOURNAL OF COMMERCE, April 26, 1990

A Test of 'Trade Not Aid'

WASHINGTON — It would be an exaggeration to say that Africa has been completely upstaged in recent months by what has been happening in other corners of the globe, notably the Soviet Union and Eastern Europe.

After all, South Africa's first surprising steps toward ending its system of racial apartheid and the

WASHINGTON

Tom Connors

often stormy events that have followed have won their share of headlines and the attention of top U.S. officials.

But by one important measure of official U.S. interest — aid dollars — Africa has been, and will continue, playing second fiddle.

That prospect was underscored by Lawrence Eagleburger, deputy secretary of state, earlier this month. The occasion was a conference, sponsored by the Business Council for International Understanding, that brought American businessmen together here with U.S. ambassadors from roughly four dozen African nations.

Addressing the ambassadors in the audience, the deputy secretary said, "You are all concerned that events in other parts of the world will have an impact on the amount of budget assistance, aid money available to Africa. You are worried that it will be going to Eastern Europe, Central America, other places around the world and I want to tell you that your worries are correct. I wish I could say otherwise but . . . for at least the course of the next year or two, the primary focus is likely to be, at least in terms of our aid efforts, in Eastern Europe and Central America."

His statement came after comments from ambassadors who indicated that while the African business climate generally has improved, the continent still presents American companies with major challenges.

Much of the atmospheric improvement has been fostered by the economic structural adjustment programs required by the international lending institutions, such as the World Bank.

Frances Cook, U.S. ambassador to Cameroon, says those programs have led to a new interest among African nations in attracting foreign investment and particularly investment from countries other than former colonial powers like France. Many countries have revised their investment codes "dramatically" and also have established foreign trade zones.

Ray Ewing, the U.S. ambassador to Ghana, seconds that view but he also raises a "yellow flag" about African interest in such investment. He cites a recent investment seminar in Ghana that conveyed a "somewhat ambivalent message" that he finds typical of many nations on the continent. It amounts, he says, to "we welcome and are glad to have foreign investment, we know that that's important for the future but we don't want the wrong kind."

Mr. Ewing adds, therefore, that anyone coming into Africa for the first time should realize "there are opportunities there but you also have to be cautious and careful how you pursue them."

Ms. Cook maintains that the structural adjustment programs also have helped produce "better economic teams" — ministers of finance, planning and commerce — to handle African nations' negotiations with the international institutions. In the process, she says, those teams "have been getting a heavy dose of free-market economics that many of them, frankly, haven't had a lot of before."

Another byproduct is a greater transparency in government actions that she says should help anybody new to Africa.

Both she and Mr. Ewing think there are have been some good investments for foreigners in the state-owned enterprises that African governments have begun selling off. But Ms. Cook cautions that some of those so-called parastatels are "absolute dogs that you should not touch."

She also warns that "corruption is bad on the continent." Bribery and similar practices reflect the continental custom of tribute and, in the French-speaking countries, "the way the French have always done business in Africa."

William Swing, the U.S. ambassador to South Africa, says that country's economy has been virtually stagnant for a decade and faces a painful process of economic adjustment as well as difficult political change.

He sees a need for a fundamental restructuring of the South African economy away from a system of "Afrikaner statism in which in excess of 30% of gross domestic product is in state hands and about six conglomerates who control roughly 90% of the $900 billion traded on the . . . stock exchange.

"This is not free enterprise in the sense we know it and it doesn't form a particularly promising paradigm for the blacks who are looking for economic models."

Ultimately, Mr. Swing says, South Africa is "going to get through this and get through it well . . . This is an irreversible process and it's going to work and it's going to need the support of the corporate world."

Given Mr. Eagleburger's statement of U.S. aid priorities, that "need" for corporate support for adjustment and development is likely to be poignantly true across Africa in the years immediately ahead.

Tom Connors is Washington bureau chief of The Journal of Commerce.

Financial Times, April 20, 1990

Eastern European reform

Best of both worlds

By Michel Camdessus

The so far peaceful revolution sweeping through eastern Europe raises critical questions. Will all its promise be fulfilled? Will the process of reform be derailed?

Can the people of eastern Europe enjoy the best of both worlds, by reaping the benefits of a market system while retaining some of the apparent security of the planned system? Can reforms be implemented gradually, to reduce the disruption? Most difficult of all: is it possible, after these countries have suffered scarcities for so long, to ask them now to undertake such hard adjustments? No one could pretend to have complete answers to these questions, but experience suggests some pointers:

- Attempts to find a "third way" between central planning and a market economy have not been successful. Partial reforms failed in both Hungary and Poland. Both now accept the need for a more fundamental reshaping of their systems.
- If the aim is fundamental change in the system, it is probably a mistake to take a piecemeal approach. Because all the elements of the economic system are related, it is desirable, if you want a market-oriented system to work effectively, to introduce all the main elements at the outset.

You will want a price system that sends the right signals to producers and consumers, that reflects relative scarcities, and encourages an efficient allocation of resources. Freeing prices also means moving towards a more flexible system of wage determination. With a freer wage system, you need labour market policies that encourage labour mobility. This also implies giving up some of the job security that has been a customary feature in these countries.

With greater scope for market forces, you will have to allow more decentralised decision-making. Enterprise managers have to learn to be fully accountable for their decisions, in a system that permits both the rewards of success - profits - and the consequences of failure - bankruptcy. At the same time, a social safety net is needed. These domestic elements of reform will work best if the system is simultaneously reformed to open the economy to foreign competition and the benefits of fuller participation in the world trading system.

It is probably impossible to introduce these and the other necessary institutional and legal changes overnight, and it is important to design them carefully: but proper decision-making will develop more readily if elements of a market-oriented system are put in place from the beginning.

The economic reforms will only produce good results if they take place in an environment of strong financial discipline at all levels - from governments to individual companies. This means giving up long-held habits such as the tendency to subsidise or protect inefficient or ailing companies. We know all too well from some of the advanced industrial countries how hard it can be to resist pressures for such subsidies - and how costly it is to society if governments fail to stand firm.

The introduction of market reforms in centrally planned economies can unleash pent-up forces that are hard to predict, and that need to be dissipated by appropriate policies. Prices are the most vivid example. Typically the pre-reform price system will contain many prices - for basic food items, housing and fuel, say - that have been kept artificially low for social reasons.

Economic reforms will only produce good results when coupled with strong financial discipline

Low administered prices usually conceal a huge amount of repressed inflation - excess money holdings and shortages of goods that are reflected in long queues, black markets, and cumbersome barter arrangements. When these prices are freed, and market forces start to produce a correct structure of relative prices, there is almost always an initial surge of price increases. This can be a relatively short-term phenomenon but only if financial conditions are kept tight enough to absorb the excess liquidity. If financial policies are loose, then inflation can snowball when price controls are lifted, and a price-wage spiral can quickly get out of hand.

Economic reforms alone are not enough. Reforming countries need financial assistance and investment. They will require considerable help from abroad, and a readiness on the part of the advanced industrial countries in particular to expand their trading and financial links with eastern Europe. The EC countries should continue to openly and generously welcome their eastern neighbours.

The IMF is extending substantial financial assistance to some of the reforming countries, to contribute to a closer integration of their economies into the global trading and financial network, and to act as a catalyst for financing from other sources.

Poland may be a test case for the comprehensive approach to reforms. It started from a situation of economic crisis with $40bn of convertible currency debt, and entered the last quarter of 1989 with an inflation rate of more than 30 per cent a month, falling output, and a widening and unsustainable current account deficit. In this difficult position, the newly elected government has introduced, in very short order, a major economic package.

There are grave risks in the Polish programme, but so far the results are encouraging. We had thought that the first three months would be crucial, particularly as regards inflation - and if inflation had remained out of control, then other elements of the package would have been doomed. But prices have stabilised, after an initial spurt in January, when key prices were freed.

On this basis, we are reasonably confident that the Polish programme will succeed, provided that authorities persevere with their reforms and the external support continues.

The years ahead will be difficult for the countries that are introducing reforms. There is much that the international community, including the IMF, can and should do to ease the transition and welcome these countries into a more complete participation in the world economic system. Everything must be done to help them succeed.

The author is managing director of the International Monetary Fund.

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WALL STREET JOURNAL, May 23, 1990

No More Third World Surliness—Promise

By Stephen Kampimpina Katenta-Apuli

On Monday, two Third World leaders made speeches at the UN that would have seemed unthinkable in the recent past. Bolivia's planning minister, Enrique Garcia, argued for a move from "societies that overemphasize centralism and state paternalism to those where individual initiative becomes the driving force." Yugoslavia's foreign minister, Budimir Loncar, dismissed Third World demands for a New International Economic Order.

The multiple failures of Marxism-Leninism are filling everyone with euphoria about the advance of freedom and democracy these days. But the tightened belts of the Third World countries are turning into nooses that threaten to strangle all but the most repressive governments. It will take a resurgence of growth to save the situation. And growth requires an inflow of capital, not merely debt reduction.

Fortunately, this scenario points to a well-balanced solution. Begin with the fact that the industrialized nations face static horizons and a darkening unemployment picture unless entirely new markets are found. The tendency of the free enterprise system to produce up to and often beyond the limits of effective demand cannot be corrected by perpetually calling on the sated economies to boost their growth rates by another 0.5%.

On the Third World side, there are rapidly growing populations that will turn into engines of violence and instability unless they become gainfully employed using the capital, technological know-how and management of the West.

But wasn't that the great experiment and the great failure of two decades ago? Not really, because the earlier investments in and loans to the Third World were done half-heartedly or imprudently by all parties. Third World countries foolishly confused independence with surliness in those days. They thought the world owed them everything for its earlier misdeeds; and they saw each business overture as a warning of neo-colonialism.

The advanced countries were so caught up in their guilt complexes that they dared not tell Third World countries of their glaring management errors. So the corrective advice that every business partner gets from his investors was denied to the new leaders who needed it most.

Those mental lapses are evaporating. No longer fearful of being dominated, Third World countries are recognizing that equity participants are a far better source of capital and growth than lenders who want their payments promptly and often. And they have learned in a remarkably short time that investors expect hospitality and equal treatment from a host country.

The spectacular successes of such Third World countries as Thailand, Taiwan and South Korea have quieted fears that emerging nations could never make good use of capital. Costa Rica, Colombia, Chile, Kenya, Uganda, Nigeria, the Philippines, Indonesia and at least a dozen other Third World countries could very well surge into similar growth patterns.

What is needed is an invitation to the most promising Third World countries to join in a partnership for growth. The 24 advanced countries of the Organization for Economic Cooperation and Development, working together to launch the necessary infrastructure projects, could—with trifling sums of capital from each one—start a move in the high-growth direction. This is the program that HUD Secretary Jack Kemp, former U.S. Agriculture Secretary John Block, Belgian Foreign Minister Leo Tindemans and 13 other developed country political leaders and experts have recently proposed in Charles Cerami's "An International Roundtable on World Economic Development," (Praeger, 1990). The selected developing nations would accept stringent responsibilities—hospitality to investors, free trade and an acceptance of outside advice in deciding the projects to be undertaken.

North-South partnership must come. When it does, let us hope that there is no minimalism about it. For, as Israeli diplomat Abba Eban has said, "The world's leaders are too often occupied in marking time so vigorously that they give the illusion of moving forward." Small moves would be utterly wasteful in this area. Governments must show enough vitality and consistency to tell private business that this time is for real.

Mr. Katenta-Apuli is the Ugandan ambassador to the U.S.

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TREASURY NEWS
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STATEMENT OF THE HONORABLE
DAVID C. MULFORD
UNDER SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY
UNITED STATES SENATE
APRIL 19, 1990

Mr. Chairman and members of the Committee:

It is a great pleasure to be here today to discuss with you the Department of the Treasury's report on international economic and exchange rate policy. This report and the consultations with Congress on U.S. international economic policy have proven to be highly effective in broadening understanding of the world economy and in advancing U.S. international economic objectives.

I would like to examine two aspects of U.S. international economic policy. First, the economic policy coordination process and our efforts to promote a strong and smoothly functioning world economy. Second, developments in Korea and Taiwan, two economies with an important role to play in the international adjustment process, in view of their sizable external surpluses and growing responsibilities in the world economy.

Economic Policy Coordination

The economic policy coordination process has contributed importantly to the strengthened performance of the world economy over the past years. This process has helped policymakers to better understand the international ramifications of their domestic policies. It has also helped them to put in place the consistent and compatible policies necessary for sustained global growth, low inflation, and reduced external imbalances.

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The G-7's record of success in this regard is quite impressive. The economic expansion is now being sustained into its eighth consecutive year. Inflation has been substantially reduced from the high levels of the late seventies and early eighties. World trade growth has been robust, facilitating external adjustment. Also, I would note Mr. Chairman -- and this is a point which often does not receive adequate attention -- that the major countries have put in place policies to rein in public spending, reform tax regimes, liberalize financial markets, and reduce excessive red-tape and government regulation in general.

1989 represented another solid year of performance for the G-7 economies. Growth, after recording an extremely vibrant increase of 4.4 percent in 1988, eased to a still healthy and strong 3.4 percent in 1989. Though consumer price inflation rose approximately 1 percentage point in 1989, to an average rate of about 4-1/2 percent, much of this increase took place in the first half of the year and was associated in part with special one-time factors.

Recent data indicate that inflation pressures persist for the G-7 countries as a group, although for some countries the recent increases in large measure reflect temporary commodity price developments more than underlying problems. We continue to expect that important factors -- such as moderating demand growth and the unwinding of some of the negative influences that adversely affected the January and February price indices (oil and food) -- will dampen price pressures this year. As these influences move through the markets into consumer prices, the core rate of inflation is expected to return to previous levels. Nevertheless, it is clear that continued vigilance will be required.

External imbalances again declined substantially in the United States and Japan in 1989. In the United States, the current account deficit fell by a further $21 billion to $106 billion, the lowest deficit since 1984, and substantially down from the $144 billion deficit in 1987. Japan's current account surplus declined from roughly $80 billion in 1988 to $57 billion in 1989 and the overall surplus of the European Community has been reduced to nearly zero.

Moreover, the prospects for G-7 performance in 1990 remain quite favorable. Overall growth prospects remain good, with growth in the major countries projected to ease only slightly from the rate recorded in 1989. World trade should continue expanding solidly.

Despite these achievements, I do not wish to seem complacent. Challenges lie before us in the period ahead.

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External imbalances remain large and the adjustment process slowed over the course of 1989. In Europe, significant external imbalances have emerged, with Germany registering a massive current account surplus of $53 billion in 1989, or 4.4 percent of GNP, the largest such ratio in the G-7. Current account trends are difficult to project with certainty, but it would appear that any further improvement in the U.S. current account position in 1990 will at best be very modest, and the possibility of a deterioration in the current account cannot be excluded.

Also, over the past six months, significant changes in the world economy have taken place. These include the changes in Eastern European political and economic life and developments in global financial markets, particularly in Japan. The G-7 Finance Ministers and Central Bank Governors met against this background in Paris on April 7. They reaffirmed their commitment to economic policy coordination as the best means of addressing these developments.

In this context, the Ministers and Governors noted the shared responsibility of surplus and deficit nations in promoting sustained growth, reduced external imbalances, and greater stability of exchange rates. The United States is doing its part. We have achieved significant progress in reducing the U.S. budget deficit. From a peak of 6.3 percent of GNP in FY 1983, the Federal budget deficit was reduced to 2.9 percent in FY 1989 and is projected to decline further to 2.3 percent in FY 1990. Combining Federal, state, and local governments, our deficit in FY 1990 is projected to be around 1 to 1-1/2 percent of GNP. Personal saving is returning to the historical average level in the United States and the Administration has made a number of proposals to improve the national saving rate. The most important step in this process is to continue to reduce the budget deficit.

Developments in Eastern Europe and efforts to achieve market-oriented economies in this region are among the most profound and welcome events in decades. Also, the prospective reunification of the German economies should contribute to improved global growth and to a reduction of external imbalances. This will be a most welcome development, particularly in light of Germany's massive surpluses.

The Japanese yen has depreciated sharply in recent months against the world's major currencies. This is an important matter of concern, and one that may have undesirable consequences for the global adjustment process. The weakness of the yen, and Japanese financial market developments more broadly, must be viewed in the context of the sharp appreciation in Japanese asset values over the past several years. These financial market developments may have been further accentuated by the lack of a deep and liquid money market for yen-denominated instruments. We will continue to address these issues in our yen/dollar talks which take place again in late May.

On balance, the underlying fundamentals of the Japanese economy remain sound. Nonetheless, the depreciation of the yen and Japan's relatively closed markets are not sustainable over time as their continuation would pose important risks for the world economy. We will be keeping these developments under close review and we will continue to cooperate with other G-7 countries on exchange markets.

Asian Newly Industrialized Countries

Other economies have an obligation to assume a greater responsibility for contributing to the reduction of the world's external imbalances and promoting a sound and growing world economy. In particular, the newly industrialized economies of Asia are playing an increasingly important role in the world economy. Some of these economies have sizable external surpluses.

The Omnibus Trade and Competitiveness Act of 1988 recognized that undervalued currencies can be unfairly exploited to build up sizable external surpluses. The Treasury Department concluded in its October 1988 report on International Economic and Exchange Rate Policy that Korea and Taiwan "manipulated" their exchange rates within the meaning of the legislation. Following this report, we initiated bilateral negotiations with Korea and Taiwan, aimed at assuring that their exchange rate and other policies contributed to the adjustment of global imbalances. In October 1989, we concluded that there were no clear indications at that time that Taiwan was "manipulating" its currency for competitive advantage within the meaning of the legislation, given the introduction of its new exchange rate system and certain other factors. Regarding Korea, however, the Treasury determined there were indications of continued manipulation.

We have achieved progress in our bilateral negotiations and discussions with Korea and Taiwan. Both Korea and Taiwan have instituted more market-based systems for determining the exchange rate. Korea's external surplus has sharply declined and Taiwan's gives evidence of moving in the right direction. We still have concerns, however, which I will discuss in the remainder of my testimony.

Since the October 1988 report, the New Taiwan dollar has strengthened by 10 percent against the U.S. dollar, more than that of any major trading partner. Between May 1989 and early March of this year, the exchange rate fluctuated narrowly against the U.S. dollar. Subsequently it depreciated by 1 percent, before strengthening slightly. The depreciation was the result of short-term speculation and capital outflow in response to political uncertainties. The Central Bank resisted the depreciation, recognizing that it did not reflect Taiwan's strong economic fundamentals and would fuel inflation.

In absolute terms, Taiwan's global current account surplus rose by 9.5 percent last year to $11.2 billion. The U.S. trade deficit with Taiwan also increased by 3 percent in 1989 to $13 billion. If, however, one-time extraordinary purchases of gold from the United States by Taiwan's Central Bank in 1988 are excluded, the Taiwanese current account surplus and the U.S. bilateral trade imbalance with Taiwan fell by 15 percent and 14 percent, respectively, last year.

Following our bilateral negotiations last year, Taiwan instituted a new and liberalized exchange rate system in April 1989. Most foreign exchange transactions under the system are now freely determined and the authorities' ability to manipulate the rate has been greatly reduced. Since the October 1989 report, Taiwan has taken further steps to liberalize the system, although remaining capital and foreign exchange restrictions continue to limit supply and demand in the exchange market.

In light of these developments, we remain of the view that there are no clear indications that Taiwan is "manipulating" the exchange rate for competitive advantage. Taiwan's large external surpluses, however, remain unsustainably high. The Taiwanese authorities need to recognize the need for the further reduction of the surpluses and the continued importance of the exchange rate and of the liberalization of remaining capital and exchange controls in advancing this adjustment process. We will continue to monitor the situation closely.

Since the release of the October 1988 report, the Korean won has appreciated by only 1/2 percent in nominal terms against the U.S. dollar. From the won's strongest point, shortly following the April 1989 report, it has depreciated by about 6 percent in nominal terms against the dollar. Since the October report, however, the won has appreciated 25 percent against the yen, including 13 percent since April 1989. Thus, on a trade-weighted basis, the won has appreciated an estimated 7 percent since the October 1988 report.

Following the introduction of a new exchange rate system on March 2, the won has depreciated by 1.8 percent against the dollar, but has appreciated over 3 percent against the yen. These developments largely reflect Korea's trade and current account deficits in the first two months of this year, and capital outflows prompted by the possible introduction of a "real name" financial system (which has now been indefinitely postponed).

Korea made considerable progress last year in reducing its external surpluses. The current account surplus fell 64 percent to $5.1 billion compared to the same period last year. This is equal to 2.5 percent of GNP, following a 8.4 percent ratio in 1988. Also, our bilateral trade deficit with Korea declined by 30 percent to $6.3 billion. On a quarterly basis, our bilateral trade deficit with Korea has shown no significant growth since the beginning of 1988. These declines continued in January-February of this year and the prospects are for somewhat lower imbalances this year than last.

These welcome declines reflect a number of factors. The won's past currency appreciation, both against the dollar and non-dollar currencies, is a principal cause. Large wage increases in 1988-89 exceeding productivity gains are another important factor, contributing both to higher export prices and to higher import demand. Korea's on-going trade liberalization program also facilitated import growth. Severe labor-management disputes also played an important role in restraining Korea's export growth last year.

Korea's introduction of a new "market average rate" system of exchange rate determination in March is an important development. Under this system, the won/dollar exchange rate at the beginning of each business day is set equal to the weighted average interbank rate on the previous day's transactions. This system's success, however, will depend on how it is implemented. The liberalization of pervasive foreign exchange and capital controls is especially necessary to allow market forces to play a greater role.

Also of significance, the Treasury and Korea's Ministry of Finance initiated Financial Policy Talks in late February. We hope to make progress in these talks on problems facing U.S. banks and securities firms in gaining access to the Korean market. The initial round of these talks produced some indications of flexibility in some areas, but follow-up actions have yet to be taken and much more remains to be done in subsequent meetings.

Since introduction of the new exchange rate system, there is a lack of evidence of continued direct government "manipulation" of the exchange rate, within the meaning of the legislation, particularly in view of the developments in the Korean external accounts. We nonetheless remain concerned about the won's nominal depreciation against the dollar. The recent policy measures which aim to increase exports add to our concerns as they could delay the adjustment process. We will, therefore, continue to monitor Korea's trade and exchange rate developments carefully and press for further liberalization of the financial, capital, and exchange markets in the Financial Policy Talks.

Conclusion

The United States is committed to cooperating with its major trading partners to promote the sound world economy and stable financial system on which all countries' prosperity rests. The success of this effort will also require that the Executive Branch and the Congress work closely to deal with difficult domestic issues. Our dialogue on the international aspects of U.S. economic and exchange rate policies is an important element in this effort.

Thank you, Mr. Chairman.

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From Cold War to Trade War?

By C. Fred Bergsten

Three global transformations of historic dimension are well underway as we enter the 1990s. First, the reforms in the Soviet Union and Eastern Europe, if carried through successfully, will end the Cold War and East-West confrontation. Substantial reductions in military arsenals will ensue. Second, the salience of security issues will decline sharply. Economics will move much closer to the top of the global agenda. The international position of individual countries will derive increasingly from their economic prowess rather than their military capability. The status of Japan and a uniting Europe will rise relative to the United States and, especially, the Soviet Union. Third, the world economy will complete its evolution from the America-dominated regime of the first postwar generation to tripolarity. An economically united Europe, led by a unified Germany, will be the world's largest market and largest trader. Japan is already the world's largest creditor and leader in many key technologies.

International relations will look very different by 2000 as a result of these transformations. Economics will play a central role in world affairs. There will be three roughly equal economic superpowers. The hierarchy of nations will shift to a considerable degree. The US is the only superpower in both military and economic terms. It alone will remain in the top rank as the nature of world affairs changes. But the US is also the power in relative economic decline. It is caught in a scissors movement between increasing dependence on external economic (especially financial) forces and declining capacity to influence those forces. America may soon be the only military superpower, but such status will be of much less utility in a peaceful world where international competition is largely economic.

The American body politic and its political leadership do not yet fully understand the overwhelming importance, in both economic and political terms, of restoring America's ability to compete effectively in the world economy; or of altering the nature of its leadership in the new milieu. Continued erosion of America's economic position vis-à-vis both Europe and Asia would further reduce the standard of living. It could also produce a nationalist upsurge triggering new trade controls, restrictions on foreign investment and a generalized withdrawal from international economic cooperation. Such economic conflict could jeopardize overall alliance relationships and even the prospects for lasting peace. America's world role, as well as its economic prosperity, can be preserved only through the

creation of effective new international economic arrangements. The US recognized this imperative at the end of the Second World War and, in very different circumstances, took the lead in devising such arrangements. A strategy to replicate that enormous achievement, working cooperatively with Europe and Japan in the new tripolar world, should rank at the top of the national agenda in the post-Cold War era of the 1990s and beyond.

The Risk of Conflict

A central question for the 1990s is whether the new structure of international relations will produce conflict over economic issues or healthy competition and cooperation. History suggests that there is considerable risk of conflict, even spilling over from the economic sphere into new political rivalries. The US-Japan economic problem, in particular, could escalate in this direction (with Europe siding with America). If Europe were to turn significantly inward as it coalesces economically and politically, the US could find itself fighting a two-front economic war.

A breakdown of economic cooperation among the industrial countries would inevitably pervade their political and security relationships. In the short run, this could undermine the allied unity that is essential to seize the opportunities for lasting peace offered by Gorbachev and the reforms in Eastern Europe. In the long run, it could produce new global divisions that would be profoundly destabilizing. Today's economic competitors enter the new era, however, as political allies with strong security ties and democratic governments. Their cooperation over the past four decades has largely avoided major crises and has proven superior to all historical antecedents. A central issue in reordering international relations is how to anchor Germany to the West. The value of NATO, despite frantic efforts to adapt it to the new geopolitics, will inevitably decline and thus offer limited help.

The end of the Cold War could heighten the prospect of trade war because of the sharp decline of the overriding security imperative that has blunted trans-Atlantic and trans-Pacific economic disputes throughout the postwar period. The US and its allies, particularly West Germany, have made economic concessions at crucial junctures to avoid jeopardizing global security structures. Removal of the security blanket could thus make it considerably harder to achieve the needed economic cooperation. Such cooperation will depend on the achievement of joint leadership by the Big Three economic superpowers, just as nuclear deterrence was maintained by the Big Two military superpowers. Unfortunately, the world economy has never experienced successful "management by committee." The construction and subsequent maintenance of a stable regime in such circumstances is a daunting task. The ultimate paradox of the 20th century would be a realization of the Marxist prophecy of inevitable conflict among the capitalist nations just as the political conflict spurred by Marxist ideology was waning. The "end of history" might not be so dull after all.

The US is clearly in relative economic decline. The value of its bargaining assets is likely to fall further in the years ahead.

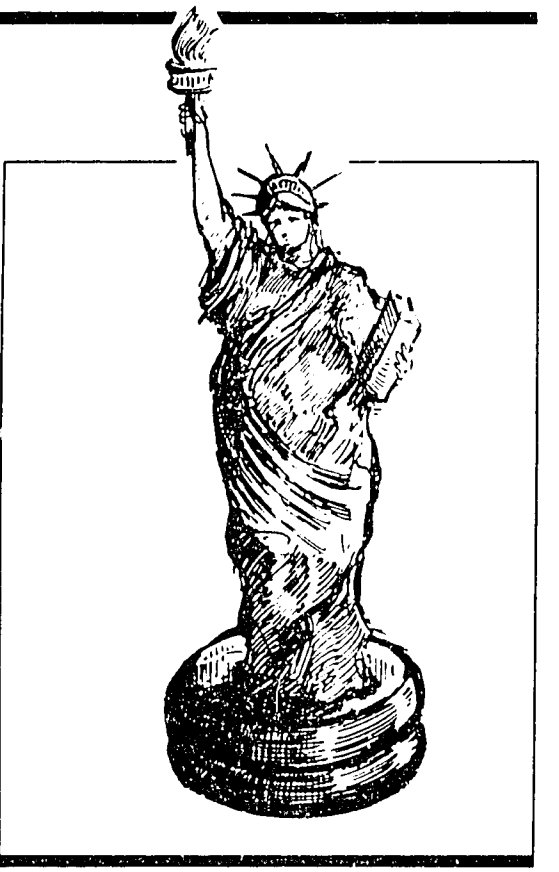
The Case for Economic Reform

The history of international economic policy reveals that large-scale initiatives are required to accommodate changes in underlying power relationships, and to resolve thorny individual issues by subsuming them in a broader political framework. Moreover, far-reaching political and strategic considerations underlie most major economic advances. The Kennedy Round was the global response of the 1960s to the creation of the Common Market, and to

budding US protectionism. The shift to flexible exchange rates and the Tokyo Round were the strategic counter of the 1970s to America's first postwar trade deficits and to Japan's new global power. The Plaza Agreement sought to derail the trade pressures which derived from the soaring dollar and American deficits in the mid-1980s.

Under fairly consistent American leadership, these initiatives succeeded impressively through the first postwar generation. But the postwar regime was eroding by the early 1970s. American hegemony declined. Unintegrated Europe and reticent Japan could not fill much of the void. The institutions began to lose credibility and even relevance. Largely as a result, currency misalignments and instability have become endemic. Huge trade imbalances persist. Protectionism and neo-mercantilism intensify. Third World debt remains unresolved. Policy cooperation is ad hoc and fragile. The system no longer provides strong defenses against international economic conflict. To restore such defenses, a uniting Europe and Japan must join America to provide collective leadership. The Big Three need to start acting as an informal steering committee for the world economy, creating new institutional structures and initiating concrete steps to utilize them.

Such international leadership must rest on firm internal foundations. Europe can only be a full partner after it achieves Economic and Monetary Union (EMU) as well as "completion of the internal market." The US can play a constructive role only with restoration of its international competitiveness through several years of convincing reduction in the budget and trade deficits along with firm evidence of corporate renewal. Japan must internationalize further through fostering additional penetration of imports of both manufactured products (including high technology) and agricultural goods, a conspicuous expansion in the presence of foreign direct investors, and additional reductions in its current account surplus. Absent such developments, each area will



lack the internal self-confidence and/or the international respect needed for global leadership. These crucial internal changes in each of the Big Three can be promoted by the adoption of international policy commitments and specific steps suggested here. Such global commitments would underline the need for domestic reforms and outward orientation and strengthen those groups within each that support such a focus.

A Blueprint for Houston

Political leaders of the Big Three first must recognize publicly the three historical transformations and declare their intention to construct and maintain a stable international economic order based on shared leadership and mutual responsibility. Such a commitment should be enunciated at the Houston summit in July, the first of the 1990s, to set the essential political framework and begin to define the needed initiatives. The commitment would be credible only if it encompassed effective follow-through to translate principle into prac-

tice. Several major areas must be addressed: monetary arrangements including economic policy cooperation, trade, the entry of Eastern Europe including the Soviet Union into the world economy and its institutions, the environment, energy, and the needs of the Third World. The summiteers at Houston should take at least initial steps on money and trade, the most essential components of the package.

The Big Three should start the process by convening an *international monetary conference* to launch construction of a new regime to replace the Bretton Woods system that collapsed in 1971–73. No system worthy of the name has existed since that time, with enormous costs for the world economy. The major countries have been groping toward a new monetary order since the Plaza Agreement of 1985. They have been following a two-track approach: the "reference ranges" for currencies adopted in the Louvre Accord of early 1987, and the "economic indicators" adopted at the Tokyo summit in 1986 to guide coordination of national economic policies. But the imbalances, still far too large, may soon rise again. Little is left of the reference ranges. No policy coordination is visible.

The European dimension is again crucial. The EC has agreed to launch a negotiation by the end of 1990 to create EMU. A successful outcome is highly desirable, both for the prosperity of Europe itself and to enable Europe to become a full partner in steering the world economy. As with trade, however, there is a risk that Europe's regional arrangements will run counter to the interests of other countries. As with trade, the most effective way to ensure reconciliation is to engage Europe simultaneously in negotiation to improve the global system. The preferred course is to build in evolutionary fashion on the reference ranges, the Tokyo indicators and the European Monetary System (EMS) itself. The key countries would agree to set zones for their currencies which, given reasonable consistency of domestic policies, would avoid large current account imbalances (and thus limit both financial risks and protectionist pressures). The zones would be shifted in response to differences in national inflation rates and to major changes in the world economic environment, such as large jumps in oil prices. But the countries would otherwise pledge to adopt new policies as needed to preserve them. Other policy instruments would be adjusted if necessary to achieve internal economic goals. Surplus and deficit countries would share responsibility for initiating adjustment measures, with the mix determined by the needs of the world economy as a whole. The International Monetary Fund would play the critical "honest broker" role in providing forecasts, analyses and policy recommendations to guide implementation of the system.

It would be essential to reach agreement on the broad outlines of such a new regime prior to convening the launch conference, to make sure that the meeting itself conveyed a clear sense of harmony and common purpose. The Houston summiteers could direct their finance ministers to provide such a blueprint by the end of the year, and set a date for the conference itself in 1991.

The ultimate paradox of the 20th century would be a realization of the Marxist prophecy of inevitable conflict among capitalist nations just as Marxist ideology was waning. The "end of history" may not be so dull after all.

Inevitably, the details will take time to develop. But the global negotiation should proceed in parallel with European regional integration in any event. Moreover, the new regime

should be implemented only when actions have been taken that promise subsequent correction of today's huge imbalances. The summiteers and their monetary officials, in addition to launching the systemic reforms, should also work out national commitments for decisive fiscal adjustment in the US, for structural liberalization in Japan and Europe, and for further changes in exchange rate relationships among the Big Three. On trade, the immediate key is a successful Uruguay Round that would convincingly resume market liberalization and refurbish the credibility of the General Agreement on Tariffs and Trade (GATT). Realization of the Round's full agenda would move significantly in these directions by expanding international agreements on agriculture and safeguard measures, broadening the rules to encompass services and intellectual property rights, reintegrating textile trade into the GATT, and improving the dispute settlement process. A strong push from the Houston summit is essential to achieve these results, just as the summits of the late 1970s were decisive in pushing the Tokyo Round to a successful conclusion.

Much more is needed, however, to make a quantum leap in the effectiveness of global trade arrangements. The Big Three should thus agree at Houston to push for the implementation of four sweeping new goals no later than 2000 (except perhaps by the poorest countries): elimination of all tariffs on industrial trade, a complete ban on quantitative trade barriers including "voluntary export restraint agreements," a sharp expansion in the mandate given the GATT to police the system, and creation of a "GATT for Investment" to provide a stable framework for international corporate activities (and help resist protectionist pressures in this area). World trade and investment would become essentially free of governmental impediments at the dawn of the 21st century, within a much more effective institutional framework. These proposals should be taken up promptly after the scheduled conclusion of the Uruguay Round at the end of 1990. This would enable the liberalization process to continue moving forward, avoiding the post-negotiation malaise which permitted substantial protectionist pressures to flourish after the conclusion of both the Kennedy and Tokyo Rounds. It would also help ensure the outward orientation of the EC by maintaining its engagement in multilateral trade bargaining through to the culmination of its new regional compact.

The Big Three need to start acting as an informal steering committee for the world economy.

From an American standpoint, there are important strategic reasons to launch these efforts soon. The US still retains enormous economic power, particularly through its huge market (for both goods and investments) and the dollar. America's security pre-eminence remains vital through the East-West transition period. The US has much closer relations with both Europe and Japan than they have with each other, enhancing its ability to lead the way to a new world order. But the US is clearly in relative economic decline. The value of its bargaining assets is likely to fall further in the years ahead. It thus behooves the US to move sooner rather than later to promote construction of a new system that will promote both global economic and political stability and its own national interests. It would be an affirmation of continued US readiness to assert international leadership—albeit of an altered nature—in the post-Cold War era of the 1990s.

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The United States and the World Economy
Alvin Paul Drischler, Editor
Johns Hopkins Foreign Policy Institute
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Preface

When historians look back upon the 1980s, they are likely to be as impressed by the transformation of the position of the United States in the world economy as by the dissolution of what used to be called the Soviet bloc. The precipitous development of enormous U.S. fiscal and trade deficits throughout the decade together with the rise of East Asia and the coalescing of the European Community have created a multipolar international environment that stands in striking contrast to the conditions prevailing after World War II when the United States emerged as an unchallenged economic hegemon. These events have also generated increasingly insistent demands that government devote more of its resources to protecting the nation's future economic welfare. All told, they raise new questions at home and abroad about the United States' capacity and willingness to sustain its economic leadership.

How will America's relative decline from unchallenged economic hegemon after World War II to one among equals in today's highly competitive international environment affect public attitudes at home and relations with our allies overseas? How can America's alliance commitments be supported in the face of growing budgetary pressures and our now prosperous allies' reluctance to assume a larger share of the burden of "the common defense"? What, if anything, should the government do to preserve and enhance the nation's industrial vitality? And how will the United States' preoccupation with its economic future affect the ability of developing countries to cope with the demands and pressures of a less forgiving world political economy?

To examine these questions and some of the answers that have been given to them, The Johns Hopkins Foreign Policy Institute (FPI) of the Paul H. Nitze School of Advanced International Studies (SAIS), during the academic year 1988-89, conducted a series of meetings devoted to examining the impact of the changes in the international economy on the United States' role in the world. On three occasions, experts and policy makers familiar with different aspects of U.S. foreign economic policy were invited to share their views with other representatives of the foreign policy community and the media. The papers that were commissioned to provide a starting point for these discussions have been revised by the authors and are now published by the FPI in the belief that the views expressed in those meetings deserve a wider hearing.

As was to be expected, no consensus on the necessary prescriptions for America's economic dilemmas emerged either in the papers that were presented or in the debates that they served to provoke at the FPI. Yet some fundamental points were held in common. Thus there was general agreement that America's relative decline is less a reflection of the deterioration of the nation's inherent economic strength than it is of the progress of our leading allies. By any standard, it was agreed, the United States is today far richer and economically much more powerful than it was in the late 1940s when unique and ephemeral circumstances made this nation the world's preponderant economic power.

By the same token, the emergence of powerful competitors in an open international economy and the dilution of American economic dominance in an expanded world output were commonly recognized to be the natural and desirable results of America's postwar foreign economic policies. Far from representing a measure of American failure, the emergence of vibrant, ambitious economic powers in the western half of Europe and the Pacific rimlands of Asia underscores the great success of America's postwar vision. The rise of East Asia in particular, as former deputy defense secretary William H. Taft IV observed, represents the achievement of a long-standing U.S. strategic objective: the

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consolidation of a number of wealthy, politically stable, and increasingly open and democratic states in a region not long ago marked by poverty, dictatorship and war.

Finally, the participants in these discussions shared an appreciation of the possibility that the new international economic circumstances also create opportunities for redistributing the burdens of safeguarding western and international security. With or without fundamental and permanent change in the Soviet Union, Eastern Europe and elsewhere in the communist world, the development of new sources of economic strength has combined with the political and social recovery of World War II's defeated powers to create conditions in which the United States may approach other states as partners in and contributors to (rather than mere beneficiaries of) the effort to preserve an open international system.

By the same token, however, as the contributors to this volume make clear, the new international economic conditions also create important challenges to U.S. policy makers. Thus Secretary of Commerce Robert Mosbacher does not hesitate in his contribution to this volume to flaunt the many achievements of the U.S. economy in recent years—including eight years of continuous economic growth, the longest peacetime expansion in the nation's history, the creation of twenty million new jobs, the halving of the national unemployment rate, and the sharp drop in inflation after 1982. Yet Mr. Mosbacher also pointed to the need to take specific policy actions to safeguard the economic foundations of U.S. national security and to enhance the nation's ability to compete in the global marketplace. It was over the specific prescriptions to achieve these goals that Mr. Mosbacher and his colleagues disagreed.

As a fundamental policy premise, Mr. Mosbacher reiterates in his contribution to this volume the longstanding commitment of the U.S. government to the multilateral trading system and to the expansion of world trade through the current Uruguay round of negotiations in the General Agreement on Tariffs and Trade (GATT). But he also asserts that the United States must be prepared to deny access to its market as leverage to pry open those of its trading partners. And he asserts that the U.S. must express itself vigorously on specific trade-related issues, such as rules-of-origin and local-content requirements pending before the European Community, as well as other potentially trade-restricting regulations pertaining to standards, testing, and certification.

At home, Secretary Mosbacher warns, there is a pressing need to lower the cost of capital to American firms. Accordingly, he recommended reducing the fiscal deficit of the federal government. In this, of course, he is not alone; vigorous action to reduce budget deficits is perhaps the single policy recommendation endorsed by all participants. Mr. Mosbacher also supports increasing the size of the domestic savings pool available for investment by cutting the long-term capital gains tax rate. He suggests that long-term investment in high technology industries be stimulated through such tax law changes as making permanent the current tax credits for research and development. In addition, he endorses a relaxation of antitrust laws to enable U.S. firms to work together more closely to compete with larger international rivals.

In a separate contribution, William H. Gray III (D-PA), the majority whip of the U.S. House of Representatives, addresses the issue of defense burden sharing. The basic security structures of the West—NATO and the bilateral security treaty between the United States and Japan--should not be abandoned, Mr. Gray is careful to stress. Yet the time has come, he declares, for our allies in both Asia and Europe to assume a greater share of the costs of the common defense. Far from calling for a withdrawal from the far East and West, he argues that updating existing security structures by redistributing defense costs is the most effective way of ensuring the continued viability of our international commitments in this dramatically turbulent new age.

Having chaired the House Budget Committee, Mr. Gray is in a position to judge whether the United States has the resources to do what is necessary to provide for our national security, and his remarks on this point are telling. The Reagan and Bush administrations' refusal to raise taxes to support our defense expenditures, he notes, and Congress' reluctance to reduce domestic expenditures have resulted in a political and fiscal impasse. And the demands for greater defense burden sharing by our allies now emanating from Capitol Hill, are directly attributable to this domestic fiscal squeeze.

The public, Mr. Gray observes, is keenly

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aware that the Europeans and the Japanese are relatively richer while we are relatively poorer than when the burdens of common defense were first allocated. Therefore, as long as the Bush administration refuses to raise revenue and the fiscal deficit remains large, he warns, there is no way that Congress is going to gut social programs for poor Americans to pay for the defense of rich Europeans and Japanese. Mr. Gray's remarks, it should be noted, were first made at the FPI in December of 1988. Since then the pace of world change has accelerated, and the prospect for a constructive transformation of East-West relations has improved dramatically. The events of the past year have not, however, altered Mr. Gray's fundamental views concerning the U.S. fiscal squeeze and the need for our allies in both Europe and Asia to contribute more to the common defense.

The changes in the international political economy have produced not only increasingly urgent demands for new thinking in U.S. foreign policy, but have also reinforced calls for a reconsideration of basic economic policies. Should the U.S. government, in the face of new international economic realities, now begin to consider playing a more active role in stimulating and supporting private investment? On this issue, we were particularly fortunate to have received the views of Murray Weidenbaum, a former chairman of the Council of Economic Advisors, now of Washington University in St. Louis.

Dr. Weidenbaum argues that the high cost of capital in this country imposes a crippling burden on U.S. business and that, therefore, action must be taken to reduce the federal budget deficit. Beyond this, however, he stresses macroeconomic rather than microeconomic approaches to the competitiveness issue. In his view, taxpayer financed assistance to firms in strategic sectors, whether called "federal bailouts" or "business-government partnerships," is generally wasteful and, at best, serves only to shift investment from areas favored by private business to those supported by government planners.

The track record of governments attempting to pick and choose among alternative investment opportunities, Weidenbaum argues, has not been good either in this country or abroad. Older established firms tend to know better how to seek and obtain government resources than newer more innovative companies, and thus taxpayer assistance is directed to the firms least able to utilize it efficiently.

In a final contribution, former Bolivian finance minister Juan Cariaga focuses on the problem of debt-related hyperinflation in Latin America, a serious danger to social and economic stability in Latin America that the United States and the rest of the international community have largely failed to recognize or respond to. Specifically, Mr. Cariaga urges that the United States firmly support structural and sectoral-adjustment programs designed by the international financial institutions to restore economic equilibrium in the developing countries; that it deploy its food aid rapidly and directly to bolster those countries undergoing the pains of adjustment; and that it direct its development assistance programs to focus on alleviating the extreme poverty that so encourages the profitable production of illicit drugs.

Along with the long-festering and largely unresolved Third World debt problem, hyperinflation poses an acute danger to social and political stability throughout Latin America. Mr. Cariaga draws a number of useful political and economic lessons from Bolivia's highly successful macro-economic stabilization plan. Privatization, rigid fiscal discipline, tax restructuring, and a reorientation of monetary and exchange rate policies were all combined to transform one of the poorest countries on the continent into a model of successful reform that is now being showcased by the international financial institutions to other developing nations.

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IMPLICATIONS OF CORPORATE INDEBTEDNESS FOR MONETARY POLICY

ABSTRACT

The extraordinary increase in reliance on debt by U.S. business in the 1980s has generated widespread concern that overextended borrowers may become unable to meet their obligations and that proliferating defaults could then lead to some kind of rupture of the financial system, with ensuing consequences for the nonfinancial economy as well. The thesis advanced in this paper, however, is that the more likely threat posed by a continuing rapid rise of corporate indebtedness is instead a return to rapid price inflation. In particular, a review of recent developments lead to four specific conclusions:

First, problems of debt service within the private sector are more likely to arise among business borrowers, not households. Because businesses, and especially corporations, have used much of the proceeds of their borrowing merely to pay down their own or other firms' equity, their interest payments have risen to postwar record levels compared to either their earnings or their cash flows.

Second, despite these high debt service burdens, debt default on a scale large enough to threaten the financial system as a whole is unlikely in the absence of a general economic downturn. But the sharp increase in indebtedness has made U.S. businesses crucially dependent on continued strong earnings growth.

Third the consequent need to prevent a serious recession -- so as to preclude the possibility of a systemic debt default -- will increasingly constrain the Federal Reserve System's conduct of monetary policy. The Federal Reserve's reluctance to risk a situation of spreading business (and LDC) debt defaults, especially with the U.S. commercial banking system in its current exposed position, will increasingly prevent it from either acquiescing in a recession or bringing one about on its own initiative.

Fourth, over time this constraint will severely limit the ability of monetary policy to contain or reduce price inflation. Episodes of disi in the United States since World War II have invariably involved busi recessions, including declines in business earnings and increases in bankruptcies and defaults. If the economy's financial system has beco fragile to withstand any but the shortest and shallowest recession, it is unlikely to be able to support a genuine attack on inflation by monetary policy.

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Mixed Diagnosis From the IMF

WASHINGTON — Jacob Frenkel, the International Monetary Fund's research chief, recounted a "good news, bad news" story last week, as a preface to his agency's latest world economic checkup.

A doctor, said Mr. Frenkel, told his patient that the "good news" was that he had five days to live.

"What's the bad news?" asked the impatient patient. Replied the doc: "I forgot to tell you that four days ago."

TRADE SCENE

Richard Lawrence

The anecdote, it turned out, had little to do with the world economic outlook, as perceived by the IMF's economists.

World economic growth this year will moderate, but it will pick up next year to about 3% as inflation declines, according to the IMF consensus. World trade volume won't grow as fast as in recent years, but will still average more than 6%-a-year growth in 1990-91, Mr. Frenkel's economists estimate.

Hardly any really bad news there. Add to that IMF optimism about the benefits to flow from Germany's unification, the apparent confidence in Japan's continued economic robustness and a sense by IMF staffers that the four Far Eastern tigers — Taiwan, South Korea, Hong Kong and Singapore — are past their days of super trade surpluses.

But perhaps most surprising is the IMF staff's Latin American scenario. It projects an economic surge next year — as much as 4.2% growth for the region, with inflation plummeting from an average of more than 500% last year to less than 30%.

All this is possible, say IMF futurologists, if Argentina, Brazil and Peru carry through the right economic reforms.

Not so big an "if" accompanies the prognosis for German unification, which IMFers apparently believe can bring nothing but economic good. With unification, it says, will come a German investment boom and surging consumer demand, and thereby more sales opportunities for the world at large.

Those sales, say IMF economists, will help offset any rise in world interest rates fueled by unification economics. All West Germany has to do, they say, is manage its fiscal and monetary policies with prudence.

And who knows financial prudence better than the Germans?

As an extra bonus, the IMF economists suggest, West Germany's excessive international payments and trade surpluses finally may start tumbling down.

Like just about everyone these days, the IMF is fascinated by Eastern Europe. The region, it forecasts, is in for further recession this year, but as early as next year it could rebound, however modestly, as reforms take hold.

Nobody seems more hopeful about economic reform in Eastern Europe than Michel Camdessus, the IMF's managing director.

Poland, which has adopted IMF-style "shock" economics, is already showing results, he says. He cites rising foreign reserves, sharply lower inflation, a budget surplus, a stable zloty and a much improved Polish international payments balance.

And hadn't Poland been seen as Eastern Europe's basket case?

If there's clearly "bad news" in the IMF crystal ball, it's the outlook for sub-Saharan Africa. A few countries — Ghana, Mozambique, Nigeria and Uganda — are posting some impressive economic gains, but for most others in the region the prospect is just more stagnation, say IMF staffers.

Meanwhile, they let it be known, the world's wealthiest countries, sometimes known as the Group of 7 (the United States, Japan, West Germany, Britain, France, Italy and Canada), are not doing all that much to help.

Two years ago, the Group of 7 ballyhooed a plan to help relieve sub-Saharan African debt. How much is it amounting to? About $40 million a year spread over 14 countries, the IMF discloses.

The outlook for U.S.-Japanese economic relations isn't all that good, either, if you read between the IMF report's paragraphs.

The IMF consensus is that next year the recent improvement in the payments balances of the two countries will reverse sharply. The U.S. payments deficit and Japan's surplus could start approaching the record highs of a few years ago, the IMF warns.

A weaker Japanese yen, an anticipated rebound in the U.S. economy and slower economic growth in Japan next year are behind this forecast.

The IMF offers yet other reasons for concern about the U.S-Japanese imbalances. The longer they persist, it says, the harder they will be to overcome. Moreover, it doubts that the recent rise in Japanese investment in U.S. manufacturing will have more than a limited impact on the imbalances.

If the IMF is right, the U.S. and Japanese trade gap will widen just at the wrong political moment, as U.S. and Japanese pledges of economic cooperation — remember the Structural Impediments Initiative and Super 301? — are supposed to start closing the gap.

Now that's bad news, even for Mr. Frenkel's doctor.

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THE LOS ANGELES TIMES , March 26, 1990

Borderless Economy Calls for New Politics

■ Economy: The world is on the threshold of a quantum leap in material wealth, if it's not derailed by nationalist emotion.

By KENICHI OHMAE

TOKYO—When Sony purchased Columbia Studios and Mitsubishi bought a substantial interest in Rockefeller Center, the opinion pages of American newspapers, reflecting the political mood, warned of a "Japanese invasion." Japanese commentators responded in their columns and on their front pages with charges of "bashing" by the United States.

Yet the financial sections of these newspapers discussed the same events in terms of "joint ventures" or "corporate tie-ups."

These divergent perceptions—which are likely to be repeated with the latest news that Japanese concerns plan to purchase Southland Corp. (7-Eleven stores) and a major interest in Saks Fifth Avenue—illustrate the conflict between fact and myth that has led to so much acrimony between the United States and Japan. The opinion pages reflect a fiction rooted in the 19th-Century notion of the nation-state. The financial pages reflect the reality of today's borderless economy.

Because of this borderless economy, the world stands at the threshold of a quantum leap in material wealth—if this promising future is not derailed by nationalist emotion.

The economies of the great global triad—America, Japan and Europe—are so interwoven that loosening a few threads could unravel the entire cloth and expose us all to a depression.

We often hear about Japanese investments in America, but tend to forget that the reverse situation also exists. IBM Japan has more than 1,000 corporate affiliates and more than 19,000 employees in Japan. Texas Instruments is Japan's strongest competitor in the production of semiconductors. Estée Lauder is Japan's most successful cosmetics manufacturer. In 1989, the top 2,000 American companies operating in Japan had an annual production value greater than that year's $49-billion U.S.-Japan trade deficit.

This transnationalism is particularly clear in the auto industry. Ford owns about 25% of Mazda. General Motors, with 34% of the stock, is the largest shareholder in Isuzu and owns 5% of Suzuki. Chrysler owns 25% of Mitsubishi.

Nissan and Toyota have established major auto plants in the United States. Honda even exports cars back to Japan from its American plants.

In Europe, Ford and GM each share about 12% of the European market. Mitsubishi and Daimler-Benz are negotiating a plan of intensive cooperation in automobile technology, aerospace and microelectronics.

It is difficult to designate the nationality of these successful global corporations. They fly the flag of their customers, not their country. They thrive on the loyalty of denationalized consumers.

The key to enduring prosperity for any nation lies in recognizing the emergence of the "triad marketplace" and actively participating in it. Insiders will prosper and grow strong. Outsiders and protectionists will wither because they will be unable to earn the allegiance of consumers who have plenty of choices.

The borderless economy has two key characteristics: global commonality and regional differentiation.

As national boundaries lose significance for both consumers and corporations, the commonalities of the triad become more important than national differences. At the same time, regions within national boundaries have very distinct attributes, tastes, needs and interests. This means, for example, that Osaka might compete with Tokyo and Los Angeles with New York.

To be successful, corporations must adopt a strategy of "global localization," as Sony's Akio Morita has phrased it, or as I prefer, a strategy of "insiderization" with a multilocal approach. This simply means that successful companies will base their strategies on an appreciation of the unique character and needs of regions within national borders.

Most Japanese companies have learned to differentiate their markets in the United States by regional attributes. For example, they have seen that subcompact cars sell best in the heavily urbanized regions while larger cars seem to fit the tastes of consumers in the Midwest and South.

By contrast, most American businesses still view Japan from 12,000 miles away. At that distance, Japan's regional consumer patterns are as indistinguishable as individual stars in the Milky Way.

But the commonalities of the triad economy are far greater than the unique attributes of localities. In our management consulting work, we have found that 80% of what applies in the United States also works in Germany. The consumer desires of the Japanese *shinjinrui*—the generation younger than 30—are far more similar to the same generation in Los Angeles or Paris than they are different.

□

As national borders continue to erode, what will emerge?

The future's winners will not be nations, but regions, such as Alsace-Lorraine, Wales, Kansai or Orange County. The winning corporations will be those that serve the global consumer well.

Politicians around the world will have to turn their energies away from preservation of the status quo to the more important mission of creating a political framework for the borderless economy.

The European vision does not extend beyond 1992. The Japanese vision is even more shortsighted: We have been meekly hiding behind America's nuclear umbrella, implementing the obsolescent assignments of Gen. Douglas MacArthur. Meanwhile, the end of the Cold War has removed America's postwar sense of mission.

A borderless economy inside a political vacuum spells peril. Without a workable framework, the danger is great that new villains will be created to put flesh on the old skeleton of nationalism. Without the Russians as archrivals, might an America without a mission cast the Japanese or Germans in that role?

A xenophobic scenario such as this is what most threatens our full passage to the borderless economy. Only the creation of a political culture that reconciles the duality of citizen and consumer can clear the way.

Kenichi Ohmae, a management consultant in Tokyo, is the author of "Beyond National Borders: Reflections on Japan and the World."

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Anthony Harris finds rather more to worry about in the long-term US economic outlook than in the present

First the good news then the bad

"THIS IS a boring report; but that is probably not a bad thing." Only 10 days ago this seemed an apt conclusion for a Wall Street analyst to draw from the US economic statistics. Under the surface, it is true, the trends looked rather less steady (and less favourable), but their tale of profits squeeze, threatened recession and rising bankruptcies was familiar enough to be boring too. Not even recurrent scares about a possible Japanese retreat from the US markets could keep readers awake for long.

Last week, though, news broke, though there was some dispute about what it was. "Inflation beats up, chills markets;" "Japanese sell-off rocks bonds." There is in principle no contradiction here, since bad news about inflation might well frighten Japanese fund managers, but the reported Japanese retreat began two days before the inflation figures were published.

It is possible, then, that the inflation figures were made to look worse than they really were by the market fall, which brought the long bond down 3 per cent and blue chip equities down 2 per cent during the week. Commentators can seldom resist explaining market movements in terms of any suitable news.

This certainly appears to be the view of the country's most senior economy-watcher, Mr Alan Greenspan, the Federal Reserve Chairman. In written evidence to a Senate committee two days after the consumer price news, his only remarks about inflation were these: "The central tendency of the Federal Open Market Committee forecasts suggests that most members are of the view that some progress toward lower consumer price index inflation can be achieved this year without a sizable rise in the unemployment rate."

The bulk of his statement was concerned with risks in the commercial credit market which could easily cause a sizable rise in unemployment. This suggests that the market and the commentators may have been dwelling on the wrong sort of bad news.

Commercial building seems to be heading for a major pause, the result of past over-building

First, however, the headline news of rising inflation and an improving trade balance must be analysed briefly. The trade figures were indeed unexpectedly good, and might have caused more celebration if the market had been going up. In a weak market, they were treated as an aberration.

This is also the official reading: the Treasury, by coincidence, marked the news with a warning that the trade balance might now get worse. At the same time the Department of Commerce issued the first official forecast of the benefit which US trade is likely to enjoy from the build-up of Japanese car production in the US – $15bn annually by the end of next year. Some of the improvement last year is clearly from this source, so there may be some good news to come which did not get into the Treasury computer model. It will not mean much for growth, though.

The inflation story is a tale of 0.3 per cent – the difference between the actual 0.5 per cent rise in the index in February and the 0.2 increase which market economists had forecast. This was partly over-optimism about food and energy: analysts had expected the oil industry to trim product prices rather more promptly than they did in response to falling crude oil prices. They also seem to have under-estimated the effect of the continuing drought in California, which is the major source of fresh produce in US food stores at this time of year.

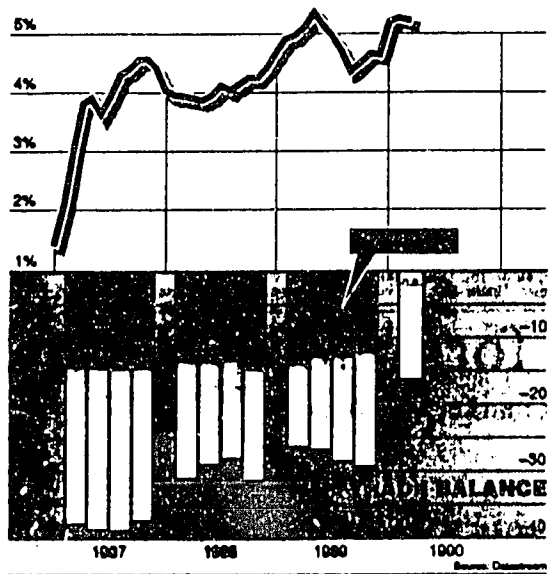
However, it was the level of "core inflation" – all items less food and energy – which attracted the grimmest comments. This reached an annual rate of 7.5 per cent in the first quarter, after running at 4 to 4.5 per cent for the previous six years. About a third of this acceleration, and a third of the unexpected 0.3 per cent March price rise, was due to one item: women's clothing. The apparel index rose 4.9 per cent in two months, after rising just 0.2 per cent in the previous 10 months together.

The clothing price rise could well be regarded as sinister. Indeed there is some sign that the industry is trying to take advantage of quota protection, but it has all happened before. There have been at least three fashion price scares since 1987-88. All three faded away as prices relapsed with the first sales, and stayed down. In the last year a number of well-known names have vanished into bankruptcy; the survivors appear to be trying again.

This story of desperation in a hard-pressed industry could have wider application. After-tax profits in manufacturing fell by nearly a quarter in the year to end-1989 in the official figures, which unfortunately include profits from asset sales.

Some sectors of retailing, and some services – notably airlines (and recently restaurants) have suffered worse. There have been consumer complaints that domestic air fares have risen steeply as hard times have thinned the competitive field. These fare increases often fail to stick. Similar news may well be heard before long in furniture retailing, which has recently had a high casualty rate. So far as this is true, recent inflation is a lagged response to cost rises long ago. Time may work a cure; tighter monetary policy might make things worse.

US INFLATION



How widespread is such distress, and is it likely to spread? The evidence is mixed, but not encouraging. On the positive side, US businesses plan to increase their plant and equipment spending 7.8 per cent in 1990, following a 10.4 per cent actual rise in 1989. This is a slowdown (and performance is usually short of stated plans), but still enough to sustain some growth in the economy. If the trade balance continues to improve – despite the Treasury forecast – that would be another bull point. Unfortunately the list of bear points is longer:

● Construction is facing generally very weak demand. Housebuilding is slowing down from its brief spurt in a tropical January. Permits for future starts in March were 8 per cent down on February, and the lowest monthly total for seven years. The cause seems to be as much demographic as a result of high interest rates; the whole house market is now extremely sluggish. Commercial building seems to be heading for a major pause, the result of past over-building, and bank finance for new projects has virtually dried up in many regions.

● Public spending, especially at State level and in defence, is being increasingly squeezed. Most US states operate on balanced-budget rules. These are economically destabilising because they require expenditure cuts or tax increases when other activity is slowing. There is plenty of anecdotal evidence of this in the Metro section of almost any daily newspaper. Aggregate figures are hard to come by until long after the event.

On the national level the Gramm-Rudman rules, which aim to reduce the budget deficit through automatic spending cuts if necessary, could have a similar effect. Last week Budget director Richard Darman said that Congress should be looking for a further $8.5bn in cuts on top of the $36bn requested by the President to compensate for the economic slowdown. The cuts, of course are for the year starting in October, but the effects are already being anticipated in areas like Washington which have a large government market.

The savings and loan crisis will have a cumulatively deflationary effect as growing sums of revenue are diverted from goods and services to maintaining interest payments on insured deposits, or on the money borrowed to pay them off.

● Credit demand is weak, supply is constrained by heightened appreciation of risk. The banks are also playing a destabilising role. Mr Greenspan, reporting to the Senate on the result of a survey of major banks, said: "During the past six months a large majority of respondents had become less willing to make construction loans, while about one-fifth were less willing to extend business credit. Generally, they cited less favourable economic conditions as the most important factor leading to their policy change."

Mr Greenspan said that this might have "potential effects on the level of local economic activity," a characteristically restrained description of what could be the most potent deflator of all. Meanwhile, borrowers seem to be imposing their own restraints. There was virtually no loan growth in December or January, but an annualised increase of 5.3 per cent in February. The monthly average for 1989 was 7.6 per cent.

The Chairman went on to show why things might get worse as a result of the collapse of the junk bond market. The loss of liquidity will directly affect the ability of highly leveraged companies to refinance their debts, and may prevent them selling assets to pay them off, since many of the buyers have themselves relied on junk bond finance. This sounds like what the London market used to call "pig on pork."

● Personal spending has been subdued, and seems likely to remain too weak to lead a recovery, despite a reported revival in confidence. Persistant optimists – and stale pessimists – still talk of consumer-led growth. There is precious little evidence to back them. The picture is typical of a weak outlook, with weak sales of cars and durables, and some of the money saved spilling over into clothes and other non-durables. Total retail sales in the first quarter were 5.6 per cent up on 1989, prices were up 5.2 per cent. Meanwhile previously sceptical academics have agreed with some market economists that private saving is likely to go on rising for the time being for purely demographic reasons.

In short, the reasons which supported recession forecasts at the turn of the year are still in place, and looking stronger. Why, then, have the forecasts gone out of fashion? Mainly, probably, because they have been wrong so far. Nothing is more trying than waiting for a premature forecast to come right. But as stale dollar bears learned in 1985, and as those expecting inflation to slow down may learn next month, sound forecasts can remain sound even when they are beginning to gather dust.

DIALOGUE

How to Shrink the Deficit

The Budget Summit

Illustrations by Thomas Ferr

Cut Spending, Raise Taxes

By Alice M. Rivlin

WASHINGTON

The President and leaders of Congress have a splendid opportunity this week to enhance their political popularity. If they can agree on a credible plan for eliminating the Federal deficit over the next several years, they can strengthen the economy, restore faith in the democratic process and prove cynics wrong.

The media's obsession with the painful aspects of deficit reduction, tax increases and spending cuts, has obscured the fact that eliminating the deficit would make us better off. The positive effects of deficit reduction — falling interest rates, rising stock prices, more affordable housing, increased private and public investment, stronger exports — could be dramatic, especially in the long run.

Massive Federal borrowing has kept interest rates high for a decade much higher, after allowing for inflation, than in the 70's. If the Government reduces its borrowing, more funds will be available for the rest of us and rates will fall. If, after several years, the Government stops borrowing and begins retiring even a small part of the debt, we can expect a long period of low interest rates, perhaps a return to the era of the 6 percent mortgage.

Falling interest rates give relief to families with variable-rate mortgages. Many families realize they can afford better housing. Home builders and renovators respond. Construction employment rises. Sales of cars, furniture and appliances rise in response to more home building and more favorable financing.

Falling interest rates send stock prices up. Borrowing and equity financing are then less costly for business. Expanding or modernizing the plant, fixing up the store, undertaking more advanced research, developing new products — all become more attractive when financing is cheaper. The much criticized shortsightedness of business — caring more about the next quarter's earnings than the company's long-run health — may change when lower interest rates make future orientation more affordable.

With borrowing costs reduced, state and local governments can take a longer view. They can afford to modernize transportation and other public facilities. In the long run, we will all live better because private and public investment will increase the economy's productivity.

A lower deficit will spur growth.

Other benefits of eliminating the deficit include lowering dependence on foreign capital and making U.S. exports more attractive. Our trade deficit will shift to a surplus, instead of remaining the world's No. 1 debtor; we will become a net lender again, earning income on U.S. investments abroad and having more say in how the world develops.

No benefits come without cost. Americans have not been paying enough taxes to cover the cost of Federal services; that is why the Government has borrowed so much. This situation can be fixed only by raising taxes or reducing spending, which alienates voters.

But the pain of deficit reduction need not be great if spread over several years and distributed broadly over a large number of taxpayers and benefit recipients. Plans like Representative Dan Rostenkowski's are fair and relatively painless: everyone gives up a little and nobody is hurt very much.

Many tax increases and spending cuts have politically attractive aspects. Higher energy taxes, phased in gradually, could provide greater fuel efficiency, less pollution and lower dependence on foreign oil. Reducing farm subsidies could give us cheaper food. Cuts in the military would be applauded by those who consider today's defense spending wasteful and ill-matched to current threats.

America urges fledgling Eastern Europe democracies to adopt painful economic programs involving large-scale unemployment, cuts in real incomes of people who are barely making it — all in the name of instituting a more efficient and productive market economy. Yet our politicians apparently fear that voters are too shortsighted to accept the far less painful measures needed to make our economy more efficient and productive.

The budget "summit" meeting offers a chance for our political leaders to show their faith in the public's intelligence and good sense and prove that the governmental system we urge on others can still work for us. □

Alice M. Rivlin, an economist at the Brookings Institution, was director of the Congressional Budget Office.

Don't Raise Taxes

By Martin Anderson

STANFORD, Calif.

The brazen cry to raise taxes in 1990 has to be the most shameless assault on Americans' pocketbooks in this century.

We have just had the largest back-to-back annual tax increases in our history. In 1988, the Government got $751 billion of our money. This year, it will get that and another $165 billion. That whopping increase in tax receipts — a product of economic growth and inflation — is one of the best kept secrets in America.

Washington is awash in tax money.

During the next three fiscal years, tax revenues are expected — without any change in tax rates — to increase by another $254 billion. That's a grand total of $419 billion of new spending money for the Federal bureaucrats in just five years. It is almost $1 billion of new tax money for every single Congressman.

Surely, $419 billion is more than enough for those rascals.

Then how can there be a problem? Because politicians want to spend even more than the cash that is flooding in on them. Displaying remarkable ingenuity, they have figured out how to spend much, much more than the paltry $1 trillion and change that they have today.

And that is unconscionable. Here we are rolling along in the 89th month of the greatest economic expansion in our history, with 19 million new jobs, a gross national product of nearly $6 trillion, low inflation, interest rates and unemployment, a stock market that has tripled in the last seven years — and these bozos want to jeopardize it all by raising tax rates.

The deficit isn't the real problem.

Moreover, the collapse of socialism and the prospects of bilateral nuclear disarmament will soon produce a financial windfall. The savings over the next decade could easily accumulate to more than $500 billion.

How bad is the Federal deficit? The deficit, as a percentage of gross national product, has fallen steadily since 1985 (when it was 5.4 percent) to an estimated 2.2 percent for 1990. Even with the latest revised "the sky is falling" estimates, the deficit would still be only 2.6 percent of G.N.P. in 1990 and 1.5 percent in 1991. We have had deficits in this range many times before. They are serious but not catastrophic, and certainly not justification for raising tax rates and jeopardizing the economy.

The same is true of Federal debt. As a percentage of G.N.P. it has been falling in recent years and now stands at about 40 percent. That is lower than at any time from 1945 to 1965. It was not a serious problem then, and it is not a serious problem now.

The real problem with our economy is that politicians want to spend more of our money than they have any right to. But where is it written that government has a right to an ever increasing share of our income?

In fact, as our economy grows ever more huge — into the $6 trillion and $7 trillion dollar range — we should be getting savings in Government operations from economies of scale. As peace breaks out around the world and our economy gets bigger, the Government should take a smaller percentage out of our pockets.

Rather than raising taxes, we should be taking decisive steps to keep the economic expansion rolling, to create more jobs. In addition to refraining from tax hikes, here are three things we should do in 1990:

- Eliminate the capital gains tax (which will create hundreds of thousands of jobs and put us on a more equal footing with foreign competitors), and delay any increase in the Social Security tax for at least one year. Getting rid of the capital gains tax will raise Federal revenues. Delaying the Social Security tax for a year would cost about $12 billion.
- Earmark all of the "peace dividend" for further deficit reduction and to pay for the delayed Social Security tax increase.
- Slow, by a measly two or three percentage points a year, the incredible growth of Federal spending. If we could do that, we could balance the budget easily in a few years.

When it comes to spending taxpayers' money, politicians and bureaucrats — of either party — have no sense of restraint. They need to be disciplined.

The only way to deal with them is to just say no — no more new taxes.

Read our lips. □

Martin Anderson is a senior fellow of the Hoover Institution, at Stanford University.

THE WASHINGTON POST, May 16, 1990

Robert J. Samuelson

Finally, Budget Embarrassment

If you've watched the budget process for the past decade, the latest budget summit looks depressingly familiar. We've been here before. Countless other summits have failed to end the deficits. They remain stuck roughly between 2 and 3 percent of gross national product, which is uncomfortably high for a peacetime economy near full employment. Cynicism is natural.

Is anything different this time? Well, maybe.

President Bush's desire for budget talks and his pledge of "no preconditions"—implying he might accept a tax increase—are not flukes. No president likes to be embarrassed. Until now, big deficits haven't been an embarrassment. Everyone condemns them, but no one cares about them. They're an abstraction. This may be about to change. The Gramm-Rudman-Hollings law may finally transform budget politics.

You'll recall that this law triggers automatic spending cuts if specific deficit targets aren't met. The idea was to force Congress and the president to cut the deficit themselves to avoid automatic cuts. The estimated deficit for fiscal 1991 (beginning in October) is now so far above the $64 billion target that inaction could cause Draconian cutbacks. Imagine. Airline congestion worsens because there aren't enough air traffic controllers. The FBI drops investigations. National parks close. The Agriculture Department inspects less meat. The Pentagon grounds aircraft.

The media would have a field day, dramatizing the horror stories of disgruntled federal bureaucrats. What's possible, in short, is a political calamity. The finger-pointing would get violent. The president would blame congressional Democrats. The Democrats would cite a "lack of presidential leadership." Meanwhile, the nightly network news shows would continue running stories about halted highway projects and the drug war in retreat. Budget deficits wouldn't be an abstraction. They could become a mega-embarrassment.

The White House and Congress now have a shared interest in stopping automatic cuts ("sequestration"), because no one can predict who would be blamed most. There are only four ways to avoid automatic cuts, all politically unpleasant: (1) make specific—as opposed to automatic—spending cuts; (2) raise taxes; (3) increase the deficit targets in the Gramm-Rudman-Hollings law or eliminate the law entirely; and (4) create phony deficit estimates that understate the problem. Any budget agreement is likely to include all these mechanisms.

How much would the deficit have to be cut?

In January, Bush projected a 1991 deficit of $100.5 billion under then-existing policies. This made the Gramm-Rudman-Hollings target look attainable without much hard political work. The law allows a $10 billion leeway, so Congress had to reach a $74 billion deficit. In a

"Suddenly, the Gramm-Rudman-Hollings target is a monster."

$1.3 trillion budget, a $26 billion cut isn't huge. The collapse of communism in Eastern Europe was reducing defense spending below estimates. Accounting gimmicks can always "save" a few billion. Tiny spending cuts and arcane tax increases could have made up the rest. The trouble is that the $100 billion estimate was wildly unrealistic. In January, the Congressional Budget Office projected $138 billion.

All these estimates excluded extra costs for the savings and loan bailout, which could add $50 billion or so to the deficit. Even exempting the bailout from Gramm-Rudman-Hollings—something the White House and Congress will probably do—is no salvation. Interest rates have been higher than the White House expected and tax revenues lower. The administration is now apparently conceding that a realistic 1991 deficit estimate is at least $128 billion. It could be higher. Suddenly, the Gramm-Rudman-Hollings target is a monster. That's why Bush moved for a summit with Congress.

Only a fool would predict the outcome of the budget negotiations. But there's a case for modest optimism. Everyone assumes that major deficit cuts would involve wrenching public sacrifices. Not necessarily so. There would be winners and losers, but the overall changes wouldn't be devastating. Consider a $60 billion package split between higher taxes and lower spending. The higher taxes would be less than a 3 percent federal tax increase, while the spending cuts would barely exceed 2 percent of outlays. Rhetoric has outrun reality.

In contrast, the Gramm-Rudman-Hollings spending cuts could be far more damaging politically. Because the law involves no tax increase and excludes many programs—Social Security, for example—all spending cuts would be concentrated on everyday basic services (like air traffic control and defense). Congress ought to focus cuts on the least essential or effective programs. That's good government and good politics.

Of course, there's also a case for pessimism. The depressing thing is that no one is talking about government's obligations and citizens' responsibilities. A budget defines what government does and how. The deficits ultimately stem from a bipartisan refusal to put the debate in these terms. Democrats haven't wanted to argue for higher taxes to support higher spending. Republicans haven't wanted to press for spending cuts to justify lower taxes. The deficits have represented a political equilibrium: a comfort level that suited everyone.

Deficit reduction should be an opportunity to restore discipline and accountability to government spending: to weed out bad programs and emphasize new needs, supported by fair and efficient taxes. But this is not a process that occurs spontaneously. Someone has to argue the case for what's needed and create a public climate for change. The president isn't doing so. Neither are leading Democrats.

They're all squirming. They've been doing that for a decade. Distrust runs high among Republicans and Democrats. In an election year, they may select the safest choice: enact cosmetic deficit cuts and raise the Gramm-Rudman-Hollings targets. Politicians dislike discipline. Abstract deficits are easier.

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It's Time to Talk About the S-Words Too

By MARTIN FELDSTEIN

For the past five years the political taboo against discussing tax increases has made it impossible to negotiate any serious reduction in the budget deficit. Now that a tax increase is on the table, a significant budget deal looks quite likely. It's time now to consider adjusting the future growth of Social Security benefits as well.

Only by considering Social Security benefits as well as taxes can the negotiating process produce a serious and fair long-term plan to eliminate the budget deficit. And extending the Gramm-Rudman process to include parallel automatic adjustments to taxes and Social Security benefits could be the centerpiece of a reformed budget process that limits spending increases and guarantees an eventual budget balance.

The budget deficit has been stuck at $150 billion a year since 1987. The Office of Management and Budget's new estimates confirm what private analysts have been saying for a long time. Without tough budget action, the deficit will be as high next year and will continue to be at least $100 billion a year in the future, keeping real interest rates high and depressing our national rate of investment in productivity increasing plant and equipment.

But even the new OMB estimates make no allowance for accumulating a real Social Security trust fund. Instead, all of the projected Social Security surpluses are devoted to offsetting deficits elsewhere in the budget.

Goal for 1996

Social Security should instead be removed from the ordinary budget and the surpluses accumulated to finance future benefits when the baby-boom generation begins to retire. By 1996, such a safeguarding of the Social Security surpluses would add $140 billion to the annual budget deficit.

Combining this Social Security accumulation with the projected budget deficit implies that the appropriate deficit-reduction goal for 1996 is about $250 billion. With that much to be done, it's important to have a long-term plan. The budget negotiators should be aiming for $50 billion a year of reliable deficit reductions over each of the next five years. A new Gramm-Rudman framework could ensure such reductions by adding automatic adjustments in tax revenue and Social Security benefits to the current across-the-board sequestration cuts. Unlike the current talk about cutting $100 billion in 1991 alone, such a gradual and predictable multiyear reduction would not upset the pace of year-to-year economic expansion.

It is impossible to achieve such reductions by spending cuts alone. The substantial reduction in defense spending that now appears to be justified by the current military conditions can make a major contribution to deficit reduction. But even a massive 20% cut in current real defense spending—reducing defense outlays to the lowest share of GNP in more than half a century—would provide less than one-third of the needed $250 billion a year.

Nondefense spending other than Social Security and interest on the national debt will exceed $500 billion by 1996 if there are no changes in existing programs. That much spending should provide opportunities for substantial savings. But although I have my favorite list of cuts, I'm not optimistic about the amount that Congress will accept. And many of the savings in existing programs will undoubtedly be used to fund increased spending on an array of programs that the public feels has received too little support during the past decade.

Turning to taxes, opinion surveys show that raising excise taxes on alcohol and tobacco would meet relatively little opposition from an increasingly health-conscious public. Doubling the 16-cents-a-pack tax on cigarettes and adding a dollar in tax to the price of a six-pack of beer and a bottle of wine would yield about $15 billion a year in revenue. An extra 10 cents a gallon on gasoline would reduce air pollution and add $10 billion a year to revenue.

Board of Contributors

A simple and fair way to fill the remaining deficit gap would be to modify the indexing of both the Social Security benefits and the personal income tax.

The combination of major cuts in defense and nondefense outlays and the general increase in excise taxes would also have an important favorable effect on the government's annual interest bill. Even without any fall in interest rates, the gradual reduction in annual deficits would cut the projected national debt by enough to knock $30 billion off the government's 1996 interest outlays. And if the smaller budget deficits bring the interest rate down by one percentage point, the additional interest savings would be $25 billion a year.

But even with all of these outlay cuts and revenue increases, the annual deficit in 1996 would still be about $75 billion. What should be done to fill this remaining gap?

A simple and fair way to fill the remaining deficit gap would be to modify the indexing of both the Social Security benefits and the personal income tax. A basic approach would be to adjust benefits and tax brackets by the excess of inflation over 2% instead of by the full inflation rate as required by current law. With a 4.5% inflation rate, benefits and tax brackets would be raised by 2.5% instead of the full 4.5%. Even if lower-income beneficiaries and taxpayers are exempted and each individual is limited to no more than a cumulative 10% adjustment, this inflation-minus-2% rule for taxes and Social Security would shrink annual deficits by $70 billion in 1996 and beyond.

Although most politicians have been understandably reluctant to suggest any modification of Social Security benefits, any program of deficit reduction that can be described as fair must include a slowing of the growth of Social Security outlays. Ways and Means Committee Chairman Dan Rostenkowski recognized this when he proposed a total freeze on Social Security benefits as part of his own 1991 budget plan.

Unlike most other government transfer programs, the vast bulk of Social Security benefits go to individuals who are not poor. Indeed, benefits are higher for those who have had the highest earnings during their working years and who are therefore most likely to have substantial private pensions. Full adjustment of Social Security benefits for inflation has become increasingly unfair after a decade in which average wages have failed to keep up with inflation. Since 1975, real wages per worker have fallen more than 10% while real average Social Security benefits per retiree have increased by nearly 20%.

Modifying the adjustment of income-tax brackets by the same inflation-minus-2% rule would raise the growth of tax revenue by about the same amount that it cuts the growth of Social Security outlays. There is also enough ambiguity in this tax change to satisfy most politicians: The inflation-minus-2% rule raises revenue without a tax increase and reduces benefit outlays without lowering anyone's benefit.

Broadening the Range

The inflation adjustment of income-tax brackets and Social Security benefits also provides a good way to expand the Gramm-Rudman automatic mechanism to keep the proposed budget declines on track. If the deficit is greater than the target level in some future year, the traditional Gramm-Rudman spending cuts could be supplemented by a reduced inflation adjustment to benefits and tax brackets.

The narrow range of budget categories that are now the only eligible items for the Gramm-Rudman sequesters has implied such draconian reductions in individual programs that Congress and the administration have preferred to use phony numbers to avoid painful real deficit reductions. Broadening the range of automatic deficit cuts to include tax and Social Security adjustments would make Gramm-Rudman more effective.

President Bush has emphasized that he regards a reform of the budget process to be an important goal of this year's negotiations. A two-year budget cycle and some form of enhanced rescission authority would help to make the budget process more rational. But expanding the Gramm-Rudman fail-safe procedure to include the inflation adjustments to both tax brackets and Social Security benefits is the best way to achieve declining budget deficits and to make certain that broad and fair reductions in the growth of spending are the centerpiece of that deficit reduction.

Mr. Feldstein, former chairman of the president's Council of Economic Advisers, is a professor of economics at Harvard.

EDITORIAL/OPINION

Zero Inflation Comes With Costs

By BENJAMIN M. FRIEDMAN

The House Banking Committee is considering a bill introduced by Stephen Neal, D-N.C., directing the Federal Reserve system to implement monetary policy so as to achieve a zero rate of price inflation within five years. Zero inflation is an objective that deserves support, but the Neal resolution is sufficiently flawed that it might do more harm than good.

Reducing inflation from the patently unacceptable levels prevailing 10 years ago — 9% yearly for prices overall, and 13% for consumer prices — was the nation's outstanding economic policy achievement of the 1980s. Even so, the nearly 4% inflation that has prevailed for the last five years remains well above what public opinion deemed acceptable not long ago. Reducing inflation further, perhaps even to zero, is an objective well worth pursuing.

But mounting a serious disinflation program, one that has a good chance to proceed to a successful conclusion, requires that both Congress and the public understand the costs — in terms of forgone output, jobs, income, profits, capital formation and so on — likely to be incurred along the way. The Neal resolution is flawed because it indicates no recognition that a monetary policy to reduce inflation from 4% to zero is likely to entail any costs at all.

Through much of the postwar period, the prevailing view was that monetary policy influenced inflation primarily by affecting output and spending. By the late 1970s there was even something of a consensus on the magnitude of the short-run trade-offs involved, indicating that each percentage point reduction in inflation achieved by monetary policy would require between two and six "point-years" of unemployment. (A "point-year" is one percentage point of unemployment, in excess of whatever non-inflationary rate corresponds to "full employment," maintained for one year.)

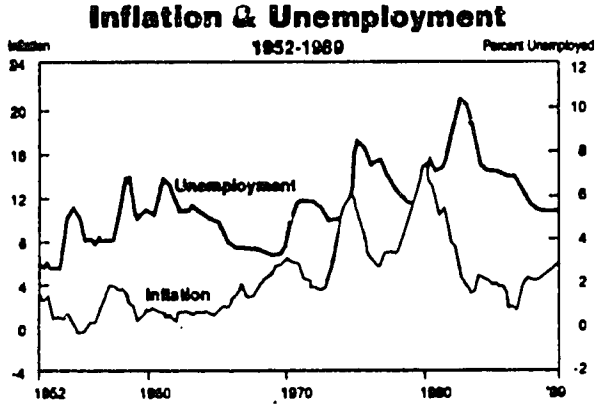
Such an unfavorable trade-off — at the median, 15 point-years of unemployment to cut the inflation rate by five percentage points — constituted a clear discouragement to an active disinflationary policy.

A radically different view of how monetary policy works, developed during the 1970s, maintained that central bank actions that are anticipated in advance have little or no consequence for real economic activity. Under this view, the central bank can achieve any desired reduction in inflation without adverse effects.

The experience of recession and disinflation in the early 1980s, however, makes the previous view more plausible.

Overall U.S. inflation reached a post-1947 peak of 9.7% in 1981. By 1983 it had slowed to 3.9%, and it remained below 4% until 1989. But behind this dramatic decrease was a period of tight monetary policy marked by record high interest rates, and with it a pair of recessions. Unemployment, which had averaged 6% during 1978-79, reached nearly 11% by the time the 1981-82 recession ended. Utilization of industrial capacity fell to a post-war low. So did the rate of investment in new plant and equipment. By the end of 1988, the cumulative unemployment in excess of 6% totaled 15 "point-years," in line with prior consensus estimates for such a drop in inflation.

The disinflation of the early 1980s was not atypical. Using monetary policy to slow inflation always entails substantial real costs. The disinflations of 1953-54, 1958-59, 1970-72, 1974-76 and, of course, 1981-83 all have been related to increases in unemployment. Except for two small and short-lived dips — one in 1967 (the year of the "mini-recession"), and one in 1986 (when oil prices collapsed) — every reduction in inflation since 1952 has been accompanied by greater unemployment.



Despite this historical record, the Neal resolution contains not one reference to any loss of jobs and incomes, any sacrifice of output and profits or any shortfall of investment. Instead, the resolution simply states that "zero inflation will promote the highest possible sustainable level of employment, the maximum sustainable rate of economic growth and the highest possible rate of savings and investment." Disregarding the higher interest rates that have accompanied every American disinflation since World War II, the resolution asserts that "zero inflation will reduce interest rates to, and maintain them at, their lowest possible levels."

None of these claims is necessarily wrong as a description of conditions that might prevail once zero inflation were achieved. But they signal no recognition whatsoever of the economic events that would be likely to accompany the path to zero inflation. Indeed, in light of the great increase in corporate indebtedness since the 1981-82 recession and the increasing exposure of the commercial banking system to debts created via leveraged buy-outs and similar forms of corporate reorganizations, there is good reason to believe that the adverse effects of disinflation may be significantly greater than past experience implies.

Surely it would be better to acknowledge honestly that, whatever the favorable effects of zero inflation may be in the longer run, achieving zero inflation will not be perfectly compatible with everybody's list of favorite objectives, such as the low interest rates, high employment, maximum economic growth and highest possible investment rate touted in the Neal resolution. As has always been the case, a substantial reduction in inflation will involve some heavyweight trade-offs.

Congress has both the right and the responsibility to resolve these trade-offs. Once it has done so, the Federal Reserve is appropriately obligated to implement monetary policy so as to carry out whatever mandate Congress sets — including achieving zero inflation. But the resolution now under consideration seems designed less to step up to that responsibility than to duck it.

Benjamin M. Friedman is professor of political economy at Harvard University, Cambridge, Mass.

THE WASHINGTON POST, JUNE 30, 1990

Governments Agree on Ozone Fund

Negotiations Speed Pace of CFC Ban

By Glenn Frankel
Washington Post Foreign Service

LONDON, June 29—Government ministers from 92 countries agreed today to establish the world's first global environmental fund to help save the ozone layer and to speed the elimination of chemicals that damage the earth's protective shield.

After three days of acrimonious debate and delicate negotiations, delegates came up tonight with a compromise that attempted to strike a balance between the desire of industrialized states to speed the phaseout of the chemicals and the fear of Third World countries that they cannot afford the cost of the new technology needed to do so.

Environmentalists said the fund, which will provide at least $160 million to developing countries over the next three years, marked the first time Western nations have conceded that they have an obligation to aid those countries in eliminating harmful technology passed on from the First World to the Third.

Officials from India and China, the Third World giants that so far have not signed the 1987 Montreal accord on ozone layer protection, said they were satisfied that the fund would help pay for the transfer of the expensive technology needed

See OZONE, A26, Col. 1

Governments Agree on Ozone Fund

OZONE, From A1

to replace the ozone-depleting chemicals. They said they would recommend that their governments ratify the pact, which would boost the total of the fund to $240 million.

Environmental groups also hailed the fund as a precedent of international cooperation that could be applied this year when officials get down to the thornier problem of how to cut carbon dioxide emissions to ease the so-called "greenhouse effect," in which air pollution traps heat in the atmosphere that otherwise would be radiated into space.

But they accused the United States of sabotaging efforts to win an even earlier date for the elimination of chlorofluorocarbons (CFCs), the chlorine-based gases used in electronics, refrigerants, fire extinguishers and aerosols that are primarily responsible for eating a hole in the atmosphere's ozone layer, which protects the earth from the sun's ultraviolet rays.

The 1987 Montreal Protocol called for a 50 percent cut in CFCs by 2000. Under tonight's agreement, hammered out after new scientific evidence showed ozone damage far greater than anticipated three years ago, CFCs will be totally phased out by then.

Environmentalists and some Western nations had pressed for an earlier deadline and stalled today's signing seeking a tougher pact. While they signed the new agreement, 13 countries—including Australia, Canada, Norway, Sweden and West Germany—issued a statement committing themselves to phasing out the gases by 1997, and a European Community statement called the new pact "inadequate."

The conference, sponsored by the U.N. Environment Program, also committed members to phasing out methyl chloride, a powerful industrial solvent linked to ozone depletion, by 2005 and set deadlines for eliminating several other suspect chemicals. It stipulated that members would meet in 1992 to consider speeding the deadlines again.

"It was a very successful conference," said William K. Reilly, administrator of the Environmental Protection Agency and head of the U.S. delegation. "The most difficult issue was technology transfer and we did work that out. . . . The agreement to go from 50 percent to 100 percent [phaseout of CFCs] is a marvelous example of worldwide cooperation really without precedent."

But Liz Cook, of Friends of the Earth, an environmental group, said today's accord falls short of what is needed to begin reducing ozone damage. "It's an improvement, but there's still a long way to go," she said.

Establishment of the new global fund was guaranteed two weeks ago when the White House withdrew its objections. But India held out, seeking language that would allow it to abrogate the pact unilaterally if it decided it had not received enough aid. The final agreement does not allow abrogation but does permit a Third World country to appeal if it believes it has been shortchanged.

"Our ability to transfer out [CFCs] depends on your ability to transfer in technology," said Maneka Gandhi, India's enviroument minister. "We've got a guarantee that if they don't give us the knowledge, we don't have to do it."

Gandhi also told U.S. officials she had received commitments from Dupont and ICI, two of the largest manufacturers of CFCs, to aid India in ending its use of the gases.

The fund will rise by another $80 million if China and India sign on. It is to be administered by a 14-nation executive of seven industrial and seven developing states. As it insisted beforehand, the United States, which has pledged to provide 25 percent of the fund and is its biggest donor, has been granted a permanent seat on the board.

The delegates found it harder to resolve their dispute over CFCs. Despite evidence presented here that many companies believe they can eliminate CFCs within the next five to seven years, Reilly and the U.S. delegation, backed by Japan and the Soviet Union, insisted on the end-of-the-century deadline.

"I am absolutely convinced that if you give a clearcut timetable, it will stimulate industry to come up with substitutes," said West German Environment Minister Klaus Topfer. "But if there is more time allowed, I really believe they will take more time."

The Bush administration was so insistent that today's funding pact did not commit the United States to a similar package of expenditures when the issue of the greenhouse effect comes up that U.S. delegates demanded a statement in the preamble acknowledging the ozone question as "unique." But observers said it was clear that an important precedent had been set.

[In a related move, Reilly announced that the Department of Justice yesterday sued five U.S. importers of chlorofluorocarbons, alleging violations of the Clean Air Act and an EPA rule restricting production of the substances, the Los Angeles Times reported.]

Intergovernmental Panel on Climate Change
Policy Makers Summary of the

Scientific Assessment of Climate Change

A Report from Working Group 1
June, 1990
Meteorological Office, Bracknell, UK

Executive Summary

We are certain of the following:

• there is a natural greenhouse effect which already keeps the Earth warmer than it would otherwise be.

• emissions resulting from human activities are substantially increasing the atmospheric concentrations of the greenhouse gases: carbon dioxide, methane, chlorofluorocarbons (CFCs) and nitrous oxide. These increases will enhance the greenhouse effect, resulting on average in an additional warming of the Earth's surface. The main greenhouse gas, water vapour, will increase in response to global warming and further enhance it.

We calculate with confidence that:

• some gases are potentially more effective than others at changing climate, and their relative effectiveness can be estimated. Carbon dioxide has been responsible for over half the enhanced greenhouse effect in the past, and is likely to remain so in the future.

• atmospheric concentrations of the long-lived gases (carbon dioxide, nitrous oxide and the CFCs) adjust only slowly to changes in emissions. Continued emissions of these gases at present rates would commit us to increased concentrations for centuries ahead. The longer emissions continue to increase at present day rates, the greater reductions would have to be for concentrations to stabilise at a given level.

• the long-lived gases would require immediate reductions in emissions from human activities of over 60% to stabilise their concentrations at today's levels; methane would require a 15-20% reduction.

Based on current model results, we predict:

• under the IPCC Business-as-Usual (Scenario A) emissions of greenhouse gases, a rate of increase of global mean temperature during the next century of about 0.3°C per decade (with an uncertainty range of 0.2°C to 0.5°C per decade); this is greater than that seen over the past 10,000 years. This will result in a likely increase in global mean temperature of about 1°C above the present value by 2025 and 3°C before the end of the next century. The rise will not be steady because of the influence of other factors.

• under the other IPCC emission scenarios which assume progressively increasing levels of controls, rates of increase in global mean temperature of about 0.2°C per decade (Scenario B), just above 0.1°C per decade (Scenario C) and about 0.1°C per decade (Scenario D).

• that land surfaces warm more rapidly than the ocean, and high northern latitudes warm more than the global mean in winter.

• regional climate changes different from the global mean, although our confidence in the prediction of the detail of regional changes is low. For example, temperature increases in Southern Europe and central North America are predicted to be higher than the global mean, accompanied on average by reduced summer precipitation and soil moisture. There are less consistent predictions for the tropics and the southern hemisphere.

• under the IPCC Business as Usual emissions scenario, an average rate of global mean sea level rise of about 6cm per decade over the next century (with an uncertainty range of 3 - 10 cm per decade), mainly due to thermal expansion of the oceans and the melting of some land ice. The predicted rise is about 20cm in global mean sea level by 2030, and 65cm by the end of the next century. There will be significant regional variations.

There are many uncertainties in our predictions particularly with regard to the timing, magnitude and regional patterns of climate change, due to our incomplete understanding of:

- sources and sinks of greenhouse gases, which affect predictions of future concentrations
- clouds, which strongly influence the magnitude of climate change
- oceans, which influence the timing and patterns of climate change
- polar ice sheets which affect predictions of sea level rise

These processes are already partially understood, and we are confident that the uncertainties can be reduced by further research. However, the complexity of the system means that we cannot rule out surprises.

Our judgement is that:

• Global - mean surface air temperature has increased by 0.3°C to 0.6°C over the last 100 years, with the five global-average warmest years being in the 1980s. Over the same period global sea level has increased by 10-20cm. These increases have not been smooth with time, nor uniform over the globe.

• The size of this warming is broadly consistent with predictions of climate models, but it is also of the same magnitude as natural climate variability. Thus the observed increase could be largely due to this natural variability; alternatively this variability and other human factors could have offset a still larger human-induced greenhouse warming. The unequivocal detection of the enhanced greenhouse effect from observations is not likely for a decade or more.

• There is no firm evidence that climate has become more variable over the last few decades. However, with an increase in the mean temperature, episodes of high temperatures will most likely become more frequent in the future, and cold episodes less frequent.

• Ecosystems affect climate, and will be affected by a changing climate and by increasing carbon dioxide concentrations. Rapid changes in climate will change the composition of ecosystems; some species will benefit while others will be unable to migrate or adapt fast enough and may become extinct. Enhanced levels of carbon dioxide may increase productivity and efficiency of water use of vegetation. The effect of warming on biological processes, although poorly understood, may increase the atmospheric concentrations of natural greenhouse gases.

To improve our predictive capability, we need:

- to **understand** better the various climate-related processes, particularly those associated with clouds, oceans and the carbon cycle
- to **improve** the systematic observation of climate-related variables on a global basis, and further investigate changes which took place in the past
- to **develop** improved models of the earth's climate system.
- to **increase** support for national and international climate research activities, especially in developing countries
- to **facilitate** international exchange of climate data

World Resources 1990-91: A Guide to the Global Environment

World Resources Institute

1. World Environment Outlook

When the 20th Century began, the world was home to about 1.6 billion of the human species. Although pollution and environmental degradation were common—some cities lived under a pall of smoke, soot, and ash—the problems were local. The world as a whole seemed vast, with huge regions virtually untouched by its human inhabitants.

By midcentury, airplanes and radio broadcasts had begun to shrink distances and bring the peoples of the world, now 2.5 billion, into greater contact. Industrial growth had multiplied per capita consumption of natural resources—and per capita pollution—in many countries. As that growth continued, air and water pollution became more widespread, as did concern about the cumulative impact of toxic industrial products on living species.

As the 1990s begin, world population has more than doubled since 1950, to 5.2 billion people, and world economic activity has nearly quadrupled (1). To local concerns about environmental degradation have been added new, global worries. The pressures of agricultural and industrial development have begun to crowd out and extinguish other species at a rapid rate, to visibly erode the carrying capacity of the planet's soils, forests, estuaries, and oceans, and to alter its atmosphere. These pressures can only increase if the human population doubles again and economic activity continues its explosive growth.

The scale of the changes under way are spelled out in the following passage from *Our Common Future*:

> The planet is passing through a period of dramatic growth and fundamental change. Our human world of 5 billion must make room in a finite environment for another human world. The population could stabilize at between 8 billion and 14 billion sometime next century, according to UN projections.... Economic activity has multiplied to create a $13 trillion world economy, and this could grow five- or tenfold in the coming half century (2).

The world's environmental dilemma is that the scale on which natural resources are being consumed and wastes are being produced is already immense, yet many poor countries still lack and desperately need the benefits of industrialization and economic development. How this dilemma is resolved is likely to dictate our planet's prospects for the coming century.

Of the hundreds of topics addressed in this volume, a few stand out as having a pervasive impact on the human condition, exerting unique leverage on the future of the planet, or requiring urgent action. Together, they highlight how seemingly isolated environmental problems are, in fact, bound in a contin-

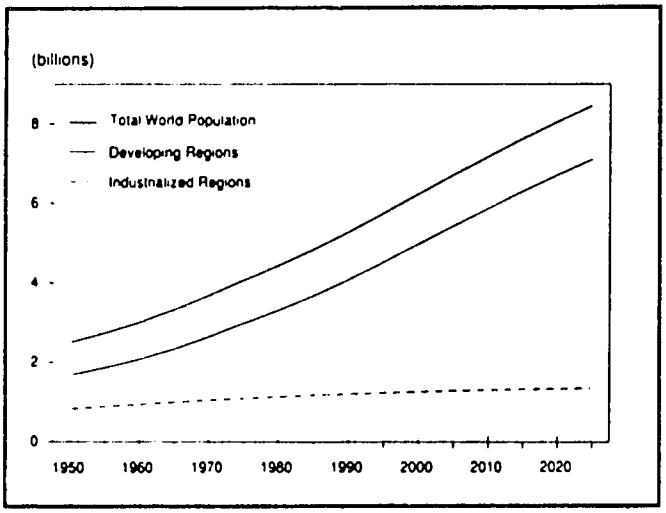
Datapoint: Population Growth Will Add 959 Million People In 1990s

The world's population passed 5 billion in 1987 and continues to rise: an increase of 842 million during the 1980s and a projected increase of 959 million during the 1990s. Even though the average number of births per woman is declining in most countries, the excess of births over deaths means that world population is not yet approaching stability.

Most of the growth is occurring in developing countries. (See Figure 1.1.) Rapid population growth in these countries recently has created populations in which young people predominate. As these young people reach childbearing age, some additional population growth is virtually certain. This demographic momentum makes it more difficult to stabilize populations; it also means that stresses on natural resources and food supplies and the demand for jobs are likely to intensify in the next few decades.

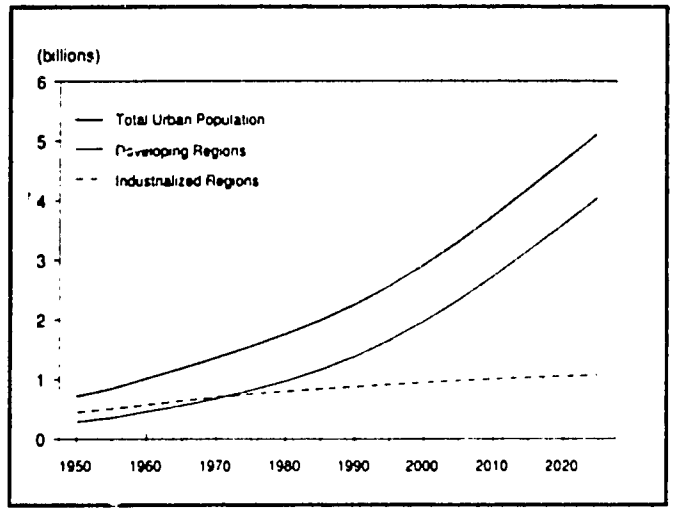
About 40 percent of the world's people now live in urban areas, and urban population is growing rapidly—again, predominantly in the developing world (see Figure 1.2.)—while the population in rural areas is growing very slowly, if at all. This trend will intensify the need for and the difficulty of supplying basic services and maintaining infrastructure in large urban areas.

Figure 1.1 World Population Growth[a]



Source: United Nations Population Division, *World Population Prospects 1988* (United Nations, New York, 1989).
Note: a. Based on United Nations medium variant projection, the middle projection of possible high, medium, and low projections.

Figure 1.2 Urban Population Growth, 1950–2025



Source: United Nations Population Division, *World Population Prospects 1988* (United Nations, New York, 1989).

uum of cause and effect, and suggest the scope of the problems that must be addressed if our civilization is to be ultimately sustained and the dignity and potential of human life enhanced in the decades to come.

ENDANGERED RESOURCES

Air—The Global Commons

From the ground, Earth's atmosphere is nearly invisible and easy to take for granted. From space, it is perceived more readily as a thin blanket of gases, shielding our planet from the harshest of the sun's ultraviolet radiation and trapping the sun's warmth to keep Earth's rivers and oceans from freezing. Now, human activity is releasing gases into the atmosphere on a scale that threatens to alter both of these atmospheric functions significantly, degrading the ultraviolet-shielding ozone layer and intensifying the heat-trapping properties of the atmosphere as a whole.

Because the atmosphere thoroughly mixes the pollutants that cause these changes, it does not matter where the gases are emitted. The global effect of a billion metric tons of carbon dioxide is the same, whether it is released from a northern industrial country or a southern developing nation, whether it comes from burning coal in a power plant, gasoline in a car, or trees in a forest. Preventing atmospheric degradation is, therefore, a task that must be shared globally.

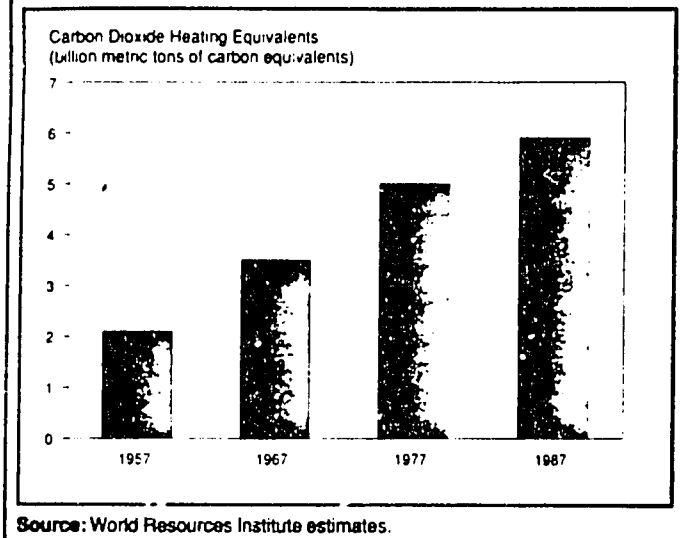
The need is becoming increasingly urgent. In 1987, human activity added the equivalent of 5.9 billion metric tons of carbon—in the form of carbon dioxide or other heat-trapping "greenhouse" gases—to the atmosphere, more than a metric ton for every person on the planet (3). The total would be 14.6 billion metric tons of carbon equivalent—the amount actually emitted—were it not for natural processes that remove greenhouse gases from the atmosphere. The most rapidly rising levels are of chlorofluorocarbons, which in the lower atmosphere trap heat but in the stratosphere are the source of chemicals that degrade the ozone layer.

Datapoint: The Greenhouse Index: Each Country's Contribution To Global Warming Potential

The Greenhouse Index combines net annual emissions of three major greenhouse gases, weighting each gas according to its heat-trapping capability. When calculated for a given country, the index is a measure of that country's responsibility for the increase in the atmosphere's warming potential. The annual increase for the world as a whole is rising rapidly, having nearly tripled in three decades. (See Figure 1.3.) Thus, in 1987, the world is adding to the heating potential of the atmosphere at three times the rate of 1957.

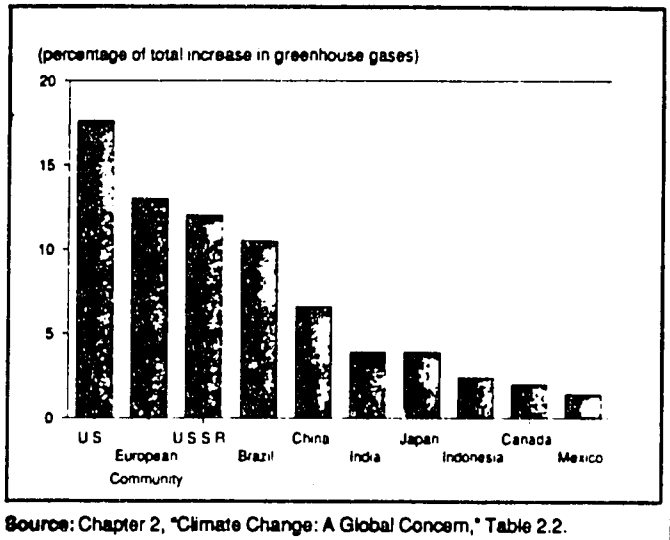
The responsibility for these increases is widely shared. Worldwide, 30 industrialized countries account for 55 percent of total emissions. But of the 10 largest emitters in 1987 (counting the European Community as a single entity), half are industrialized countries and half are developing countries. (See Figure 1.4.) The top 50 emitting countries, which account for an estimated 92 percent of global emissions, span every region of the world, including the developing portions of Africa, Latin America, and Asia, and include both capitalist and planned economies. Clearly, the problem is already a global one, and only common global efforts can hope to stabilize or reduce greenhouse gas emissions. However, solutions must also address the need for equity and for industrial development: industrial countries with less than 20 percent of the world's population are responsible for over 50 percent of global emissions. (See Chapter 2, "Climate Change," Greenhouse Gas Emissions.)

Figure 1.3 Annual Additions of Three Major Greenhouse Gases to the Atmosphere 1957–87



Source: World Resources Institute estimates.

Figure 1.4 Greenhouse Index: 10 Countries with the Most Greenhouse Emissions, 1987



Source: Chapter 2, "Climate Change: A Global Concern," Table 2.2.

The Uncertain Climate

There is no doubt that degrading the protective layer of stratospheric ozone will increase the amount of biologically damaging ultraviolet radiation that reaches the surface of the Earth. How the climate will change as greenhouse gases accumulate in the lower atmosphere and alter its heat-trapping properties is less certain. If present trends continue, greenhouse gases will reach the equivalent of twice the preindustrial levels of carbon dioxide within 40 years and will double again before the end of the 21st Century. If current models of the Earth's climate system are correct, even one doubling will raise global temperatures a few degrees centigrade. The best current consensus appears to be that temperatures would rise an average of 1.5-4.5° C, with smaller increases in the tropics and larger increases at high latitudes.

The prospective shift in temperatures may seem small, but it is nearly comparable to the change between the extreme climate of the last ice age, 18,000 years ago, and today's climate (4). It is enough to alter significantly rainfall patterns and temperature regimes in much of the world (see Chapter 10, "Freshwater"), with impacts on agriculture, forestry, and virtually all living things. (See Chapter 6, "Food and Agriculture," Chapter 7, "Forests and Rangelands," and Chapter 8, "Wildlife and Habitat.") Even a 2° increase would take temperatures higher than human societies have ever experienced.

Global climatic feedbacks—involving clouds, ocean currents, the biota, or several other, as yet, poorly understood mechanisms—might decrease or amplify such temperature changes. These uncertainties—what is known and what is not known about climate change—are discussed in Chapter 2, "Climate Change: A Global Concern"; efforts to monitor and model the climate are discussed in Chapter 13, "Global Systems and Cycles."

If the present patterns of industrial and agricultural activities that are the sources of these atmosphere-altering gases are not themselves altered, there is a distinct possibility of large-scale climate change, forcing what could be very difficult adjustments. In fact, the world may be committed to some degree of global warming already. Whether a warming is detectable now is controversial; what is certain is that the 1980s was the warmest decade of the past

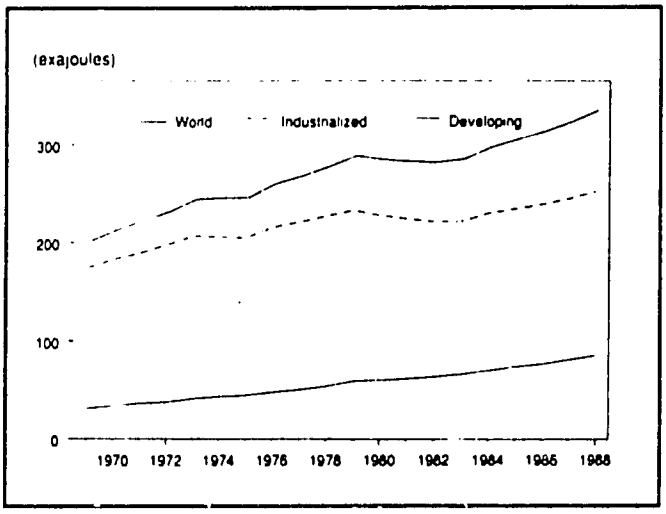
Datapoint: Energy Consumption: Is Continued Growth Sustainable?

Energy, in one form or another, is essential to industrial civilization. But, in addition to its beneficial role, energy production and use are major causes of environmental degradation. Production and use of coal, oil, and natural gas—fossil fuels—are the major sources of local air pollution, regional problems such as acid precipitation, and greenhouse gases that are changing the composition of the atmosphere and that may lead to changes in the global climate. Nonfossil energy sources, such as nuclear power and large-scale hydroelectric power, also raise environmental concerns. Together, these sources constitute virtually all commercial energy production. (In developing countries, however, biomass—largely wood—is an important source of energy and one that, with proper management, is renewable.) Thus, energy occupies a special place in any discussion of global environmental and resource problems and is central to strategies aimed at reducing air pollution and preventing global warming.

Energy use had long been closely associated with economic growth. During the late 1970s and early 1980s, however, energy use stabilized and even declined, while economic growth moved ahead rapidly. This important development was largely the result of shifts to more efficient use of energy in cars and trucks, in homes, and in industrial processes. In recent years, however, as energy prices have declined, the world's use of energy has again begun to climb. (See Figure 1.5.)

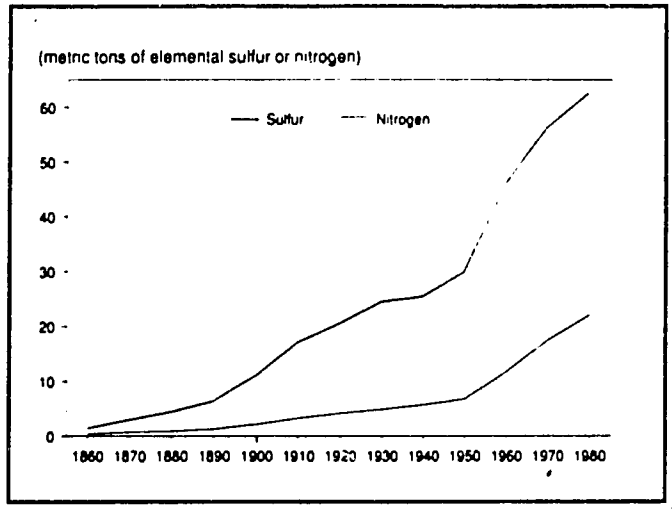
If economic growth is to continue without exacerbating the environmental problems caused by energy, then fundamental changes in energy production and use are likely to be necessary in the coming decades. The easiest gains will come from still higher energy efficiency, the technology for which needs to be shared widely with all nations. However, in view of the long periods required to phase in new energy technology on a global scale, the development of nonfossil energy sources should also be encouraged.

Figure 1.5 Consumption of Primary Energy



Source: British Petroleum (BP), *BP Statistical Review of World Energy* (BP, London, 1989).

Figure 1.6 Global Emissions of Nitrogen and Sulfur Oxides from Fossil Fuel Combustion



Source: Jane Dignon, Sultan Hameed, "Global Emissions of Nitrogen and Sulfur Oxides from 1860 to 1980," in *Air Pollution Control Association Journal*, Vol. 39, No. 2, p. 153.

century and included 6 of the 10 warmest years on record. If the predicted levels of warming do occur, the changes would be extraordinarily rapid compared with most climatic shifts in the geological record. The changes may occur more rapidly than trees and other biota can adjust to new temperature regimes or migrate to new ranges; the result may be disrupted ecosystems and accelerated extinction for many plant and animal species.

The largest source of greenhouse gas emissions intimately linked with human activity is the use of fossil fuels as a source of energy, but other major sources include the clearing of forested land for agriculture, industrial and consumer use of chlorofluorocarbons, the growing of rice in flooded paddies, and the raising of domestic livestock. Potential alternatives to fossil fuels as sources of energy exist, but they are not available on the scale needed, not yet economically competitive, or, in some cases, not without environmental problems of their own. (See Chapter 9, "Energy," Nonfossil Sources: A Look Ahead.) Yet energy is so central to economic activity and its current sources are so embedded in our industrial infrastructure that promising efforts to develop and spread the use of nonfossil sources should be intensified.

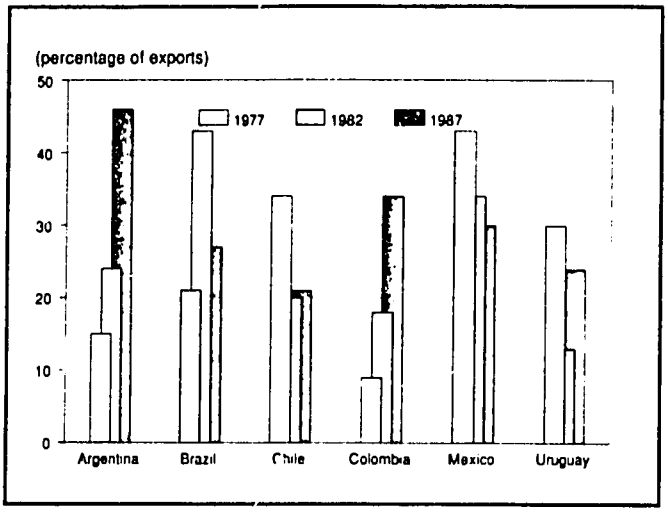
Dealing with Greenhouse Gases

The Montreal Protocol on Substances that Deplete the Ozone Layer, agreed in 1987, was an important step toward limiting the production and release of the chlorofluorocarbon chemicals that cause the destruction of ozone and that are also long-lived greenhouse gases. But there is already widespread consensus that additional steps will be needed if

Datapoint: Latin American Debt

The context for Latin American environmental issues during the 1980s—and much else—has been the economic stagnation of the region. A factor in that stagnation has been the region's mounting external debt, which in 1987 totaled $387 billion. By comparison, the external debt for all of Asia was $342 billion and for Africa $212 billion. To pay the interest on that debt, countries struggled to increase exports, with varying success. For the largest countries in Latin America, debt service consumed between 25 and 45 percent of export earnings. (See Figure 1.12.) To make matters worse, prices for agricultural commodities (one of Latin America's major exports) dropped on world markets. The result was a decline in per capita gross domestic product of almost 1 percent per year between 1982 and 1989. Under such conditions, it is hard to make protection of the environment the highest priority.

Figure 1.12 Debt Service as a Percentage of Exports of Goods and Services in Six Latin American Countries



Source: Chapter 15, "Basic Economic Indicators," Table 15.2.

or halt the deterioration of the biological systems on which all life depends.

A CHANGING WORLD

The year 1989 saw unprecedented political change in Eastern Europe, as country after country adopted democratic reforms. Equally dramatic transitions to new or strengthened democratic governments took place in Latin America, and there were strong currents of political change in the Soviet Union and South Africa. This sweeping tide is a reminder that attitudes and human institutions can and do change, and change quickly, given appropriate conditions. That is a source of great hope, not only for a freer and more peaceful world, but also for a world less threatened by continuing environmental degradation.

Where will the financial resources come from to build an enduring economic base and to combat poverty in the developing countries, to clean up and rebuild the pollution-prone industrial base of Eastern Europe and the Soviet Union, and to develop new technologies everywhere that can provide the foundation for economic growth without degrading the environment? One potential source, if the world turns from confrontation to peaceful cooperation, is the huge resources now devoted to military budgets—an estimated $1 trillion per year worldwide and significant fractions of the industrial workforce: 11 percent in the United States, 9.7 percent in the Soviet Union (18). One rationale for such a refocusing of resources is the growing concern that local and global environmental problems can be as serious a threat to national security and prosperity as military conflicts (19).

In order for sustainable economic development to proceed, however, the environmental consequences of development must be considered from the start, in developing countries and industrial countries alike. It is a hopeful sign that major funding organizations such as the World Bank and a growing number of large international corporations have made commitments to environmental standards (20). It may also prove essential to measure economic progress more realistically. At present, such economic indicators as gross national product give misleading indications. For example, when applied to countries that rely heavily on their natural resources, gross national product fails to take into account the depletion or destruction of those assets in the process of economic development. (See Chapter 14, "Policies and Institutions.")

Public Opinion on the Environment

As democratic governments spread, support for rechanneling resources to environmental problems may come more and more from ordinary citizens. Widespread concern about the environment is becoming a potent political force. Environmental issues have played a strong role in the wave of democracy sweeping over Eastern Europe and have increasingly become an election issue in the new democracies of Latin America. Environmental questions are being raised repeatedly in the Soviet Union and are already a recurring issue in elections in Western Europe and North America. Increasingly, the environment is becoming a global political issue, occupying a major

ozone depletion is not to grow, intensifying ultraviolet rays that can harm many forms of life. In late 1989, the Antarctic ozone hole was again large (see Chapter 12, "Atmosphere," Severe Ozone Depletion Returns in 1989), and scientists reported that conditions were ripe for a hole to form in the Arctic as well. The urgency is underscored by the fact that some chlorofluorocarbons remain in the atmosphere for up to 100 years. On the positive side, however, many of the industrial companies that manufacture chlorofluorocarbons were moving to develop less-damaging substitutes, and other companies announced plans to phase out use of the chemicals or to recapture them before their release into the atmosphere.

Preparations are under way for a similar, but more difficult, step toward controlling greenhouse gas emissions. An Intergovernmental Panel on Climate Change, under the sponsorship of the United Nations Environment Programme and the World Meteorological Organization, has been studying the science and the impacts of climate change and policy responses and is scheduled to report its findings in the summer of 1990. In the fall of 1990, the Second World Climate Conference will take place in Geneva to consider those findings. The United States has offered to host an international conference in 1991, at which governments might negotiate the foundations of a treaty for regulating greenhouse gas emissions. If successful, such an agreement would be followed by the development of a specific protocol analogous to that established in Montreal. International agreements will be critical, but they also must be supplemented by national actions to share technologies that can create a more sustainable industrial system and to provide the resources to acquire and use them.

Industrial Air Pollution

At regional levels, meanwhile, urban and industrial air pollution remains a serious problem. Concern about the impact of air pollution on human health and on forests has led many industrial countries to tighten regulations and reduce emissions of lead, sulfur dioxide, and oxides of nitrogen in recent years. (See Chapter 12, "Atmosphere," Approaches to Air Pollution Control.) In most centrally planned economies in the developing world, and in the emerging market economies of Eastern Europe, these concerns are just beginning to be addressed; often, not even the extent of the problem is known. Since most of the growth in populations will occur in the urban areas of the developing world, urban air quality will become increasingly crucial to human health.

Worldwide, emissions of sulfur dioxide and oxides of nitrogen continue to climb. (See Figure 1.6.) These pollutants cause economic, environmental, and aesthetic harm, as well as damage to human health. The oxides of sulfur form particulates that reduce atmospheric visibility, degrading recreational values. Oxides of nitrogen help to form ozone, a principal constituent of urban smog. Concentrated in urban areas, sulfur dioxide and smog cause lung damage and raise the incidence of many respiratory diseases. But even when these pollutants are widely dispersed, they pose a significant environmental threat through the formation of acids that precipitate as rain, snow, or in other forms.

Acid precipitation has altered the chemistry of tens of thousands of lakes and streams to the point where they can no longer support life. It is implicated in damage to crops and forests in many areas of the world, among them China, North and South America, Africa, and nearly 50 million hectares of forest in Europe alone. It can also help to mobilize toxic metals from soil, sediments, and even drinking water pipes. It is, in short, a major indirect cost attributable to the use of fossil fuels.

Land and Sea—The Fertile Earth

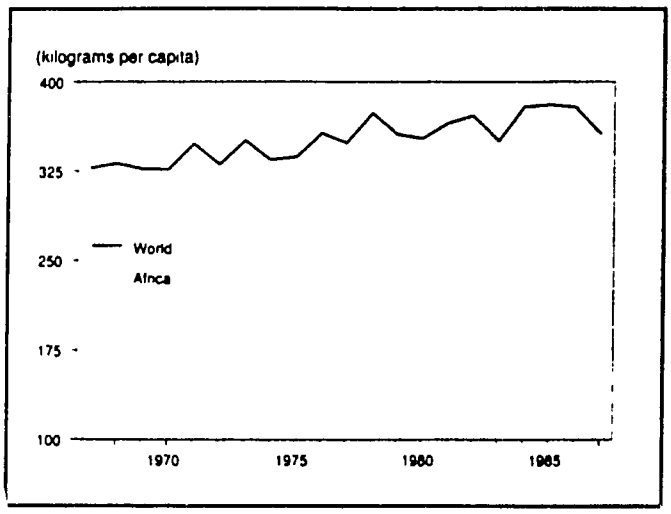
Life on Earth depends very directly on the living soil and the aquatic ecosystems of rivers, lakes, estuaries, and oceans. Without fertile soil and the microbial fauna that inhabit it, food would not grow, dead things would not decay, and nutrients would not be recycled. Without the plankton and algae that form the base of the aquatic food web, there would be no fish to harvest; even the ocean's ability to remove carbon dioxide from the atmosphere—and thus moderate global warming—would be greatly decreased.

Yet the Earth's soils are being stripped away, rendered sterile, or contaminated with toxic chemicals at a rate that cannot be sustained. By some estimates, 10 percent of the land surface of the planet has been transformed by human activities from forest and rangeland into desert (5); as much as 25 percent more is at risk (6). Cropland is already scarce in much of the developing world; it is getting scarcer as urban areas expand and high dams flood fertile valleys. A country is often described as "land scarce" when more than 70 percent of the potentially arable land is under cultivation. In Asia, an estimated 82 percent of all potential cropland is under production. In Latin America and Africa, the percentages are lower, but misleading. Latin America has the highest concentration of land ownership—10 percent of the population owns 95 percent of the arable land—but subsistence farmers must seek land on steep hillsides or in tropical forests, hastening erosion and deforestation (7). Large areas in Africa are plagued by drought or by the tsetse fly. As a result, continuing the rate of expansion of cropland in these regions—by 14.1 percent in South America and 4.6 percent in Africa, from the mid-1970s to the mid-1980s—may prove unsustainable.

Expanding Agriculture

Most areas of potential expansion for agriculture either lack water or have physical or chemical constraints such as steep slopes, easily eroded or

Figure 1.7 Per Capita Cereal Production 1967–87



Source: Food and Agriculture Organization of the United Nations, *1948-1985 World Crop and Livestock Statistics* (FAO, Rome, 1987), pp. 8-9. *Production Yearbook*, 1987, Vol. 41 (FAO, Rome, 1988), p. 113. (Population figures derived from the World Bank Database.)

poorly drained soils, alkaline or other conditions toxic to plants. New agricultural lands often prove illusory, as evidenced by the failure of an estimated 20 percent of new ranches in the Amazon within a few years. Indeed, the loss of existing agricultural land through erosion is estimated at 6–7 million hectares per year, with an additional loss of productivity to 1.5 million hectares from waterlogging, salinization, and alkalinization (8). Modern irrigation systems can bring water from long distances, careful terracing can make steep slopes usable, and imaginative new technical solutions such as those being used in Latin America's tropical savannas (see Chapter 6, "Food and Agriculture," Sustainable Land Use for South America's Tropical Savannas) may overcome soil limitations, but these are not solutions for subsistence agriculture. All too often, expansion into new and marginal agricultural land is, out of basic necessity, led by those least able to overcome its difficulties or to farm it in a sustainable manner.

Asia has increased its per capita food production over the past decade through a massive increase in agricultural inputs such as fertilizers, pesticides, and mechanical equipment. Over the same period, Latin America barely maintained its per capita food production (despite substantial increases in inputs and in land used for agriculture), while Africa's per capita food production declined. For grains, specifically, world production has continued to rise, even on a per capita basis, except during the North American drought years of 1987 and 1988. The major exception is Africa, which continued a 20-year trend of declining per capita grain production. (See Figure 1.7.) Meanwhile, the world's margin of error for food declined in 1988, as grain stocks fell by nearly a quarter, to 305 million metric tons, in large part because of droughts in North America.

At present, the world's cropland averages about 0.28 hectare per capita, but varies widely. Latin America has nearly double the world average (but, as noted above, concentrated in the hands of a few); Asia, in contrast, has only 0.15 hectare per capita. If world food production is to increase 60 percent by the year 2025—as it must to maintain current nutritional levels for a population projected at 8.5 billion—then either croplands must expand or crop yields must increase. The latter is likely to require more inputs of fertilizer, pesticides, and irrigation—with the risk of worsening water pollution—or novel means of increasing productivity, such as higher yielding or pest-resistant strains developed through biotechnology. The extension of plant breeding methods typical of the Green Revolution to dryland crops—if that proves possible—could also increase yields and reduce losses to pests.

Growing Demands on Freshwater Supply

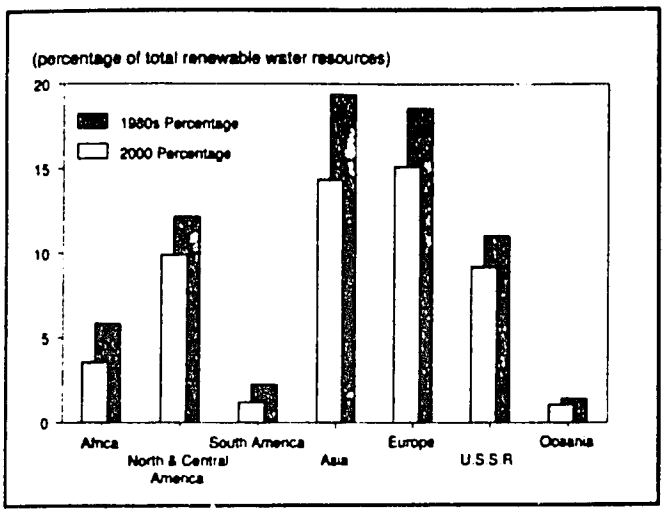
Freshwater for irrigation is increasingly limited in many regions of the world. Withdrawals of water for municipal and industrial use are rising. Projections based on a detailed model of water use prepared by the Institute of Geography of the Soviet Academy of Sciences suggest that withdrawals of freshwater will continue to rise rapidly in the near future, approaching 20 percent of the total runoff for both Asia and Europe and much higher percentages in specific river basins. (See Figure 1.8.) The environmental effects of excessive withdrawals are demonstrated dramatically by the devastation of the Soviet Union's Aral Sea, which has lost 40 percent of its area, 60 percent of its volume, and virtually all of its once productive fishery over the past 30 years. (See Figure 1.9.)

The first global assessment of water quality, completed in 1989 under the auspices of the United Nations Global Environmental Monitoring System, found growing contamination of freshwater. (See Chapter 10, "Freshwater," Freshwater Quality: A Global Perspective.) Runoff from urban and agricultural areas is a major continuing source of pollution. In developing countries and in many industrialized countries with centrally planned economies, domestic sewage and industrial effluents are often dumped untreated into rivers and lakes; the problem is severe in Eastern Europe and the U.S.S.R. and growing in the concentrated urban areas of the developing world where perhaps 500 million people do not have access to treated water for drinking, bathing, and preparing food.

Polluting the Oceans

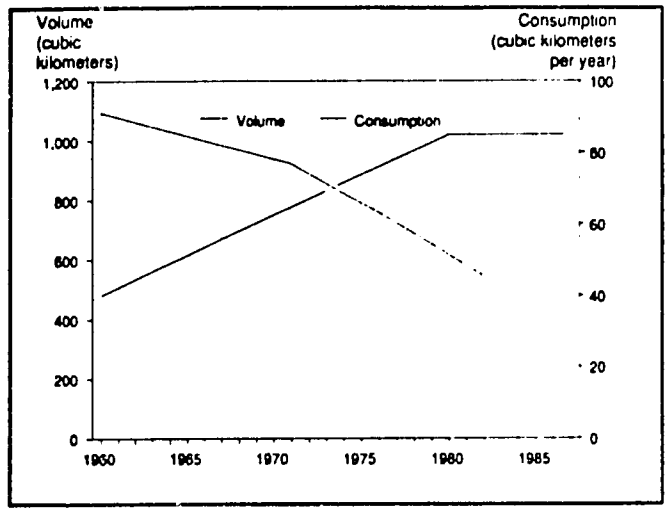
The oceans, vast as they are, are beginning to show the effects of pollution too, particularly in coastal areas. This was demonstrated graphically in Alaska when the tanker *Exxon Valdez* went aground and spilled 38.5 million liters of oil into the cold waters of Prince William Sound. Oil spills are isolated, if recur-

Figure 1.8 Freshwater Withdrawals By Region, 1980s and projections for 2000.



Source: Chapter 10, "Freshwater," Tables 10.4, 10.5, and 10.6.

Figure 1.9 The Rising Consumption of Irrigation Water and the Declining Volume of the Aral Sea, 1960–87



Source: Philip P. Micklin, "Desiccation of the Aral Sea: A Water Management Disaster in the Soviet Union," *Science*, Vol. 241 (Sept. 2, 1988), pp. 1170-1176.

ring, incidents, but the effects of urban sewage, silt, plastics, pesticides and other organic substances are pervasive and compound the damage. A recent study by the United Nations Group of Experts on the Scientific Aspects of Marine Pollution concluded that "chemical contamination and litter can be observed from the poles to the tropics and from beaches to abyssal depths....We fear, especially in view of the continuing growth of human populations, that the marine environment could deteriorate significantly in the next decade unless strong, coordinated national and international action is taken now." (See Chapter 11, "Oceans and Coasts," New Assessment of Ocean Pollution.)

Coastal waters, where pollution is at its worst, shelter the vast majority of the ocean's life. Although the world's fish catch continues to climb, some fisheries in heavily fished and polluted areas are declining. And although the global fish catch is just below its estimated sustainable yield, fishermen exceed the estimated sustainable yield in 4 of 16 major fisheries—the Pacific Northwest, the Mediterranean and Black Sea, the Eastern Indian Ocean, and the Southeast Pacific—and are close to it in many others.

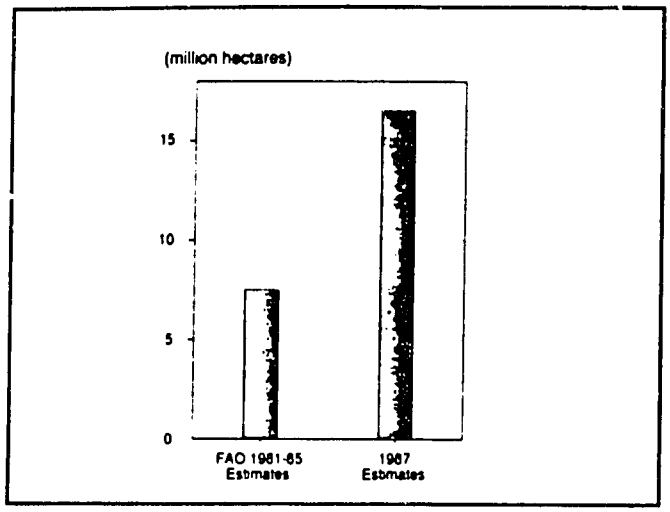
The Earth cannot produce its bounty if we continue to damage its productive capacity. Human action has increased the global rate of soil erosion threefold since prehistoric times (9), based on the evidence of the sediment loads of the world's rivers compared with the history of earlier sediment loads written in the muds of the ocean floor. Toxic materials abound—oil spilling into the oceans at 10 times the rate of natural seeps (10), lead being deposited on soils and in waterways at 100 times the prehistoric levels (11), cadmium being released into the environment at 40 times the natural rates (12), radioactive materials contaminating soils at many sites, and the acidity of precipitation over millions of square kilometers increasing 10-fold (13).

Living Resources

The living resources of the planet surely include the few dozen species of plants and animals grown for food and fiber. They also include the human resources—people themselves. But it is the vast diversity of other species that constitute the biological systems on which life itself depends. Now, that diversity, and the genetic heritage that it represents, is increasingly at risk.

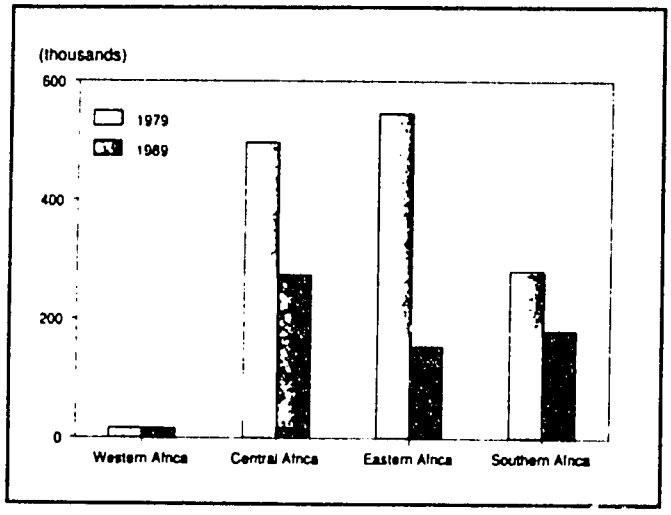
The largest density of those species is to be found in the tropical forests of the world, which are under intense pressure. Over the past decade, land conversion and deforestation in these regions have accelerated dramatically. An estimated 17 million hectares of closed forest were deforested and converted to other uses in 1987, up from 7.5 million hectares in 1981. (See Figure 1.10.) Estimates of deforestation vary substantially and the true extent is not known with any great accuracy, but the trend is not in doubt and it is alarming. The best current estimate for 1987, in what may have been a peak year, is that the worldwide loss of both closed and open tropical forest amounted to 20.4 million hectares. (See Chapter 7, "Forests and Rangelands," New Estimates of Tropical Deforestation.) In many areas of the world, the loss is not only the trees and the habitat for an enormous variety of species that the forest provides, but also the relatively poor soils beneath it, which often compact, laterize, or erode when the tree cover has gone.

Figure 1.10 World Total of Closed Tropical Forest Area Lost Per Year



Source: Chapter 7, "Forests and Rangelands," Table 7.1 and Food and Agriculture Organization of the United Nations (FAO), Forest Resources Division, *An Interim Report of the State of the Forest Resources in the Developing Countries* (FAO, Rome, 1988).

Figure 1.11 Elephant Populations in Africa, 1979[a] and 1989



Source: TRAFFIC USA, World Wildlife Fund, unpublished data (Washington, D.C., October 1989).
Note: a. Estimated in 1979.

Clearing land for agriculture and environmental degradation of other kinds have accelerated the rate of habitat loss and species extinction to levels not seen on Earth for 60 million years. A precise measure is not possible because scientists have not yet identified many of the life forms that are threatened and they do not know, with any precision, the number of species that inhabit the Earth, but careful estimates are that we are losing 100 species per day (14). The trends are all too clear—from declining American songbirds whose winter habitat is the disappearing Central American forests to the African elephant whose numbers have been sharply reduced over the past decade by ivory poachers. (See Figure 1.11.)

Human Poverty and Ill Health

The human species is not declining in numbers, but some 350 million to 1 billion people remain seriously undernourished. Estimates are that 1 billion people live in households too poor to obtain the food they need in order to be able to work, that one child in three is underweight by age 5, and that hundreds of millions of people suffer from anemia, goiter, and impaired sight—conditions associated with a lack of iron, iodine, or vitamin A (15). Beyond outright hunger, many people lead lives trapped in subsistence agriculture or in urban poverty.

Conditions in urban environments are deteriorating in many developing countries: untreated sewage, uncontrolled industrial effluents, and rapidly growing automobile fleets pollute air, water, and nearby cropland. By the year 2000, a billion people are expected to be without satisfactory sanitation and half a billion without adequate drinking water. (See Chapter 5, "Human Settlements," Conditions and Trends.) Competition for housing in already overcrowded cities is expected to increase. The strong trend to urbanization in developing countries means that more and more of the world's population must contend with these conditions.

The consequences for human health are severe. An estimated 60 percent of Calcutta's population suffer from respiratory diseases related to air pollution; lung cancer in Chinese cities (where coal is the main fuel) is 4 to 7 times higher than in the nation as a whole; and lead from auto exhausts is found in the blood of children in Mexico City at levels high enough to cause brain damage (16).

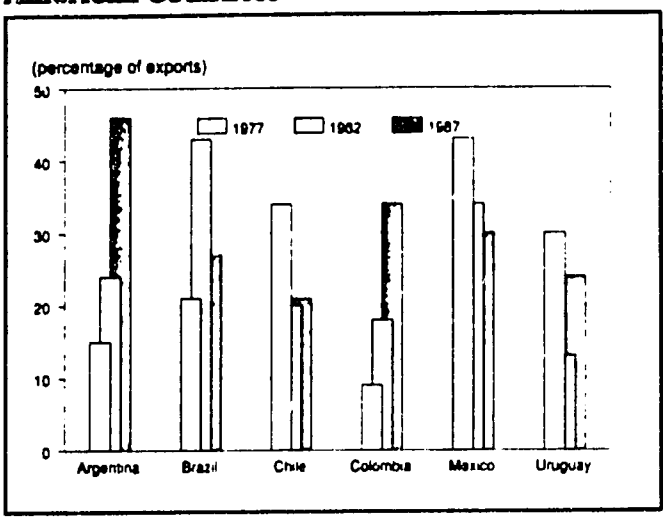
Access to health care has improved in recent decades, but the health care systems of many developing countries cannot cope with many serious health problems. Diseases related to inadequate sanitation and absence of clean water are widespread, leaving hundreds of millions of people debilitated and unable to reach their full potential. Malaria is resurgent—the total number of cases may reach 100 million per year—and AIDS is spreading steadily in Africa, Latin America, and the Caribbean, as well as in many industrialized countries. (See Chapter 4, "Population and Health," Focus on a Major Killer: Malaria and AIDS in the Americas.)

With the expected increase in the world's population rising by about 96 million additional people per year during the decade of the 1990s (17), it will take extraordinary efforts to supply the world's population with adequate food and health care and to slow

Datapoint: Latin American Debt

The context for Latin American environmental issues during the 1980s—and much else—has been the economic stagnation of the region. A factor in that stagnation has been the region's mounting external debt, which in 1987 totaled $387 billion. By comparison, the external debt for all of Asia was $342 billion and for Africa $212 billion. To pay the interest on that debt, countries struggled to increase exports, with varying success. For the largest countries in Latin America, debt service consumed between 25 and 45 percent of export earnings. (See Figure 1.12.) To make matters worse, prices for agricultural commodities (one of Latin America's major exports) dropped on world markets. The result was a decline in per capita gross domestic product of almost 1 percent per year between 1982 and 1989. Under such conditions, it is hard to make protection of the environment the highest priority.

Figure 1.12 Debt Service as a Percentage of Exports of Goods and Services in Six Latin American Countries



Source: Chapter 15, "Basic Economic Indicators," Table 15.2.

or halt the deterioration of the biological systems on which all life depends.

A CHANGING WORLD

The year 1989 saw unprecedented political change in Eastern Europe, as country after country adopted democratic reforms. Equally dramatic transitions to new or strengthened democratic governments took place in Latin America, and there were strong currents of political change in the Soviet Union and South Africa. This sweeping tide is a reminder that attitudes and human institutions can and do change, and change quickly, given appropriate conditions. That is a source of great hope, not only for a freer and more peaceful world, but also for a world less threatened by continuing environmental degradation.

Where will the financial resources come from to build an enduring economic base and to combat poverty in the developing countries, to clean up and rebuild the pollution-prone industrial base of Eastern Europe and the Soviet Union, and to develop new technologies everywhere that can provide the foundation for economic growth without degrading the environment? One potential source, if the world turns from confrontation to peaceful cooperation, is the huge resources now devoted to military budgets—an estimated $1 trillion per year worldwide and significant fractions of the industrial workforce: 11 percent in the United States, 9.7 percent in the Soviet Union (18). One rationale for such a refocusing of resources is the growing concern that local and global environmental problems can be as serious a threat to national security and prosperity as military conflicts (19).

In order for sustainable economic development to proceed, however, the environmental consequences of development must be considered from the start, in developing countries and industrial countries alike. It is a hopeful sign that major funding organizations such as the World Bank and a growing number of large international corporations have made commitments to environmental standards (20). It may also prove essential to measure economic progress more realistically. At present, such economic indicators as gross national product give misleading indications. For example, when applied to countries that rely heavily on their natural resources, gross national product fails to take into account the depletion or destruction of those assets in the process of economic development. (See Chapter 14, "Policies and Institutions.")

Public Opinion on the Environment

As democratic governments spread, support for rechanneling resources to environmental problems may come more and more from ordinary citizens. Widespread concern about the environment is becoming a potent political force. Environmental issues have played a strong role in the wave of democracy sweeping over Eastern Europe and have increasingly become an election issue in the new democracies of Latin America. Environmental questions are being raised repeatedly in the Soviet Union and are already a recurring issue in elections in Western Europe and North America. Increasingly, the environment is becoming a global political issue, occupying a major

place on the agenda at the "Group of Seven" (Canada, France, Federal Republic of Germany, Italy, Japan, the United Kingdom, and the United States) economic summit meeting in 1989.

The reasons for the emergence of the environment as a political concern are not hard to find. In 1988 and 1989, the Harris polling organization surveyed public opinion and leadership attitudes around the globe on behalf of the United Nations Environment Programme (21). The survey encompassed 15 countries, including the developing regions of Africa, Asia, and Latin America as well as North America, Western Europe, and Eastern Europe, and found widespread concern about the quality of the environment. Most of those surveyed in all but one country, Saudi Arabia, believed that their environments had become worse in the past decade, large majorities in every country surveyed believed that environmental protection should have a high priority and favored stronger actions by both governments and international organizations. Women surveyed were more aware and concerned about environmental degradation than were men; younger people were more aware and concerned than older people.

The greatest concern of those polled was pollution of drinking water, but large majorities also thought that air and water pollution, the dumping of toxic chemicals on the land, loss of agricultural or farm land, loss of forests, and overuse of pesticides and herbicides were serious problems.

Perhaps most striking was the finding that, by large margins in all the countries surveyed, the public put a higher priority on reducing environmental health risks than they did on increasing living standards. Most people in all 15 countries surveyed (except Argentina) declared that they would be willing to pay higher taxes to see an improvement in the environment, and substantial majorities everywhere (except Japan) would be willing to spend some of their time or money to help improve the environment. Overwhelming majorities of those polled wanted governments to pass and enforce stronger laws and to make protection of the environment a higher priority.

A Common Future

A more peaceful and cooperative world, governments that are more responsive to their citizens and capable of redirecting resources to deal with environmental problems and assist the development process, widespread public concern and growing knowledge about the environment—these are the hopeful signs for the coming decade. The growing role of nongovernmental organizations and of grassroots participation in environmental issues is also a positive trend. The 1992 United Nations Conference on Environment and Development, for which preparation is now under way, ought to be regarded as a unique and crucial opportunity for industrial and developing countries to work together to mobilize world attention on environmental issues and to further sustainable development. These and other initiatives will need widespread support if the world's environmental problems are to be successfully confronted and Earth is to be sustained as a fertile, bountiful planet, the common home of all living things.

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EXECUTIVE SUMMARY

ICUN
World Resources Inst.
Conservation Int'l.
World Wildlife Fund-US
World Bank

Our species entered the industrial age with a population of one billion and with biological diversity — the total of genes, species, and ecosystems on earth — possibly at an all-time high. Biological resources — the portion of diversity of actual or potential use to people — were freely available for exploitation to support development.

In the late 20th century, we are coming to realize that *biological resources have limits*, and that *we are exceeding those limits* and thereby reducing biological diversity. This is therefore a time of extraordinary change in the relationship between people and the biological resources upon which their welfare depends. Each year, more people are added to the human population than ever before, species are becoming extinct at the fastest rate known in geological history, and climate appears to be changing more rapidly than ever.

Human activities are progressively eroding the earth's capacity to support life at the same time that growing numbers of people and increasing levels of consumption are making ever greater demands on the planet's resources. The combined destructive impacts of a poor majority struggling to stay alive and an affluent resource-consuming minority are inexorably and rapidly destroying the buffer that has always existed, at least on a global scale, between human resource consumption and the planet's productive capacity.

The erosion of the planet's life-support systems is likely to continue until human aspirations come more into line with the realities of the earth's resource capacities and processes, so that activities become sustainable over the long term. The problems of conserving biological diversity therefore cannot be separated from the larger issues of social and economic development.

Maintaining maximum biological diversity assumes far greater urgency as rates of environmental change increase. Diversity in genes, species, and ecosystems provides the raw materials with which different human communities will adapt to change, and the loss of each additional species reduces the options for nature — and people — to respond to changing conditions.

The tropics harbor a major proportion of the planet's biological diversity. The industrialized countries also depend on tropical resources, as industrial materials, sources of breeding material, pharmaceuticals, tourism sites, and a wide range of other tangible and intangible benefits. So far, however, the exploitation of the tropics by the industrialized societies has yielded great benefits without making commensurate investments in conservation and without paying the environmental costs of over-exploitation. Cheap labor, raw materials with low prices that do not reflect their true value, inappropriate development aid, and the control of commodity prices and interest rates, among other factors, have encouraged much more rapid levels of resource depletion and destruction than would otherwise be the case. The situation is continually worsening through the ramifications of the developing world's debt crisis and related high interest rates.

Governments, industry, development agencies, and the general public are therefore becoming increasingly concerned about the depletion of biological resources, with the growing awareness that development depends on their maintenance.

How can the scientific knowledge be mobilized that will best enable the planet's biological diversity to be conserved? How can the process of change be managed so that biological resources can make their best contribution to sustainable development? What information is required to address the problems of conserving biological diversity? Which problems need to be addressed first? How can the many initiatives in conservation of biological diversity be coordinated most effectively? Where can the financial resources be found to respond to these issues at a scale that will be commensurate with the problems?

This document seeks answers to these questions.

The Values of Biological Diversity

Biological resources provide the basis for life on earth, including that of humans. The fundamental social, ethical, cultural, and economic values of these resources have been recognized in religion, art, and literature from the earliest days of recorded history. The great interest that children have in nature, the numerous wildlife clubs, the generous donations made to non-governmental conservation organizations, the political support for "Green Parties," and the popularity of zoos and wildlife films are economic expressions of preference and show that the general public does not think of biological resources merely in terms of a cash value.

But in order to compete for the attention of government and commercial decision-makers in today's world, policies regarding biological diversity first need to *demonstrate in economic terms the contribution biological resources make to the country's social and economic development.* Even partial valuation in monetary terms of the benefits of conserving biological resources can provide at least a lower limit to the full range of benefits and demonstrate that conservation can yield a profit in terms that are meaningful to national accounts.

Three main approaches have been used for determining the value of biological resources:

- assessing the value of nature's products — such as firewood, fodder, and game meat — that are consumed directly, without passing through a market ("consumptive use value");
- assessing the value of products that are commercially

harvested, such as timber, fish, game meat sold in a market, ivory, and medicinal plants ("productive use value"); and,

- assessing indirect values of ecosystem functions, such as watershed protection, photosynthesis, regulation of climate, and production of soil ("non-consumptive use value"), along with the intangible values of keeping options open for the future ("option value") and simply knowing that certain species exist ("existence value").

How and Why Biological Resources are Threatened

The proximate causes of the loss of biological resources are clear. Biological resources are degraded and lost through such activities as the large-scale clearing and burning of forests, overharvesting of plants and animals, indiscriminate use of pesticides, draining and filling of wetlands, destructive fishing practices, air pollution, and the conversion of wildlands to agricultural and urban uses.

When the problem of biodiversity loss is defined in terms of its immediate causes, the response is to take defensive and often confrontational actions, such as enacting laws, closing access to resources, and declaring additional protected areas. Such responses are necessary in times of rampant over-exploitation. But they are *seldom really sufficient to change the social and economic causes of the threats to biological diversity.*

The foundations of over-exploitation include demands for commodities such as tropical hardwoods, wildlife, fiber, and agricultural products. The growing human population, even without accompanying economic growth and development, places increasing demands on natural resources and ecosystem processes that are already impoverished and stressed. Settlement policies promote the movement of the growing unemployed labor forces to frontier zones. The debt burden forces governments to encourage the production of commodities that can earn foreign exchange. Energy policies encourage inefficiency in many nations, and in so doing add to the burden of air pollutants and the risk of substantial global climate change. Inappropriate land tenure arrangements discourage rural people from making the investments that would enable sustainable use of the available biological resources.

When the problem is defined in terms of its root causes, a more constructive response can be stimulated that seeks *cooperative efforts to address the social and economic foundations of resource depletion.*

Six main obstacles to greater progress in conserving biological diversity need to be addressed:

- National development objectives give insufficient value to biological resources.
- Exploiting biological resources yields the greatest profit for traders and manufacturers (who can externalize environmental costs), not for the local people who have few other sources of livelihood, and who must pay the environmental costs of over-exploitation.
- The species and ecosystems upon which human survival depends are still poorly known.
- The available science is insufficiently applied to solving management problems.
- Conservation activities by most organizations have focused too narrowly.
- Institutions assigned responsibility for conserving biodiversity have lacked sufficient financial and organizational resources to do the job.

Approaches to Conserving Biological Diversity

Conserving biological diversity needs to address both proximate and ultimate causes. The complex threats to biological diversity call for a wide range of responses across a large number of private and public sectors. All are necessary, with the mix of responses adjusted to the local conditions. Since government policies are often responsible for depleting biological resources, it stands to reason that policy changes are often a necessary first step toward conservation. National policies dealing directly with wildlands management or forestry, or influencing biodiversity indirectly through land tenure, rural development, family planning, and subsidies for food, pesticides, or energy can have significant impacts on the conservation of biodiversity. National and sub-national conservation strategies can often provide the mechanism for carrying out such reviews.

Protecting species can best be done through *protecting habitats.* Most national governments have established legal means for protecting habitats that are important for conserving biological resources. These can include: national parks and other categories of reserves (some 4,500 major reserves exist, covering nearly 500 million hectares); local laws protecting particular forests, reefs, or wetlands; regulations incorporated within concession agreements; planning restrictions on certain types of land; and customary laws protecting sacred groves or other special sites. The responsibility for such management is often spread widely among public and private institutions. While accomplishments to date are impressive, the amount of habitat protected needs to be increased by a factor of three if these areas are to make the necessary contribution to conserving biological diversity; these new areas may need more flexible approaches to management than is usual in national parks.

In addition, the protected areas will succeed in realizing their conservation objectives only to the extent that the areas themselves are effectively managed, and to the extent that the management of the land surrounding them is compatible with the objectives of the protected areas. This will typically involve protected areas becoming parts of larger regional schemes to ensure biological and social sustainability, and to deliver appropriate benefits to the rural population.

Ex situ conservation programs — zoos, aquaria, seed banks, botanic gardens, and so forth — supplement *in situ* conservation by providing for the long-term storage, analysis, testing, and propagation of threatened and rare species of plants and animals and their propagules. They are particularly important for wild species whose populations are highly reduced in numbers, serving as a backup to *in situ* conservation, as a source of material for reintroductions, and as a major repository of genetic material for future breeding programs of domestic species. Some *ex situ* facilities — notably zoos and botanic gardens — provide important opportunities for public education, and many make important contributions to taxonomy and field research.

Measures to *curb the pollution of the biosphere*, perhaps the most widespread conservation measures, are the most expensive, and have attracted the greatest attention from both the public and government. Biological diversity is threatened by various forms of chemical pollution, but the gravest threat may be climate change brought about by air pollution and the increase in atmospheric carbon dioxide due to deforestation and the burning of fossil fuels. Mean world temperatures could increase by about 2 °C and mean sea levels rise by around 30-50 centimeters in the next 40 years. While the species and ecosystems contained within protected areas will certainly be affected by climate change, it is unrealistic to expect the boundaries of existing protected areas to change very much, because they are usually surrounded by more intensive human land uses. Instead, new forms of management intervention will be required to maintain systems deemed desirable.

Many of the responses just discussed have been supported by *international legislation* that has fostered useful cooperation in conserving biological diversity. However, species and ecosystems are still being exploited at rates that far exceed their sustainable yield. Recognizing the growing severity of threats to biological diversity and the increasingly international nature of the actions required to address the threats, IUCN and UNEP have embarked on the preparation of an International Convention on the Conservation of Biological Diversity. This effort has gained the broad support of governments, including a joint resolution from the US Congress.

People form the foundation for the sustainable use of biological resources. Local communities need to be more involved in the management of biological resources, and to benefit from their sustainable use. Because groups of *indigenous people* in many parts of the world regard natural resources, particularly wildlife, as essential to their cultural continuity and economic well-being, they should be given particular attention in all conservation programs. Local people should be closely associated with the authorities responsible for the management of biological resources and for the establishment and management of protected areas. However, the tension between local interests and national interests in conservation requires great sensitivity and site-specific solutions.

The Information Required to Conserve Biological Diversity

Effective action must be based on accurate information, and the more widely shared the information, the more likely it is that individuals and institutions will agree on the definition of problems and solutions. Developing and using information is therefore an essential part of conservation at all levels, from the local to the global community.

The current state of knowledge about species and ecosystems is woefully inadequate; detailed knowledge is still lacking on the distribution and population sizes of even such large and well-studied animals as African primates. It seems self-evident that increasing knowledge about the kind and variety of organisms that inhabit the earth — and the ways that these organisms relate to each other and to humans — must be a foundation of conservation action. Therefore, a major effort is required to:

- document the wealth of the world's species of plants and animals, involving museums, zoos, aquaria, botanic gardens, universities, and research stations;
- carry out ecological fieldwork to show how the various pieces fit together, discover the population dynamics of species of particular concern, assess the effects of fragmentation of natural habitats, and determine what management steps are required to enable ecosystems to flourish with their full complements of species;
- develop new mechanisms for *ex situ* conservation, including both captive propagation and eventual release into "natural" ecosystems;
- monitor the changes in ecosystem diversity and function as the influences of humans become more pervasive, including climate change, deforestation, and various forms of pollution;
- assess the ecological differences between relatively large but minimally disturbed ecosystems and ecosystems that have been heavily affected by humans, as a basis for enhancing productivity and restoring degraded ecosystems to a more productive state; and to
- carry out research in the social sciences to determine how local people manage their resources, how changes in resource availability and land use affect human behavior, and how people decide how to use their biological resources.

Such basic inventory and fundamental research work should be carried out simultaneously with field action, with the two forms of activity reinforcing each other.

Government agencies, local communities, and conservation organizations all need information to enable them to manage their biological resources more effectively. Information tools that can help meet this need include basic descriptions of fauna and flora, practical handbooks for field identification, rapid inventory techniques, and basic computer programs for use with micro-computers.

The *information needs in the tropics are particularly important*, because these areas hold the majority of the world's biological diversity and they are losing species at rates that far exceed the world's capacity to record them. Highest priority for basic inventory work should be given to the sites of greatest diversity and local endemism coupled with the greatest threat, for the information contained by the species in these areas could disappear before humanity even knows what it is losing.

Development agencies should support national efforts to establish local, sectoral, and national information management systems, through demonstrating methodologies, providing training opportunities for taxonomists and biologists, and subsidizing the publication of status reports. Universities, research institutions, and non-governmental organizations (NGOs) need to be strengthened so that they can help governments assess their biological resources. Closer working relationships should be established between museums and other taxonomic-oriented institutions and those concerned with conservation of biological diversity.

Establishing Priorities for Conserving Biological Diversity

When governments approved the World Charter for Nature in the United Nations in 1982, they agreed that *all species and habitats should be safeguarded to the extent that it is technically, economically, and politically feasible*. But resources for conservation are always limited, so efforts spent in deciding what to do first are usually well repaid in savings of time, finances, and personnel.

Determining priorities is a complex task. The genetic landscape is constantly changing through evolutionary processes, and the world contains more variability than can be expected to be protected by explicit conservation programs; further, the capacity of governments or private organizations to deal with environmental problems is limited and many urgent demands compete for their attention. So governments, international organizations, and conservation agencies seeking to conserve biological diversity must be selective, and ask *which species and habitats most merit a public involvement in protective measures*

No generally accepted scheme exists for establishing priorities for the conservation of biological diversity, nor is it either possible or advisable for such a scheme to be devised. *Different organizations and institutions can be expected to have different ways of establishing priorities because of their differing goals*. For example, from a global perspective on biodiversity, regions with high species diversity may be most "valuable"; from the perspective of a pastoral community in the Sahel, however, the diversity of life available in the local ecosystem will be of highest value even though it exhibits relatively little diversity on a global scale.

The various methods of establishing priorities suggest different types of conservation action and will result in the conservation of different subsets of the world's biological resources. Each system has its own strengths and weaknesses, with the major point of difference being the *objective for which the system was devised.*

The Role of Strategies and Action Plans in Promoting Conservation of Biological Diversity

One of the best ways to ensure that the various institutions involved in conservation are in general agreement on priorities is to prepare a *strategy that defines the basic problems and agrees to appropriate objectives*. Strategies are turned into action through a more tactical process of planning specific activities to address the broad strategies; this often involves the preparation of an action plan.

A global strategy is required to provide the framework for local and regional efforts, and to give concise guidance on the options and opportunities for action capable of achieving global goals while addressing local priorities. The strategy needs to be supported by regional, national, local, and sectoral strategies, and by action designed to meet specific needs.

Such a strategy, dealing with all aspects of biodiversity, including both marine and terrestrial ecosystems at all latitudes, is currently being prepared by a coalition of the World Resources Institute, IUCN, and UNEP, in close collaboration with WWF, CI, the World Bank, the Asian Development Bank, and other key governmental and non-governmental institutions in both tropical and temperate nations. It is expected that FAO and Unesco will also participate in the process. It aims to:

- establish a common perspective, foster international cooperation, and agree to priorities for action at the international level;
- examine the major obstacles to progress and analyze the needs for national and international policy reform;
- specify how conservation of biological resources can be integrated with development more effectively and identify the linkages with other related issues facing humanity; and to
- promote the further development of regional, national, and thematic action plans for the conservation of biological diversity, and promote their implementation.

How to Pay for Conserving Biological Diversity

Innovative funding mechanisms will be required to support conservation efforts. These mechanisms should be based on the principle that *those who benefit from biological resources should pay more of the costs of ensuring that such resources are used sustainably*. Efforts are required at the community level to provide economic incentives for conser-

vation, at the national level to ensure that government policies are compatible with such incentives, and at the international level to ensure that the wealthy nations benefitting from the biological resources of the tropics are able to invest in conserving the productive capacity of those resources.

Approaches useful primarily at the national level include charging entry and other fees to national parks, levying charges for ecological services, collecting special taxes, building funding linkages with large development projects, returning profits from exploitation of biological resources, building conditionality into concession agreements, seeking support from the private sector, and establishing foundations for conservation. Approaches useful at the international level include international conventions that provide financial support, direct assistance from international conservation organizations, debt-for-nature swaps, restricted currency holdings, and conservation concessions.

In general, conservation should be supported to the maximum extent possible through the marketplace, but the marketplace needs to be established through appropriate policies from the central government. One problem faced by all the funding mechanisms described in this book is opportunity costs; any funds earned might be used by the government in other ways that the government considers of higher priority. The attraction of the methods suggested is that the *income is being earned by the biological resources*, and some of the funding is being provided by the public in expression of their support for non-consumptive uses of biological resources.

In many countries, funding is not the major constraint to conservation achievement. While conservation agencies never have sufficient funding, and additional funding is certainly called for, even generous budgets will not lead to conservation if government policies in other sectors are incompatible with conservation. Therefore, any new funding mechanisms need to be part of a package that includes necessary *policy changes in national security, land tenure, energy, frontier settlement, foreign trade, transportation, and so on.*

The major requirement from government policymakers is that they recognize the many values of biological resources, and take advantage of *opportunities to invest in the continued productivity* that such resources require. They also need to be persuaded to create conditions whereby the local community or the private or NGO sector can assume total management control of certain important biological resources or areas, and can seek their own funding in an attractive tax and investment climate. Through the use of innovative funding mechanisms backed by compatible government policies, one of the major obstacles to progress in conservation can be overcome.

Conclusion

The elements now exist that will reverse the trend toward the biotic impoverishment of the world. Novel approaches, new financial mechanisms, and new policies need to be applied at the appropriate level of responsibility to translate the new approaches into a *reality of improved human well-being and a secure biotic heritage.* New partners in conservation need to be found, involving all ministries, departments and private institutions that are directly dependent on biological resources. National parks departments, for example, should be joined in habitat management by a wide range of other institutions to represent all interests. Furthermore, other line agencies need to develop the capacity to manage biodiversity of particular relevance to their respective missions.

The 1990s may be the last decade during which constructive and creative decisions, activities, and investments — rather than emergency rescue efforts — can be made to ensure that many of the world's species and ecosystems are maintained, examined for their material and ecological value, and promoted for sustainable use to support new and innovative approaches to development. The combination of maintaining the *maximum possible biological diversity*, the *maximum possible cultural diversity*, and the *greatest possible scientific endeavor* would seem the most sensible approach toward dealing with the dynamic future facing humanity.

We are at a crossroads in the history of human civilization. Our actions in the next few years will determine whether we take a road toward a chaotic future characterized by overexploitation and abuse of our biological resources, or take the opposite road — toward maintaining great biological diversity and using biological resources sustainably. *The future well-being of human civilization hangs in the balance.*

Following page: A southern elephant seal *(Mirounga leonina)* pup (photo by W.V. Reid).

Policy and Research Series 8
The World Bank, March, 1990

Executive summary

Soil degradation in many developing countries constitutes a serious ecological and economic problem. Assessing ecosystems that are susceptible to soil erosion and measuring the extent and costs of the damage is difficult and often subjective. While the technical aspects of soil conservation are important to policy work, the focus of this review is on socioeconomic analysis and interpretation. The analytical structures that economists use to link technical aspects consist mainly of production and damage functions, sometimes buried implicitly in mathematical programming models, soil loss and fertility tracking functions, sometimes encapsulated in dynamic programming or optimal control formulations, and user cost, common property resources, and externality concepts.

Many factors bear on farmers' decisions about adopting soil conservation measures. The evidence, however, is based on studies in the industrial countries, especially the United States, and it is unclear how the results relate to developing countries. Factors that are positively associated with soil conservation include income, on and off farm; access to low-cost credit, especially when targeted to conservation; a low rate of discount or a long policy planning horizon; a high level of education among farmers; access to sound technical advice; and secure land tenure. Barriers include the negatives of these factors (insecure tenure), high subsidies on inputs such as fertilizer and irrigation water, and high population pressures.

The influence of three other groups of factors is ambiguous. First, agricultural technology. Although generally regarded as a complement to conservation, land-saving technologies such as modern cultivars have taken the pressure off the cultivated margins of forests, uplands, and semiarid areas but have sometimes hastened degradation. Second, the risk attitude of farmers has not been found to work in one direction or the other. The mixed findings on this factor probably mean that any general influence is dominated by other related factors such as wealth, tenure, discount rates, and so on. Third, the most contradictory evidence and opinion relate to the influence of price supports (or taxes) on primary agricultural products. Schuh (1987) takes the view that such price disincentives as export taxes and high marketing costs lead farmers to undervalue farm land — in sharp contrast to the more conventional view that high price supports serve to increase the rate of degradation, in the absence of any cross-compliance incentives. The difference here may arise from the fact that the first view is developing-country oriented, the second industrial. Alternatively, perhaps there are unstated assumptions about time horizons and expectations that may make the polar positions not as inconsistent as they seem, especially if supported farmers feel that they should get in and exploit the situation while the "going is good," and if taxed farmers cannot imagine their situation as ever being effectively and permanently changed.

Development agencies can intervene most di-

rectly and probably most effectively through projects addressed to soil conservation, but can also be associated with other projects where resource management issues merit overt concern, even if peripheral. Information for designing these projects is typically scarce, whether for assessing hazards or evaluating agronomic data. Appraising the tangible and intangible benefits is also difficult, as it depends on valuing improvements in water quality, reduced sedimentation, and a protected environment. In implementing projects, paying more than lip service to land management will require monitoring with relatively expensive measurements, and perhaps more staging and conditionality than is typical in project work. Micro-level incentive structures can function most readily when there is existing strong support for agriculture, in which case measures where participation in price-support programs is contingent on adoption of conservation practices can be the "stick" that follows the "carrot," although careful monitoring is also required.

The effectiveness of price intervention on land management is difficult to determine. Further research may reveal that reducing distortionary taxes on agriculture may encourage farmers to undertake conservation measures. The scope for using fiscal measures more effectively seems severely circumscribed by the lack of information, but there seems to be some opportunity to match taxes to rents associated with land degradation. There are analogous problems in fine-tuning monetary measures insofar as they impact on land management, but maintenance of an overvalued currency appears to constitute a significant disincentive to crop choices and crop management practices that are consistent with efficient conservation. Land tenure issues seem important in many conservation decisions, but apparently not in all. The opportunity for development agencies to become involved in these overtly national matters is severely restricted, but some headway could be made by national institutions.

Nearly every relationship in soil erosion and land conservation systems is either difficult to define or is inherently random. Much erosion is associated with extreme events that occur rarely but cause the bulk of the damage. Formal modeling requires analysts to resort to flexible simulation modeling to describe the systems being studied. Such models require considerable information and skill to use and construct. Under certain circumstances probability distribution estimates of system performance are useful along with comparable information from other public investment possibilities.

Distances between the source and destination of sediment can be considerable. There appears to be considerable scope for coordinating policies on disparate elements of land degradation and the downstream effects. Typically quite different agencies are concerned and, unless they are linked through intergovernmental committees, will not respond with socially efficient policy. Evidence on the relative extent of damage to agricultural land versus that from sedimentation lower in watersheds is so incomplete as to make opinion speculative and generalization impossible. Unless there are reservoirs or shallow shipping ways downstream, it seems fairly clear that the main damage affects the eroding agricultural land. Where there are important stream-based structures and facilities, the major damage may reflect the situation generally encountered in the United States of being primarily downstream. In the absence of more concrete data, a tentative policy conclusion can be reached. Project intervention in erosive agricultural areas is only justifiable when productivity losses there can be reduced cost-effectively. If a project involves downstream damage, planners should compare the benefits with the lowest cost method of confining sediment, which will probably seldom be through changed agricultural practices.

Government-sponsored research is necessary and must be undertaken at many sites in diverse ecosystems. Important though the work at the Consultative Group on International Agricultural Research center has been thus far, especially at the International Crops Research Institute for the Semi-Arid Tropics and the International Institute of Tropical Agriculture, much more long-term research is required before policymakers are reasonably well-informed about the options and opportunities.

FINANCIAL TIMES THURSDAY JUNE 21 1990

There is much to play for at the London conference on the ozone layer which opened yesterday, write **David Thomas** and **John Hunt**

Taking aim at a global issue

A wave of industrial investment, costing more than $100bn on some estimates, is almost certain to be triggered by the international conference on the ozone layer which opened in London yesterday.

More important, the 10-day conference is a test case of the world's ability to deal with even more intractable global environmental problems, such as the greenhouse effect. In particular, it will see the first concerted attempt to bind leading developing countries such as China and India into costly environmental accords.

By the glacial standards of international diplomacy, governments have already moved with breathless haste since the discovery in 1985 of a hole in the stratospheric ozone layer over Antarctica. The ozone layer filters out ultraviolet light, which would cause an outbreak of skin cancers.

Unusually for a global environmental problem, a scientific consensus about the cause of ozone depletion quickly formed. The culprits were identified as chlorofluorocarbons (CFCs) and some other substances widely used in refrigeration, air conditioning, industrial cleaning, fire-fighting and aerosols. This consensus resulted in swift action to curb the use of CFCs, a cooling substance devised for General Motors' refrigeration division in the 1930s.

An agreement in 1987 known as the Montreal Protocol committed participating countries to a phased reduction of CFC use, culminating in a 50 per cent cut in 1986 levels by 1998. After 1992, consumption of halons, widely used in fire-fighting equipment, must not exceed 1986 levels.

Even some environmental groups, normally quick to expose governmental sloth on green issues, have a few kind words for the Montreal Protocol. "The world community has moved faster on this issue than on any other international agreement," says Ms Fiona Weir of Friends of the Earth.

Yet it quickly became clear that the protocol needed strengthening. Scientific evidence mounted of the cumulative damage of CFCs and other substances on the ozone layer. Widespread depletion of the ozone layer in winter over Europe and North America was confirmed yesterday in a report from scientists on the UK Government's Stratospheric Ozone Review Group.

A strengthening of the Montreal Protocol will be the first task facing the representatives of more than 100 countries in London. The European Community, for instance, has agreed to press for a revised agreement which would:

- Phase out all CFC use preferably by 1997 and by 2000 at the latest.
- Phase out halons by 2000, with limited exceptions for essential uses such as aircraft fire extinguishers.
- Phase out carbon tetrachloride, a chemical used in CFC manufacture by 2000.
- Cut by 50 per cent the use of methylchloroform, an industrial cleaning substance, by 2000.

There will be considerable haggling over the fine print. The US, for instance, is understood to be concerned about some of intermediate steps proposed on the way to the final CFC phase-out. It was ahead of most other countries in removing CFCs from aerosols, a relatively straightforward exercise. The next round will force US companies to find substitutes for ozone-depleting substances in more complex and costly areas, notably fridges and solvents used in the electronics industry.

The green groups, such as Greenpeace and Friends of the Earth, have condemned the London conference in advance. Their central concern is that the amount of ozone-destroying chlorine in the atmosphere will continue to rise for decades without swifter action than that contemplated by most delegations. They point to the West German plan to phase out CFCs by 1995 as a model of what could be achieved. "The danger is that the Antarctic hole will not be eliminated even before the end of the next century. The timescale is too slow and ignores other damaging chemicals," says Ms Weir.

Nevertheless, even a CFC phase-out by the end of the century will have profound consequences for industry.

Large chemical companies, including Du Pont, ICI, Allied Signal, Atochem, Hoechst and Enimont, account for most of the world's production of CFCs. Many have launched expensive research programmes into CFC substitutes. Du Pont and ICI will soon open their first production plants resulting from this work. Chemical industry estimates of the amount it will have to spend on CFC substitutes by the end of the century are as high as $4bn.

This figure will be dwarfed by industries which use CFCs. Estimates of more than £100bn have been quoted for the total costs of weaning consuming industries such as fridge makers away from CFCs. These are inevitably speculative, although one thing seems certain: they will feed through into higher prices.

Industry's worries about the London conference are twofold: that it will result in chemicals being phased out before substitutes are ready; and that pressure is mounting for controls on some of the substitutes.

ICI's £100m research programme into CFC substitutes, for example, has so far yielded a substance called HFC-134A, which will be used as a coolant in fridges. It is spending £105m on building two plants, in the US and UK, to make this substitute. Its next most promising research lines are into substances, called HCFC-123 and 141B, which could be used in foam-blowing.

However, environmental groups are now demanding controls on these substitutes: the HFC family contributes to global warming and HCFCs also deplete the ozone layer, albeit typically with less than 10 per cent of the strength of CFCs. The London agreement is likely to contain a non-binding declaration backing a phase-out of HCFCs, possibly with a target date.

Talk of controls on CFC substitutes alarms companies such as ICI. Mr Chris Tane, ICI's marketing manager for new fluorocarbons, says the company might scrap plans to make HCFCs if an early phase-out date appeared likely. "Although we accept they will only be transitional substances, even the voices of pressure groups raised against them concern us," he says.

The other big issue in London is how to persuade some of the biggest developing countries to join the 56 nations which have signed the Montreal Protocol. China and India have made it plain that that they will not sign unless the developed world meets the resulting costs.

A big obstacle to developing country participation was removed this week when the US dropped its opposition to a special ozone layer fund for developing countries. Nevertheless, the size of the fund, which could grow to more than $200m over three years, and how it will be administered, still have to be settled. There is much to play for in London over the next 10 days.

Panos Institu

The cesspit of Central Asia

Text from an article which appeared in the *Sunday Times Magazine*, London, 4 March 1990.

At the point where the great deserts of Karakumy and Kyzylkum meet, a new desert has been born. It has been given the name Aralkum.

The city of Aralsk ends in dust and sand. Almost half the people who lived there have gone, for the sea is gone. The quay now sticks out into the sand. The long arms of the portside cranes are sagging and the ships lie stranded with their keels leaving wakes in the dunes.

Birdat Alseitov, a doctor in the city of Kitezh, sees the transformation starkly: "Of every thousand babies born here a hundred die before their first birthday. There are deformations. Some are born with no anal passage. Without parts of the intestine. With mental handicaps. Without limbs. With no skulls, just a boneless layer of skin to cover the brain. I have been here for 23 years, and none of this used to happen." Infant mortality is higher than it is even in Paraguay, and 20 times higher than in Japan.

The death of the Aral Sea is not the whole problem, that the 30 million people of Central Asia face, but just the most visible aspect of it. The more threatening part of that process is the degradation of the environment caused by the flow of salted and poisoned water into the low-lying areas. There is poison in the land they walk on, poison in the water they drink, poison in the air they breathe.

The root of the problem is over-irrigation on a scale so vast that it has washed all the humus away from the soil. The legacy today is a life on the borderline of starvation.

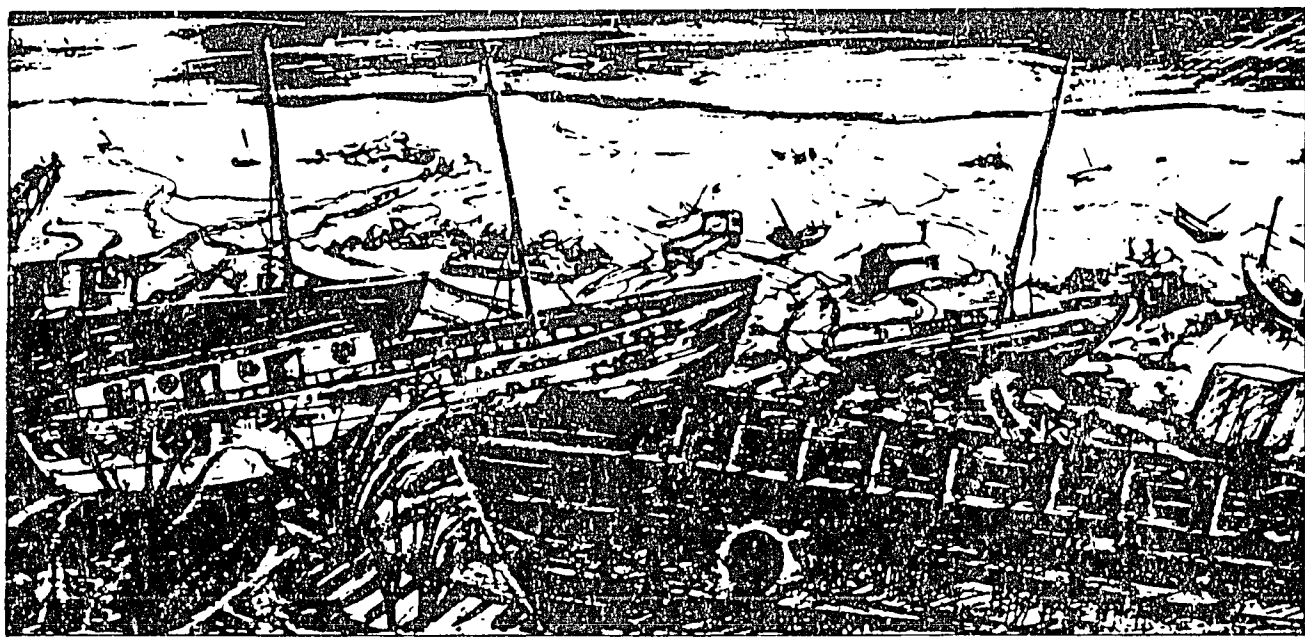
Health is the first problem. It is not the drying-up of the sea itself that causes the epidemics. Nine out of 10 babies born on the coastline suffer from anaemia, but the situation is hardly better anywhere else in Central Asia. The causes of anaemia are well known: poor diet, and weakness brought on by the almost annual round of child-bearing. The two things are inextricably linked. Aral or no Aral, there will continue to be anaemic babies and weak children until these things are changed.

Here, when you stare in the face of poor man's woes, then you feel the huge gulf that exists between the urban intelligentsia and these rural people. You feel it not in your head or in your mind, but deep in your guts.

These people are the bread-winners of the nation. It is not just that they no longer believe in speeches and promises. They simply do not understand what is wanted of them.

But where does the sea come into all this? It is the misfortune of those who live by the Aral that their home is in the lower reaches of great rivers, and that they are obliged to drink water which is saturated in pesticides, herbicides and other filth. These rivers are rivers no more: they are the cesspit of Central Asia. I went to copy down the official figures for the levels of harmful substances found at various points along the Syr-Darya and Amu-Darya rivers, from their highest reaches down to the delta.

In samples taken from the middle and, particularly, the lower reaches of both rivers, the levels of long-since-banned poisons rise exponentially. I took along a doctor of chemistry and I asked him what the figures meant. All he said was: "*A fatal dose, this is a fatal dose.*" This is the water that people drink. There is no other.



Ken Bishop

Ships are stranded on the Aral Sea's bare and exposed bed, their rusty hulls covered by sand and salt.

Vasily Selyunin

Translation: Jonathan Bastable.

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***Vasily Selyunin is a Russian writer. The full text of this report was published in the Soviet magazine* Novy Mir.**

EDITORIAL/OPINION

Losing Fight to Save the Earth

By LESTER R. BROWN

With Earth Day 1990 approaching, the good news is that the environmental movement is spreading. When first celebrated in 1970, Earth Day was largely a U.S. event, one in which millions of Americans participated. By contrast, more than 130 countries have events and activities planned for Earth Day 1990.

This spread in environmental concern notwithstanding, the gap between what we are doing to reverse the degradation of the planet and what needs to be done has widened dramatically since 1970. No comparable two-decade period in human history has witnessed such wholesale destruction of the natural systems and resources on which civilization depends.

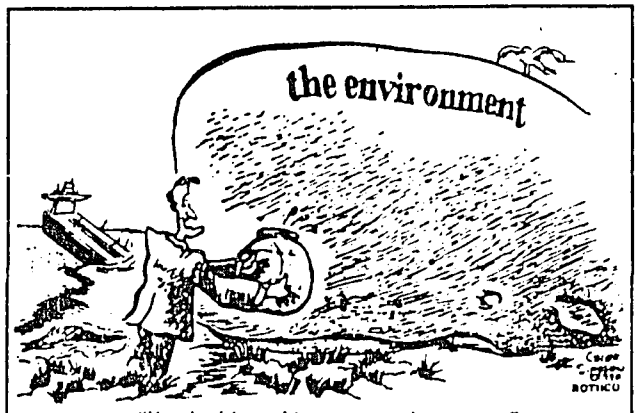
On Earth Day 1990, the sun will rise on a planet far more crowded, degraded and polluted than it was when the first Earth Day was celebrated in 1970. Every major indicator shows that the planet's physical condition has declined markedly. We are losing the battle to save the planet.

Since 1970, the earth's population has increased by 1.6 billion. Meanwhile, it has lost an area of tree cover roughly equal to the United States east of the Mississippi, and an estimated 480 billion tons of topsoil, more than the amount on all U.S. cropland.

Levels of the chief greenhouse gas, carbon dioxide, have risen 9%, while the protective ozone layer has eroded by more than 2% worldwide. Air and water pollution, hazardous wastes, and species loss have reached unprecedented levels. More than a billion people live in areas where air pollution has reached health-threatening levels.

At the same time, these factors have helped to push one-fifth of humanity into poverty so desperate that their lives are at risk. The growing food scarcity in developing countries — affected by all the principal changes in the earth's physical condition — is an early warning sign that ecological decline is undermining the future for more and more of the world's people.

This deterioration is no longer hypothetical. Both Africa and Latin America ended the 1980s with lower food consumption and more hunger than they had at the beginning.



"Hop in, I brought you some clean water."

If the world does not act quickly, this decline will continue and spread to other regions during the 1990s.

No country in the world has an environmentally sustainable economy, one that satisfies its needs without jeopardizing the prospects for future generations. More importantly, no country can achieve sustainability on its own.

In an environmentally sustainable global economy, tree cutting and tree planting, soil erosion and soil formation, carbon emissions and carbon fixation, human births and human deaths are in balance.

A six-point program is needed to achieve sustainability: stabilizing population size, increasing energy efficiency, shifting to renewable energy sources, reusing and recycling materials, phasing out ozone-destroying chemicals, and halting agricultural practices that erode the land, reducing its productivity.

To achieve that balance is not a matter of fine-tuning, a minor adjustment here and there. It depends on a massive shift in reproductive behavior and a fundamental restructuring of the global economic system.

Needless to say, such a restructuring involves overcoming massive social inertia and powerful vested interests. Any of the six steps outlined above would challenge any generation, but ours is facing all of them simultaneously.

Difficult though the goals are, some countries have already achieved some of them. For example, 14 countries, all in Europe, now have zero population growth. The United States has reduced its losses from soil erosion by one-third since 1985 and is expected to reduce it another third by 1995 with programs already in place.

Although the ranks of environmental activists have swelled dramatically since 1970, their number is not yet nearly large enough to turn the tide.

There is little precedent for the scale of activity needed during this decade. Reversing the deterioration of the planet depends on the wholesale reordering of priorities, a fundamental restructuring of the global economy, and a quantum jump in international cooperation such as that which occurred after World War II.

As the Cold War wanes, humanity has the opportunity to redefine security, to convert a global economy now using 6% of its resources for means of destruction into one devoted to the reconstruction of the planet. This will permit a reordering of fiscal priorities, shifting resources from building missiles, bombs and tanks to planting trees, planning families and developing solar energy resources.

Reflection on the political changes over the past year restores one's faith in miracles. But the political changes in Eastern Europe may signal something more fundamental, the cutting edge of a global shift in thinking on basic issues. Societies appear to be crossing thresholds of awareness beyond which change can occur on a scale that once seemed impossible.

Earth Day 1990 promises to be the largest worldwide public demonstration of concern over any issue ever seen, including tens of millions of people. Momentum in the battle to save the planet may be shifting. If enough of us become actively involved, we can reverse the degradation of the planet.

Lester R. Brown is president of the Worldwatch Institute, Washington. This is adapted from an article in Worldwatch Magazine.

THE LOS ANGELES TIMES --June 22, 1990

The 'Lungs of the Planet' Are Imperiled

■ Environment: Bush's desire to open new oil drilling off Southern California is dangerous. Alternative energy sources are available and should be tapped.

By ROBERT H. SULNICK

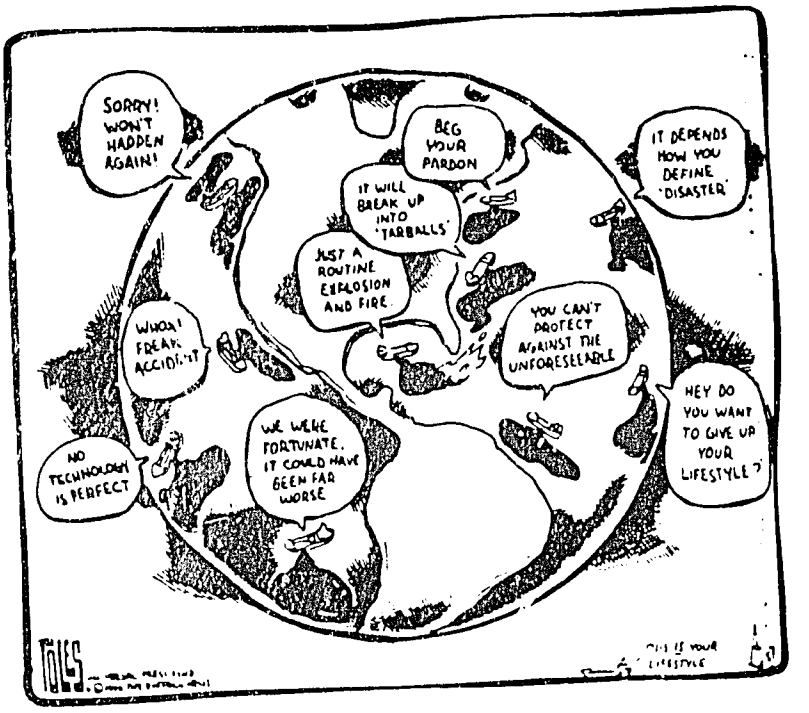
At the beginning of the Industrial Revolution, we were seduced by oil. The thick, black substance powered our inventions. It made our economy grow. We had no idea that oil was an environmental poison that would one day pollute our air and threaten to spoil our oceans.

In the 1920s, we learned that certain properties of oil are uncontrollable: No amount of preparation and care can prevent a well blowout. California's Supreme Court enshrined that fact by declaring oil drilling on land and on sea an ultra-hazardous activity.

In the 1950s, we began to see and feel the effects of an oil-based economy. Smog began to get our lungs' attention. At the end of the 1960s, we were shocked and saddened by the waves of dead marine life caused by the Santa Barbara oil spill. Nevertheless, the politics of oil moved out to sea in the 1980s: President Ronald Reagan, for the first time in history, opened the entire coastline of America to the oil industry.

The oceans are the lungs of the planet, the main source of our oxygen. They play a crucial role in shaping our climate. It is in the coastal zones where the life force of the ocean germinates and breeds. Spilling oil, a toxin, into them is analogous to injecting poison into a person's veins.

There is no need to put our coastal resources at risk. There are alternatives that are technologically feasible and readily available. All that's needed is political will.



But President Bush remains wedded to an offshore oil policy that envisions oil fields in Southern California waters. The announcement is expected shortly. His perseverance in promoting a 19th-Century energy source is dangerous and environmentally reckless.

At the current rate of consumption, the world's oil supplies will be exhausted in about 100 years. Why cling to this dwindling energy source that poisons our habitat? California's and the country's continuing energy need does not mean that offshore oil development is necessary.

The 21st Century will be fueled by conservation and by clean, renewable fuels. The only question is whether we will sentence our grandchildren to a frantic, polluted world that is desperately trying to develop a renewable-fuels/conservation economy or begin preparing now to shift away from fossil fuels.

Today, the city and county of Los Angeles use methanol to power their fleets of cars. Southern California Edison uses electricity to keep its vans going. The Southern California Gas Co. runs trucks on compressed natural gas. We can—and should—develop vehicles that run on ethanol (made from corn). The sun, after all, could supply much of the world's energy.

We also have the technology to conserve billions of barrels of oil as we move to a renewable-fuels economy. We can make automobiles that are capable of getting 107 miles per gallon; many cars sold today get 50 m.p.g. Yet President Bush, as did his predecessor, continues to embrace the 1985 fleet standard of 27.5 m.p.g.

If we raised that fleet average to 40 m.p.g. by the year 2000, we could save four times the amount of oil that is estimated to be off the Atlantic and Pacific coasts. If the nation's households installed storm windows and insulation during the next decade, we could save twice the oil offshore.

The battle to drill for oil in the ocean must end, for a healthy, living ocean is essential to the planet's well-being. If an oil field is developed off Southern California, the probability of a major oil spill occurring in the area is 94%. It is certain, too, that we would have many more oil tankers in Southern California's waters, because the the Coastal Commission, the State Lands Commission and the affected municipalities are not going to approve pipelines to move the oil.

Californians do not want to go to the beach and see an oil field. What we do want is an energy policy that protects our coastal resources. We can have both energy and an unpolluted environment. It is time for the government and the oil industry to join with the environmental community in developing a renewable-fuels/conservation energy policy that guarantees both the integrity of the ocean and the well-being of the Earth's environment.

Robert H. Sulnick is executive director of American Oceans Campaign, based in Santa Monica.

THE WASHINGTON TIMES, June 10, 1990

ALSTON CHASE

Rescuing the rain forests

Rain-forest depletion is the stuff that tears are made of. Covering less than 2 percent of the Earth, these leafy places are habitat to nearly half of all living things. They contain 70 percent of plants identified as having anti-cancer properties, they are home to many important human cultures, they add moisture to the atmosphere, assuring that tropical regions receive adequate rainfall, and they absorb prodigious amounts of the greenhouse gas, carbon dioxide. Yet 40 percent of these places have disappeared already, and a recent report suggests they are being gobbled up faster than even the most pessimistic had predicted.

According to the World Resources Institute — a Washington-based think tank — rain forests are being logged, burned, dozed, blacktopped or plowed under at the rate of between 40 million and 50 million acres a year. This means that during the time it takes you to read this column another 300 acres will be gone.

These denuded forests reveal a naked truth: that growing economic disparities between rich and poor nations threaten the Earth's ecological stability.

The principal culprits of rain-forest decimation are wasteful consumption by industrialized societies, poverty and injustice in the Third World, and human population growth. In Indonesia, loggers for the United States, France, Germany, Italy and Japan cut tropical hardwoods such as mahogany, teak, rosewood and ebony for everything from chopsticks to decorative furniture. In Brazil, the government, unwilling to promote real land reform, has deliberately encouraged the poor to make new farms in the rain forests. And throughout the underdeveloped world, towns and cities with exploding populations are spreading onto neighboring pastureland, pushing farmers still farther out into the woods.

These forces produce a cycle of poverty. Industrialized societies are taking wealth — in the form of natural resources — from the less developed. This creates larger contingents of rural poor, who try to escape poverty using ax or match. And the more that rich nations take, the less poor countries have for solving environmental problems that threaten all of us.

Keeping the planet green, therefore, requires both reforming ourselves and helping the Third World. Last April, Virgilio Barco, then president of Colombia — a country that already has set aside 50 million acres of rain forest — urged industrial countries to create "mechanisms of compensation" for countries that preserved these places. Likewise, the Trilateral Commission recently recommended that wealthy nations raise taxes to reduce consumption of natural resources and to make huge payments to underdeveloped countries to encourage them not to pollute.

But U.S. response to such suggestions has been lukewarm. In May, President Bush opposed a plan offered by European governments to give developing nations $100 million to find safe alternatives to ozone-depleting CFCs. And both the president and Congress have been consistently unwilling to take up the cudgel against galloping population growth. The world population, now 5.3 billion, is increasing at the rate of 84 million people a year. According to U.N. projections, it could reach 14 billion by the year 2120. The number could be stabilized at 9.3 billion by the end of the next century — if the world's governments will spend $10.5 billion a year on family planning between now and then. That would require, says the United Nations, a contribution of $1.2 billion annually from the United States. But America, always squeamish about family planning, is giving just $235 million.

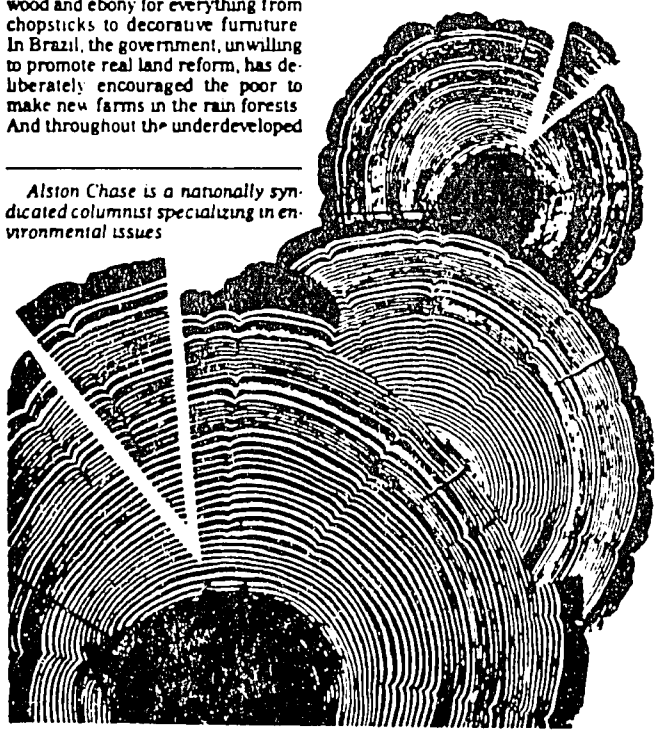
By not helping these countries, we are hurting ourselves. The growing gap in wealth between First and Third Worlds is the greatest economic and ecological threat this country faces. Rain forests are not the only victims. All environmental protection, from clean air to resource preservation, costs money that undeveloped nations, saddled with huge debts, cannot afford.

In his "Study of History" — an examination of the rise and fall of 21 civilizations — Arnold Toynbee observed that one of the signs of decline of great empires was the growth of an "external proletariat", permanently alienated people living beyond the borders. Eventually the powerful societies succumbed to these growing external forces.

The Third World is, in relation to our society, an external proletariat, and so long as we remain indifferent to its plight, its problems increasingly will be ours as well. As disparities in wealth grow, immigration from the Third World to the First World will accelerate. Suffering a brain drain, developing countries will be less able to cope. Flooded with new immigrants, industrial nations will experience more ethnic strife. And global environmental problems — from air pollution to resource depletion — will worsen.

It is time we put our money where our mouths are. In May the Interparliamentary Conference on the Global Environment — representing legislatures from 42 countries — urged creation of a "global Marshall Plan" to help poor countries cope with environmental problems. That is urgently needed. Otherwise, as the Cold War between East and West comes to an end, a new struggle over the health of the planet, between north and south, will begin.

Alston Chase is a nationally syndicated columnist specializing in environmental issues.



THE WALL STREET JOURNAL FRIDAY, APRIL 20, 1990

The Best Earth Day Present: Freedom

By LAURENCE SOLOMON

Since the first Earth Day in 1970, there has been a lot of good news on the environment. The deserts of the Sahel may not be spreading after all. And Lake Erie is no longer dead; its waters now team with tens of millions of walleye. But the best environmental news of all is the opening of the Berlin Wall and the democratization of Latin America.

A very large proportion of the globe's environmental problems are caused by policies that cannot stand the scrutiny of either the marketplace or the voting booth. Sweeping world trends—political, economic, and technological—are fundamentally changing the globe's environmental ground rules for the better.

Take Eastern Europe, the dirtiest, most degraded region on Earth. Eighty percent of East Germany's rivers are contaminated, and some of its citizens breathe air polluted 50 times above safe limits; two-thirds of Poland's trees are damaged, two-thirds of its rivers too dirty even for industry; 80% of Bulgaria's farmland is threatened by erosion, 25% of its animal and plant species are threatened. Throughout the Eastern Bloc life expectancy has been dropping, with millions suffering from environmentally induced disease. Some Eastern Europeans can expect to live a decade less than Western Europeans.

Now all this is being swept away by democracy and economic rationality. One of the first steps taken by the transitional government in post-communist Czechoslovakia—where posters denouncing nuclear power vied for power with those denouncing communist rule—was the cancellation of a reactor under construction. In East Germany the notoriously unsafe nuclear reactor at Griefswald on the Baltic coast has been shut down and, with West German help, East Germans are investing $250 million in advanced coal-burning technologies and in incinerators for the disposal of chemical wastes. Poland is cleaning up the Vistula River by building 168 large water purification plants to treat municipal sewage and industrial wastes and 200 smaller plants for highly toxic chemical wastes.

Replace Juntas

In Latin America, too, the winds of change have toppled one junta after another, replacing them with popularly elected leaders who offer hope of meaningful reform—environmental as well as economic. The slashing of the Brazilian rainforests—50,000 square kilometers were being cleared in 1989—was the consequence of economic approaches remarkably similar to those of Eastern Europe. Central planning authorities were recklessly promoting industrial expansion, regardless of profitability, while property rights, always a bulwark against unfettered central planning, were undermined.

The first elected president to rule Brazil in 25 years, Fernando Collor de Mello, has promised to drop many of the policies that have simultaneously polluted his country and mired it in debt. He is proposing a moratorium on new incentives, subsidies and credits to businesses that cause a negative environmental impact in any region, and taxes on polluters and users of natural resources. Electricity rates have been raised nearer to market levels and agricultural sprawl—blamed for forest clearings—is being curbed by the elimination of the tax breaks that helped to cause it in the first place. As important, Mr. Collor is attempting to settle property disputes with Brazil's native people; at the request of Yanomami Indians, he is using force to evict from the Indians' rainforest land some 45,000 prospectors.

Entrenched interests in both Eastern Europe and Latin America—powerful bureaucracies in the former, military and landowning aristocracy in the latter—are likely to delay and perhaps halt the tempo of reform. But technological change is on the side of ecological progress.

The slashing of the Brazilian rainforests was consequence of economic approaches remarkably similar to those of Eastern Europe. Central planning authorities recklessly promoted expansion, regardless of profitability.

Ten years ago, a Third World community faced with the flooding of its farmland by a state hydroelectric project or the removal of its forests for subsidized pulp production was all but helpless. Generally it was given no say in the decision, let alone compensation for the loss of its property, and Westerners would learn of the project too late to intervene, even though the project was typically built by Western engineers using Western tax dollars.

Today, that community is as likely as not to have a fax machine or to be able to reach local environmentalists who—via fax, phone or electronic mail—can reach a global network of environmental, human rights and native rights activists. Within days, the project's developers can be identified, environmentalists in the country involved can be enlisted and an international campaign mounted. Though most projects nevertheless proceed to completion, through this process literally dozens of ill-conceived projects are being stopped, and hundreds more slowed or improved. As the ease of communication rises and as information flows improve through increased trade and travel, the rejection rate for bad projects can only increase.

The good news isn't universal: In regions such as Africa, where political and economic reforms have been slow to materialize, and where communication technologies tend to be strictly controlled (Kenyans, for example, need government permission to use a computer modem), environmentalists must often work in secret, and suffer debilitating intimidation much as their counterparts in Latin America did under military rule.

But in Chile and Argentina once-muzzled environmental critics of government policy now find themselves in positions of power. In Brazil, Jose Lutzemberger, one of the world's most outspoken defenders of the rainforest and the founder of the first environmental group to challenge the generals, Agapan, now finds himself secretary of the environment. With information he gets from daily satellite surveys, he claims that "no destruction of the environment can happen in this county, even pollution . . . that can be hidden." He is hopeful that this access to information will further "a capitalist *perestroika*," that revamps the tax system, eliminating destructive subsidies, removing power from big landowners and protecting the rights of the inhabitants of the last wilderness.

Nor is capitalist perestroika confined to the Third World. The drying up of state subsidies to the petroleum industry has rid North America of most new tar sands, oil shale, frontier and other environmentally harmful and economically wasteful energy megaprojects. In Britain, privatization pulled the plug on nuclear power expansion by forcing investors to see nuclear power and all its latent liabilities from an owner's point of view.

The U.S.-Canada Free Trade Agreement is likely to hasten the adoption of higher U.S. environmental standards in Canada, just as the European Community has leaned on member states to raise their water standards up to the levels of the cleaner members. Strong freedom-of-information laws—the one reform environmentalists around the world agree on—hinder cover-ups, and provide the public with knowledge and resolve.

Mirage Emergency

World-wide, power has shifted away from the remote elites of the national and international bureaucracies, whose understanding of local economies and environments is necessarily limited. The Sahel exemplifies that limited understanding: At an international conference in 1977, the Nairobi-based United Nations Environment Program pronounced—on the scantiest of information—that the Saharan desert was advancing an average of six kilometers a year, and pointed fingers at peasant practices that supposedly degraded the land. As satellite studies and ground surveys from the World Conservation Union now show, the emergency that the UN and other outsiders saw was a mirage.

The costly emergency measures they championed—chiefly a green Maginot Line to defend against desert creep—were unwarranted and sometimes counterproductive. Despite droughts and rapid population growth, the land of the Sahel has become increasingly bountiful over the years. The people are coping admirably, despite perverse government policies that, for instance, discouraged tree planting by expropriating local lands.

Not surprisingly, the methods that have helped the peasants of the Sahel and their environment survive these past few thousand years continue to have merit. If people throughout the globe are to do better for themselves and their environment, as is usually their desire, the answer will be in more, not less freedom for their communities.

Mr. Solomon is executive director of Environment Probe, in Toronto.

The Challenge Facing the Developing World

by Mohan Munasinghe

Developing countries share the worldwide concerns about environmental degradation; some have already started to bring management of their natural resources in line with the goal of sustaining their economic development. However, these countries also face urgent issues like poverty, hunger, and disease, as well as rapid population growth and high expectations.

The paucity of resources available to address all these problems reduces the ability of developing countries to contribute to the protection of the global commons. The crucial dilemma is how to reconcile development and the elimination of poverty—which require increased use of energy and raw materials—with stewardship of the environment. The per-capita GNP of low-income countries, which include half the world population, averaged $290 in 1987, or less than one sixtieth the U.S. per-capita GNP of $18,530. In the two largest developing countries, India and China, per-capita GNP was $300 and $290, respectively. Correspondingly, the U.S. per-capita energy consumption of 7,265 kilograms-of-oil-equivalent in 1987 was 35 and 15 times greater, respectively, than the same statistic in India and China.

Economic growth has already placed a heavy burden on humankind's natural resource base; fossil fuel carbon-dioxide (CO_2) accumulation in the atmosphere is a good example. Developed countries accounted for more than 80 percent of this accumulation in the period 1950 to 1986. On a per-capita basis, they emitted more than 11 times the cumulative CO_2 as developing countries. The latter's share would be even smaller if emissions prior to 1950 were included. Clearly, any growth scenario for developing nations that followed the same material-intensive path as the industrialized world would result in unacceptably high levels of Greenhouse-gas accumulation as well as a general depletion of natural resources.

In the area of policy reform, especially pricing, developing countries are showing a greater willingness to use market forces more effectively.

Scientific analysis has provided only broad and rather uncertain predictions about the degree and timing of global warming. However, it is generally accepted that mankind would be prudent to buy an "insurance policy" in the form of mitigatory actions to reduce Greenhouse-gas emissions.

Ironically, environmental degradation might affect developing countries more severely since they depend more on natural resources while at the same time they lack the economic strength to prevent or respond quickly to such problems as flooding, drought, and soil erosion. From their viewpoint, an attractive insurance premium would be a set of inexpensive measures that would address a range of national and global environmental issues without hampering development efforts. However, the adoption of mitigatory measures to reduce Greenhouse warming that went beyond their own immediate economic interests would constitute crossing a definite "pain threshold."

In the area of policy reform, especially pricing, developing countries are showing a greater willingness to use market forces more effectively. Typically, by raising the subsidized price of a scarce resource like energy to reflect real economic costs, it is possible to signal to consumers that this resource is valuable and should be conserved. Further, governments could take steps to protect the environment in cases where market forces have not worked. One example is the overuse of a common resource, such as the excessive discharge of noxious gases into the air. Here, restructuring the market to make the polluter pay or limit the discharges is essential.

Improved natural-resource management also requires laws that go beyond the short-term concerns of political leaders. Implementation of environmental regulations is a serious problem, too, requiring cooperation among public and private organizations with multi-disciplinary teams. Finally, enlightening the public is necessary if citizens are to participate actively in making and implementing environmentally sound decisions.

Economic efficiency is critical in obtaining the maximum value from the scarce resources of a developing country's economy. When market incentives are brought to bear, and the costs of growth-related environmental damage are considered, economic efficiency can help to protect the environment as well. Energy issues are especially illustrative, because energy is a primary cause of the current global ecological crisis, and in most developing countries, energy use is growing rapidly. In many, energy is wasted. For example, more than one third of electricity generated is often lost before reaching consumers; an acceptable norm might be less than one tenth. Devices ranging from sophisticated industrial boilers to simple woodstoves consume fuel inefficiently. Energy policies aimed at improving methods of supply, managing demand, and encouraging end-use conservation could lead to simultaneous gains in efficiency, conservation, and environmental protection.

Particularly in rural areas, which in developing countries contain more than 70 percent of the population, per-capita energy consumption is low, and potentially profitable energy uses are constrained by lack of supply. In such cases, it may be necessary to promote energy consumption in order to raise output and incomes. Other social goals

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complicate the decision-making process even further. For example, most countries want to satisfy the basic needs of their citizens, especially the low-income populations. In the energy sector, this may have to be achieved by providing a minimum of energy to all families at a price that is well below its economic cost.

Several proposals have been made for setting up a global environmental fund to help developing countries, and some industrialized countries have indicated their willingness to contribute. Currently, discussions are under way to define criteria and mechanisms for both generating and disbursing funds from such a fund. While agreement will not be easy to reach, global financing might be approached in terms of several criteria: affordability or "pain threshold" considerations, fairness or "equity," and economic efficiency.

Developing countries cannot afford to finance their existing energy-supply needs. Assuming 4.5 percent annual economic growth and a continuation of techno-economic trends, the power sector capital requirements alone could average $100 billion annually in the 1990s, compared to the $50 to 60 billion being spent currently, of which less than $10 billion is official foreign aid. Even though better management could reduce this burden significantly, some growth in energy use is inevitable. The adoption of pollution-abatement policies that further increase energy costs—thereby crossing the "pain threshold"—will not be feasible without external funding. Further, such assistance should be additional to existing conventional aid received by developing countries.

In terms of the global commons, the fairness criterion recognizes that historically, growth in the industrialized countries emphasized needs rather than resource limitations. Development of these societies exhausted a disproportionately high share of global resources, including physical resources consumed in productive activity, as well as the waste-absorbing capability of the global ecosystem. Indeed, this resource-intensive historical growth pattern suggests that developed countries owe an "environmental debt" to the larger global community. Applying this criterion could help determine how remaining global resources might be shared equitably and used sustainably.

The final consideration is economic efficiency. To the extent that global environmental costs of human activity can be quantified, the "polluter pays" principle may be applied to generate revenues. If total emission limits are established under a permit system, then emission permit trading among nations and other market mechanisms could help increase efficiency.

Pressures to address environmental issues, especially global ones, place a severe burden on developing countries. Even with additional external assistance, the near-term response cannot extend much beyond sound economic management of natural resources that is consistent with both developmental and environmental goals. Thus, the energy policies of these countries in the 1990s are likely to focus mainly on conventional supply efficiency improvements, pricing, demand management, and end-use conservation.

The developed countries, particularly the United States, can facilitate this process by providing financial and technical assistance based on the principles described above. They can also show leadership by trading some growth for improved environmental quality and pioneering the use of advanced technologies that will usher in the less material-intensive economies of the future. The example set by industrialized countries would help convince the developing countries to undertake more costly abatement measures and cross this "pain threshold" early in the 21st century. □

Non-mechanized farming in Sri Lanka uses little fuel. However, as agriculture modernizes here and in other developing countries, energy use and pollution will increase

World Bank photo

India

by Dilip R. Ahuja

Ahuja

India's current contribution to emissions of Greenhouse gases from non-natural sources has been estimated to be 4 percent. Given that 16 percent of the world's population lives in India, this contribution, per person, represents one-fourth of the global average and just one-eighteenth of the contribution of an average American.

In India, Greenhouse-gas emissions consist predominantly of carbon dioxide (CO_2) (47 percent) and methane (38 percent). Coal-burning and rice cultivation are the primary sources of these emissions.

Policies to respond to the threat of climate change are still evolving in India. One school of thought favors a wait-and-see approach, influenced by conflicting opinions in the literature about the potential seriousness of the global-warming problem. For instance, one of the arguments against global warming as a significant problem is that negative climatic feedbacks may hold warming trends to negligible levels. Much of the literature that raises questions about global-warming projections comes from organizations that regard developing countries as potential allies in resisting emissions-reduction efforts.

Others cite pragmatic arguments against policy initiatives to mitigate the Greenhouse Effect—namely, the hypothesis that a global-warming trend may benefit India. For example, it is widely believed that increased temperatures will increase the total amount of rainfall over the subcontinent: More rainfall, coupled with higher CO_2 concentrations in the atmosphere, might work to enhance agricultural production. However, this hypothesis discounts other, undesirable effects that could complicate the scenario. Such effects might include regional shifts in rainfall patterns, increased run-off and soil erosion, and life-threatening floods and droughts in unexpected places.

The third and perhaps most compelling reason why India does not at this time have more pro-active policies for mitigating the Greenhouse Effect is the competition for limited resources by more pressing needs. This situation applies not only in India, but also in other developing countries. For this reason, the International Conference on Global Warming and Climate Change held at New Delhi in February 1989 made the following recommendation:

> The developing countries' contribution in response to the Greenhouse challenge should be carried out in a way that enhances, rather than diminishes, development prospects. Where these are in conflict, priority should be given to development . . . .

Thus, for India and other developing countries, the key is to determine what initiatives will help development and reduce emissions of Greenhouse gases and then to pursue these initiatives aggressively.

Realistically, given India's chronic shortages of electricity and unmet demands for energy services, it is unlikely that Greenhouse-gas emissions from the energy sector will be reduced in the near future. Most credible projections indicate that these emissions will grow at an average annual rate of nearly 4 percent, quadrupling over the next 40 years. However, with effective conservation and energy-efficiency policies, the rate of increase in emissions could be halved while still meeting the basic needs of an expanding population—currently growing at an annual rate of 2 percent.

The Indian government is taking steps to promote awareness of the Greenhouse issue. The government is also sponsoring research on the potential effects of climate change in India, especially in coastal areas that would be vulnerable to a rise in sea level. The possibility of flooding in densely populated coastal zones warrants special concern because it could cause very serious resettlement problems. In addition, researchers are participating in internationally coordinated studies on the potential effects of climate change on sea level and agriculture.

India is currently promoting the development of renewable energy sources such as biomass, small-scale hydroelectric power, and solar and wind energy. The government has also initiated several reforestation projects that will increase CO_2-absorbing tree cover in the country. In addition, it is subsidizing higher-efficiency cookstoves that have the potential to reduce fuelwood consumption in areas where wood is the dominant fuel. Some other actions that represent environmentally positive steps include using natural gas for electricity production, curbing energy losses during the transmission of electricity, and phasing out coal-driven locomotives. These policies can help hold back India's Greenhouse-gas emissions while they also make sense for other reasons.

In international negotiations on climate change, India is in favor of equitable agreements that, so far as possible, take into account each country's population, its recent cumulative contribution to all known Greenhouse-gas emissions, and its need to seek a reasonable standard of living for its citizens. Clearly, it will not be easy to reach consensus on this kind of agreement, but it is important to press forward with the negotiations.

One final point: Last year, India proposed that an international planet-protection fund be established to help finance the development and transfer of technology where it is most needed to mitigate climate change. Norway, Sweden, and the Netherlands have made proposals along similar lines. If appropriate institutional mechanisms for such a fund can be worked out in international negotiations, this would be a small step forward in dealing with the global-warming problem. □

(Dr. Ahuja is a Fellow of the Tata Energy Research Institute in New Delhi, currently on a sabbatical with the Bruce Company, a contractor to EPA's Climate Change Division.)

SPEECH BY SIR WILLIAM RYRIE, EXECUTIVE VICE PRESIDENT
INTERNATIONAL FINANCE CORPORATION

ODI CONFERENCE ON THE PROSPECTS FOR AFRICA IN THE 1990s
6 JUNE 1990, HOUSE OF COMMONS, LONDON

FINANCING AFRICAN DEVELOPMENT

It would be presumptuous of me, coming after the expert speakers we have heard this morning, to offer a diagnosis of the ills of Africa. But I would like first to make three quick points in that connection as background to what I want to say about financing African development.

First, on the world economic environment. This has not been kindly in the 1980s but it is the same environment as other developing countries have had to live in. Leaving out oil-exporting countries, there was no great change in Africa's terms of trade during the 1980s, the main deterioration having been in the 1970s. On the other hand African countries are particularly vulnerable to weakness in terms of trade, because raw materials account for so much of their exports, and because their exports account for a high percentage of GDP. Of course African countries have suffered from the generally higher level of interest rates in the 1980s, but this also applied to other developing countries. Exports from Sub-Saharan African countries have grown very slowly in recent years and so the ability to service debt has been less, but this was due as much to domestic conditions as external factors. Generally, one cannot conclude that adverse economic conditions in the world have been the sole or main reason for Africa's troubles in the last decade.

Secondly, it is now more widely acknowledged that these problems stem to a considerable extent from weaknesses in government and administration in Africa. This administrative weakness is less easy to document but a familiar fact to those who work in Africa. And it is just as well that the problem of corruption is no longer an unmentionable subject. Of course it is by no means unique to that continent, I think it takes more extreme and damaging forms in some African countries than elsewhere.

Thirdly, there is a general consensus that the African problem has been due to a considerable extent to mistaken economic policies, especially the failure to allow market forces to operate. Agriculture has been a particular victim of this kind of policy, the tendency to hold down prices of food in the interest of townspeople, thereby giving farmers little incentive to produce. The prevalence of state ownership and management of industrial enterprises, many of which have been extremely inefficient, and the discouragement of the private sector by all manner of controls have been damaging. Of course these problems have also been compounded by factors which are beyond the control of African governments (at least in the short term) including the small size of national markets.

Whatever the combination of reasons, the record of Africa in the past 15-20 years must give us all cause to think very carefully about the effectiveness of aid; and much serious thinking on that subject has taken place — for example Robert Cassen's 1986 study and an excellent note on The Developmental Effectiveness of Aid to Africa by Tony Killick prepared for a

World Bank symposium in February. Mr. Killick concludes that generally on aid effectiveness "the main evidence favours a moderately positive but still rather tentative verdict", a very judicious conclusion, justified I am sure by a close look at the evidence. But if we stand back and look at the scene, it is impossible to avoid some glaring constrasts.

Africa has been increasingly on the conscience of the world and this has been reflected in many special aid efforts and initiatives -- the Structural Adjustment Facility, the ESAF, the Special Facility for Africa, the Special Program of Assistance and so on. As a result the African share of worldwide official development assistance has nearly doubled in the past 15 years and now stands at 30% although only about 12% of the population of the developing world lives in Sub-Saharan Africa. Between 1980 and 1988 a total of about $83 billion was provided in official development assistance to Sub-Saharan Africa. The flow of official development assistance from the World Bank, the European Community, other international agencies and bilateral donors has recently been running at about $12 or 13 billion a year, representing about 8 1/2 percent of the GNP of the region, or about $28 per head of the population per year.

There is no parallel in history for such a flow of funds through governmental and official channels to any region, funds provided in goodwill and for the purpose of economic development. But despite this, the overall result of all the efforts by African governments and their overseas helpers during the years 1980-88 was that standard of living in Sub-Saharan Africa

fell on average by 1.2% a year (excluding Nigeria where there was a larger fall reflecting the decline in the oil price). Whatever may be concluded from examining the data project by project and loan by loan, the overall record can only be characterized as one of failure. Genuine progress of various kinds can be found in some statistics such as infant mortality rates and school attendance rates and I do not belittle this at all. But the overall purpose of the prodigious flow of aid funds was, surely, to strengthen the economies of the African countries, to enable them to grow and generate resources which could be used, in whatever way, to alleviate poverty and improve social conditions. The main measure of the success must be in the growth of GNP and GNP per capita, and by this test the record has hardly been one of success.

Moreover, while the flow of funds did not raise standards of living, it did result in the continent becoming heavily indebted, adding a new and serious dimension to its problems. The region's debt is now about 100% of its GNP and more than 350 percent of its export earnings; and about 70% of this debt is at market rates.

One might be tempted to draw from these facts the conclusion that international development aid is a misguided and hopeless effort; that money provided by governments to governments for development purposes is inevitably misused and that the only way for genuine development to take place is to allow the forces of the market to operate. I do not take that view but we should consider whether there isn't just a grain of truth in it. The misuse of resources (and surely no one can deny that there has been misuse on a large

scale) may have something to do with the fact that almost all of them have been transferred by methods which avoid the disciplines of the market. Let me return to that point in a moment.

We must ask ourselves a large and simple question: assuming, as I expect everyone in the room does, that we have an obligation as human beings to help Africa to rise out of its problems, how can we do this and avoid the failures of the past? How is development to be achieved and financed in the 1990s and beyond?

I can offer no complete answer to this question, but let me make three points: the need to deal with the burden of debt; the need for a continuing flow of official aid which will be used more effectively than in the past; and above all the need for a massive increase in private investment.

The first point is that whoever is to blame, it must be obvious that the most serious immediate impediment to development, and one which it is within the power of the international community to deal with, is the burden of debt. In contrast to the debt of Latin America, African debt is predominantly to governments and official agencies. Of course a certain amount has been done, arising partly from the discussion of the subject at the summit meetings in Venice in 1987 and Toronto in 1988, but I believe this question needs to be tackled much more energetically by the major donors. More governments should be prepared to consider outright forgiveness of debt, as the British government has done in a number of cases, and the effort needs to be extended

not only to low income countries but also to some lower middle income countries which have acute debt problems.

Secondly, we have to recognize that for a good many years to come there is going to be a continuing and growing need for amounts of aid so large that they can come only from official sources, governments and international agencies. The World Bank estimates the need for official development assistance at about $15 billion in 1990 rising to $22 billion in 2000, without allowing for inflation. These are daunting sums which would call for a further major effort by the donor countries, who ultimately provide the money whether it comes bilaterally or through the international agencies. I find myself wondering whether this is a statistical game or whether we are talking about realistic possibilities. One or two more points in this connection.

Whatever the size of the effort, there must be a renewed determination by donors to make sure that the money is used better than in the past. Probably everyone would agree that aid must be closely linked to policy reform. Some progress has been made on the subject in recent years. About 30 African countries are now engaged in programs of structural reform, some more serious than others, and here and there we are beginning to see results. In the last years of the decade of the 1980s, there were signs of GDP growth turning up slightly. In certain countries such as Ghana and to some extent in Madagascar this has been very visible. (I was in Ghana recently and was very struck by the change in the economic climate of that country over the last five or six years.) Most African countries have more realistic exchange rates

after a period in the early 1980s when many currencies were overvalued. Fiscal positions and monetary policies have been improved. Some privatization is taking place, although there is a long way to go in this respect.

Most people also recognise the importance of improving coordination between the various donors. Here too there has been progress. It is not only a matter of avoiding conflicting advice but of reducing the impossible demands that are sometimes made on the staffs of African governments through the multiplicity of donors, donor agencies and projects. While we are no doubt right to blame African governments for their institutional failures, the institutional failure of the donor community to get its act together must have contributed to the relative ineffectiveness of the development effort in Africa.

And of course it is tremendously important that the new flow of resources should, so far as possible, avoid creating more debt. It is an obvious point that loans on market terms should be made only to poor countries when it is clear that the money will be used in such a way as to create the resources to service future debt but this has seldom happened. The fact is that much of the public investment needed in African economies, though very important, will not produce a short term pay-off in the form of enhanced capacity to service debt and so highly concessional funds are needed. It is vitally important that, in our efforts to help Africa we should avoid aggravating the debt problem.

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So it seems that large amounts of official aid on grant or near-grant terms will be essential for some time if Africa is to avoid collapse and make some progress. But the prospect of official development aid rising year after year, nearly doubling in real terms by the end of the decade to $22 billion a year, as the World Bank's projections would have it, is not a reassuring but a depressing. All experience shows that aid provided to governments, especially in Africa is frequently not well used. Both we and Africa should be fully aware of the dangers of a long continuation of this process — the danger of dependence on charity and all the corrosive inefficiency and demoralization that comes with it. And we should be alert to another danger too: that one effect of the supply of funds on a large scale to governments, for whatever well-intentioned purpose, will be to strengthen the role of the state in the recipient country, and thus undermine the trend towards a market economy and a healthy private sector which we all want to see.

The objective must be to break out of this pattern as soon as possible. In the long run the key to African development has got to be a quite different form of financing — I mean private investment — something about which all too little is said or heard in the African context at present. Africa will not achieve rapid growth, even moderately rapid growth, without an energetic private sector and a much higher level of private investment. Only such a private sector can produce the diversification of exports which will break Africa's dependence on primary products. If we are serious about development in Africa we must be thinking about how Africa is going to make the transition from dependence on official aid to private investment.

One reason for the dismal economic record of most of Sub-Saharan Africa in the 1980s was that private investment fell away. It has recently been running at a level equivalent to about 5% of GDP in Sub-Saharan Africa, a total of $7-8 billion per year. Within this total, foreign investment has been an almost negligible amount, equivalent to no more than one-half of one percent of GDP for the region as a whole, about less than $1 billion a year and/or a mere $2 per capita.

In its Long Term Perspective Study for the next 30 years, published in 1989, the World Bank estimated that to achieve a rate of growth consistent with per capita incomes rising only marginally each year, total investment in Sub-Saharan Africa, public and private, would have to reach about 25% of GDP by the year 2000, compared to 15% today. But it is not enough just to increase the magnitude of investment: it also must be productive. In most countries the evidence shows that capital employed in the private sector is more productive than in the public: a major increase in private investment, domestic and foreign, in Sub-Saharan Africa would greatly improve the chances that the needed gains in productivity will be forthcoming. Africa is the only region in the developing world where public investment still vastly exceeds private investment. What is really needed, at a minimum, is a tripling of private investment from 5% of GDP to 15%. Productivity gains might also be achieved by accelerating the privatization of public enterprises and by subjecting the remaining public enterprises to market forces and competition.

How is this to be achieved? Well, the first requirement is obviously that the governments should get the policy environment right for the private sector, and create stable conditions in which businessmen will invest with confidence. Most African governments still have a long way to go in doing that and in fact there has been considerable capital flight, especially of course where currencies are overvalued: a sad paradox in very poor countries. On the other hand there are some countries which have been doing the right things for quite a number of years — I am thinking again of Ghana — but have been disapointed to find that the "supply response" from the private sector has been slow in coming. Do we simply have to wait until entrepreneurs appear and start to drive the economy forward, or is there anything that can be done to encourage and accelerate the "supply response"?

This is a key important question. Up to now the international development effort has been very much an affair of governments, official aid and the public sector. It was the product of a period when belief in the ability of governments to create economic growth was at its height. Nowadays we are everywhere much more skeptical about that; but we have not thought enough about how to bring our techniques for helping developing countries into line with our modern belief in market economies.

I believe there is a new kind of development role to be played, a role of helping markets to meet the needs of development, helping the private sector to manage the risks of investment. It has to be a role of support for and partnership with the private sector, not one of control and direction. It

is a different role from the government-centred one which has held the stage for most of the last three or four decades. It is a role which is being played, still on a relatively small scale, by a number of institutions -- the International Finance Corporation within the World Bank Group and a growing number of bilateral agencies, such as the Commonwealth Development Corporation in the U.K. This type of development role is highly relevant in the circumstances of today when building up private investment to finance development is so crucial. I would like to say a little more about how this can best be done.

First, let us start with the financial sector. We now recognize much more clearly than we did some years ago that a healthy financial sector, a sound banking system and efficient capital market, are absolutely essential to sound economic development. The World Bank and the IFC work together in advising governments on the development and regulation of such markets. But it is also vital to have institutions, financial companies, which can function in them and do the job of accumulating savings and allocating them to productive use. Over the years, IFC has participated in the creation of more than 130 financial companies in the developing world. Not nearly enough of these have been in Africa, where the difficulties are greater, but we now recognize this as a priority and are devoting more staff time to it.

Above all, what we need are institutions which will be able to nurture small, developing businesses, institutions of a venture capital type. Unfortunately Africa is plagued with s generally dismal record of official

development banks many of which have been highly politicized, and not businesslike. The essential thing is to create institutions which will operate on a market basis, free from political interference.

This question of helping small and emerging businesses needs special attention. This is recognized as important in most Western countries where governments have established advisory and support mechanisms for small businesses. It is much more important in Africa, where in many cases there is very little private sector and the future depends on businesses which are now small or do not yet exist. We have to find effective ways of supporting these businesses.

In IFC we are trying to do this in a number of ways. We created, with the help of the UNDP, the Africa Project Development Facility or APDF to provide entrepreneurs with advice and help in planning invstments. For the last four years it has been operating from two centres, Abidjan and Nairobi. The demand for its services has been overwhelming — more than 1600 applications, even though there are only these two offices on the continent — which tells us something interesting. A number of donor governments, including the UK, have contributed to this effort and we are now enlarging it and establishing three new offices, but even this will not meet the demand.

This mechanism provides advice, but not finance for investment, and we come back to the lack of financial institutions which can provide funds and good supervision. To fill the gap, we decided recently in IFC to create our

own Fund for this purpose, the Africa Enterprise Fund which makes much smaller investments than IFC usually does, but we aim to maintain the same exacting standards. We are putting a lot more of our own people into field offices with delegated authority to make decisions on quite small investments. Here too we are finding a big demand and response, confirming that the entrepreneurs are there and the need is to find ways of helping them.

More needs to be done. We must find ways of meeting the need for equity funding for smaller businesses. It is not that there is a shortage of money because many aid agencies would be ready to provide it — again the real problem is not shortage of money but of ways of using it well. There are some who will suggest dealing with this problem by providing what they call "soft equity", equity on which a return is not expected, a concept which originates I think in Scandinavia and which seems to me to be a sure recipe for starting unsound businesses. We have to find better ways.

But besides developing the financial sector and nurturing small businesses, we have to look for ways of encouraging and helping larger scale private investment. This is IFC's central role. All too little private investment is going on in Africa at present, but if the structural adjustment policies now being followed in many countries are maintained, we can hope to see a revival of interest in private investment in the course of the 1990s. It is tremendously important that these investments, when they come, should be successful. The role of the IFC and similar institutions is to act as a catalyst — to provide some financing (but always a minority share, avoiding

control); to provide technical and financial advice based on long experience in investments in developing countries; and to help mobilize funds from other sources. The essence of this role is that, although the overriding aim is development, the method is to act like a business. We must be a full risk-sharing partner of the private investors with whom we work, not sheltering behind government guarantees or protecting ourselves in ways that are not available to our private partners, seeking profit because that is the test of success and efficiency in business.

The scale of IFC's activities in Africa in supporting private investment in Africa may seem quite modest. We are now investing a little under $200 million a year in about 25 companies a year in Sub-Saharan Africa; but we estimate that the investments in which we have participated have recently accounted for about 12-15% of total private investment (domestic and foreign) in the region a very substantial share.

But if Africa is to achieve the levels of private investment needed to produce rising standards of living and reduce the dependence on foreign aid, foreign investment will have to play a vital part. As I said earlier, Sub-Saharan Africa has recently been getting an almost negligible amount of foreign investment, less than $1 billion a year and a large proportion of that has been going to one country, namely Nigeria. Foreign private investment has been playing virtually no part in the development of Africa in the 1980s.

Obviously this is not going to be changed quickly. Investing in Africa was always a rather specialized business, but there used to be certain companies in this country and France, particularly, which made it an important part of their business to do so, the Unilevers, Mitchell Cotts, Bookers and others. A very few, such as Lonrho, are still there, but in most of Africa that kind of investment has virtually come to a halt. The new foreign investments we are seeing at present in Sub-Saharan Africa are in a few large mineral resource projects -- for example gold in Ghana and oil in Nigeria, Gabon and the like. Investment in manufacturing in black African countries by foreign companies is almost at a standstill.

I believe African governments need to pay much more deliberate attention to the question of attracting foreign investment. Of course basic policies, macroeconomic stability and political conditions are of furndamental importance, but there are often other discouragements, for example restrictions on percentage ownership of companies and on the remittance of profit, and excessive taxation, sometimes discriminatory taxation. While small countries in Europe and individual States within the USA run international campaigns to try to attract foreign investment, many African governments adopt an ambivalent attitude; and of course the history of nationalizations in many countries is a discouragement.

Restoring a significant flow of foreign investment to Sub-Saharan Africa will take time, but I believe it can be done, if only because there was a flow in the 1960s and it can happen again. Here too we can help. First of

all, we can provide advice on policies for foreign investment. Together with MIGA we run the Foreign Investment Advisory Service or FIAS which has advised a number of African governments. MIGA itself, the Multilateral Investment Guarantee Agency, offers insurance to investors against non-commercial risks. IFC can be an investment partner, playing the same kind of role for foreign investors as we do for domestic companies, that is to say providing finance, providing technical advice and mobilizing funds from other sources. In the case of foreign investment our role very often is to help in negotiations with local partners or governments about new investments and simply by our presence as a risk-taking partner to provide a reassurance to the foreign investor.

As confidence develops and the economies of Sub-Saharan Africa revive, it should be increasingly unnecessary for an agency like ours to play this role, but I think those happy days are some time away. The job of facilitating and assisting investment in Sub-Saharan Africa, domestic and foreign, will be crucially important in the next couple of decades. Unless we can achieve a strong growth of private investment in Sub-Saharan Africa, the outlook for that region of the world will be grim indeed.

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AFRICA IN THE NEW WORLD ORDER

Pauline H. Baker

Thirty years ago, Sub-Saharan Africa was the Eastern Europe of the times. Although poor and underdeveloped, the world's second largest continent was undergoing change more rapidly than any other part of the globe.

Today, however, the promise that surrounded the collapse of colonial rule and the birth of over forty new nations in Africa remains unfulfilled. Economic stagnation, political instability, and superpower rivalry followed in the footsteps of imperial retreat, with ethnic, racial, class, and religious conflicts rending the political fabric of the continent. Current economic prospects are grim, a crisis of political legitimacy is coming to a head, and the end of the Cold War may further marginalize Africa. Nevertheless, there are some hopeful signs of change: a consensus is growing about the causes of Africa's deterioration, a new pragmatism born of necessity is emerging among African elites, and one-party states and military rulers are coming under increasing pressures for democratization. Over the next several years, Africa's role in the world order will change, and America's interest in the continent, while currently at an ebb, may be revived.

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Unfulfilled Expectations

Beginning with Ghana in 1957 and continuing through the 1970s, dozens of African states achieved independence, forming a bloc that represented roughly one third of the membership of the United Nations. Just as the cluster of territories ranging from Hungary to Lithuania is now rejecting the authoritarian rule of the Soviet Union, an area approximately eight times as large (from the Sahara to the Kalahari Deserts), with about twice the population, was then throwing off the colonial domination of Western Europe.

Events leading up to African independence were obviously quite different from those which have led to Eastern Europe's freedom. Among other things, Africa suffered from centuries of conquest and exploitation by adventurers, propagandists, opportunists, and empire builders seeking commercial gain, military expansion, political status, and international prestige. The continent was drained by slavery and carved up by colonialism. Its national boundaries were not defined by physical barriers, socio-cultural patterns, or indigenous political forces. Rather, the modern map of Africa was drawn by foreign powers at the 1884 Conference of Berlin. Consequently, contemporary African conflicts stem largely from competition among diverse peoples thrown together more than a hundred years ago by Great Britain, France, Germany, Italy, Portugal, Spain and the King of Belgium.

At the time of independence, Africa's experience was seen to have universal relevance. The "winds of change" blowing across the continent added new perspectives to prevailing concepts of global change. Economists wrote about the stages of economic growth which new nations would go through in order to "take off"—that is, to achieve industrialization, few doubting that this was either a desirable or realizable near-term goal. Political scientists predicted radical transitions from traditional societies based on "primordial" loyalties to modern political systems based on "ascriptive" criteria. Students of comparative politics wrestled with loosely defined notions, such as "nation-building" and "political culture." And a lively debate arose about whether Africa would, or should, follow Marxist, neo-colonial, or capitalist lines of development.

Most observers were optimistic about Africa's future. As development analyst Goran Hyden noted: "Independent Africa was born into a world characterized by its faith in progress. Captivated by scientific and technological success, the postwar generation in both the East and the West had lost their sense of proportion, thrown cautions to the wind, and dismissed as unfounded pessimism all realistic reference to man's natural

limits."[1] This sense of "Prometheus Unbound," as Hyden termed it, not only convinced the European powers that it was no longer necessary to keep their overseas colonies in bondage, but raised exaggerated expectations among Africans themselves. "With independence, Prometheus moved to Africa—more unbound than ever—in search of new victories," concluded Hyden.[2]

African leaders readily accepted the labels bestowed on them by a world fascinated with the continent's emancipation. Upon birth, Nigeria, Africa's most populous state, was termed a "showcase of democracy." Uganda was "the pearl of Africa;" its hilly capital, Kampala, was "Africa's Rome." Sudan, the largest land mass in Africa, was envisioned as "the breadbasket of the region." And the Ivory Coast, which remained intimately tied to France, was dubbed an "economic miracle."

Ghana's Kwame Nkrumah preached a pan-Africanist ideology, calling for a supranational confederation transcending ethnic identities and national frontiers. The idea of an all-Africa army was touted for a while. Senegal's Leopold Senghor, a poet as well as a politician, switched from advocating a Eurafrican entity led by France to a philosophy of *negritude*, that asserted a unique African cultural nationalism based on humanistic values.

Major foreign powers tended to view these events in geopolitical terms. France and Great Britain were keen to preserve their commercial and military footholds, even as they retreated politically. China saw Africa as being "ripe for revolution." The Soviet Union regarded the region as a seedbed for the spread of Marxism–Leninism. And the United States, preoccupied with containing communism, saw Africa, first, as an ideological battlefield of the Cold War and, second, as a sphere of European influence.

Thirty years later, few of the original expectations that surrounded Africa's entry into the community of nations have been fulfilled. Nigeria is now making its third bid for democracy. Uganda is recovering from the ruthless dictatorships of Idi Amin and Milton Obote. The Sudan is facing starvation as a result of a grueling civil war. And the Ivory Coast's economic miracle has turned into an economic mirage.

Africa as a whole has turned inward. Rather than forming a unified voice or collectively playing a global role, the fifty-one states that comprise Sub-Saharan Africa are consumed with overwhelming internal political

1. Goran Hyden, "Urban Growth and Rural Development," in Gwendolen M. Carter and Patrick O'Meara, eds., *African Independence: The First Twenty-Five Years* (Bloomington: Indiana University Press, 1986), 189.

2. Ibid., 190.

and economic problems. Many are still linked tightly to their former colonial rulers, as trade and travel patterns show. Indeed, some African nations still behave in ways that reflect the views or influence of their former European rulers. "French power in Africa," political analyst John Chipman has noted, "can still be wielded largely because the African elites have collaborated in its maintenance."[3]

Although some inroads were made by non-European powers, neither Chinese revolution, Soviet-style Marxism–Leninism, nor American free enterprise have really taken root. Except for a handful of projects, Beijing has virtually withdrawn from Africa. And Moscow is in the process of cutting its losses, gradually scaling down its military and economic assistance programs, although the latter were never generous to begin with. Furthermore, according to press reports, Moscow has warned its allies on the continent (Ethiopia and Angola) that they must now pay for their weapons with hard currency.[4]

For its part, the United States has yet to come fully to terms with the implications of these trends. It clings to lingering Cold War interests, preferring the Soviet Union to leave the continent first; and it is reluctant to challenge European pre-eminence, principally out of deference to NATO unity. On balance, Washington seems more removed than ever from the real concerns of the continent, responding on a case-by-case basis to issues such as famine, Libyan aggression, and South Africa—the only issue in Sub-Saharan Africa that has stimulated sustained interest among the American public.

The Fear of Being Forgotten

As the decade of the 1990s opens, African decolonization and the Cold War are, coincidentally, both coming to an end. Namibia, Africa's last colony, achieved independence in March 1990, the result of an agreement concluded fifteen months earlier with Soviet–American cooperation. Remnants of the Cold War linger in Angola, where Moscow and Washington continue to arm rival forces, and, to a lesser extent, in Ethiopia, where the Soviet-backed regime has its back to the wall from insurgencies that are gaining ground. Notwithstanding these quagmires, however, superpower rivalry as an overarching theme in African international relations is clearly withering away.

Most African states decried the bipolar split as it played out on their territory, but the rivalry between Moscow and Washington partially served their ends. As an editorial in the Liberian press observed:

3. John Chipman, *French Power in Africa* (Oxford: Basil Blackwell, 1989), 3.
4. *The Independent* (London), January 3, 1990, 9.

> It was, to an extent, a great advantage to Third World countries to balance in a world divided between two camps. In light of such division, the camp of one superpower served as a protector against any encroachment upon a small country by another superpower or its surrogate. In this way the world was able to maintain a balance of power without engaging in major global conflagrations . . . . With the West rushing to the economic rescue of Eastern Europe, we in the Third World should begin to rethink our situation . . . . [We must get] our political and economic houses in order, or we might be left out in the cold.[5]

The new world order taking shape has sparked deep concerns in Africa. One commentary observed that "despite the wild jubilation in the Western media and government about what is happening in Eastern Europe, no African can view recent events with equanimity."[6] General Denis Sassou-Nguesso, president of the Congo, warned that the combination of the end of the Cold War and the economic unification of Western Europe in 1992 could "estrange Africa."[7] And Bernard Chidzero, Zimbabwe's respected finance minister, has noted that "we may become Cinderella partners in this whole game."[8]

Africa's anxieties about the changing international environment are similar to those of other Third World areas. But because the continent has traditionally been a low priority in global politics, Africans feel they have a special cause for concern. There is a palpable fear of impending abandonment or benign neglect as the global competition for aid, trade, and investment intensifies. Indeed, the flow of resources to emerging democracies in Eastern Europe, Central America, and Asia may drive Africa further into the rearguard of history at a time when many of its leaders have committed themselves to economic reform.

Bleak Prospects

Few would disagree that, on economic grounds, Africa is more in need than any other part of the globe. The continent's food production, while having increased slightly over the last few years, in part due to the adoption of structural adjustment programs since the mid-1980s, has not

5. *Daily Observer* (Monrovia, Liberia), November 10, 1989, as quoted in *Foreign Broadcasting Information Service (FBIS), Africa*, January 5, 1990, 13.

6. *The Herald* (Harare, Zimbabwe), December 1, 1989, as quoted in *FBIS, Africa*, January 23, 1990, 10.

7. Paris, Agence France-Presse, January 9, 1990, as quoted in *FBIS, Africa*, January 10, 1990, 2.

8. Quoted in the *World Development Forum*, vol. 8, no. 4 (February 28, 1990): 1.

kept pace with its 3.3 percent annual rate of population growth, the highest in the world. Africa's population is, in fact, projected to double over the next twenty years, rising to one billion people by the year 2010. Economic development, however, has gone into reverse, particularly over the last decade. Austerity programs have diverted funds from social services and infrastructure, deepening poverty and sharpening social inequalities. Common diseases, such as malaria and dysentery, are as widespread as ever. Two out of every three Africans still lack safe drinking water. And one quarter of the population—over 100 million people—faces chronic food insecurity and hunger.

To make matters worse, a new killer stalks the continent: AIDS. Having already reached epidemic proportions, the HIV virus is estimated to have claimed the lives of 300,000 Africans and infected another 2.5 million. The figures represent, according to *Africa Report*, a "frightening trend that is still in its initial stages . . . the disease is ready to explode across the continent and grab the terrible distinction of being Africa's most pressing problem."[9]

Current prospects are bleak by any measure. According to the World Bank, "Africa's long-term debt has risen nineteen-fold since 1970 and is now equal to its gross national product (GNP), making the region the most heavily indebted of all. (Latin America's debt amounts to only around 60 percent of GNP). More than one hundred debt reschedulings have been negotiated, and still arrears accumulate."[10] Altogether, Sub-Saharan Africa, with roughly 450 million people, has a total gross domestic product (GDP) that is roughly the size of Belgium's, which has a population of 10 million.

With the exception of international financial institutions deeply involved in Africa, the main responses of the outside world have ranged somewhere between cynicism and discouragement—or what one development expert has aptly described as "compassion fatigue."[11] Typical of the American attitude is the sentiment contained in a letter to the editor of the *Washington Post* that replied to an op-ed article calling for action. "Instead of asking, 'Why Not More Aid to Africa?'" the skeptic wrote, "[it should be asked] . . . 'Why Indeed More Aid to Africa?'"[12]

9. *Africa Report* (November–December): 6.

10. *Sub-Saharan Africa: From Crisis to Sustainable Growth* (Washington, D.C.: The World Bank, 1989), 2.

11. John Hammock, executive director of OXFAM, in the *Washington Post*, January 17, 1990, G1.

12. Marco A. Caceres, letter to the editor, *Washington Post*, February 9, 1990, in response to Leonard H. Robinson, Jr., "But Why Not More Help for Africa?" *Washington Post*, February 1, 1990, 21.

Though it seems harsh, this sentiment probably reflects the view of the general public in the United States, with whom foreign aid has never been popular. The dismal results of development assistance in Africa only reinforce this lack of enthusiasm. Africa has received more official foreign assistance and debt relief relative to its GNP than any other region in the world.[13] An average of $13 billion per year in foreign assistance flowed to Africa from 1980 to 1987, but per capita income fell by 10 percent. Even the World Bank now admits that half of its completed African rural development projects have failed.[14]

There are, as always, exceptions to the record of deterioration. Botswana has had a consistent 8 percent economic growth rate for the last twenty-six years and a sustained democratic system. Zimbabwe has substantially increased agricultural production, with smallholders tripling their output of maize, peanuts, and cotton since independence in 1980. The World Bank has spotlighted selected projects with a good track record, showing that progress is possible. And the International Monetary Fund (IMF) cites Ghana as a star pupil of its structural adjustment program. Ghana has achieved an annual economic growth rate of 6 percent over the last six years and a 60 percent increase in exports since 1983.[15]

But these are exceptions that prove the rule. Botswana has rich reserves of diamonds, a small population, and strong economic ties to South Africa. Although Zimbabwe has made remarkable strides in agriculture, it has failed to attract sufficient foreign private investment for manufacturing because of its rhetorical adherence to Marxism and its drift toward a one-party state. In general, international donors have been unable to claim success in project aid on a scale large enough to reverse Africa's declining economic trends. Ghana's accomplishments, while impressive, were made possible only by massive assistance. And with international aid to the country doubling over the last four years to a total of $850 million in 1990, Ghana serves as a dubious model for the rest of Africa.

With economics becoming an important determinant of world politics, Africa is in danger of being marginalized entirely. "For the most part," reports the World Bank, "Africa is simply not competitive in an increasingly competitive world."[16] Fifty percent of the continent's export earnings goes to service its debt, making the world's poorest continent a net exporter of capital. Africa's share of the world market has halved

13. *Christian Science Monitor*, December 28, 1989, 8.

14. *The Economist*, November 25, 1989, 47.

15. *The Economist*, March 10, 1990, 50–51.

16. *From Crisis to Sustainable Growth*, op. cit., 3.

since 1960, to a minuscule 1.5 percent.[17] And returns on investment, which were around 30 percent in the 1960s, are now less than 3 percent.[18]

Moving From Blame To Cooperation

For years the debate over Africa's decline has been mired in unproductive accusations and counter-accusations about who or what was at fault. In general, African leaders have blamed external factors over which they have had no control: the legacies of colonialism, poor terms of trade, misguided advice from development experts, and fluctuating commodity prices. Foreign observers have blamed internal factors, such as bad management, irresponsible leadership, pervasive corruption, and state domination of the economy.[19]

Now there seems to be a consensus emerging that apportions responsibility to both sides. Donors are becoming more sensitive to the African predicament, having learned the hard way that the bulk of their aid may have been misspent. And African nations are displaying more economic realism, admitting that they have made fundamental mistakes.

While painful lessons have been learned, this emerging consensus unfortunately will not garner additional international resources for the future or make Africa more competitive on the world stage. Putting aside the IMF, which is restructuring the economies of some thirty-five African nations, and the World Bank, the leading development voice in the Third World, all the major donors, with the exception of Japan, appear to be shifting their attention elsewhere.

The United States is leading the pack. American assistance to Sub-Saharan Africa has declined for the past five years, dropping from slightly over $2 billion in 1985 to a proposed level of about $1 billion—roughly the cost of two B-2 "Stealth" bombers—for 1990. And about half of that amount is food aid. As one observer has noted, "[T]he most dramatic indication of the comparative inequity [between aid to Africa and other regions] is the per capita aid amounts between all of Africa and Israel. Africa averages about $1 per person in aid from the United States while

17. *Christian Science Monitor*, December 28, 1990, 8.

18. *The Times* (London), November 23, 1989, as reported in *Africa Research Bulletin*, vol. 26, no. 11 (December 31, 1989): 9757.

19. For succinct summaries of this debate, see Carol Lancaster, "Economic Reform in Africa: Is It Working?" *The Washington Quarterly* (Winter 1990): 115–128; and *Africa News*, vol. 32, nos. 9 and 10 (December 25, 1989).

Israel gets $1,000 per person."[20] This year the Bush administration has already reprogrammed $32 million in aid designated for Africa and given it to Panama, promising to reimburse the account later on.[21]

Even if the aid picture were turned around, Africa's crisis would remain a daunting challenge. Long-term recovery must go beyond economic restructuring and external assistance to deal with some of the more profound problems holding Africa back: soaring birthrates which will double the number of mouths to feed in the next twenty years; devastating civil wars in which hundreds of thousands of civilians, particularly children, are dying; repressive political systems that stifle democratic expression and thwart economic initiative; and widespread official corruption which eats at the moral fabric of society and erodes confidence in the state.

Africa's economic crisis is now fully as much a political and social problem as it is a developmental one. For that reason, the main point of departure must come from Africa itself. Eastern Europe was made free not by outside intervention, but by the actions of its own people. Unless and until there is popular demand in Africa for change on that order, economic aid, private investment, and even political attention will probably be limited in scope and narrow in effect.

The Potential For Political Instability

As Africa's economic problems continue to swell, a crisis of political legitimacy is bound to occur. Post-independence leaders and their successors are finding it increasingly difficult to live off charisma, coercion, and cooptation—their traditional means of staying in power. The most dramatic change likely to occur is the dissolution of the one-party state, a political system that is discredited worldwide. Its days are numbered in Africa.

Justified on the grounds of trying to achieve unity—an understandable preoccupation of young, fragile, and ethnically diverse states in the post-independence years—one-party rule and its armed equivalent, the military junta, have been Africa's most prevalent forms of government in the post-colonial era. But they have not solved the continent's most pressing problems, including ethnic fragmentation. The voices of dissent are multiplying. Within the first three months of 1990, anti-government

20. Steve McDonald, *Washington Report on Africa*, vol. 8, no. 1 (January 16, 1990): 1–3.

21. *Washington Post*, February 18, 1990, 50.

disturbances occurred in Gabon, Niger, Benin, Ivory Coast, Kenya, Zimbabwe, Liberia, and Lesotho. "Perhaps not since the time of independence thirty years ago," reports the *New York Times*, "have so many African nations been swept up in protests, strikes and political activity."[22] Mozambique has begun to shift from one-party rule to democratic pluralism, and Tanzania's former president Julius Nyerere, a key apostle of the one-party state, has conceded that its utility may need to be reexamined. This piecemeal process of democratization may be fostered by world events. As the Cold War draws down, the superpowers will be less inclined to continue their unconditional support of certain repressive African regimes.

To the extent that it was ever seriously adopted in Africa, socialism is also in retreat. In the words of *The Independent*, there have been "few devout socialists among Africa's leaders. Ideology has often been an end rather than a means."[23] The only remaining country on the continent likely to engage the debate over socialism with conviction is South Africa, where capitalism has long been closely identified with apartheid. When full-scale negotiations to create a non-racial democracy take place, state ownership and management of the economy may well become the most difficult and contentious issue on the table.

In the past, political instability in Africa usually took the form of military coups d'état. While that threat remains, there are likely to be more incidents of popular unrest among frustrated urban workers desperately seeking jobs, disillusioned students whose futures are in jeopardy because of scant employment prospects, embittered civil servants laid off by austerity programs, and the displaced intelligentsia and professional classes who cannot make a living. Discontent could reach into rural Africa as well, although at a slower pace.

Cumulatively, these trends may stimulate a resurgence of African nationalism far deeper than that which occurred in the post-independence period. At that time, Africa experienced a change of flags and a rotation of elites. After the euphoria wore off, life for the average person went on as before. Over time, it even got worse. Essentially, post-independence African leaders did not create new political systems; they took over the institutions of the colonial state and the mechanisms of the colonial economy, which was structured by the metropoles to supply Europe with raw materials. Bureaucratization was a common feature of colonial and post-colonial African states, and Marxist and non-Marxist regimes alike. Some, of course, were more democratic than others. Nigeria, for example,

22. *New York Times*, March 3, 1990.

23. *The Independent* (London), January 3, 1990, 9.

had a vibrant press and a highly politicized electorate; and Kenya boasted a respected judiciary. Overall, however, the makings of a civil society are only now beginning to take shape in most African countries.

Not only does Africa have to adjust to a rapidly changing world order, it must also confront new internal problems. Religious conflict is increasing, partly due to the expansion of Islam, a religion that is highly adaptable to African cultural traditions and offers a spiritual home for people in poverty. Terrorism could also spread in Africa, as was demonstrated when a French DC-10 airliner was blown up over Chad on September 19, 1989. Investigations revealed that a bomb was placed aboard by pro-Iranian Shiites, who reportedly have established a network of operatives in West Africa.[24] The drug trade has also come to Africa. Smugglers now use the continent as a transit route, ferrying heroin from Asia, cocaine from Latin America, and locally-grown cannabis to European and American markets.

Finally, there are major environmental problems that have been ignored. Principally because of the need for cheap firewood for cooking, Africa's forests are disappearing at a rate of over 27 million acres a year.[25] Savannah fires used by farmers to clear land are polluting the air. Toxic wastes and wildlife management in Africa are issues that have long been neglected by development experts. But environmental deterioration in a continent of Africa's size and resources will affect the world at large. In Madagascar, for example, slash-and-burn agriculture is threatening a medicinal flower known as the rosy periwinkle, a key ingredient in the treatment of childhood leukemia and Hodgkin's disease.

Prospects for Change

Not everyone is gloomy about Africa's prospects. Noted Africa expert Colin Legum, for example, predicts a "second period of liberation," with democratization, economic liberalization, and human rights progress on the horizon.[26] And Mwizenge Tembo, a research fellow at the University of Zambia, points out that despite statistical economic decline, African countries have made great strides in education. Thousands of graduates

24. *Los Angeles Times*, November 27, 1989, 1; *Washington Times*, November 28, 1989; *New York Times*, December 15, 1989.

25. Stephanie Agresta, *Washington Report on Africa*, vol. VIII, no. 4 (March 2, 1990): 13.

26. See Colin Legum, "The Coming of Africa's Second Independence," *The Washington Quarterly*, vol. 13, no. 1 (Winter 1990): 129–140; also Theresa K. Smith, "In Africa, Glasnost . . .", *Christian Science Monitor*, February 22, 1990, 19.

are available to implement the new economic programs that African nations are adopting.[27] There are others, however, such as David Newsom, the former assistant secretary of state for African affairs, who maintain that "it is too soon to proclaim victory for the West, capitalism, or democracy in Africa."[28] Richard Joseph, an African specialist at the Carter Center, takes somewhat of a middle position. He contends that while Africa has adopted its own form of *perestroika* (or economic restructuring), it has failed thus far to adopt *glasnost* (or political reform).[29]

A conference sponsored by the Stanley Foundation and convened in October 1989 summed up the feeling of most experts on Africa. It concluded that "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."[30] Africa's future, these experts concluded, depends on two factors: first, "the emergence of a stable middle class capable of providing continuity of managerial and entrepreneurial leadership," and second, "the establishment of representative, responsive and enduring governmental structures."[31]

Perhaps over the next thirty years, Africa may recapture some of the attention and excitement it attracted when it was the Eastern Europe of the world. If so, then it will present the world with the development challenge of the twenty-first century. In the interim, other international actors are taking up the slack created by superpower withdrawal. Japan, for one, is attempting to extend its influence on the world stage through aid; its assistance to Africa has multiplied tenfold since the late 1970s, reaching $900 million in 1988. Japan's aid consists of innovative, non-project grants that are not tied to the purchase of Japanese goods, require quick disbursement within a year, and are focused on buying urgently needed spare parts or raw materials.[32] Middle powers such as Israel, Brazil, India, Canada, and the Scandinavian countries may also fill the vacuum. Smaller European nations see in Africa an opportunity to counter-

27. Mwizenge S. Tembo, ". . . And Perestroika," *Christian Science Monitor*, February 22, 1990, 19.

28. David D. Newsom, "After the Cold War, U.S. Interests in Sub-Saharan Africa," *The Washington Quarterly*, vol. 13, no. 1 (Winter 1990): 99–114.

29. Richard Joseph, "Glasnost for Africa," *New York Times*, December 28, 1989, 21.

30. Michael Clough, "Africa in the 1990s," *CSIS Africa Notes*, no. 107 (January 29, 1990): 5.

31. Ibid.

32. *The Economist*, November 25, 1989.

balance the growing strength of Eastern European nations and larger West European members of the Common Market. Thus, while France is "starting to tire of the continent,"[33] Portugal has made relations with its five former colonies "one of the primary focuses of Portuguese diplomacy."[34]

Provided internal stability is achieved, significant political shifts might take place within the continent. Regionally powerful states, like Nigeria, seem destined to reassert themselves sooner or later. In fact, a democratic Nigeria and a non-racial South Africa could be the two giants leading Africa's recovery by the next century. Indeed, after apartheid is dismantled, the South African business community, which is an indigenous entrepreneurial class, could be a vital source of local investment and technical input for all of Sub-Saharan Africa, its natural frontier.

Regional economic groupings should solidify despite a record of ineffectiveness. Africa must intensify inter-regional trade to keep pace with global trends. As things now stand, intra-African trade is estimated by the IMF to represent merely 5 percent of the continent's current imports and exports. Some tentative steps toward economic integration have already been taken by ECOWAS (the Economic Community of West African States), the PTA (the Preferential Trade Association in East and Central Africa), and SADCC (the Southern African Development Coordination Conference), but the pace has been painfully slow.

The American Role in Africa

Of all the major outside powers, American interests in Africa seem most likely, eventually, to be rekindled. Preoccupied with internal matters, neither the Soviet Union nor China is likely to substantially revive its involvement in Africa over the next several years. In this regard, the age of ideology—including U.S.–Soviet and Sino–Soviet rivalries—is drawing to a close. A revealing article in a Soviet journal reviewing economic relations between Moscow and Africa was entitled bluntly: "What Shall We Buy in Africa?" It complained, among other things, that "countries of the region have yet to start supplying us with goods we need."[35]

Two factors may drive American interest in Africa. First, as the United States becomes more involved in global issues, redefined from a

33. *The Economist*, April 22, 1990, 39.

34. *Expresso* (Lisbon), October 14, 1989, 18; as reported in *FBIS, Africa*, November 15, 1989, 1.

35. Grigori Polyanov, "What Shall We Buy in Africa?" *International Affairs* (October 1989): 69.

geo-social rather than a geo-strategic perspective, Africa may assume larger importance. Especially with the development challenge, public health concerns, environmental issues, and the desire to spread democracy replacing traditional geopolitical concerns. Second, a resurgence of ethnic and racial identification worldwide could trigger a stronger domestic interest in Africa in the United States.

Approximately 12 percent of the American population trace their ancestry to Africa. As their influence grows, so may the domestic constituency for Africa. When Nelson Mandela was released from prison, for example, Roger Wilkins, a noted civil rights leader, wrote that he made "an immediate identification with him and other South African blacks because their problem is the same as ours." Understandably, African–Americans felt "a surge of pride" in this historic event.[36]

American interest in the continent is not confined to African–Americans alone, however. Few realize that the United States has the largest reservoir of expertise on Africa in the world. Although late to African studies compared to Europe, the United States has, according to the authoritative journal *West Africa*, clearly become the dominant Africanist force. America's African Studies Association, with a membership of approximately 2,000, "is five times as large as that of the UK," notes the journal.[37] In fact, "though Africanists bemoan . . . shortage of funds, the US provides more funds for African study centers, Africanist staff, visiting professorships, and research than all of Europe combined."[38]

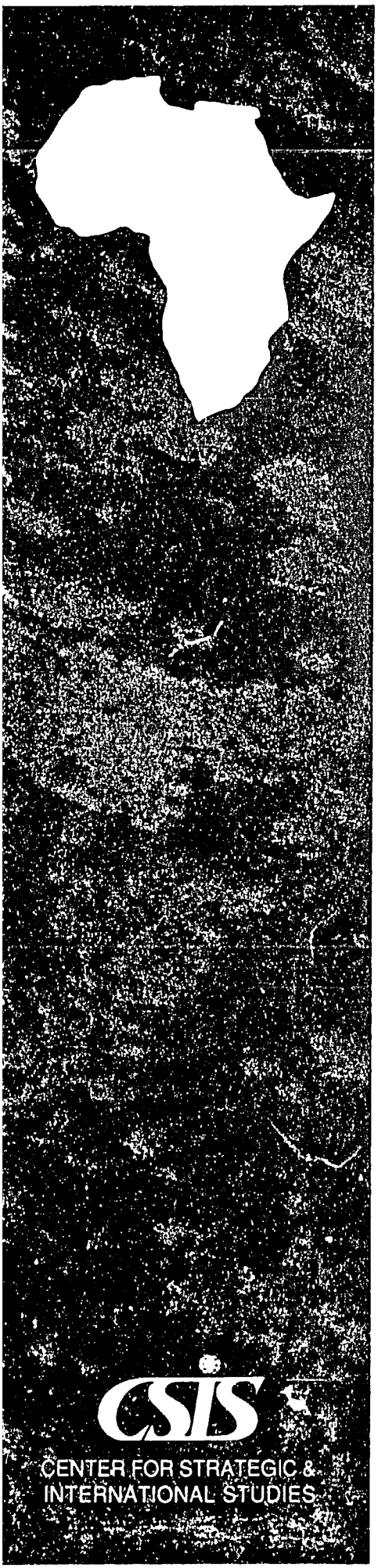
The evolving American perspective on Africa will, consequently, become less Soviet-oriented and Eurocentric, shifting to policies that reflect domestic interests and national values. In this regard, the decision of the U.S. Congress in 1986 to enact sanctions against South Africa, overriding the veto of President Ronald Reagan, may foreshadow national trends in the years ahead.

While there is a real danger that Africa could become "ghettoized" as the larger sweep of world politics rivets attention on Europe, the Soviet Union, and other dynamic parts of the globe, the wheel of history may turn full circle. The initial excitement of the post-independence era probably will never be re-created. But a sober reassessment of global self-interest could redirect America's attention back to the continent which is, after all, the cradle of humanity.

36. Roger Wilkins, "Mandela: Our Cousin, A King," *New York Times*, February 22, 1990.

37. *West Africa*, October 23, 1989, 1761.

38. Ibid.



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Soviet Assistance to Africa: The New Realities

by Sergei I. Shatalov

An epoch of Soviet assistance to Africa is drawing to a close. Moscow now faces mounting economic difficulties at home and is in reduced strategic competition with the West. The traditional priorities that shaped Soviet foreign aid policy throughout most of the postwar era are dissolving and new ones have not yet been established. Thus, it seem appropriate to assess past results in this area and to outline options for the future.

Soviet analysts speak of a "pause" in Soviet-African relations. Some even use the term "crisis of confidence" and explain Soviet Foreign Minister Eduard Shevardnadze's visit to seven African states in March 1990 in terms of the need to overcome this crisis. These opinions are justified, but only for the short run. With old links weakening, new ones are being forged to replace them. Some of these new African links will arise from the opening up of the Soviet economy. Aid will inevitably follow trade.

A Dispiriting Record

Soviet-African economic cooperation, even with Moscow's closest allies on the continent, has always been marked by rather modest volumes of aid and trade. Soviet-African trade turnover has never exceeded 2 percent of total volume for either side. Both the share and the absolute volumes of trade declined in the 1980s, the latter by over one-third.

Another important feature of Soviet-African relations has been the priority given to political and strategic goals over commercial goals. Aid has suffered the most from the Cold War zero-sum-game mentality. For decades, decisions on aid have been made in reaction to the policies of the ideological adversary, i.e., the Western donors.

Military assistance has dominated the overall aid picture. Reliable estimates suggest that assistance to the civilian sector has never exceeded one-third of all Soviet aid flows to Africa. For some key countries such as Angola and Ethiopia that have been directly involved in regional and domestic conflicts, the share of civilian aid has been even lower.

The predominance of ideological motives has been reflected in the concentration of aid flows. The leading borrowers have changed over time, but the "top five" have always accounted for over three-fourths of the total. Ethiopia, Algeria, Angola, Egypt, and Libya (ranked here in decreasing size of debt owed to Moscow) accounted for over 80 percent of total Soviet loans outstanding on the continent in 1989. (See "Soviet Lending to African Countries," page 3.) But even for these countries Soviet aid flows have never

rivaled those of the West, and for most African nations Soviet aid has constituted under 5 percent of the total.

The predominance of strategic and ideological motives explains the slow pace of change in this sphere. Only in late 1989, and only under the pressure of the Supreme Soviet, did aid policies become subject to extensive critical reappraisal.

The Institutional Tangle

In the 1980s, the aid management system exhibited the structural pattern now often referred to as "bureaucratic socialism." Aid was administered by the State Committee for Economic Cooperation (GKES). GKES combined three distinct roles: it was an agency for soft lending, an export credit agency operating on harder terms, and an agency for military assistance. In practice, GKES executed only individual projects. Lending was controlled by the Ministry of Finance and channeled through the Bank for Foreign Trade of the USSR (VTB). The ultimate authority over aid strategy was held by the top political leadership; the Ministry of Foreign Affairs had the weightiest vote in determining the overall priorities of the aid program.

At first glance, this highly centralized system made sense. It permitted flexible adjustment of the terms and structure of lending as priorities changed. In reality, however, the system was chaotic. Most major programs were devised on the occasion of state visits, not unlike the petrodollar aid of the Persian Gulf monarchs. There existed a chasm between mechanisms of aid allocation and debt repayment. GKES was responsible only for the former. Tracking the profitability of projects was not its task. Specific repayment arrangements added to the confusion. In principle, most credits could be repaid in kind, but GKES lacked the authority to make such agreements with debtors, because the Ministry for Foreign Trade held a monopoly on external trade transactions. The ministry preferred to operate through international commodities exchanges, even if the same commodity could be supplied at a discount as part of the debt repayment agreement.

The Promotion of Inefficiency

As was the case elsewhere in the Soviet economy, volume criteria dominated GKES activities. There was a built-in bias to produce grandiose projects, often poorly integrated into the recipient's economic structure. These projects involved significant outlays in local currency and distorted national credit markets. The projects were not always thoroughly prepared, forecasts of future trends were rare, and this led to miscalculations. Tentative official estimates suggest that some 30 percent of all Soviet projects executed in Africa have been unprofitable. Unofficial figures are even bleaker.

Aid strategy suffered from the "imitation syndrome." Being the novice in the aid business, the Soviet Union followed the "fashions" predominant among the (non-Communist industrial) member countries of the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD), but with a 5 to 10 year lag. The Soviet Union continued to build huge infrastructure projects well into the 1970s, when it was already quite obvious that such projects did nothing but put African nations deeper in debt. In 1989, a large-scale rural development scheme was canceled on the grounds of its potentially devastating ecological consequences—again, more than a decade after major Western donors had accepted that such schemes were nonstarters in Africa. The same is true with the debt issue: the Soviet Union was one of the last (along with the United States) to move on it.

The African states that received the most Soviet assistance became the least successful in economic terms. This assistance was originally intended to help countries that had recently achieved political independence to become economically independent as well. The former colonies were regarded as the natural allies of world socialism and their economic independence was seen as a means of weakening capitalism, but efficiency and common sense were casualties of the process. The African protégés established economically dubious import-substitution industries, while the competitiveness of their exports was declining. In sum, Moscow exported to the developing world the worst principles of its administrative economic system.

Military Assistance

Military assistance has been the slowest aid sector to yield to the pressures of *glasnost*. One rather cynical explanation recently offered is that arms are among the few competitive Soviet exports. This argument does not hold. Sales are financed by huge and in most instances excessively soft loans, and the repayment record is as bad as for nonmilitary loans. Even comparatively creditworthy countries (e.g., Libya) are in arrears. Some of the major

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customers are in particularly bad shape in this regard. The ratio of arrears to total claims is 29 percent for Ethiopia and 38 percent for Angola.

The opinion is gaining strength that military assistance has been inefficient even in geopolitical terms. It aggravated regional conflicts and dragged the Soviet Union into the dangerous spiral of superpower competition in Africa. For years, political options for resolving conflicts often were not even explored.

A unilateral freeze on arms sales would not solve the problem. Such countries as France, Sweden, Brazil, and Israel would be ready to fill the gap. Arms sales are a clear case for international negotiations. Even so, unilateral reductions could enhance the Soviet Union's diplomatic prestige and help dampen some African conflicts.

The Impact of *Perestroika*

The first stage of Soviet economic reform (1987-1989) emphasized decentralization of decision making. Two laws adopted in 1987 (on state enterprise and on external economic activity) broke up the state monopoly on foreign trade and established the right of individual economic entities, including cooperatives, to deal with foreign partners. Over 14,000 such entities existed as of the end of the first quarter of 1990. The latest round of market-oriented reforms further extends these rights.

This has brought about a profound transformation in the nature of the Soviet economic relationship with sub-Saharan Africa. The ultimate decision-making power now rests in the hands of the legislature; in July 1989 the Supreme Soviet assumed supreme control over aid appropriations. It votes both the total amount of aid for the coming budget period as well as the appropriations for individual countries. This is viewed as a guarantee against excess politicization of aid in the future. This mechanism has some similarity to the U.S. aid process.

This change will not necessarily be comfortable for the recipients. In Moscow, as in Washington, the aid budget has become a target of the deficit-cutting effort. Many parliamentarians echo the growing "aid fatigue" of their constituencies. It is hard to defend an aid budget which is 20 times as large as the health budget at a time when the Soviet infant mortality rate is among the highest in Europe and rising. The aid program's lackluster record is another factor that makes cuts seem easy to justify.

Institutional aspects of aid reform have not been flawless. The Ministry for Foreign Trade and GKES have been merged into the Ministry for External Economic Relations (MVES). This move was aimed at overcoming the rift between lending and debt collection functions. A growing number of experts now argue that creation of an independent aid agency is the only way to overcome the present impasse.

This new aid institution would be clearly different from GKES. Its job would be strictly limited to providing soft loans and executing projects. Simultaneously, a "normal" banking system will be introduced, with independent commercial banks as the main players. The traditional blurring of borders between different forms of lending will

Soviet Lending to African Countries as of November 1, 1989

(in millions of rubles[a] unless otherwise indicated)

Country	Debt	Written Off	Rescheduled (1986-1989)	Debt Share (%)
Top Five African Borrowers				
Ethiopia	2,860.5	51.7	854.9	21.2
Algeria	2,519.3	0.0	560.0	18.7
Angola	2,028.9	0.0	768.0	15.0
Egypt	1,711.3	0.0	8.2	12.7
Libya	1,707.3	0.0	360.1	12.7
Subtotal	10,827.3	51.7	2,551.2	80.3
Rest of Africa				
Benin	31.6	0.0	12.1	
Burkina	4.3	0.0	0.0	
Burundi	14.8	0.0	0.0	
Cameroon	0.6	0.0	0.0	
Cape Verde	7.2	0.0	0.0	
Central African Republic	1.0	0.0	0.0	
Chad	2.2	0.0	0.0	
Congo	199.5	0.0	83.7	
Equatorial Guinea	1.5	0.0	0.2	
Ghana	9.6	0.0	0.0	
Guinea	258.3	0.0	0.0	
Guinea-Bissau	66.0	0.0	12.7	
Madagascar	100.6	0.0	36.0	
Mali	285.0	1.2	88.4	
Morocco	2.2	0.0	0.0	
Mozambique	808.6	0.0	363.0	
Nigeria	26.7	0.0	0.0	
São Tomé & Príncipe	4.8	0.0	1.8	
Senegal	1.6	0.0	0.1	
Seychelles	0.2	0.0	0.0	
Somalia	260.8	3.5	0.0	
Sudan	3.8	0.0	0.0	
Tanzania	310.3	0.0	88.6	
Tunisia	17.7	0.0	0.0	
Uganda	36.4	3.0	0.8	
Zambia	206.0	0.0	23.3	
Subtotal	2,661.3	7.7	710.7	
Total	13,488.6	59.4	3,261.9	

SOURCE: Official data, reported in *Izvestia*, March 1, 1990.

a. As of April 25, 1990, the official conversion rate for the ruble was 0.607 rubles per dollar.

end. The state will not assume direct responsibility for commercial lending, although a scheme of official guarantees for private export credits is planned. Only development assistance will be financed directly from the budget. Bank lending will be undertaken by individual commercial banks fully on their own responsibility. Vnesheconombank (the renamed VTB) will also operate strictly on commercial banking principles. Enterprises with access to the foreign markets will have the right to extend export credits on their own.

Reaching Out to the Private Sector

Official development assistance will constitute only the hub of the emerging cooperation network. It could stimulate various forms of commercial links, regulated but not run by the state.

Most of the Soviet enterprises eager to enter the world markets are so unsophisticated that even the markets of the newly industrialized countries may prove too demanding for many. For these enterprises, African markets offer some opportunities for export expansion. And for the shortage-plagued Soviet consumer, the prospect of an influx of imports from Africa could become the weightiest argument against "aid fatigue."

It is time to extend the circle of aid recipients beyond the state sector. African entrepreneurs could be invited to participate in joint ventures on African as well as Soviet soil. Links with various African nongovernmental institutions could be established, since they are often more efficient than official channels in distributing humanitarian aid.

Sectoral priorities could be reshaped too, as the Soviet Union moves from ideologically driven economic isolationism to a quest for reintegration into the world economy. Special attention could be given, for example, to assisting the reconstruction of the African mining industry, so that costly domestic production could be supplemented with imports from Africa. Another obvious candidate is export-oriented agriculture, which can absorb both soft loans to enhance basic infrastructure and direct investment by the emerging Soviet private entrepreneurs.

The Information Dearth

The statistical coverage of Soviet aid flows is in urgent need of improvement. Under the terms of the agreements reached at the 1988 Vienna Conference on European Security, the Soviet Union committed itself to disclosure of all financial, monetary, and macroeconomic data. Still, information is often inconsistent or lacking. Detailed data on Soviet official development assistance (not to mention military aid) are unavailable. Some figures have been published, but this has generally been done only under pressure from the Supreme Soviet. This gap between words and deeds harms Soviet prestige. An annual report is needed, containing statistical series detailed and long enough (going back at least as far as the 1970s) to permit sensible analysis. Military aid should not be left out of the picture. According to Chairman V. Kirichenko of the State Statistical Committee (Goskomstat), this work is under way. Yet the results are long overdue.

The Soviet statistical organizations could benefit greatly from cooperation with the corresponding units of the DAC, the World Bank, and the International Monetary Fund. This fits logically into the context of *glasnost*.

The Debt Knot

As financial pressures on African nations have mounted, governments have sometimes failed to repay their debts to the USSR. The hitherto largely political-ideological motivation for Soviet aid has led African countries to perceive the Soviet Union as a malleable creditor. The Africans are further emboldened by the fact that the USSR does not participate in the activities of international bodies involved in debt rescheduling. African debtors usually negotiate first with the Paris Club and the IMF and only then approach the Soviet lending organizations, seeking (and expecting) treatment on terms comparable to those provided by the Paris Club. Thus, Moscow is sometimes forced to accept decisions it did not negotiate. Official sources put the volume of this "involuntary rescheduling" in 1986-1989 at over 24 percent of total African debt to the Soviet Union. Unofficial estimates suggest that 50 percent might be a more realistic figure.

As we move into the 1990s, the debt crisis continues to unravel: arrears mount, Soviet-African trade declines, and Soviet public opinion turns more and more against foreign assistance. The only recent move of practical significance has been a write-off of a part of the debt owed by the poorest African countries, from which Ethiopia has benefited the most.

Writing off even the whole official development assistance (ODA) debt of the poorest African nations would entail small losses to any creditor. Apart from the "big five" debtors, the remainder of Africa's debt to the Soviet Union is around 2 billion rubles, less than 20 percent of the total amount owed by the continent to Moscow. Most of this debt is rated on the secondary market at less than 20 percent of its face value and seems unlikely ever to be repaid in any case.

For the better-off African debtors, versions of debt swaps hold promise. Admittedly, both debt-to-equity and debt-to-bonds swaps have inflationary consequences, and their effectiveness in restoring flows of foreign direct investment to debtor nations is likely to be limited. Nevertheless, such swaps can be at least part of the solution. Debt conversions can be channeled through trilateral joint ventures (involving the Soviet Union, debtor governments, and Western European banks and investment companies), with the Soviet side absorbing some local exports as debt service payments. Another innovative scheme tried recently is debt-to-commodity swaps combined with buy-backs. The option to repay uncollectible debts with otherwise unsalable export goods, which will then either be used to satisfy Soviet domestic demand or resold at a discount on Western markets is one of the few that can work.

Some of the outstanding debt claims could be used to obtain various goods and services (e.g., partially offsetting

the costs of repairs to Soviet vessels, purchasing fishing rights, leasing land). Unfortunately, Sovfintrade, the Soviet investment body entitled to engage in debt-to-equity and debt-to-commodity swaps, considers such activities to be of secondary importance. Recently, several Western companies (Swedish, West German, and French) have explored this type of trilateral deal.

Soviet and Western credit institutions have some interests in common when it comes to the optimization of their LDC portfolios. Soviet overseas banks (especially the Paris-based Eurobanque) have recently begun to swap some of their LDC claims on the secondary market. The claims have been bought by leading French banks interested in acquiring claims on francophone African nations at deep discounts. The Soviet banks' behavior was not unlike that of some big West German banks which have all but eliminated their African portfolio, swapping it mostly for claims on Eastern Europe. In the Soviet case, though, the sums have been minimal.

Coordination Among Donors

Due to acute budget concerns in most OECD and Eastern European nations, feelings of "aid fatigue" are already being translated into action. The amount allocated to aid in the 1990 Soviet budget is 30 percent below the 1989 figure. Yet Africa needs more aid, not less. One of the few options available to reverse the decline in aid flows is to enhance coordination among donors.

The reorganized Soviet aid strategy places an emphasis on agricultural and especially food production projects. It has also undertaken a shift from megaprojects to smaller ones, which can more easily be absorbed by the recipient economy. These priorities provide a common ground for multidonor coordination and joint financing of development projects.

This can either be realized on a bilateral basis, or, better, involve the World Bank and regional development banks. The first step was taken in May 1989, when the Soviet Union participated in the UNDP/World Bank roundtable for Guinea-Bissau. The follow-up to this meeting, however, has yet to materialize.

Another logical move would be for the Soviet Union to join the Paris Club. This could go beyond helping the USSR itself. Both Western creditors and some developing countries have suggested that Soviet participation could help generate viable solutions for the debt crisis.

The government is also studying the possibility of joining the African Development Bank. Membership could provide Moscow with useful experience in dealing with larger institutions such as the IMF and the World Bank.

Widening the Circle

The burden of adjustment remains excessive for the poorest nations, but the crisis of the 1980s has shown that they have no alternative but to address the distortions in their economies.

If adjustment programs are to work, they must not be perceived by the African leadership as just serving the interests of Western creditors. (See "How the IMF and the World Bank Affect African Decision Making" by Carol Lancaster, *CSIS Africa Notes* no. 97, April 20, 1989.) Such perceptions are still strong and provide debtor governments with ready arguments to evade unpopular and painful measures.

An obvious way to enhance the integrity of the adjustment process is to widen the range of institutions advising the debtor government on the details of restructuring policies. The vast experience of specialized UN agencies is of particular relevance here. Such cooperation is in line with the Soviet aim (shared by the present U.S. administration) to strengthen the prestige of the UN.

Cooperation between the Soviet Union and international financial institutions would strengthen the case for less painful adjustment. Most components of adjustment apply to the present Soviet situation. Two-way sharing of this experience would benefit all concerned.

The decline in East-West tensions is viewed by some in Africa as the possible prelude to the forging of a united stance by the North against the debtor nations. Such fears stem from the obvious fact that Africa still has a very limited say in decision making within the international monetary system. The poorest nations of Africa are reaching the point where the outside world has little interest in doing business with them. Their economic marginalization threatens to become irreversible. Widening the consensus basis for decision making is the way to do away with such fears.

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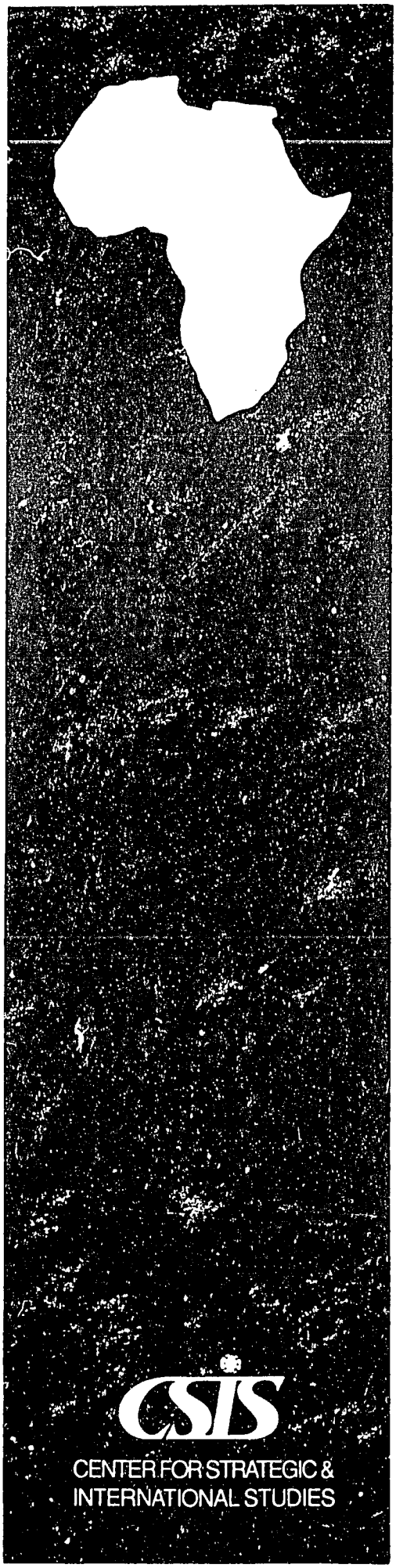

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Who's Where in the Debate on "Nationalization" in South Africa

by Witney W. Schneidman

Ghana's Kwame Nkrumah, an architect of the African independence movement of the early 1960s, counseled in his writings that an oppressed people had to seize control of the political kingdom in order to gain control of their economic destiny. Events in South Africa since Nelson Mandela was released from prison in February 1990 have stood this maxim on its head. The public debate at this moment does not revolve around the new political order being addressed in prenegotiations "talks about talks" between the government and the ANC. Instead, the most contentious issues relating to South Africa's future now argued in public are economic—economic justice, redistribution, and restructuring. The buzz-word around which the debate focuses is "nationalization."

Because neither the ANC, the trade unions, the government, nor any other political grouping in South Africa was prepared or positioned for this turn of events, exchanges on the country's economic future have been largely on a level of emotive slogans rather than defined blueprints. That "nationalization" is at the center of this debate is not surprising. Nearly 60 percent of South Africa's fixed capital is owned by the public sector. South Africa's four largest corporate conglomerates control more than 80 percent of the capitalization of the Johannesburg stock exchange. Black economic interests control less than 2 percent of the country's formal sector. Nationalization has emerged as the strategy of choice for many of the black-led organizations determined to rectify this inequity.

Although it is impossible to itemize all of the complexities and nuances of this issue (much less give fair representation to all perspectives), it is possible to convey a sense of how the debate on nationalization is unfolding, who is driving it, and the direction in which it is headed. In the course of the many gatherings of activists, businessmen, academics, and government officials that have occurred in the four months since Mandela was released from prison, a notable flux can be charted in the positions taken on the country's economic future by some of the major protagonists. The ANC has relaxed its strict, formalistic adherence to nationalization. The government has made some well-publicized adjustments in its economic policies in an effort to respond to some of the black demands.

This fluidity has several implications. Foremost is the implicit recognition among all parties that the economic status quo is untenable. It also suggests that the positions of the various actors are likely to evolve as they become more familiar with the complexities of South Africa's economy and accept the

reality that no one party will be able to dictate the terms for restructuring. The intensifying debate further underscores the need for detailed sector-by-sector negotiations among the government, white-controlled business, and the major black-led organizations as a prerequisite for successful transition from an apartheid economy to one that is both growth-oriented and capable of rapidly creating new socioeconomic opportunities for the black majority.

Mandela's Ambiguity

Shortly before Mandela was released from prison on February 11, he was visited at his residence at the Victor Verster Prison by Richard Maponya, a prominent black businessman and longtime friend. Following the visit, Maponya told journalists that Mandela "did not believe in nationalization" and that the ANC leader felt that a free-market economy was the only way to provide employment for a rapidly growing population. The firestorm that Maponya's comments sparked among blacks compelled Mandela to undertake quick damage limitation in the form of a written statement affirming that "nationalisation of the mines, banks and monopoly industries is the policy of the ANC, and a change or modification of our views inconceivable."

This contradiction reflects the challenges facing Mandela as the objective of achieving a redistributive, growth-oriented, postapartheid economy is pursued. On the one hand, the ANC leader is expressing a deeply held belief of his constituency when he says that blacks must have "a share in the control of wealth of the country." It is not enough to create a welfare state; black South Africans must have the opportunity to fill key roles in the ownership of companies and in the decision-making process of the national economy. From Mandela's perspective, reciting the 1955 Freedom Charter (which states that "The mineral wealth beneath the soil, the banks and the monopoly industry shall be transferred to the people as a whole," and that "all other industry and trade shall be controlled to assist the well-being of the people") is the bluntest way to get this message across to white South Africans. Moreover, as he has pointed out, nationalization is "part of the history" of South Africa, a pointed reference to the fact that successive National Party governments have used state-controlled industry as an essential part of a strategy to boost the standard of living of many Afrikaners and establish political hegemony.

At the same time, however, Mandela wants to win the support of white businessmen for this restructuring. Indeed, speaking to the press after a February meeting with Gavin Relly, chairman of the Anglo American Corporation, Mandela said that the "entire economy, insofar as we are concerned, will remain intact. . . and will continue to be based on private enterprise." Taking a middle-ground position in an effort to keep the door open to future negotiations on this issue, Mandela said on April 25 that thorough research would be undertaken before the ANC adopts a firm stance on nationalization. Most recently, in his first formal address to business leaders on May 23, Mandela voiced the ANC's commitment to rapid economic growth as well as its desire to win the confidence of national and international private investors. This was a message that many of the several hundred South African businessmen present had been waiting to hear. But he maintained his policy of deliberate ambiguity by adding that, while the ANC was not wedded to nationalization, it was not rethinking its position on the issue.

The Lost Years

Confusion over the ANC's strategy for restructuring is due in part to the low priority placed on developing an economic policy during the 30 years it was banned and its leaders were in prison or exile. As the party's leaders acknowledge, waging an armed struggle to win political power does not prepare cadres to run economies. The decentralized nature of the ANC's Economic and Planning Department (EPD) has also complicated the development of an economic policy. Based in Lusaka and headed by Max Sisulu (son of Walter Sisulu, now chief of the ANC's internal wing), the EPD has been primarily concerned with administration and coordination among its consultants in London and Maputo rather than original economic research. The various meetings between the exiled ANC leadership and South African businessmen over the last several years have focused mainly on how to pressure the government into negotiations, contrasting scenarios of a postapartheid economic order, and simply coming to know each others' concerns.

In an effort to enhance its research on economic matters, the ANC gave its tacit support to the establishment in 1987 of the Center for Development Studies at the University of the Western Cape. Managed primarily by social-democratic white academics, the

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Center was also envisaged as a way to involve black civic organizations in the planning process. Two of the Center's 10 commissions (the economic and land reform commissions) were structured to focus on economic issues, but they have been slow to jell into cohesive units, in part because of a lack of full-time staff, a shortage of funds, and a vague research agenda. It appears unlikely that the EPD or the Center for Development Studies will overcome their bureaucratic and institutional weaknesses in time to provide the ANC leadership with the research needed in formulating a coherent policy regarding a postapartheid economy.

The Several Voices of the ANC

The nationalization debate has been further muddied by the fact that the ANC has a variety of positions on the issue. Joe Slovo, general secretary of the South African Communist Party and a member of the 11-person ANC delegation that met with President F.W. de Klerk and eight other senior officials of the South African government in early May, is an influential voice in the debate over a new economic policy. Slovo shares with Mandela a recognition of the need to ensure continued economic growth, retain white skills, and attract foreign investment in order to bring about a greater economic egalitarianism. On the matter of striking a balance between a market and a planned economy, however, the SACP leader takes the position that "pride of place must go to the latter."

Although Slovo remains committed in principle to the creation of a genuinely socialist South Africa, there has been some updating of this commitment. Formerly the ANC's staunchest defender of pre-Gorbachev, Soviet-style central planning, the 63-year-old white lawyer has responded to events in Eastern Europe by thoroughly revising the SACP's strategy for South Africa. In Slovo's view, socialism failed in the Soviet Union and Eastern Europe because of the inability of these governments to go beyond "mere state planning." As a result, there was a "perversion" of socialism's goals, specifically a "lack of democratic participation by producers at all levels."

For these reasons, he has concluded that "public control" must be the guiding principle to the restructuring of the economy of South Africa. "Public control" must be exerted over South Africa's largest industrial, mining, and financial institutions to ensure that the interests of the people—as opposed to the "interests of profit"—are paramount in the economic decision-making process. Although still quite vague, Slovo's definition of public control appears to imply that a future economy would be directed by a multitude of democratically selected committees that would distill the concerns of the majority of black workers as well as bureaucrats and managers into a coherent economic policy.

Slovo's views on nationalization are important not only because he is a senior member of the ANC's National Executive Committee but also because the South African Communist Party is perhaps the only Communist party in the world that is gaining adherents. In fact, the SACP has stated its intention to transform itself into a mass-based political party within South Africa. The April 1990 meeting in Harare between leaders of the SACP and of the Congress of South African Trade Unions (COSATU), South Africa's largest labor federation, (a meeting in which the ANC was also represented) is indicative of the SACP's inclination to rely on the trade unions to provide organizing muscle. The SACP will be able to draw on a reservoir of goodwill from many black South Africans—particularly workers and youthful militants—who see capitalism and apartheid as inextricably linked and socialism as a strategy yet to be tested in South Africa.

While Slovo is holding out for a phased democratic transition to socialism, Walter Sisulu, who is overseeing the ANC's transition to an internal political organization, told more than 500 businessmen and bankers at a meeting in Johannesburg on March 10 that the state should take the leading role in restructuring the postapartheid economy. In his address, Sisulu described ANC policy as favoring a mixed economy, and cited "creative" nationalization as the most effective means for promoting growth and correcting past injustices. State intervention, according to Sisulu, should be the prominent characteristic of a postapartheid economy. The state should play a central role in directing the flow of investment, determining the distribution of income, and setting the general direction of economic policy. Where necessary, legislation should be used to curb monopoly power as well as bring about the "dismembering" of some large conglomerates. In instances where it was not economically feasible to break up a monopoly, the state should assume ownership.

In addition to laying out his agenda for restructuring, Sisulu affirmed the black community's profound distrust of existing government economic policies. He characterized the government's promotion of free enterprise as a ploy to enflame white opposition to the ANC's proposed restructuring of the economy. "Trickle down" policies, such as President de Klerk's recently announced Trust Fund, were cited as part of an effort to keep the country's wealth in white hands. In closing, Sisulu told the businessmen that they must be prepared to make sacrifices—including lower profits and incomes—in order to compensate for the "history of grotesque irresponsibility" on the part of white-controlled business.

As with Slovo's strategy for restructuring, Sisulu's remarks on a future South African economy failed to convince the business community that the ANC is as yet serious about engaging business in discussions on a postapartheid economy—even though Sisulu made an earnest appeal for such a dialogue at the end of his speech. In fact, instead of easing the fears of the business community, as Sisulu said was his objective, his address heightened concern about the future of the economy.

A more measured approach to economic restructuring has been suggested by Thabo Mbeki, the ANC's director for international relations. While acknowledging nationalization as a legitimate means for addressing the control and distribution of wealth, he—like Mandela—emphasizes that nationalization is only one option that has

to be considered in the context of a host of other issues, including tax and fiscal policy, regulation of the markets, and international economic relations. For Mbeki, who has a master's degree in economics from Sussex University, one of the most important aspects of shaping the future economy is that all sectors of South African society—including the trade unions, black businessmen, the white private sector, and economic specialists at universities and think tanks—discuss together specific measures under consideration.

In sum, the ANC does not now have a policy on nationalization, but several. It seems unlikely that the various threads will be brought together before the December 16, 1990 party congress, which will be held in South Africa for the first time since 1959. Even then, the leadership will be faced with a difficult task in trying to synthesize the divergent views on nationalization. Prospects for a consensus will depend in part on completion of the analytical research needed for devising a coherent economic policy that could guide the transition to a postapartheid society.

COSATU Looks Inward

COSATU is in a position similar to that of the ANC in that it has not yet developed a thoroughly researched and coherent blueprint for a postapartheid economy. A second parallel is that the labor federation shares the ANC's instinctive distrust of capitalism and white-controlled big business. As Cyril Ramaphosa commented at an April 1990 Aspen Institute conference in Bermuda, "a society cannot be democratic if it is ruled by profit motives."

A major difference between COSATU and the ANC is the belief of some in COSATU that a postapartheid South Africa will not attract significant amounts of new foreign capital. Therefore, it is argued, industrial wages should be raised by 30 to 40 percent virtually overnight in order to bring about a dramatic expansion of black spending power. This would, they say, provide a vital stimulant for shifting South Africa's manufacturing sector from its current emphasis on the production of capital-intensive luxury goods to the manufacture of more labor-intensive basic consumer goods; redistribute income; increase black consumer power; and draw blacks more fully into the economic mainstream of South African life.

To achieve this restructuring, COSATU officials maintain that the state will have to control investment decisions through the establishment of a state market bank, and possibly the nationalization of banks. COSATU also envisages the possible creation of a national board comprising labor, business, and the state to oversee a restructuring of the economy and mediate labor conflicts.

Thus, although COSATU continues to advocate a high degree of state intervention in the economy, wholesale nationalization is not the centerpiece of its economic strategy. In fact, at the previously cited meeting in Harare between COSATU and the SACP, the two organizations reportedly moved toward a policy that would rely on antitrust legislation to break up the conglomerates in an effort, inter alia, to reduce corporate influence in the country's economic decision-making process.

The intellectual underpinnings of this strategy were developed by the Economic Trends Group. Formed in 1988 as a COSATU affiliate, the Economic Trends Group (consisting of 21 members—19 whites and 2 Asians) reportedly has completed a structural analysis of South Africa's economy to be published later this year, and has begun work on specific policy options for COSATU. Although supportive of nationalization, the thrust of the group's current thinking seems to advocate a policy of "democratic state planning." This would include a high degree of state involvement in the economy through tax and fiscal policy, regulation, public ownership of some enterprises, and state planning. Events in Eastern Europe, however, are said to have impelled many of the Group's members to move away from an economic model based on nationalization and central planning.

A prominent member of the Economic Trends Group is Alec Erwin, the education officer of the National Union of Metalworkers of South Africa, a COSATU affiliate. Erwin's view of a postapartheid economy, as expressed in a paper he presented at a December 1989 conference in Paris, is in many respects one of the most nuanced to emerge from the antiapartheid movement. He reflects COSATU's concern for "management accountability," a dramatic improvement in black living and working conditions, and a genuine multiparty democracy as the means for entrenching mass participation in the formulation of economic policy. And like some others in the ANC and the Mass Democratic Movement, he envisages a postapartheid economy with a range of ownership forms, including nationalization, private enterprise, parastatals, and cooperatives.

Erwin's comments suggest that COSATU is not wedded to nationalization as the answer to South Africa's economic and societal ills. The fundamental question he poses is not one of state versus private ownership, but how to restructure the economy so as to minimize unemployment and poverty and maximize the supply of social consumption infrastructure.

In examining the role of state intervention, he points to the intervention by the South Korean government in the development of that country's manufacturing sector as instructive for South Africa. While acknowledging the suppression of trade union rights in South Korea, he notes on the positive side that the state has directly influenced the rate and direction of investment—and provided active support for research, development, and training—in order to develop an internationally competitive manufacturing sector. In South Africa, in contrast, manufacturing grew behind a protective wall of tariffs and caters to a racially divided and materially unequal market. As a result, Erwin maintains, South Africa's manufacturing sector is structurally incapable of providing for the needs of the mass market, competing internationally, or serving as an engine of economic growth.

Erwin characterizes South Africa's economy as a high-

cost and low-wage manufacturing economy. The challenge, he says, is how to increase productivity in order to restructure the economy along low-cost and high-wage lines. Such a turnaround would require coherent strategic planning in a number of key areas, including investment policies, research and development, manpower training, and ecological awareness.

Aside from a careful consideration of—and debate over—the likely consequences of its proposals for restructuring, labor also needs to determine its role in negotiating a new political and economic order. Sorting this out could become a source of friction between COSATU and the ANC, given the desire of each to maximize its influence in the negotiation process. In fact, COSATU's growing aggressiveness may be one reason that Cyril Ramaphosa, who is general secretary of COSATU's largest affiliate, the National Union of Mineworkers, was reportedly dropped from the ANC delegation to the May 1990 prenegotiations meeting with President de Klerk and other senior officials. Perhaps most important, COSATU also has to reconcile its calls for an economy dominated by state intervention with its determination to maintain the hard-fought and highly prized independence of South African trade unions.

Other Voices

Although the ANC and the loose coalition known as the Mass Democratic Movement (in which COSATU is a senior partner, particularly on economic issues) have dominated the debate on nationalization, there are other positions on this issue in the black community. (For a fuller characterization of the MDM as well as the United Democratic Front, see "The ANC in Transition: From Symbol to Political Party" by Marina Ottaway, *CSIS Africa Notes* no. 113, June 20, 1990.)

The charter of the Black Consciousness movement, adopted in 1975, commits the movement to both collectivization and large-scale nationalization. Some Black Consciousness adherents, such as those in AZAPO, are still sympathetic to this type of strategy for restructuring, but other Black Consciousness supporters have adopted a different approach. Aggrey Klaaste, a Black Consciousness partisan and editor of the influential *Sowetan*, has a prescription for restructuring that is rooted in the notions of "self-reliance" and "nation-building." The essence of this strategy would compel black South Africans to become more active in the economy's formal sector through a range of township-based enterprises that would include cooperatives and private businesses.

Although the Pan-Africanist Congress (PAC) shares the ANC's attraction to socialism, it criticizes Mandela and his followers for glossing over the land issue and argues that the "return" of the land to black South Africans is the key to a new political and economic order. According to one PAC spokesman, the organization also believes that public, or community-based, ownership—as opposed to ANC-COSATU calls for state intervention—is a more appropriate strategy for restructuring. Beyond these rudimentary distinctions, however, the PAC is still debating the specifics of its position on restructuring.

Chief Mangosuthu Buthelezi's Inkatha is the strongest advocate of free enterprise among black political organizations. Buthelezi's experience as head of the KwaZulu "homeland" in Natal province has led him to the conclusion that private investment and a free-market economy are vital in providing jobs. He is therefore opposed to nationalization in the absence of convincing evidence of its effectiveness in achieving economic redistribution. At the same time, he is critical of the government's policy for redistribution and insists that greater resources have to be transferred to the black majority. Like the other organizations, however, Inkatha has not yet developed a detailed strategy for redistribution.

The United Democratic Front (UDF), the amalgam of several hundred organizations that from its formation in 1983 in protest against a proposed new constitution (which was eventually approved in a whites-only referendum) until the unbanning of the ANC was at the forefront of the antiapartheid struggle, has not been actively involved in the nationalization debate. This is due in large part to the fact that the decentralized structure of the UDF does not lend itself to the production of detailed analyses of complex economic issues. The recent decision by Archbishop Desmond Tutu, a patron of the UDF, to step back from the political limelight and leave center stage to Mandela and others suggests a period of reappraisal. Most UDF supporters broadly subscribe to the ANC's position on restructuring.

Of all the parties involved in the debate over South Africa's economic future, perhaps least has been heard from the black business community. At a conference in early May sponsored by the National African Federated Chambers of Commerce (NAFCOC), it was evident that South Africa's oldest and largest black business association has not yet formulated a position on restructuring the country's economy. In fact, NAFCOC, which represents about 15,000 blacks in the commercial sector, only recently announced that it would conduct a joint study with the ANC of future economic options. In a statement akin to the ANC's position on nationalization, NAFCOC President Sam Motsuenyane recently said that nationalization will not solve the country's socioeconomic and political dilemmas but "it can undoubtedly serve as a vehicle providing an answer to some of the problems."

In sum, the divergent positions found in the Black Consciousness movement, the PAC, Inkatha, and among black businessmen indicate that support for nationalization in the black community is widespread but not monolithic. As these organizations refine their positions and enter the negotiating process, nationalization's appeal seems likely to be diluted—certainly challenged—by competing strategies for redistribution.

De Klerk's Position

President de Klerk repeatedly has told visitors to his Tuynhuys office that he is more concerned about the

future of South Africa's economy than he is about negotiating a new political system. Indeed, Mandela reportedly came away from his early talks with government officials grumbling that they only seemed to be interested in discussing economic issues.

De Klerk's concern over a postapartheid economy—specifically the threat of nationalization as a means of redistribution—was evident in February when the government unveiled its 1990-1991 budget proposals in Parliament. In a significant departure from the past, Minister of Finance Barend du Plessis said that the new budget would aim "to help the less privileged by making the greatest possible provision on the expenditure side of the account." To that end, defense spending was cut sharply in real terms, generating a saving of over 1 billion rand (1 rand = $0.38 as of May 23, 1990), three-fourths of which was reallocated to black education. As a result, authorized expenditures in this area increased by 17.6 percent, twice the rate of increase for white education.

A more substantial gesture in response to black economic grievances was made in March when de Klerk announced the creation of a 2 billion rand trust fund for capital spending to improve black living conditions, especially in the areas of education, health care, and housing. The new trust, which will be under the independent control of the Urban Foundation's honorary chairman, Jan Steyn, has several objectives (in addition to its utility in influencing the debate over nationalization). It is the government's hope that the ANC and other black groups will participate in deciding how the funds are to be spent. The trust fund is also intended to demonstrate to blacks that fiscal policy can be used to redistribute the nation's wealth more effectively than nationalization. The government reportedly plans to use the 1990-1991 budget and the trust—which is to be augmented by another 1 billion rand derived from the privatization program—as part of its negotiating strategy in the deliberations over a new constitution.

De Klerk's strategy for influencing the nationalization debate is unlikely to have much success, at least initially. The 3 billion rand allocated for black social empowerment is at best a modest attempt to narrow the gap between spending on blacks and on whites. According to University of Stellenbosch economist Sampie Terreblanche, social spending accounts for nearly 28 billion rand or 40 percent of the 1990 budget, which represents about 10.4 percent of GDP. If an effort were made to achieve parity in social spending at present white benefit levels (which in per capita terms is three times higher than the average spending on the entire population), total spending on social services and programs would have to increase to 84 billion rand or 31 percent of GDP.

The government clearly has no intention of undertaking this type of radical restructuring, in part because of concern that it would fuel further inflation (currently running at about 15 percent) and undermine Pretoria's ability to meet its foreign debt obligations. To complicate the situation, the economy is not expected to grow more than 1 percent in 1990. Nevertheless, de Klerk appears prepared to adopt further measures in an effort to expand black property ownership, overcome the backlog in black housing, and increase opportunities for employment and training. For example, the government indicated in May 1990 that it would allow black townships to share in the tax revenues generated by the white cities. De Klerk has also made it very clear, however, that he is not prepared to compromise South Africa's free enterprise system.

Business Angst

South Africa's business community has been caught off guard not only by the speed with which de Klerk has altered the country's political landscape but also by the intensity of the debate over nationalization and the shape of a postapartheid economy. Vague as the ANC's economic blueprint may be, it is more developed than any program for restructuring that has been put forward by South African businessmen.

As Ronnie Bethlehem, group economics consultant for Johannesburg Consolidated Investment Company, Ltd., recently observed, most of the business community is "flapping all over the place" at the thought that the ANC might form the next government. He also points out that the scale of South Africa's economic inequality is still "beyond the thinking of most business people. . . . They haven't had to bother." The *Financial Mail* agrees with this assessment. In a recent editorial, the influential Johannesburg weekly commented that "many of the business sector's policies smack more of charity than of contributing to an environment in which black incomes and wealth can move ahead strongly."

More troubling to many businessmen—and to antiapartheid activists—was the recent decision by De Beers, the South African-based diamond conglomerate controlled by the giant Anglo American Corporation, to transfer its foreign assets into De Beers Centenary AG, a new Swiss-based company. Not only did this position the firm to protect most of the conglomerate's assets in the event of nationalization by a future black government; it was also perceived as a stark vote of no confidence in South Africa's economic future. Angered activists condemned the conglomerate for splitting its foreign and local assets at a time when they are needed most in South Africa for black advancement.

Despite the business community's ambivalence—if not hostility—toward the notion of a debate over nationalization, efforts are being made to sensitize white businessmen to black economic demands. Organizations such as the Consultative Business Movement and the Institute for a Democratic Alternative for South Africa (IDASA) have sponsored various workshops that include trade unionists, ANC leaders, and representative businessmen. The discussions in most of these meetings, however, have thus far centered more on developing a precise understanding of South Africa's socioeconomic problems than on generating—much less agreeing about—specific policy recommendations.

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The Battle Over Privatization

Although much of the debate on nationalization is still highly rhetorical, the issue of privatization has become a battleground where the fight over certain aspects of South Africa's postapartheid economic future is already under way.

The government's privatization program was launched in February 1988 when former President P.W. Botha announced plans to privatize parts or all of the state-owned electric supply company (ESKOM), the national transportation system (then SATS, now Transnet), the Phosphate Development Corporation (FOSKOR), the Iron and Steel Corporation (ISCOR), and Posts and Telecommunications. The program was part of a sweeping economic reform package aimed at generating new sources of investment capital and alleviating the country's general financial difficulties (precipitated in large part by the 1985 refusal of foreign banks to roll over the country's debt).

The ANC, trade unions, and other antiapartheid groups are implacably opposed to privatization, which they believe will complicate redistribution of the country's wealth. In their view, privatization is little more than a strategy for shifting state-controlled wealth into private white hands, just as the black majority is moving toward a central role in government. Therefore, it is argued, much of the privatization process will have to be "reversed" once majority rule is achieved. Trade unionists also oppose the government's privatization program on the grounds that the actions to date have already resulted in a loss of jobs and an erosion of affordable transport, postal services, and health care.

In the face of highly vocal opposition from the ANC and MDM (and a series of protest marches in Johannesburg, Pretoria, and Cape Town by thousands of members of COSATU-affiliated public-sector unions), the government has recently adopted a more conciliatory tone on the privatization issue. Minister of Mineral and Energy Affairs and of Public Enterprises Dawie de Villiers, who is charged with overseeing privatization, took note of labor's opposition by saying that "many of the state enterprises currently acting as monopolies may not be privatized at all"—an apparent reference to ESKOM, the national power supply parastatal. Government officials have indicated that they are likely to be more sensitive to the views of organized labor than they were when ISCOR was privatized in 1989. At that time, the unions were merely presented with privatization as a fait accompli.

A government slowdown on privatization is more symbolic than real, given the fact that there are few short-term candidates for sale. The government's intentions will become clearer over the next several months when it decides whether to privatize FOSKOR. For the time being, de Klerk appears disinclined to allow the privatization program to undermine progress in negotiating a new constitution.

Bridging the Divide

Several recent developments suggest that some type of accommodation between the ANC, trade unions, and white business may be reached on the issue of nationalization and redistribution. The measured progress made to date in the "talks about talks" between the ANC and government has contributed to an atmosphere of dialogue and flexibility. Equally noteworthy is the relative success that the trade unions, corporate management, and more recently government officials have had over the last several years in resolving some of their most bitter grievances through negotiation. Movement at the local level is also evident. For example, the white-controlled and well-endowed Sandton City Council and the Alexandra (township) Civic Association have begun discussions on developing joint administrative structures. All major parties, black and white, have come to recognize that the country's economic future, along with a new constitution, must be the subject of intensive negotiations.

As many in South Africa across the political spectrum point out, the debate over nationalization—which only began in earnest with Mandela's release from prison—is a healthy corrective to the 42 years during which the National Party suppressed all consideration of alternative economic scenarios. But there is concern that the era of intellectual drought is in danger of being supplanted by a new period of sloganeering and platitudes. The only way out is for an acceleration of debate, discussion, and analysis among all sectors of the population on appropriate policies for overcoming South Africa's economic and human resource inequities.

Witney W. Schneidman is a senior analyst in the South Africa Review Service of the Investor Responsibility Research Center Inc., Washington, D.C. Prior to joining IRRC in January 1990, he served for three years as South Africa analyst in the State Department's Bureau of Intelligence and Research. His extensive travels throughout Africa have included a year in Tanzania, where he received a master's degree in political science at the University of Dar es Salaam. His Ph.D. is from the School of International Relations at the University of Southern California, where he wrote his dissertation on U.S. foreign policy toward Portugal, Angola, and Mozambique in the period from 1961 to 1976. He received his B.A. cum laude (in history) from Temple University in Pennsylvania.

Congressional Staff Forum
on
International Development

Director
William E. Hellert

May 8, 1990

MEMORANDUM

To: ODC Staff
From: Anastasia Primbas

SUBJECT: HEARING ON US-EGYPTIAN RELATIONS IN THE 1990s
House Foreign Affairs Subcommittee on Europe and the Middle East

Testimonies: Iliya Harik, Indiana University; William Quandt, The Brookings Institution; Ann Lesch, Villanova University

Members in Attendance: Chairman Lee Hamilton (D-IN), Larry Smith (D-FL), Wayne Owens (D-UT), Jan Meyers (R-KS)

Summary:

Iliya Harik discussed the problematic role that the public sector plays in Egypt's economy. Egypt was one of the first developing countries to begin liberalizing its economy in the early 1970s. However, reforms and progress have come slowly, and the present indicators point to a distressed economy: growth of GNP and GDP is stagnant, almost negative; the current account deficit is high; inflation is at 30%; moreover, Egypt is one of the most heavily indebted countries in the world.

According to Harik, much of the lack of progress is due to a large public sector which has resisted any attempts at reform. Although reform opened up the economy for a considerable amount of private investment, the public sector, which has a large, well-organized constituency, was not considered subject to privatization, and continues to be a heavy drain on Egypt's national economy.

William Quandt explained that the most crucial problem facing Egypt is its $50 billion total external debt. $12 billion is owed to the U.S. government and $6 billion of this amount was incurred under the U.S. Foreign Military Sales (FMS) program. In order to deal with the growing debt crisis, Quandt urged that reduction of US aid to Egypt must go "hand in hand" with debt reduction. According to Quandt, the U.S. should consider offering the Egyptians the following trade-off: all or part of the FMS debt would be written off in return for an Egyptian agreement to a reduction of FMS grants. A similar option would be freezing the debt level at $6 billion and paying off the debt from a portion of future FMS grants.

Ann Lesch discussed the political trends taking shape across Egypt. She stated that the social and political tensions in

Egypt have been influenced largely by two factors: rapid population increases and a partially open political system. Lesch estimated that Egypt's population will increase from 55 million to 70 million by the end of this decade. The strains of this rapid growth are already being felt in the decline of living standards and in the labor market's inability to absorb the larger, and increasingly youthful, labor force. The alienation of Egyptian youths has been perpetuated by the limited democratization of a partially open political system which has had minimal respect for human rights. According to Lesch, the alienated and poor have found solace with the increasing number of Islamic fundamentalist groups that gained considerable support in the 1987 parliamentary elections.

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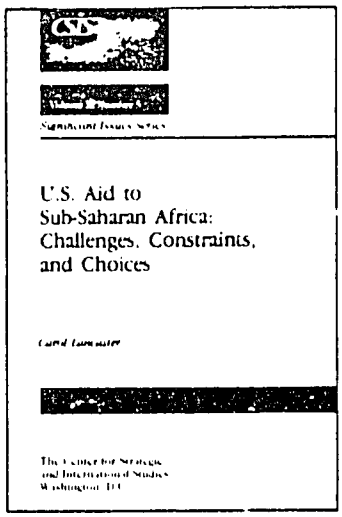

U.S. Aid to Sub-Saharan Africa: Challenges, Constraints, and Choices

by Carol Lancaster

Unlike many studies of U.S. aid to Africa, Carol Lancaster's contribution to the CSIS Significant Issues Series does not begin by asking what the United States should do to help Africa. Rather, her guidelines for aid policy in the 1990s begin with a hard look at fiscal and other constraints on aid in general and to sub-Saharan Africa in particular and then identify priorities and programs that fit within those constraints.

Her description of the bureaucratic complexities of the U.S. aid machinery in both the executive and legislative branches of government should be read by both Washington insiders and 1989 newcomers, by African government officials, by other donors, by the media, and by academic theorists sheltered from the harsh realities of the policy process within the Washington Beltway.

As she concludes in her final chapter outlining "A Realistic Program for the 1990s," the coming decade will be "a time of constrained resources (but also) an era of opportunities and challenges for the United States in sub-Saharan Africa . . . a decade that demands creativity as well as resources." Throughout, emphasis is placed on the critical importance (for Africa and for enhancing the cost-effectiveness of U.S. assistance) of greater consultation and cooperation with other aid donors, bilateral and multilateral.

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APRIL 23, 1990

LOS ANGELES TIMES

COLUMN LEFT/
JESSE JACKSON

South Africa Must Be Made To Move

■ Mandela is more than doing his job. It's time for the West to reinforce his efforts.

Much has recently been written questioning the leadership abilities of African National Congress Deputy President Nelson Mandela. Articles have described him as an elderly statesman no longer in touch with the times and unable to move his organization forward. This is not the Nelson Mandela that I have talked with and observed over the past few months.

Standing in the damp, cool spring air in London's Wembley Stadium last week, I witnessed a South African who represents more people than the president of South Africa and has more credibility in the world than that government. Yet he does not have the voting rights of an ordinary 21-year-old white person.

For 20 minutes this towering figure—who through unselfish suffering has emerged as the preeminent moral authority of our day—held spellbound more than 72,000 people in the stadium and about 1 billion others viewing this televised international tribute in 60 countries throughout the world.

(The U.S. networks did a disservice in deciding not to broadcast the mega-concert, deeming it too political. A few years ago the American news media said they could not adequately cover the situation in South Africa because of the imposed state of emergency restrictions. What was the excuse this time?)

After a thunderous five-minute ovation, Mandela thanked the rock artists and the cultural community and the millions of others who, by protest and pressure on the government, aided his release from prison after 27 years. He then implored that economic pressure be maintained: "The apartheid crime against humanity remains in place," Mandela said. "It continues to kill and maim, to oppress and exploit. Its bloodstained offspring continue to rain death and destruction on the peoples of Mozambique and Angola. Every day it produces orphans throughout southern Africa."

'The apartheid crime against humanity remains in place. It continues to kill and maim, to oppress and exploit.'

NELSON MANDELA

It is unfair that Mandela should, as the media suggest, bear the burden of ending apartheid. That burden clearly rests with the South African government and President F. W. de Klerk. The oppressed have the burden of resisting. Millions have fought and thousands have died in that resistance. Those who instituted, benefited and profited from apartheid must end it without delay.

The day before the concert, Mandela addressed supporters and journalists. He gave a masterful analysis on ANC leaders' positions as they prepare to meet with the South African government early next month. He never once sounded like someone out of touch, but rather like a clear-thinking, focused individual.

I saw in him a man who spoke about negotiation instead of confrontation and one who espouses a commitment to a new constitution that calls for equal protection for all in a non-racial, free, fair and democratic South Africa. He envisions a South Africa that will one day become an oasis of hope and possibility for everyone. But in this pep-rally environment, filled with talks of hopes and dreams, a silence fell over the room when he said: "When I was sent to prison 27 years ago, I had no vote. Twenty-seven years thereafter, I have come out and I still have no vote."

There is a profound challenge before us. Justice delayed is justice denied. It is my hope that a workable timetable will emerge from the upcoming talks, setting in motion the total dismantling of apartheid. I am optimistic, but cautious. De Klerk, in a recent speech, said that though he remains in favor of power sharing, black majority rule is unacceptable. I am hopeful that De Klerk's regressive position will not deteriorate the emerging hope in South Africa.

This also is an opportunity and a challenge to President Bush, British Prime Minister Margaret Thatcher and other Western leaders to help forge a visionary agenda for the entire southern African region. The region needs assistance, for example, in rebuilding the Beira corridor in Mozambique and the Benguela railroad in Angola, with a commitment to assure safe passage on these routes.

These and other major trade routes have been destroyed by the U.S.-supported Angolan guerrilla leader Jonas Savimbi as well as by South Africa and its agents, thus making the region totally dependent on South African-controlled trade routes.

No one person or organization should have to bear the burden of bringing about social, political and economic change for South Africa. The world must heed the call and help. Nelson Mandela represents a bright ray of hope. But he should not have to stand alone. The people of South Africa deserve hope and healing, not more platitudes and promises.

Meg Greenfield

Mandela's Discipline

Confident of his political beliefs and goals, he forced us to deal with him on his own terms.

By sheer force of his personality Nelson Mandela accomplished the impossible in Washington. No, he didn't get the money for the African National Congress and he didn't get the commitment he wished for American sanctions to be sustained until such time as he and his political partners give the sign that it is okay to lift them. He did something much more difficult: he took charge of the conversation, blew away the conventional and somewhat nasty debate we were set to have about him and compelled political Washington to receive and comprehend him on his own terms. Unheard of.

The debate we were expected to have turned on whether Mandela's organization was communist and/or terrorist, whether it would forswear armed violence and whether it would settle for a stately (i.e., foot-dragging) pace in the achievement of its aims. The tone was certain to get raw. During that first television exchange on Ted Koppel's program, and in its immediate aftermath, an audience roaring its support whenever Mandela provoked with his refusal to disavow the unholy trinity of Arafat, Castro and Gadhafi, and increasingly angry questioners from the floor and next-day critics pushing back seemed to set it up. And the dispute was legitimate. Mandela dispelled it by making very careful, fine distinctions between the Arafat-Castro-Gadhafi support of his movement and the three men's other activities (on which he declined to comment) and sticking resolutely and unapologetically to his position.

He prevailed. By the end of the week his stand was being sympathetically likened to certain American relationships of expediency with Joseph Stalin and, God help us, Pol Pot's Khmer Rouge. Then the issue just sort of vanished. He had stared his critics down and overwhelmed them with his determination and his confidence in his stand.

Woman and girl I have seen an awful lot of big-screen foreign visitors to this city—exotic, important, mysterious, celebrated, objects of huge curiosity, even political obsession. But I have never seen anything like this. The man just took command of every interview and every political circumstance in which he found himself. This wasn't a result of sycophancy or condescension or opportunism on the part of those he encountered here. It was coming from him, not from his interlocutors.

When I reflected on this after Mandela's departure, I decided his accomplishment was traceable to his much-vaunted discipline. This was his secret weapon—it is a very secret weapon in Washington, being the scarcest of all political characteristics. Mandela exudes it, and his story is a parable of discipline. Here is a man whose enemies robbed him of his mature life, or tried to or, anyhow, thought they had. He was 27 years in prison, during most of which it seemed certain he would never be released; yet he did not yield to either bitterness, introversion or despair. The rigorous physical program of daily exercise he set himself was matched by an intellectual discipline of learning and developing his political thought, staying as informed, involved and sharp as his condition allowed him to be. Something in him clearly cowed his jailers, as it cowed his political enemies who, despite having sworn they would never do so, became Mandela's negotiating partners.

As with the late Justice Potter Stewart's famous line about pornography, so, too, with discipline in this city. True, we may not have much of it ourselves—but "we know it when we see it," and we fall back in deference. This, after all, is a virtue we write and talk and worry much about. We call it, with our usual weakness for psychobabble, "deferred gratification." And we are forever telling the fractious, spoiled young and the rampaging consumers and the insistent minions of all the gimme-now lobbies that it is a quality they simply must cultivate, although we here in Political Central live in a great gooey gum of indiscipline ourselves, being masters of short-term advantage for long-term-loss politics. You don't think the federal budget deficit just happened, do you?

In fact, I think people in this city get just a little scared when they are confronted by a person of such self-evidently intense discipline as Nelson Mandela. I don't mean he came across as a glittery-eyed zealot; he was very smiley and gracious in manner. It was just that he clearly had commitments and beliefs and political goals that were larger to him than his own momentary comfort and than any particular desire to ingratiate himself, that were simply beyond compromise or manipulation or disarming by the blandishments of others. He had not succumbed to Afrikaner threats, and he was equally impervious to American charms.

We always get uneasy in this city in the presence of people who seem to know something mystical we don't know, who are driven by causes we can't deflect. We tend to characterize them as troublemakers or nuts, to work hard at undermining their single-mindedness and, when we have succeeded at least to the extent of getting them to participate in a general compromise of some kind, to compliment them on their maturity and, naturally, "moderation." No such luck with Nelson Mandela.

I met his wife eight years ago, when she was still "banned" and exiled to the godforsaken rural town of Brandfort in hostile Afrikaner country. She lived in a tiny impoverished settlement on top of a dusty hill, under constant surveillance. Weekly she walked the couple of miles to her obligatory check-in at the local police station, famously refusing to enter through the designated door for blacks. Her husband, we all assumed, would never come off infamous Robben Island where he was imprisoned—and now look. I still wish Mandela would say the right words to reassure me on the subject of his feelings about the human-rights travesties of Gadhafi et al. But he does provide another kind of reassurance. He is a man whose life instructs that people can assert control of their personal destiny no matter what the force of the hardships they incur and that they can by their own conduct overwhelm the odds against them. I think everyone in this city, including those who detest Mandela's message and his politics, was aware, by the time he left, of having been in the presence of a big guy.

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CHRISTIAN SCIENCE MONITOR, May 25, 1990

Step Up Sanctions

By Richard L. Trumka

ADVOCATES of sanctions against the South African government have been vindicated. Economic sanctions have produced the desired pressure on Pretoria to begin the process toward negotiations with the leaders of South Africa's black majority population and the elimination of apartheid. If freedom-loving people in the international community truly want this process to succeed, we need to escalate the sanctions pressure now.

That sanctions were, in part, responsible for President Frederik de Klerk's dramatic Feb. 2 unbanning of the African National Congress and 33 other organizations and the Feb. 11 release of Nelson Mandela has been confirmed by both government and anti-apartheid spokesmen in South Africa.

A broadcast on Nov. 9, 1989, by the state-controlled SA Broadcasting Corporation stated that "sanctions can no longer be brushed aside as irrelevant or easily surmountable. . . . The starting point is to acknowledge that sanctions have had . . . a serious influence on the national economy."

The broadcast referred to a study made by one of the country's largest banking groups, Bankorp, which found that sanctions and disinvestment have cost South Africa 40 billion rands (about $15 billion) in foreign-exchange losses.

Bankorp said that corporate disinvestment has had a negative long-term impact on the transfer of technology and skills.

The US General Accounting Office recently estimated that South Africa lost $417 million in exports to the US from trade sanctions. According to Business Week, South Africa has suffered from the capital flight of nearly $25 billion in the last three years alone. Even Kennedy Maxwell, president of the South African Chamber of Mines, had to admit that "those chanting the mantra of sanctions . . . have played a part in bringing South Africa to its present crossroads."

One form of economic sanctions, the oil embargo, has been particularly effective. While the embargo is voluntary, public monitoring of oil tankers shipping oil to South Africa and grassroots pressure on oil multinationals like Royal Dutch/Shell have put economic pressure on South Africa. This was confirmed recently by the South African government's National Energy Council (NEC), which blamed the embargo for three fuel-oil price hikes within the last year. "There is at present renewed pressure on suppliers not to supply crude oil to South Africa," the NEC stated. It is estimated that the oil embargo has forced South Africa to pay a premium of up to $2 billion a year for oil.

THE impact of sanctions was confirmed last October. Just days before the Commonwealth summit's consideration of added sanctions, Mr. De Klerk released Walter Sisulu and other ANC prisoners. De Klerk purposely timed the release to help British Prime Minister Margaret Thatcher defend her opposition to further sanctions. Here, the mere *threat* of sanctions produced a significant action.

Nelson Mandela is clear why De Klerk is moving in the right direction. "It is not President de Klerk," he wrote in a Feb. 3 message from prison. "It is partly the international community which has forced these concessions."

Mandela has reiterated his support of sanctions since his release. "Everything that we set out to achieve through sanctions is still the same," said Mandela. "Nothing has changed."

"To lift sanctions now would be to run the risk of aborting the process toward the complete eradication of apartheid," he said.

Even if De Klerk suspends the state of emergency, it would be unwise to lift sanctions. We must remember that the state of emergency is only a five-year phenomenon; apartheid was instituted in 1948.

As a labor leader, I know something about the relationship of power, leverage, and negotiations. It would be stupid for a union to stop a strike when collective bargaining negotiations *begin*, before a contract is signed. The strike is one of the union's levers to pressure management to sign a fair agreement.

Sanctions are similarly an important nonviolent weapon in the hands of the black majority. Sanctions, combined with pressure from blacks inside South Africa, are why the South African government has made the moves it has. Rescinding sanctions when Pretoria is just *beginning* the negotiating process would decrease leverage just when it is needed most. State power still rests in the hands of the white minority government; sanctions help level the playing field while negotiations are under way.

In the midst of the justified jubilation over the events in South Africa over the past months, we must remember that Nelson Mandela is still not free. He may have been released from incarceration, but he and his fellow countrymen are still prisoners in their own country, shackled under the chains of apartheid. Until that system is unalterably eradicated, we must remain true to our principles of liberty and justice for all and keep the pressure on. As Mandela put it so eloquently:

"We have waited too long for our freedom. We can no longer wait. Now its the time to intensify the struggle on all fronts. To relax our efforts now would be a mistake which generations to come will not be able to forgive."

■ *Richard L. Trumka is president of the United Mine Workers of America and co-chairman of the National Labor Boycott Shell Committee.*

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NEW YORK TIMES, May 19, 1990

Democracy Could Take Hold in Africa . . .

By Donald K. Petterson

WASHINGTON

In their dealings with Africa, the U.S. and the Western donor community for the most part have addressed economic and humanitarian problems and the causes and effects of civil and military strife. Until recently, the issue of democracy remained on a back burner.

Now, however, we are seeing undemocratic regimes in places like Zaire, Benin and Zambia reacting to pressures for liberalization. As the Bush Administration has come to realize, the U.S. should act to encourage these developments.

Since the end of World War II, the containment of Communism has been the driving force of U.S. foreign policy. This was as true in Africa as it was elsewhere.

Thus, with the passing of the cold war, our need for Africa — in a global strategic sense — is diminishing. This shift, by depriving hard line African regimes of political leverage, presents us with a rare opportunity to insist on democratic reforms. All our aid — except for humanitarian — should come with a string attached: we should make it clear that in return for assistance we expect movement toward democracy.

In Africa, much of the discussion about democracy centers on the one-party state. Its defenders argue that a one-party system of government can be democratic and that, because of tribalism, a multiparty system would be a recipe for disaster. I believe that these arguments are specious.

First, one-party states are either imposed by tyrants or inevitably lead to tyranny. Whether in the Soviet Union, Mexico, Tanzania or just about any other one-party state, revolutionary ideals give way to sterile defense of the status quo, the ruling establishment becomes ossified and reactionary. The will of the people is ignored or suppressed and surbordinated to the will of the party's leaders, who in turn cling to power and perquisites, fearful of change.

Second, there is little evidence that a one-party system diminishes tribalism. It may have helped to do this in some places — some would say in Cameroon, for example — but more often the one-party system has produced a brand of "winner take all" politics that promotes tribal, religious or social conflict.

Tanzanians like to say the one-party state reduced tribalism in their country. But tribalism was not nearly as strongly rooted in Tanzania at independence as it was in other places.

. . . If the West ties aid to reform.

Morever, societal changes and the forceful personality and anti-tribal convictions of Julius Nyerere were major elements in the diminution of tribalism in Tanzania. As for other countries, Kenya and Somalia, for example, tribalism is as strong as ever after years of one-party rule.

But the one-party-state question is a side issue, to some extent. While the structure in which political freedoms are exercised is not immaterial, what is of utmost importance is that the people are accorded democratic political rights. Whether the people want a one-party system or prefer something else, it should be up to them to choose. And the opportunity to do so has been sadly lacking in Africa.

We should continue to concentrate on economic reforms for now. But we should begin to stress our hope and expectation for democratic reforms in Africa. And, in consultation with our Western allies, we need to start planning how and when to introduce a policy that more explicitly and broadly ties developmental aid to political reforms in Africa.

Even with the fading of the cold war, the U.S. has many important interests in Africa and should continue to pursue them vigorously. Yet we need to re-evaluate and appropriately redefine just what we mean by truly important interests.

The diminution of East-West tensions should enable us to look after our interests more effectively and, at the same time, allow us to put greater emphasis on encouraging an expansion of political freedoms. If this entails applying diplomatic and economic pressures on undemocratic regimes, so be it. □

Donald K. Petterson was U.S. Ambassador to Somalia from 1978 to 1982, and Tanzania from 1986 to 1989.

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THE NEW YORK TIMES, April 21, 1990

FOREIGN AFFAIRS | Flora Lewis

Tide Reaching Africa

PARIS

Attenuated to be sure, little more than ripples, the tide of impulse to democracy is spreading from Europe to reach Africa.

In a sense, Africa is becoming the Dark Continent again, out of sight and almost out of ken. Asiaweek magazine recently pointed out that with attention focused on Eastern Europe and the Soviet Union, occasional headlines from Latin America and China, Africa has "disappeared. No effort has been made to find it."

That is the fear of many Africans now, after more than a generation of receiving lively international concern. A group gathered here by the former Nigerian chief of state Olusegun Obasanjo to discuss "The impact of change in Eastern Europe on Africa" took for granted that widespread aid for the East would leave their countries all but forgotten.

But there's a new tone among these representatives of the African elite

Democracy's ripples spread from Europe.

from some 20 nations: no longer the reproach and indignation at being left behind that used to characterize such gatherings. There was a surprising unanimity on the theme of democracy as essential to development, no longer "people's democracy" or "guided democracy" but "plain democracy without mysteries," in the words of Olaru A. Otunnu, former Foreign Minister of Uganda.

They are aware of the new Eastern European maxim that "the third way [between Communism and capitalism] leads only to the third world," and what they want is out of it. They are groping for ways to better develop their countries.

Mr. Obasanjo didn't mince words. He spoke of the "ridiculously large number of often economically unviable states" that should look to a Western European style of integration to pool capacities. He urged a conference in Africa to take up human rights and defense, as the Helsinki process did in Europe.

"North-North peace must not degenerate into South-South violence," he said, and he decried the "perennial dependence fueled by massive external support for undemocratic regimes," largely as a result of the cold war.

But it wasn't only the cold war. The pernicious idea that new African states and old African cultures couldn't be expected to strive for standards of civil and political freedom really came from the West. Liberals attacked critics of dictators and one-party states as "ethnocentric racists," and conservatives preferred to deal with autocrats in power.

Naturally, African regimes happily took up the theme, claiming the right not to be judged by what both sides called "Western values," but what must be seen as universal values.

One official, from one of the nastier extant dictatorships, confided: "We've been trying to say that too, for a long time. But you didn't hear us. You just listened to the regimes, and of course they called any domestic critics 'lackeys of imperialism.' "

A senior European aid official explained that dealing with governments was unavoidable and asked what the Africans wanted outsiders to do. He left unmentioned the charges of interference and lack of respect for sovereignty when the worst regimes were ticked off.

But Mr. Obasanjo had noted that "safe political conditionality" was being applied for Western aid to the East, requiring rule of law, human rights, free elections, multiparty systems and a market economy. And he expects the same for Africa.

"We have squandered almost 30 years with ineffective nation-building efforts," he said, and "it is high time to cast solid foundations for the legitimacy of our political systems."

Changes in South Africa will help. If apartheid can be negotiated into the dustbin, tyrants will find it harder to divert protest from their misdeeds. Meanwhile, the "Ceausescu factor," as one participant said, reminds leaders clinging to power that those who don't bend risk being broken.

The men around the meeting table were by no means dissidents, but neither can they turn their countries around on their own. Of course, the vast problems of Africa cannot be solved by African policies alone. Poverty breeds poverty by geometric progression. "Population growth will slow, either because birth rates come down or death rates go up," Lester R. Brown wrote recently in World Watch. "These are the only options."

But these leaders have seen that to get the help they need, their countries must put it to productive use. "Europeans aren't planning to help Europeans first for ethnic reasons, but because they have common values," said one. "We must build them."

The changes in the world are contagious. Much more than Eastern Europe is at stake.

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THE WASHINGTON POST May 24, 1990

Chester Crocker

Supporting Africa's Winners

For 30 years, the price tag of African misrule has grown starkly more visible. Why, until recently, has there been a taboo on the subject, and what are the implications of greater glasnost about Africa's crisis of governance?

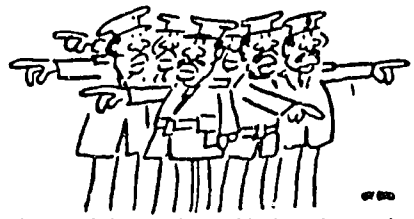
Africa's decolonization occurred during the height of the Cold War. Departing European colonial powers sought a quick and orderly transfer of power. Democratic constitutions accompanied these transfers, but the driving impetus was stable decolonization, not democratization. For their part, Africa's founding fathers were nationalists seeking freedom from alien control, not the freedom of checks and balances.

Diplomats of East and West, international civil servants and non-governmental groups all played their roles in legitimizing Africa's new rulers. The needs of the time called for cultivating "good relations" with the emerging life presidents and uniformed oligarchs who came to rule too many African countries. Prevailing relativist and liberationist fashions in Western academe caused African studies to take on the aura of a solidarity rally. Rationales for "one-party democracy" proliferated. We Westerners acted as if it would be unfair, impolite or downright dangerous to expect African systems of governance to meet universal norms.

Despite Soviet Cold War adventures in Africa, no African state experienced the totalitarian Marxism of Stalin. Africa's avowedly Marxist leaders were few, and they tended toward the Yves St. Laurent variety. But ministerial ownership of the means of production—a working definition of modern Marxism—flourished under whatever label. This explains part of Africa's shocking economic decline. The widespread absence of political accountability, raw abuse of power, rampant nepotism and corruption and the suppression of non-government organizations made matters worse.

But Africa is not immune to the sudden implosion of Marxist systems in Eastern Europe. Autocrats as politically diverse as Zaire's Mobutu Sese Seko and Zimbabwe's Robert Mugabe were dismayed by the fate of Ceausescu. Still more unsettling has been the systematic discrediting by Soviet commentators of their own political tradition of statism.

Today, Africa's autocrats enjoy a reduced margin of maneuver. Officials in London, Washington and Paris are reviewing how the issue of democratization should fit into their African policies. The World Bank, a vital institution in the life of most African states, broke new ground with a 1989 report that highlighted the "governance" issue. Last month at a Washington conference, Bank president Barber Conable went further, linking the economic crisis to a wide range of



abuses and the prevalence of leaders whose goals consist of personal power and enrichment.

Some of the strongest pressures on the autocrats come from within Africa. In February, Tanzania's founding father and former president Julius Nyerere—one of the leading theoreticians of African socialism—stated publicly that the single-party system should not be viewed as "God's wish." Pressures for basic political change are visible in a growing number of African states from pro-Soviet Ethiopia to pro-Western Zaire. One-party or one-man rule is on the defensive in Gabon, Angola, Ivory Coast, Kenya, Zambia and Somalia. Democratic Senegal, Gambia, Mauritius and Botswana are no longer swimming against the regional tide. The 1988 Namibia-Angola settlement led to perhaps the most democratic transition to independence that Africa has seen and the writing of a strong, democratic constitution for the new nation of Namibia. South Africans, who may be building their own non-racial democracy, could join forces with neighboring Botswana and Namibia in shaping a new political climate.

But the process of democratization will not be smooth or quick. For every civilian autocrat or military strongman in power today, there are scores more waiting in the wings. As the tense military politics of Nigeria demonstrate, the most immediate threat to the current military leader is a rival, and not necessarily a preferable one. Some incumbent autocrats could be unseated if we outsiders concerted to do so. But is this our business and, if so, is it also our business to anoint successors, or should we let the men with the guns take care of this detail? Who should take the lead in designing the new political conditions for Western assistance to Africa?

Democratization will not happen just because some outsiders pull the plug on the status quo. Nor can democracy be "imposed" by the sledgehammer of bilateral aid conditionality. That is especially true in Africa, where the mediating institutions and pluralistic centers of influence and power—so essential to our cherished civil society—are generally absent.

There is a vital economic reform agenda in place alongside the emerging political one. Some 30 African countries have developed structural adjustment programs with the Bank, the IMF, and Western donors. Such programs are vital to the liberation of market forces, which, in turn, represent building blocks of a pluralist democracy. It would be a simple thing to create chaos and greater misery by pulling the economic plug on political grounds.

If we accept that democratic values matter in Africa, there are things we can do to support them. For starters, we should listen with a more sophisticated ear to the varied African voices on this topic. Special heed should be paid to proven African democrats like Senegal's President Abdou Diouf, who visited Washington last week. Senegal's democracy has roots as old as ours, and its post-independence leaders have given substance to political values we cherish. Diouf does not ask us to punish Africa's losers and miscreants. That's easy—and irresponsible. He asks that we support Africa's winners in the quest for democracy and development.

Former Nigerian head of state Olusegun Obasanjo recently remarked at the Africa Leadership Forum in Paris that African leaders "have squandered 30 years"; he stressed that "unless Africa takes the lead in helping itself, nobody will rush to our help." But he also questioned Western action that only compounds Africa's economic and political marginalization. On a per capita basis, Poles and Hungarians are projected in the next few years to receive 10 times the European aid that Africans do. Central Americans under current proposals are to receive 34 times the U.S. aid that Africans get, Israelis 700 times. In the short-sighted triage that passes for our foreign affairs budget process, Africans could end up paying for the expanding frontiers of freedom everywhere else. That would be an obscene response to the African crisis.

If we wish to support Africa's democratization, let's control the imperial impulse to dictate and the moralistic impulse to punish. We should discriminate in favor of winners and engage ourselves as partners to help Africans build their own civil societies where free people and institutions gain power. That means strengthening linkages between our societies, sharing experience and skills, and supporting the goal of an Africa ruled by laws not men. The Cold War is nearly over in Africa, and the Soviets are disengaging from the region. This is a time for us to make our own foreign policy and not just copy theirs as though we, too, were a failed superpower.

The writer was assistant secretary of state for African affairs from 1981 to 1989.

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THE CHRISTIAN SCIENCE MONITOR, June 4, 1990

Support Africa's Move Toward Democracy, Too

By Richard Joseph

A BRUSH fire has started in Africa, burning away the desiccated arguments that have been used to justify one-party and military rule. But it would be difficult to know such a promising, and perilous, process had begun judging from the response of the United States.

While the changes in Eastern Europe have been greeted with immediate promises of massive direct assistance, Namibia, which achieved independence last March after decades of struggle, was granted a mere $500,000 allocation in the US aid budget, a sum since increased to $10 million by congressional action. About 11 percent of US foreign aid is allocated to sub-Saharan Africa annually, a percentage that has remained steady despite pressing needs and fundamental policy reforms being undertaken by many countries.

At last, Africa's autocracies are tottering. The rulers of Benin, Côte d'Ivoire, Gabon, Guinea, and Mali have promised to initiate political reforms. Nigeria expects a full hand-over of power from the military to civilians in 1992, unless President Babangida decrees otherwise. Other African countries like Cameroon, Kenya, Niger, and Zambia are facing mounting protests from their people, who are fed up with being ruled by sultanates. Although President Mobutu announced in April a re-introduction of multiparty politics in Zaire, this opening was followed by contradictory statements about his future role and by further repression of political opponents. While applauding these developments, we must recognize how fragile they all are.

Most of the African continent is beset by deepening economic difficulties. The structural-adjustment reforms that many countries have conducted under the aegis of international financial agencies have forced them to balance their national budgets at lower levels of external earnings and public services. After the economic devastation of the 1980s, all experts predict more hardship and austerity ahead. The elimination of political monopolies by single parties and military regimes, and the restoration of civil liberties, are difficult operations for any nation. In the case of African states, where resources are few, and where ethnic, religious, and regional divisions are vigorously reasserted with the first blush of freedom, the challenges to be overcome in implementing democratic transitions are enormous.

Without strong external support, most of these transitions will fail. Indeed, they could spiral out of control, resulting in outbreaks of violence and turmoil that could prompt more repressive solutions. The US government should play a leading role in mobilizing national and multilateral support for African nations moving toward liberalized economies and pluralist democracies. When declarations are made by our political leaders about the need to help "emerging democracies," African nations are seldom mentioned. Yet our country's economy and culture have benefited extensively from the human and material resources that have been drained from the African continent over centuries.

IT is not only the Bush administration and Congress that should respond. Universities, foundations, religious, corporate, and civic groups, as well as environmental and developmental organizations should devise ways to assist Africa's economic and political renewal during the 1990s. In his recent university commencement addresses, President Bush outlined a set of broad initiatives that should be undertaken to strengthen the democratization of Eastern Europe. Africa will certainly require a more sensitive and flexible approach than one based primarily on the export of American political and constitutional practices.

The current negotiations to devise a transition to majority rule in South Africa, and the recent introduction of political reforms in Algeria and Tunisia, suggest that the entire continent of Africa could be the scene of active experimentation with novel forms of democratic governance. A little nudging, along with appropriate assistance for democratic transitions, can go a long way in contemporary Africa. Kenyan President Daniel arap Moi usually disparages criticism of his autocratic rule. Even he seems to be getting the message after the US ambassador pointedly linked the decline of external investments to displeasure with corruption, repression, and weakened judicial institutions in Kenya.

Several US congressmen, such as Howard Wolpe, Stephen Solarz, and Donald Payne, have urged the adoption of a US Africa policy based on consistent support for human rights and democratic governance. It is now vitally important that this message be heard from other voices in our government and from a cross-section of civic leaders, especially in the African-American community. The door to wider freedoms has opened a crack in Black Africa. This crack must be widened and a period of sustained economic and political reconstruction commenced. With determined internal leadership and effort, and broad external assistance, Africa can be transformed from a continent of increasing woes to a land of great achievement.

Richard Joseph teaches political science and is a fellow for African studies at the Carter Center of Emory University.

THE WASHINGTON POST, April 2, 1990

George B. N. Ayittey

Not by Aid Alone

Congo's head of state, Col. Sassou-Nguesso, was in Washington recently to seek more U.S. aid for his shattered economy. Other African leaders will be coming to plead that they not be abandoned for Eastern Europe. Meanwhile, 5 million Ethiopians face starvation, and millions more are threatened in Sudan, Somalia, Uganda, Mozambique, Angola and Mauritania.

While every effort must be made to save the starving, it is even more important to find long-term solutions to Africa's problems. It is the persistent failure to devise such solutions that causes grisly spectacles of emaciated bodies to be visited upon us.

Africans themselves abhor beseeching the West for alms. It deprecates their dignity and sense of pride. But the West adamantly refuses to listen to what African people themselves are proposing. Apparently Africans are incapable of determining what is good for them.

To many native Africans, more foreign aid is not the answer. The aid resources Africa desperately needs are already there in abundance. Lasting solutions lie in the cessation of senseless civil wars raging in at least 10 African countries, reductions in stultifying expenditures on the military and the arrest of capital flight. More than aid, Africa needs a large dose of democracy, a commodity that is now all too scarce on the continent.

"Lasting solutions lie in the cessation of senseless civil wars raging in at least 10 African countries ... and the arrest of capital flight."

Total foreign aid from all sources to Africa now amounts to $11 billion a year. Yet, according to Sammy Kum Buo, director of the United Nations Center for Peace and Disarmament, Africa spends about $12 billion a year on arms and the maintenance of the military.

In Uganda, Maj. Okello Kolo, a former member of the President Museveni's National Resistance Army, charges that "incidents of rape, looting, slashing of food crops, razing of homes and food stores, theft of livestock have been going on unabated at the hands of the troops of the NRA." The slaughter continues in Angola, Benin, Liberia, Mauritania, Mozambique, Somalia, Sudan and other African countries.

Even the World Bank and the Economic Commission for Africa have added their voices to the chorus of calls for reductions in arms expenditures. Indeed, while all other regions of the Third World made economic progress in the 1980s, black Africa was the only region that retrogressed.

Arms are not the only reason for this. Every year at least $15 billion in capital leaves Africa. Much of this capital flight is booty, siphoned off by vampire elites. For example, in April 1989, the Christian Association of Nigeria revealed that more than 3,000 Nigerians operated Swiss bank accounts and that Nigerians were near the top of the list of Third World patrons of Swiss banks.

In Zimbabwe "Swiss bank socialists" appear in court with monotonous regularity for dipping their hands into the kitty. But the epitome of Africa's kleptocracy resides in Zaire, whose president, Mobutu Sese Seko, has allegedly amassed more than $8 billion in Swiss banks—a personal fortune that exceeds his own country's foreign debt of $5 billion and equals the entire U.S. foreign aid package for fiscal 1990.

The West has not neglected Africa. It has given more than $230 billion in aid and various forms of credits and financial assistance since the 1960s. In fact, according to Jennifer Whitaker, author of "How Can Africa Survive?": "Even in 1965, almost 20 percent of Western countries' development assistance went to Africa. In the 1980s, Africans, who are about 12 percent of the developing world's population, were receiving about 22 percent of the total, and the share per person was higher than anywhere else in the Third World." So much aid was poured into tiny Tanzania in the early 1980s ($1.7 billion from 1980 to 1983) that by 1985, almost half of government expenditures were sustained by foreign assistance. Yet its economy faltered.

Today, financial and technical assistance is pouring into Mozambique at a rate of $800 million a year. Western donors will be giving $900 million annually over the next five years—far more than what Poland and Hungary hope to get from the United States.

Compassion is a magnanimous virtue, but the waste of Western aid to Africa has become a scandal, and Africans themselves are now angrily speaking out.

At the very least, Western development assistance to *any* war-torn African country should be withheld and placed in escrow until a lasting peace is achieved. It makes no sense to build bridges, roads and railways with Western loans only to have them blown up by rebels.

More important, foreign aid should be linked to political reform. Since 1980, not one black African country has been democratized. Only four (Botswana, Gambia, Mauritius and Senegal) out of 45 allow their people to vote and choose their leaders. The rest are ruled by military and civilian dictators. The Brady Plan, which calls for debt cancellation, should be restricted to African countries that set a date and carry out free, multiparty elections. That's when real solutions will begin to emerge.

The writer is a Bradley resident scholar at the Heritage Foundation.

THE BALTIMORE SUN, April 23, 1990

The New Colonialism

Paris.

THE POOR countries of Africa are concerned that Eastern Europe is going to get most of the aid money still available from the Western nations. They are right, but the reason is not so simple as they would prefer to think.

Aid to Eastern Europe promises to work; most aid to Africa has not worked. The aid-giving countries are

By William Pfaff

not so much indifferent to Africa as baffled and frustrated.

Sub-Saharan Africa is in terrible condition. The causes are complex, but the result is that most of sub-Saharan Africa has lost control of its own future. Its governments have become the stipendaries of the International Monetary Fund and other international lending agencies. Economies have all but collapsed as prices have plunged in the markets for Africa's commodities.

One cause of the investment crisis is black Africa's political failure. Corruption is everywhere. Nowhere is there a fully functioning representative government. The high expectations of the first years of African independence were lost long ago; now frustration reigns. The people who were uprooted from agricultural subsistence by independence and an uncalculated urbanization are today without hope for jobs or social progress.

News from Eastern Europe, and the spirit of liberation it set loose in the world, has affected Africa, producing popular challenge to established authority in several of the Francophone West African countries and in Mobutu Sese Seko's Zaire — the United States' principal African client. In Western Eumpe, particularly in France — the one major European country still seriously interested in Africa — public opinion now questions support for dictatorial African governments, until now considered bad, but better than the visible alternatives.

But Africa's opposition forces are chaotic and fragmented, usually politically naive, without coherent programs. Opposition leaders often are as much the prisoners of obsolete or irrelevant ideologies as the people who govern. In fact, Africa has been stripped of its elites. Talented and educated people — the ones Africa desperately needs — have been driven into emigration.

In the past it has been convenient to blame Africa's problems on colonialism, or present-day "imperialism." Today it is evident that it makes no difference who is to blame. Colonialism lasted just long enough to destroy the indigenous economy and social structures of the continent, but not long enough to put anything lasting in their place. The simple pastoralism, the hunting and gathering economies of the past, were ruined, tribal monarchies and alliances wrecked, a fragile human ecology existing in extreme climatic conditions jeopardized.

The Europeans then tried to remake Africa and Africans to their own advantage and in their own image. Whatever the merits of that effort, which was based on a conviction of European superiority, but was not without altruism and sacrifice, it came to an end in the 1950s and 1960s. The moral upheaval produced by the two world wars, and the revolutionary doctrines preached from Moscow and Beijing, destroyed both the Europeans' belief in their right to rule Africa and the Africans' willingness to be ruled.

The new African governments mostly chose state-socialist models of development — the furthest possible from their European colonizers' model. They sought forms of industrialization irrelevant to African needs, and wrecked native agriculture. The governments themselves usually were one-party affairs, professedly "revolutionary," actually relying on tribalism and clientism.

At best the result was inefficient and repressive. At worst it produced the depravities of Idi Amin and the Emperor Bokassa. The blind ideological rivalry of the superpowers, and the ignorance and self-interest of all too many of the foreign advisers, development theorists, bankers, traders and adventurers who interested themselves in Africa's affairs, contributed to this outcome.

Today, in fact if not name, a new colonialism exists. The World Bank, the IMF, the French government and the aid agencies of the other developed countries, together with the private lending institutions, set the terms on which Africa's economies function, or malfunction.

The implications of this situation are not yet clearly grasped. Javier Perez de Cuellar, the U.N. Secretary General, said recently that the major countries cannot, even in their own interests, continue to tolerate the cruelties and misery of the backward world. He spoke of a "right" of international interference when conditions are as desperate as they are in some countries today. In Africa this interventionism is practiced but not acknowledged.

A unique opportunity exists. The Cold War struggle over Africa's ideological orientation is finished. The Soviet Union is ready to cooperate. The United Nations needs a serious role to play in today's world. Africa's post-independence models of state-socialist development and one-party rule are completely discredited. The human needs of Africa are desperate. Disease as well as hunger and chaos threaten its people.

What about a new, declared, internationalized colonialism for Africa? A disinterested international interventionism? What about installing a frankly paternalist international authority in Africa and a continent-wide development structure and program? The idea may be outrageous in terms of the political pieties of the last 50 years, but those pieties helped put Africa where it is today. What is the alternative to neo-colonialism? Africa's condition demands desperate measures.

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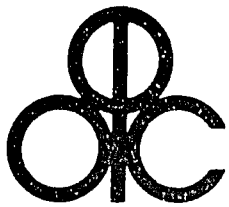

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WASHINGTON ECONOMIC WATCH

A Digest of Development Policy Information

A Project of the Overseas Development Council

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THE WHITE HOUSE

Office of the Press Secretary

For Immediate Release May 24, 1990

PRESS CONFERENCE
BY THE PRESIDENT

The Briefing Room

9:33 A.M. EDT

THE PRESIDENT: Today, after long and thorough deliberation, I have determined that MFN trade status for China should be extended for a year. MFN is not a special favor; it is not a concession. It's the basis of everyday trade. And taking MFN away is one thing I said I would not do -- that is, in doing that, take steps that would hurt the Chinese people themselves. I do not want to do that.

To express America's outrage at the tragedy of Tiananmen, the Congress and my administration promptly enacted sanctions against China. These sanctions remain basically unchanged today. And while implementing those sanctions, I have repeatedly made clear that I did not want to hurt the Chinese people. And this was a difficult decision, weighing our impulse to lash out in outrage that we all feel against a sober assessment -- weighing that against a sober assessment of our nation's long-term interests.

I concluded that it is in our best interest and the interest of the Chinese people to continue China's trade status. Not to do so would hurt the United States. Trade would drop dramatically, hurting exporters, consumers and investors. China buys about $6 billion a year of American aircraft and wheat and chemicals, lumber and other products. Lose this market and we lose American jobs. Aircraft workers in the West, farmers in the Great Plains, high-tech employees in the Northeast.

Our economic competition will not join us in denying MFN. Without MFN, an average of 40 percent higher costs for Chinese imports will turn into higher prices for American consumers. Hong Kong weighed on my mind. Hong Kong would be an innocent victim of our dispute with Beijing. Twenty-thousand jobs and $10 billion could be lost in a colony that is a model of free enterprise spirit. The United Kingdom and China's neighbors have urged me to continue MFN. Korea, Japan, Thailand, Singapore -- even Taiwan made clear that MFN should be retained.

In recent weeks, China has taken modest steps that appear intended to show responsiveness to our concerns. Beijing lifted martial law in Tibet, restored consular access there, giving us a chance to judge the situation for ourselves. Two-hundred-eleven detainees were recently released and then their names provided for the first time.

While we welcome these and earlier steps, they are -- let's face it -- far from adequate. And I am not basing my decision on the steps that the Chinese have taken so far. Most important of all, as we mark the anniversary of Tiananmen, we must realize that by maintaining our involvement with China, we will continue to promote the reforms for which the victims of Tiananmen gave their lives.

The people in China who trade with us are the engine of reform, an opening to the outside world. During the past 10 years we've seen our engagement in China contribute to the forces for

MORE

justice and reason that were peacefully protested in Beijing. And our responsibility to them is best met not by isolating those forces from contact with us or by strengthening the hand of reaction, but by keeping open the channels of commerce and communication.

Our Ambassador came to see me here in the Oval Office the other day and told me that not only the people that he's in contact with, but the students there, the intellectuals there all favor -- there in China -- favor the continuation of MFN. So this is why I've made the decision I have made.

FACT SHEET ON CONTINUATION OF MFN FOR CHINA

-- China Meets the Emigration Requirements of Jackson-Vanik. Approximately 17,000 Chinese nationals received U.S. immigration visas to travel from the mainland in 1989. Chinese immigration continues to meet U.S.-imposed limits. Other visa levels are about the same as the previous year's, with privately sponsored students up sharply and government sponsored students down.

-- U.S. Business Would Be Hurt. Investments of $4 billion in China would be put at risk, as would U.S. exports to China which totaled nearly $6 billion in 1989. The Chinese would retaliate for loss of MFN with higher duties, particularly on products where the U.S. has serious competition. Major exports at stake are:

- -- Wheat. $1.1 billion (20% of US exports)
- -- Aircraft/Aerospace Equipment. (Current prospects of $1 billion per year with big contracts pending)
- -- Fertilizer. $487 million.
- -- Cotton. $259 million.
- -- Timber/paper. $262 million (10-20% of US log exports)
- -- Computers/machinery. $342 million.
- -- Acids. $162 million.

-- U.S. Consumers Would Be Hurt. China supplies about one-third of US toy consumption, 9% of footwear, 13% of imported apparel, and a rapidly increasing volume of electronic products. Non-MFN duties would raise landed costs an average of 40%.

-- Hong Kong Would Be Hurt. Already shaken by the events in China, MFN loss would damage the colony by costing as many as 20,000 jobs and as much as 2.5% of GNP growth.

-- Denial of MFN Will Harm Reformers and Strengthen Hardliners. In China, the advocates of political and economic reform and of greater human rights depend on outside contacts and support. Cutting them off will weaken them while giving hardliners a nationalistic scapegoat for their failing policies.

-- Sanctions Remain in Place. US pressure for reform is contained in the sanctions already enacted. The Administration will continue to press for progress on our human rights and other concerns. MFN status is not a concession; it is the basis of everyday trade. Our competitors will not follow us in denying MFN.

-- Engagement Pays Off in the Long Run. Western involvement in China has helped produce the major social and economic changes behind the Tiananmen demonstrations. Despite the past year's repression, greater interaction will lead ultimately to greater influence.

MOST-FAVORED-NATION (MFN) TRADE STATUS FOR CHINA

- The Administration and Congress both share the same goals in China--make clear our deeply held views on human rights and encourage conciliatory policies and a reinvigoration of political and economic reform.

- The President, after careful consideration, decided to extend China's most-favored-nation (MFN) trade status for another year. In reaching this determination, the President weighed not only the requirements of the Jackson-Vanik amendment, which obligate him to consider whether MFN renewal would substantially promote freedom of emigration, but also the broader question of whether MFN would advance the cause of human rights and reform in China. On balance, the President concluded that extending MFN would promote US objectives in both these areas and protect other vital US interests as well.

- Emigration. Approximately 17,000 Chinese emigrate from the mainland to the United States every year. This emigration flow has continued since the military crackdown in June 1989. While the Chinese Government has imposed some new travel restrictions on students, it has continued to permit emigration travel since Tiananmen. US numerical limitations, and not Chinese restrictions, limit the number of Chinese who emigrate to the United Sates.

  -- In our judgment, continuation of MFN status will help to preserve the gains already achieved on freedom of emigration and encourage further progress in the future. Thousands of Chinese families have been reunited in the United States through emigration. The contacts which these immigrants maintain with friends and relatives in China help to encourage positive change there and promote friendly relations with the US. Denying China MFN status removes an important incentive for permitting emigration and invites retaliation in the form of new travel restrictions.

- Broad Human Rights. The President believes that a continuation of MFN for China is vital to advancing the cause of human rights and in supporting those Chinese who seek a modern, progressive China.

- Granting China MFN status, which is the tariff treatment the US accords all but a small number of its trading partners, was one of the key elements in a package

normalizing diplomatic relations in 1979-80. It signaled that the US would treat China as an equal with other countries and facilitated a major expansion in our economic relations. But MFN's impact extended far beyond commerce and trade.

- The prospect of rapid modernization through increased trade and investment with the US encouraged a broader opening to the West, gave further impetus to market-oriented economic reforms, created expanded opportunities for people-to-people contacts, and justified the sending of thousands of China's best and brightest students to the US for higher education where they were exposed to Western values and democratic ideals.

- Denying MFN status would adversely affect our ability to maintain those contacts and thereby to help sustain the impetus for internal reform.

  -- China would view MFN denial as a hostile act, and a further deterioration in the relationship would result.

  -- In this strained atmosphere, Chinese contacts with Americans across the board--business, academic and scientific--would be more difficult and may be severely curtailed. Those Chinese with an interest in furthering China's opening to the West and seeking positive change would be most affected.

  -- MFN denial would likely bolster the position of conservatives in the leadership who want to restrict Western influence, give internal policies a more ideological orientation and maintain strict government controls on society and the economy. On the other hand, reformers, who could up until now point to substantial benefits from good relations with the US and a deepening of market-oriented policies, would be put on the defensive.

- MFN denial would remove an important incentive for China to take into account a broad range of US interests--on human rights, missile and arms sales, fair trade practices abroad, and cooperation on regional issues, such as Cambodia and Korea.

- <u>Allied Solidarity</u>. The US and its G-7 allies (France, Germany, UK, Japan, Canada and Italy) have thus far maintained a united position on China policy. Since the Paris Summit in July 1989, there has been a G-7 consensus against a general resumption of World Bank lending to China. Other G-7 countries have also suspended arms exports to China and are limiting high-level contacts.

-- While our allies all agree China should do more to improve the human rights situation, they also believe that MFN is important and plan to continue this trade status for China. The US would be the only Western country to withdraw MFN if the President did not renew the waiver. We believe a united G-7 position puts more pressure on China than unilateral US actions.

- Economic Implications. The economic consequences of removing China's MFN status would also be severe--for US business, US consumers, Hong Kong and workers in export industries in China.

- Since receiving MFN status in 1980, US-China trade has nearly quadrupled, reaching $18 billion in 1989. US exports totalled $6 million, and China remains a potentially large market for a broad range of US products. Major US exports are: wheat, commercial aircraft, phosphate fertilizer and high-tech equipment, such as computers and scientific instrumentation. (See attached fact sheet for details.)

- The US has become China's largest market, absorbing 25 percent of China's total exports. China's top 20 exports to the US by value would face average duty rates of nearly 60 percent if MFN status is revoked--in some cases ten-times higher than with MFN privileges.

- Retaliation is a certainty. China would apply its higher non-MFN duty rates to imports from the US and could use a variety of administrative measures to restrict market access by US companies (e.g., through foreign exchange allocations, import licenses, quality standards and restrictions on imports competing with local production).

- US firms that have worked hard over the last ten years to develop business ties and market share within China would lose that business--perhaps permanently--to other suppliers in Europe and Japan. No other Western country is planning to deny China MFN status. Retaliation therefore would be on focused US firms.

- Effect on Consumers. US consumers would also suffer. MFN denial would lead to sharply higher prices on imports from China. Chinese manufacturers currently supply one-third of American toy consumption, 10 percent of footwear consumption, close to 15 percent of imported apparel consumption and a rapidly increasing volume of consumer electronic products. According to the US-China Business Council, non-MFN tariffs would increase the landed cost of Chinese products by 40 percent. Given the mix of Chinese exports to the US, the impact of increased prices is likely to fall disproportionately on low-income consumers.

- Hong Kong Impact. Revoking MFN status would also have long-term negative effects on Hong Kong, threatening the island's stability and prosperity in the run-up to 1997 when Beijing reassumes control.

  -- Hong Kong entrepreneurs have invested in thousands of Chinese enterprises, particularly in Guangdong's Pearl River delta region in South China, to take advantage of low-cost manufacturing. Hong Kong-invested enterprises in South China employ some 2 million Chinese. An additional 10,000-15,000 South China enterprises do processing and assembly work for Hong Kong companies.

  -- Of a total of $25 billion in Chinese exports to Hong Kong in 1989, $24 billion were re-exported to other countries. The United States is by far the largest market for Chinese reexports through Hong Kong, taking more than $8.5 billion in 1989.

  -- The dropoff in Chinese exports to the US would have a direct impact on Hong Kong firms involved in transshipment of goods to the US, including banking, insurance, shipping, and legal services.

  -- MFN withdrawal would be a serious blow to confidence in Hong Kong. Net emigration from Hong Kong is now running about 40,000-50,000 annually, resulting in a serious shortage of skilled labor and mid-level managers. A sharp deterioration in US-China trade relations would heighten concerns about Hong Kong's future at a time when confidence is already weak because of Beijing's heavy-handed suppression of dissent on the mainland.

- In short, the President has decided to extend China's MFN status because it serves clear US interests in several important areas--emigration and human rights, the need for reform in China, US business, US consumers and Hong Kong's stability and confidence.

- Need for Further Human Rights Improvments. In notifying Congress of his determination to renew MFN for China, the President emphasized that he remains seriously concerned about human rights violations in China and is personally disappointed that the Chinese Government has not taken more decisive steps to demonstrate a commitment to internationally accepted human rights, despite repeated expressions of concern by the US and many other Western countries. The President has also indicated that the US Government intends to press vigorously during the coming year for significant improvement in China's human rights practices.

- Sanctions to Continue. The extension does not signal a return to business as usual with China. The President has reaffirmed that he will maintain the sanctions against China he authorized in June 1989 on arms exports, high-level government exchanges and postponement of multilateral development loans.

- We should not let our frustration with Beijing's slow response to our concerns lead us to take unilateral actions which, in the end, only serve to undercut our long-term objectives. Denying MFN would do just this. It would also result in the United States losing the leverage it has gained over the last decade to influence positively the course of human rights developments in China.

By: The Central Intelligence Agency
Presented to the Subcommittee on Technology and National Security
of the Joint Economic Committee
June 28, 1990

The Chinese Economy in 1989 and 1990: Trying To Revive Growth While Maintaining Social Stability

Summary

Information available as of 25 June 1990 was used in this report.

Beijing is grappling with the fallout from overly restrictive austerity policies implemented in late 1988, which dampened inflation in urban areas from 30-percent annual rates to single digits, but which also caused China's worst economic slump in a decade. In 1989, real GNP grew less than 4 percent, about one-third the rate posted a year earlier, according to Chinese statistics. Weak industrial growth hurt enterprise profitability and increased price and enterprise subsidies, which expanded the government's budget deficit by about 40 percent to a record $8 billion.

Growing unemployment–which has reached its highest level in a decade–and falling urban living standards are undermining Beijing's efforts to reestablish the country's social stability, which remains tenuous a year following the government's suppression of the prodemocracy demonstrations. Consequently, Beijing has begun to ease austerity modestly–increasing credit to large state firms, loosening restrictions on capital construction, and lowering interest rates on banks loans–to head off labor discontent. The recent infusions of credit, however, have been slow to stimulate demand or revive industrial production. During the first five months of this year, industrial production remained sluggish, increasing at less than a 2-percent annual rate. Moreover, fundamental indicators point to continued weaknesses in the economy–inventories continue to accumulate, the growth rate of the once vibrant rural industrial sector has dropped sharply, and the production of large state-run enterprises remains sluggish.

To keep inflation from reemerging as it increases credit, Beijing is turning to administrative measures. Broader central controls, however, will reduce incentives for increased efficiency by curtailing managerial autonomy and increasing the share of goods sold at low, state-set prices. Increased government allocations of raw material and energy inputs to large state enterprises will drain resources from China's dynamic nonstate sector and lower its integral contribution to economic growth. Moreover, if Beijing's intensified support to large state enterprises fails to revive the economy, political pressures may force Beijing to open the credit spigot wider, renewing the inflationary pressures the government was originally so determined to squelch.

Beijing's renewed preference for administrative controls is also visible in China's foreign economic relations, as the central government has reclaimed much of the foreign trade authority it devolved to the lower levels under reforms in the late 1980s. Tightened central controls over the trade sector have helped Beijing prevent a rapid drawdown of foreign exchange reserves. As a result, China narrowed its trade deficit last year by $1.1 billion to $6.6 billion, according to Chinese customs statistics. In the first four months of this year, China posted a trade surplus of $1.3 billion.

The leadership's focus on maintaining party control by using administrative measures to treat the symptoms of China's economic ills makes prospects for return in the near term to comprehensive, market-oriented reform dim. Economic policy will probably remain dominated by stopgap measures aimed at ensuring social stability, precluding riskier, longer-term strategies for growth and development. While it is unlikely that many senior officials want to return to the command economy and isolationist policies that dominated China before 1979, some in the

leadership want to place strict limits on the development of the nonstate sector and to increase the party's role in enterprise management.

Failure to proceed with comprehensive market-oriented reforms will eventually dampen the performance of the economy by curbing productivity gains. The hold on market reform could slow lending by international financial institutions, even if Western economic sanctions are lifted. This could delay progress on China's long-term modernization goals as decreased access to low-cost financing impairs its ability to gain technological know-how through high-tech joint ventures or to import advanced technology. A continued decline in capital goods and raw material imports will also stifle the pace of China's economic development. Beijing's inability to proceed with reforms will also widen the economic gulf between China and its market-oriented East Asian neighbors.

Crises in Communist Reform: Lessons from Tiananmen

Harry Harding

The wave of political change that cascaded across Eastern Europe at the end of last year produced both amazement and satisfaction in the United States. Totalitarianism and tight central planning seemed to have lost their appeal, especially to those who had lived under them for more than four decades. Reform, moving in the direction of democratic politics and market-oriented economics, looked to be inevitable. The process of change, as it spread from country to country, appeared to be as irreversible as it was unexpected. American analysts understandably discussed these developments in epochal terms, describing them variously as the "end of the Cold War," the "end of communism," or even the "end of history." The contemporary era was said to be over, and a less threatening age was seen dawning before us.

The Tiananmen Incident in Peking last June should temper this optimism. In China, too, economic and political reform appeared to be an irreversible process, tracing an upward spiral toward greater liberalization and pluralism throughout the 1980s. The mass demonstrations that swept Peking between mid-April and early June of 1989 dramatically illustrated the extent of popular demands for even greater economic and political change. And the initial reluctance of the Chinese government to use force against its own citizenry appeared to prove that the demands for a more responsive government could not be resisted.

But the tragic night of June 3–4 has shown us that political and economic reform is not irreversible, at least in the middle term. Despite brave predictions that the hard-line government that emerged in Peking would stay in office for only a few weeks or months, China has subsequently witnessed a sustained suppression of dissent, a reactivation of political education, and a tightening of administrative controls over the economy. Moreover, as a direct result of these developments, U.S.-China relations, which appeared in 1987–88 to have entered a period of great maturity and stability, are now experiencing their most serious crisis since the establishment of formal diplomatic ties in 1978. In China, at least, both Leninism and central planning have gained an unexpected reprieve.

These recent developments in China bear some general lessons both for the process of reform in Communist countries and for American policy toward Communist states. Four lessons are particularly germane:

- Attempted reform may be inevitable, but successful reform is not. Although reform may score impressive achievements during an early honeymoon period, turbulence, crisis, and retrogression are all possible at later stages.
- The breakdowns in the reform process may be dramatic — even violent — events, serving to exacerbate the degree of retrogression at home and to magni-

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fy the impact on the international community.

- Breakdowns in reform present the United States with troubling foreign policy dilemmas, particularly regarding the appropriateness and effectiveness of sanctions against hard-line leaders in retrogressive Communist states.
- Finally, even if periods of retrogression and repression prove temporary, successfully liberalizing Communist systems may continue to pose challenges to their neighbors, albeit in a significantly different way than in the past.

The Dilemmas of Reform

Much of the Communist world now seems to believe that political and economic reform is necessary. From Mongolia to Hungary, and from Poland to Vietnam, there is consensus on the need for less central planning and greater political openness. But there has been much less agreement on how to design the reforms: how fast to proceed, what sequence to adopt, and how far to advance.

For much of the 1980s the Chinese experience appeared promising. Under the leadership of Deng Xiaoping reform produced significant increases in growth rates, spectacular improvements in living standards, more intensive interaction with the international economy, and noteworthy gains in civil and political rights. But the balance sheet turned less favorable in the latter part of the decade, with increasing corruption, inflation, and inequality fueling sharp dissatisfaction among urban Chinese. Indeed, the Chinese case suggests that even after a strong start, economic and political reform can engender increasingly serious contradictions that can jeopardize the entire effort. Why is this so?

1. *Reform causes both pain and envy.* Clearly, the purpose of reform is to improve the performance of the economic and political systems by increasing their efficiency, productivity, and responsiveness. But these long-term benefits are accompanied by some sobering short-run costs. Eliminating subsidies and price controls will create strong inflationary pressures, at least until supply catches up with demand. Subjecting enterprises to more intense domestic and foreign competition and imposing greater financial discipline on them will most likely lead to bankruptcies and unemployment. Providing greater incentives for greater productivity and allowing the emergence of private and collective enterprises will generate new inequalities that can be perceived as unjust. And dismantling or deactivating old mechanisms of political control can lead to crime, corruption, and social disorientation, just as increasing opportunities for political participation will encounter resentment and resistance from entrenched party and government elites.

2. *Agriculture is no panacea.* The Chinese case has been frequently said to show the wisdom of starting economic reform in the countryside. And it is true that the decollectivization of Chinese agriculture in the late 1970s and early 1980s provided a great boost to the overall reform effort by stimulating economic growth, providing more consumer goods for the cities, and building a firm political base in rural areas.

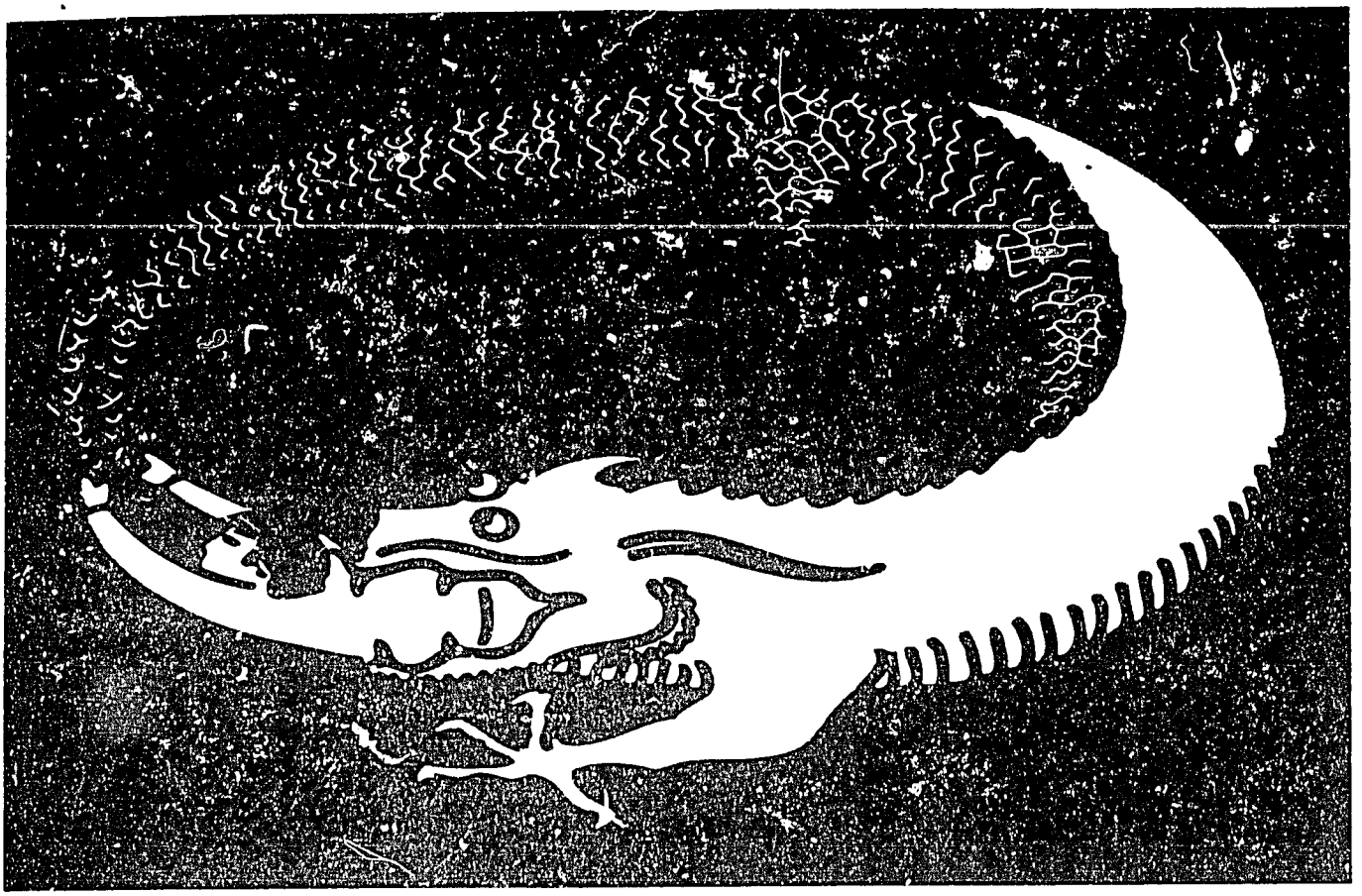
But the Chinese experience also shows that such benefits may be relatively short-lived. The increases in agricultural production in the early 1980s were largely achieved through a series of one-shot initiatives that cannot be repeated: dismantling the communes, dividing the land, and reinstituting family farming. Sustaining the gains over time will require stimulating investment and production by increasing the prices paid to farmers for their agricultural output. This, in turn, requires either that price increases be passed along to the consumer (thus exacerbating urban inflation) or that government subsidies be provided to either peasants or city dwellers (thus increasing the financial burden on the state treasury). Once the engine of reform, agriculture can soon become a brake.

3. *Stopping reforms halfway only intensifies the contradictions.* In the 1980s Chinese leaders succumbed to the understandable temptation of implementing those aspects of reform that would produce political and economic benefits while delaying those that would impose costs. Thus, they approached the conundrum of price reform by maintaining two sets of prices for critical commodities: a lower planned price (as a subsidy for favored consumers) and a higher market price (as an incentive to stimulate production). But as the gap between the two sets of prices widened, this halfway measure gave corrupt officials an irresistible invitation to buy cheap from the plan and sell dear on the market.

Similarly, Chinese leaders gave factory managers greater autonomy over investment without making them responsible for the profitability of their decisions. At the same time, they decentralized the banking system without maintaining controls over the money supply. The result: vast quantities of unprofitable projects, an overheated economy, and growing government subsidies for enterprises in the red. Once again, halfway measures selected in hopes of painless reform generated serious economic and political contradictions.

4. *Incrementalism may prolong the agony.* Chinese leaders approached restructuring in an experimental and incremental manner, trying out different strategies in local areas and phasing in reforms over a long period of time. At first, outside observers believed that such a cautious approach was wise, for it would impose the necessary pain of reform gradually and would allow a more accurate determination of the most effective techniques of reform. Increasingly, however, the risks of such an approach became clear. Incrementalism permits the contradictions inherent in halfway measures to grow and fester. By extending the costs of reform over time, such an approach may also dissipate the political support that reform may enjoy when it first begins.

This is particularly true when, as in China, an incre-



mental strategy involves distributing the gains of reform before imposing the costs. In such a case the public may gain the false impression that reform will be a relatively easy and painless process. Alternatively, rumors of impending price hikes and layoffs may create chronic unease and confusion. The Chinese experience therefore seems to support those who argue that economic reform should be conducted quickly, during the honeymoon period that a new government committed to restructuring may temporarily enjoy.

5. *Reform requires restructuring of both the economy and the political system.* One of the central issues in reform strategy involves the sequencing of political liberalization and economic restructuring. The Soviet Union under Mikhail Gorbachev illustrates the danger of undertaking political liberalization before launching significant economic change. In a more open political system, continued economic stagnation invites protest, and yet opponents of painful reform are simultaneously given greater ability to mobilize to oppose or obstruct.

China, on the other hand, exemplifies the danger of economic reform without adequate political change. The contradictions and pain inherent in economic reform produced serious social grievances. At the same time, the partial relaxation of political control and the growing independence of workers from their place of employment made it possible to turn those grievances into political action. But the political system remained authoritarian, without adequate institutions for absorbing and responding to the wave of new demands coming from urban society.

In short, the Chinese case suggests the wisdom of instituting reform rapidly and comprehensively, taking decisive action along several fronts simultaneously. Even so, the process of political and economic restructuring will still be painful. There is no guarantee that the economic situation will respond smoothly or quickly to new market forces. Nor, despite political reform, is there any assurance that reforming Communist regimes will enjoy the legitimacy they need to persuade their publics to accept economic sacrifice for a long period of time. It is very possible, therefore, that the process will bog down midway, as the growing costs of reform steadily erode its base of political support.

Possibility of Dramatic Breakdown

Before Tiananmen, it appeared that breakdowns in reform would likely occur in relatively quiet ways, such as they did in Hungary in the early 1970s. Inflation, inequality, and corruption might eventually compel a government to suspend economic reform and reimpose administrative controls over the economy. Unorthodox new ideas might lead to a reactivation of political education, and political dissent might spark the reassertion of political controls over society. But it seemed that this sequence of events would happen

Illustration by Robert Wiser

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gradually and with restraint. In fact, China's own tortuous experience with reform — its economic austerity programs of 1980–81 and 1985–86, its campaign against "spiritual pollution" in 1983–84, and its suppression of student demonstrations in 1986–87 — suggested that periods of retrogression would be relatively muted and short-lived.

Subsequent events in China showed that breakdowns in reform can also be dramatic. Indeed, what was unexpected about the Tiananmen Incident was not the severity of the dilemmas that reform had encountered, nor the degree of retrogression that these dilemmas provoked, but the scale of the demonstrations and the brutality with which they were suppressed. The Chinese experience suggests that accumulated grievances — first from years of political repression and economic stagnation, then from the unrealistic expectations generated by the inauguration of reform — can be much larger than outsiders forecast. Partial political relaxation, especially if the national leadership is obviously divided, can encourage the expression of those grievances in intense and explosive ways. The inability of public security forces to cope effectively with large-scale demonstrations can then require the use of inexperienced military units, possibly with devastating consequences.

As dramatic as the events in China were, their international implications were further magnified by television coverage. The presence of a large international press corps in major Communist countries means that demonstrations, particularly in the capital, will be the subject of immediate and extensive reportage. The revolution in telecommunications technology — the prevalence of small videocameras, the portability of videotape, and the availability of direct-dial international telephone and facsimile service — makes it extremely difficult for Communist leaders to completely cut off news accounts to the outside world. Demonstrations for further political and economic reform are thus likely to find sympathetic audiences overseas, and any suppression of protest by the authorities will be swiftly and graphically reported.

The impact of the Tiananmen Incident on American perceptions and policy was also exacerbated by the presence of tens of thousands of Chinese students and scholars in the United States, a large proportion of whom were passionately committed to economic and political reform. The most active and articulate of them quickly learned to play a prominent role in the American political process, writing op-ed essays for major newspapers, testifying before Congress, and appearing on television news programs and radio talk shows. To be sure, no other Communist country has as many nationals in the United States as does China. But the impact of retrogression may still be magnified by the visitors who are here, as well as by the large émigré and refugee communities who settled in America in earlier years.

In sum, the Chinese case suggests the possibility that breakdowns in Communist reform movements may be sudden and violent, in ways that magnify the impact both at home and abroad. Domestically, a dramatic collapse increases the possibility that the Communist regime, now fighting for its life, will respond with sustained retrogression rather than marginal adjustment. Internationally, it increases the pressure on the United States government to respond in ways that embody the public's frustration at seeing its expectations for peaceful and constructive change so brutally dashed.

Dilemmas for the United States

Much of the discussion of the reform in Communist states has focused on the opportunities it presents to the United States. How can the United States facilitate political and economic reform in Eastern Europe? How can Washington take advantage of the new possibilities for arms control agreements with the Soviet Union? How can the West encourage the remaining hard-line Communist states, such as North Korea and Cuba, to join the trend toward economic and political liberalization?

These questions remain important and deserve continued and careful attention. But the Tiananmen Incident also suggests the need to consider an additional, more sobering issue: How should the United States respond to breakdowns — particularly violent ones — in the troubled process of economic and political reform?

For major Communist powers, such as China and the Soviet Union, the United States must weigh its interest in promoting human rights against its interest in ending the Cold War. There is, of course, the possibility that a breakdown in reform could produce a hard-line regime that initiated a more confrontational policy toward the United States. But what if the new leadership still wished to maintain a conciliatory stance abroad, even as it pursued a retrogressive policy at home? With some exceptions, this has been the foreign policy of the Chinese government, which insists that it wants to maintain normal relations with the United States even as it represses domestic dissent. It could also be the foreign policy of a conservative leadership in the Soviet Union, preoccupied with maintaining control over restive minority republics and assertive urban intellectuals. In such a case, it might well be American policy that would be responsible for a return to international confrontation. As one Soviet intellectual recently asked incredulously, "Do you Americans really believe that Lithuanian independence is more important than maintaining a friendly relationship with the Soviet Union?"

Even if sanctions were deemed appropriate, what form should they take? The Chinese case suggests the wisdom of limiting relationships — especially symbolic ones — with hard-line leaderships in post-break-

down regimes. Restricting some kinds of contacts clearly signals American repugnance at the repression of dissent and the abandonment of political reform. But the Chinese experience also suggests that attenuating cultural, academic, and economic relationships is unwise. Indeed, it is through these channels that pressures for change and ideas about reform can enter a Communist country undergoing restructuring. That explains why few intellectuals and reformers inside China are currently in favor of further American sanctions. On the contrary, they warn that substantive sanctions could enable the hard-line leadership to appeal for support on nationalistic grounds, blame economic difficulties on foreign intervention, and provide an ideal pretext for reducing further cultural and economic exchanges with the United States.

Finally, in confronting a post-breakdown Communist leadership, how effective can American sanctions be? The Chinese experience indicates that they will have an impact only if they are multilateral in character, enjoying the support of a broad range of Western nations. Otherwise sanctions will simply illustrate the isolation of the United States and will divert economic relations to countries willing to carry on business as usual with regimes where reform has been sidetracked. But the Chinese case also warns that even multilateral sanctions may not have an immediate positive effect on a regime that is fighting for its own political survival. Formal sanctions, therefore, must be sustainable for long periods of time, in the absence of any renewed movement toward economic and political reform.

Perhaps the most effective sanctions are to be found not in formal government action, but in the natural response of the marketplace. As a country experiences instability, repression, and retreat from economic reform, it becomes a less attractive partner for foreign lending, foreign investment, and even foreign trade and tourism. The net impact of these private and institutional decisions can be more severe over the longer term than the consequences of official actions taken by government.

Prospects for Renewed Reform

Given the widespread conclusion that totalitarianism and central planning are ineffective and illegitimate systems, it is tempting to assume that breakdowns in reform are temporary phenomena that will ultimately give way to renewed liberalization. In China's case, for example, many analysts predict that the deaths of Deng Xiaoping and the other octogenarians now in power will be the occasion for the resurrection of reform, perhaps in a more thoroughgoing manner than appeared possible before Tiananmen. Once again, a closer look at the situation in China evokes greater caution.

It is indeed possible that reform will revive, after the political and economic costs of retrogression became more apparent and when new leaders emerge on the political stage. But the obstacles will remain substantial. Reform will still impose significant economic, political, and social costs on powerful sectors of society. The most effective strategies for undertaking reform will remain elusive and controversial. And the difficulties China's reform encountered in the late 1980s may have weakened the political base for further restructuring. For these reasons, a mixed economy coupled with a renewed authoritarian system may endure for a long time. And if reform does revive, it may prove no more successful the second time than it was the first.

In short, the Chinese case suggests the wisdom of instituting reform rapidly and comprehensively, taking decisive action along several fronts simultaneously. Even so, the process will be painful.

Even if reform does resume and prosper, the implications for the United States will still be mixed. It may be that successful reform in Communist systems will mark the end of the great ideological divide between capitalism and communism that characterized international politics throughout most of the 20th century. But to describe this outcome as the "end of history" is dangerously misleading. It may be more accurate to describe the implications as the "resumption of history," in which global geopolitics is once again characterized by a complex balance of power among many countries with competing claims for economic and strategic influence. A reforming China, Soviet Union, or Vietnam may no longer present an ideological or subversive threat to its neighbors, but it may continue to pose more conventional security challenges and may even provide an increasing degree of economic competition as well.

Thus, although the world is changing, it is not smart for us to engage in premature self-congratulation. Reform in Communist systems will be a difficult process, in which crises and breakdowns are highly likely. Periods of retrogression will present serious challenges to the United States and its allies. And, even if reform succeeds, the historical struggle for political influence and economic advantage among nations will not be completely abated. □

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Backgrounder

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AMERICA'S ROLE IN PROMOTING PACIFIC ECONOMIC COOPERATION

INTRODUCTION

Overshadowed by Western Europe's dramatic movement toward economic integration, the Pacific Rim quietly has been taking unprecedented steps that could lead to greater economic cooperation. Whether this will be achieved is, of course, still too early to say. So far, at least, the dynamic Pacific region nations have created a forum for discussing trade and economic matters. For the United States, this offers a chance to institutionalize its leadership in what has become the most important source of and market for American goods.

The forum was created last November in Canberra, Australia, at a cabinet-level meeting of representatives from Australia, Brunei, Canada, Indonesia, Japan, South Korea, Malaysia, New Zealand, the Philippines, Singapore, Thailand, and the U.S. There they agreed to establish the Asia-Pacific Economic Cooperation group, known as APEC.[1] They agreed to expand official, but informal, cooperation on economic and trade issues, with the goal of strengthening the multilateral trading system and enhancing regional economic growth.

1 The Pacific region, for the purposes of this paper, includes Northeast Asia, Southeast Asia, China, Australia and New Zealand, the South Pacific Islands, and North America. Indochina, Latin America, and the Soviet Union, while bordering the Pacific do not have sufficient economic links with the area to be included in efforts at regional cooperation at this time.

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.

A second cabinet-level APEC meeting is scheduled for mid-summer in Singapore. Last week officials of the U.S. Commerce, State, and Treasury departments and the Office of the U.S. Trade Representative met in Singapore with representatives of APEC's other countries to plan this summer's meeting and to discuss the establishment of small "working groups" to study economic and trade issues.

APEC could be a vehicle for reducing or eliminating foreign barriers to American exports and investment. APEC, for example, could negotiate common positions for its members in multilateral trade talks, as well as standardization of regulations, improved shipping facilities to accommodate increased imports, and eased customs procedures.

Supporting Informal Efforts. One problem is that, like so many other international organizations, APEC could mushroom into an expensive, ineffective bureaucracy more interested in expanding its own budget than in expanding the international economy. Thus, while the Bush Administration should support APEC's informal efforts to eliminate regional trade barriers, it should oppose creation of a permanent body until there is a clearer understanding of the potential costs and benefits.

If trade barriers can be reduced and economic growth encouraged by using existing resources, there is no need to establish a potentially costly bureaucratic organization. If, however, the establishment of a small permanent secretariat would increase significantly the efforts to eliminate impediments to U.S. trade and investment in the Pacific, the Bush Administration should support such a move.

Washington also should ensure that it keeps the American business community informed of APEC actions that ease trade restrictions and that APEC consult private individuals and companies to determine trade and investment barriers that need to be eliminated. It is the international business community — those who confront trade barriers daily — and not government bureaucrats, who are most knowledgeable about trade restrictions.

Coordinating Information. APEC will be most effective if it coordinates information gathered by existing government and private institutions rather than duplicating research, data collection, and analysis of economic conditions and policies. Where existing data are insufficient, the Bush Administration should support the creation of APEC "working groups" to study specific issue areas.

The U.S. plays such an important security and economic role in the Asia-Pacific region, and many countries depend so heavily on exports to the U.S., that Washington must play an important role in official efforts at economic cooperation. To fulfill this role, and make APEC an effective instrument in expanding trade and promoting economic growth, the Bush Administration should:

♦ ♦ Push for reductions in barriers to trade and investment in the Pacific region within the informal APEC framework;

♦ ♦ Urge that APEC use existing data collection and research when possible, including that by private institutions and businesses;

♦ ♦ Use the opportunities for trade and investment promotion available under the informal APEC structure before recommending the creation of an official body;

♦ ♦ Oppose the full membership in APEC for command-economy countries until they reform their economies extensively and guarantee legal protection for the private sector;

♦ ♦ Inform the West European nations of the APEC discussions, assuring them that APEC will not become a protectionist economic bloc that will keep out European investment and exports;

♦ ♦ Warn that attempts by the European Community to become a protectionist trading bloc will be watched closely by all APEC members; and

♦ ♦ Continue to explore other bilateral and regional efforts to reduce barriers to trade and investment, including establishing Free Trade Areas.

NEW MOMENTUM FOR COOPERATION

Though the idea of an Pacific cooperation has been discussed openly since the 1960s[2], until last year there had been little official government interest. Then, in a January 31, 1989, speech to South Korean businessmen in Seoul, Australian Prime Minister Bob Hawke announced that he would ask other Pacific nations for their ideas on how best to further official economic cooperation. He subsequently dispatched high-level delegations to Japan, South Korea, and Southeast Asia, and after receiving cautious support for the idea, he offered to host a ministerial meeting in Canberra.

There, on November 6 and 7, some two dozen foreign and economic ministers and 300 other participants established a consultative forum. The ministers' joint statement proclaimed that "the further opening of multilateral trading system was of substantial and common interest." They "reaffirmed their commitment to open markets and expand trade" through global trade talks and promised that there would be no attempt to make APEC into a protectionist economic bloc.[3]

Continued Discussions. The conference was rated a success by its participants, who agreed on future meetings to discuss "work programs" and to craft common positions on the multilateral trade negotiations underway in

2 For a background discussion of efforts at regional cooperation in the Pacific, see Thomas J. Timmons, Asian Studies Center *Backgrounder* No. 62, "The Pacific Community: Evolution of an Idea," May 25, 1987.

3 "Ministerial Level Meeting Joint Statement," p. 1, as found in "APEC," *Australia Background*, Australian Overseas Information Service, 1989.

what is known as the Uruguay Round of the General Agreement on Tariffs and Trade, or GATT. The ministers agreed to continued informal discussion at ministerial meetings in Singapore this year, and in Seoul next year.

This official interest in economic cooperation has been in large part spurred by developments outside the region. These include: the precarious nature of the GATT round as it enters its final year, progress by the European Community (EC)[4] toward economic integration, and the U.S.-Canada Free Trade Area, the latter two of which have raised fears of growing regional trading blocs.

Fears of "Fortress Europe." While the U.S.-Canada agreement is of some concern to Asian countries, it is dwarfed by Asian worries about a "Fortress Europe" raising barriers to imports. At ministerial meetings between the EC and the Association of Southeast Asian Nations (ASEAN)[5] in Malaysia last year, European officials attempted to allay these fears. The ASEAN delegates were unconvinced. Stated Malaysian Minister of Trade and Industry Rafidah Aziz: "...the concerns and fears of fortress Europe aren't without foundation and won't be dispelled by mere assurances."[6] As a result, many countries of the Pacific have concluded that if they show a united front in negotiations over market access in Europe, the EC will be forced to moderate protectionist tendencies.

Since the Pacific region's prosperity has been in large part due to an open trading system, there is a remarkable degree of agreement among APEC countries that GATT's current Uruguay Round must be supported strongly. Many APEC countries believe that, if a common positions could be reached among themselves prior to the GATT negotiations, the chances for a successful conclusion of the round would be increased. Two APEC trade minister meetings planned for this year are an effort to achieve that goal.

CANBERRA AND TOKYO – LEADING THE EFFORT

One factor that has inhibited economic cooperation, especially among members of ASEAN, has been the conflict between their desire to ensure Japanese support of Pacific cooperation efforts and their fear of economic domination by Tokyo. Many Asian countries still have painful memories of Japan's 1942 militarily-imposed, so-called Greater East-Asia Co-Prosperity Sphere, through which Tokyo sought to guarantee its access to the region's raw materials and to dominate the region economically. Thus, if Tokyo were seen as supporting economic cooperation too actively, ASEAN members be-

4 Commonly known as the Common Market, the EC includes Belgium, Britain, Denmark, France, West Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain.

5 Formed in 1967, ASEAN seeks to promote economic and political cooperation among the nations of Brunei, Indonesia, Malaysia, the Philippines, Singapore, and Thailand.

6 *Wall Street Journal*, July 12, 1989, p. A14.

came worried. But if Tokyo expressed little interest, ASEAN members argued that an economic organization that excludes Japan would be of little use.

A compromise of sorts emerged in the early 1980s; Japanese participation in economic cooperation efforts was combined with Australian political leadership. This combination has allowed Japan to play an active role, without worrying ASEAN as much as if Tokyo had acted alone. This also gives Australia the opportunity to increase its profile in Asia, after years of looking primarily toward Europe and the British Commonwealth.

Australian Prime Minister Hawke's January 1989 speech launching the APEC idea triggered a minor flap when he made no mention of involving the U.S. Nor did he mention Canada, the People's Republic of China, Hong Kong, or the Republic of China on Taiwan. Tokyo, Seoul, and ASEAN subsequently pressed for including the U.S. and Canada in the forum. Among other things, this would lessen the potential for Japanese domination of a Pacific organization.[7]

Question of China. Australia promptly agreed to expanded participation, sending an envoy to Canada, China, Hong Kong, and the U.S. to assess their interest in Pacific cooperation. Australian Minister for Foreign Affairs and Trade Gareth Evans also supported Taipei's participation, but stated before the Twelfth Australia-ASEAN Forum on May 15, 1989: "Whether a formula can be found, which is acceptable to all participants, to bring Taiwan in remains to be seen."[8] The issue of Chinese participation became moot after the massacre of Chinese demonstrators in Tiananmen Square. Beijing no longer could be invited and there was little support for including Hong Kong and Taiwan without the Mainland.

While Prime Minister Hawke was laying the groundwork for his initiative, Japan's Ministry of International Trade and Industry (MITI) was undertaking similar efforts. In a report released last June, MITI advocated making "the Pacific Ocean...a 'huge ocean of free trade' to the entire world." The report called for an economic ministerial conference "as soon as possible" and urged that actions "promoting substantive policy cooperation...should be in concert with existing associations...."[9] Many of the Japanese proposals ended up in the Hawke initiative.

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7 Japan's GNP represents some 68 percent of all of the Pacific region's GNP. With the U.S. and Canada in the group, the percentage drops to 29.

8 "Australian Prime Minister's Regional Economic Cooperation Initiative," *Australian Overseas Information Service*, 1989, p. 10.

9 See summary, *Report of the Council for the Promotion of Asian-Pacific Cooperation – Toward an Era of Development through Outward-looking Cooperation*, Ministry of International Trade and Industry, Tokyo, June 1989.

WASHINGTON'S RESPONSE TO THE HAWKE INITIATIVE

After it was clear that Hawke was not excluding America, Washington responded positively to his initiative. On June 26, 1989, Secretary of State James A. Baker told the Asia Society in New York City:

> Our involvement in the creation of this new institution will signal our full and ongoing engagement in the region. And by furthering the development of market economies within the international system, we strengthen the collective force of those that share our principles.[10]

Baker emphasized that American support depended upon the "Pacific institution" expanding trade and investment and being based on free-market economic ideas and respect for the private sector.

The U.S. Congress also has shown growing interest in Pacific economic cooperation, primarily as a counterweight to the European Community. In 1988 Senator Bill Bradley, the New Jersey Democrat, called for the establishment of a forum of eight Pacific nations to coordinate efforts on GATT negotiations, exchange rates, and Third World debt. Senator Alan Cranston and Representative Mel Levine, both California Democrats, introduced legislation urging the establishment of a Pacific Basin forum to discuss trade, economic, diplomatic, and security confidence-building.[11] Last September 21, Cranston chaired a hearing on the subject in which there was broad agreement among Administration officials, U.S. legislators, and representatives from private organization on the value of economic cooperation.

ASEAN POST-MINISTERIAL MEETING

Australia's proposal received a boost during ASEAN's Post-Ministerial conference held in Brunei on July 6 to 8, immediately following the ASEAN Foreign Ministers meeting.[12] ASEAN agreed to attend an exploratory conference in Australia on the subject of Pacific Cooperation, but stressed that its participation in no way indicated commitment to the idea.

Alarm in Europe. Immediately following the ASEAN announcement, Australia's Evans stated that his country would host such a meeting in early November and would invite the nations of ASEAN, Canada, Japan, New

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10 Secretary of State James A. Baker III, *A New Pacific Partnership: Framework for the Future*, Current Policy No. 1185, U.S. Department of State, Washington, D.C., p. 2.

11 Dick Nanto, *Pacific Rim Economic Cooperation*, Congressional Research Service, Washington D.C., 1989, p. 24.

12 Also known as the 6 + 5 + 1 dialogue, the Post-Ministerial meetings allow the six ASEAN foreign ministers to meet with their counterparts from Australia, Canada, Japan, New Zealand, and the U.S. The European Community also takes part in the discussions as an observer, and in 1989, for the first time, the South Korea was included as a "sectoral" dialogue partner.

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Zealand, South Korea, and the U.S. This alarmed the European Community, which was an observer at the Brunei meetings. Said EC Commissioner Juan Abel Matutes: "We cannot accept a forum of this kind, in which 50 percent of our external trade would be discussed [but] in which the community would not participate."[13] When the EC asked Evans for a role in the group, he refused, emphasizing that this was to be a group for Pacific countries only.

CANBERRA MINISTERIAL MEETING

By the time foreign and economic ministers of the twelve participating Pacific countries gathered last November in Canberra, there was a quiet consensus that official efforts for economic cooperation were worthwhile provided that they remained informal for the near future. As a strong signal of its support, the Bush Administration dispatched a delegation headed by Secretary of State Baker, Secretary of Commerce Robert A. Mosbacher, and U.S. Trade Representative Carla A. Hills. The presence of these three powerhouses in Canberra was viewed by some as a warning to the Europeans that they should not erect protectionist barriers to trade following Western Europe's economic integration in 1992. Said one Australian official: "Baker wants to send a signal to the Europeans that the United States has this region locked up."[14]

At the Canberra meeting's conclusion, a Joint Statement expressed satisfaction with the discussions and, although agreeing that creating a formal structure was premature, set an agenda for future meetings. Then the statement listed four broad areas for APEC's "work programs":

1) **Economic Studies:** including review and analysis of the economic outlook for the region and improvement of regional economic and trade data;

2) **Trade Liberalization:** including ministerial consultations in September and December to coordinate negotiating positions in the GATT and official discussions to streamline customs practices and business visa requirements;

3) **Investment, technology transfer and human resource development:** including information exchange programs to identify regional opportunities for trade and investment, a data base on commercial opportunities, and coordination of trade promotion events; and

4) **Sectoral Cooperation:** including an initial focus on improved cooperation in tourism, energy, traded promotion, the environment and infrastructure development.[15]

U.S. officials focused on point Number 4 in last week's meetings in Singapore. The U.S. proposes establishing small groups of officials and other ex-

13 *Far Eastern Economic Review*, July 20, 1989, p. 10.
14 "Pacific Rim Nations Tentative On Talks Over Trade Group," *Washington Post*, November 7, 1989, p. D3.
15 These points, as well as a summary of the proceedings can be found in "APEC," *Australia Background*, Australian Overseas Information Service, 1989.

perts to recommend actions to promote tourism, coordinate national responses to changing telecommunications technologies, expand transportation services, and exchange information on energy trends. If successful, these expert groups would expand greatly the information available to U.S. government officials and businessmen and could lead to significant reductions in non-tariff barriers to U.S. exports.

Preventing Hong Kong and Taipei. Although Australia wanted originally to include the People's Republic of China in APEC, the U.S. argued that since China is not a market economy, it does not belong in a body designed to ease government interference in the private sector. However, because of the political power of Beijing, its exclusion unfairly prevents the participation of the free-market economic powerhouses of Hong Kong and Taipei.

In his summary statement of the conference, Australia's Evans said that the ministers agreed that future participation of Mainland China, Hong Kong, and Taiwan, as well as the Pacific Islands, would be desirable. Washington offered a potential solution, by offering Hong Kong full APEC membership, Beijing official observer status, and Taipei unofficial observer status. This formula could gain increased support at this year's meetings as a way to allow future participation of all three Chinese territories.

CHANGING DYNAMICS

APEC's rapid progress in the past year contrasts starkly to the reluctance of governments in the 1980s to promote Pacific economic cooperation. Though that decade began with a flurry of activity, including the release of a report by Japan's Pacific Basin Cooperation Study Group and high-level conferences in Bali, Indonesia, and in Canberra, by the end of 1980, optimism had faded. Official government participation in Pacific cooperation effectively was precluded by ASEAN's unwillingness to attend future meetings. Private efforts at cooperation received a boost, with the formation in September 1980 of the Pacific Economic Cooperation Conference (PECC). Made up of representatives from government, business, and academia, the PECC seeks to examine issues influencing economic growth and improve regional economic cooperation.

For most of the past decade, the primary advocates of increased Pacific cooperation were academics and businessmen. In addition to PECC, they have been active in the Pacific Basin Economic Council (PBEC), founded in 1967. It seeks to strengthen economic and business contacts among its some 850 members, comprised of major business firms from Australia, Canada,

Japan, South Korea, New Zealand, Taiwan[16] and the U.S. Last year, representatives from Chile and Mexico were accepted as full members.

Parallel Agendas. PECC has held seven general meetings in the past decade, most recently in Auckland, New Zealand, last November. Attracting 364 participants, this session focused on PECC's relationship to APEC and on PECC task forces dealing with such specific economic sectors as fisheries, minerals and energy, and agricultural policy. PECC's Standing Committee agreed to "tailor products to parallel [APEC's] ministerial agendas, while maintaining its independence."[17] This January, the PECC formed a permanent Secretariat, based in Singapore.

This has sparked talk of APEC using the PECC as a private "think tank" to coordinate economic forecasts and other information-gathering tasks. Informal coordination of PECC and APEC activities already has begun. This will enable PECC to survive, while allowing APEC to avoid creating a research staff, with its resultant bureaucracy. With the recent establishment of a permanent PECC Secretariat, cooperation between the two organizations will be significantly enhanced.

THE ASEAN-U.S. INITIATIVE

While supporting the APEC process and exploiting the advantages of a regional forum, the Bush Administration must not ignore other efforts to reduce trade and investment barriers. Just prior to last week's APEC talks, a meeting in Singapore brought together representatives of the U.S. Trade Representative and the State Department with officials from Southeast Asia as part of the ASEAN-U.S. Initiative (AUI) process.

In a joint study released last March, Singapore's Institute of Southeast Asian Studies and the Honolulu-based East-West Center assessed current ASEAN-U.S. economic relations. It recommends that ASEAN and the U.S. negotiate a framework or "umbrella" agreement to establish the administrative guidelines for future accords on subsidies, intellectual property rights, investment, and double taxation. The study also suggests that an ASEAN-U.S. Free Trade Area would offer the greatest potential for increases in trade and investment. Within such an agreement, which could be drafted this year, the U.S. could negotiate a number of small-scale agreements to liberalize trade and investment regulations and increase U.S. business opportunities in the region.

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16 In general, the Republic of China on Taiwan is unable to join either official or private international bodies under that name, due to opposition from Beijing. Taiwan's representatives go by the following designations: in the PECC, Chinese Taipei; in the PBEC, Chinese Member Committee in Taipei, and in the Asian Development Bank, China, Taipei.

17 "PECC VII Conference," *PBEC BULLETIN*, November 22, 1989, pg 1.

HOW THE U.S. CAN HELP SPUR PACIFIC COOPERATION

The Bush Administration this year has an excellent opportunity to increase economic cooperation and reduce barriers to trade in the Pacific Rim. By combining efforts at bilateral, regional, and multilateral trade liberalization and economic cooperation, America can push for more open markets and increased trade ties. By working with its Pacific trading partners to reduce restrictions on regional trade flows and by crafting a common position with regard to the GATT negotiations, the U.S. could expand American exports and increase the American share of Pacific markets.

The U.S. must be sensitive to fears of economic domination among the smaller counties in APEC and work within the informal, consensus-based structure of APEC. This presents both difficulties and opportunities for U.S. negotiators. On the one hand, the absence of a stifling bureaucracy offers the opportunity for quick progress on reductions in barriers to trade. On the other hand, if the U.S. pushes too hard for a quick, comprehensive agreement, other APEC countries, particularly those in ASEAN, could pull back, afraid of being stampeded by the larger economic powers. In approaching the issue of APEC, the U.S. must:

1) **Strongly push for** the removal of barriers to trade and investment through the establishment of the "work programs" allowed by APEC. The initial U.S. proposals made in Singapore last week are an excellent start in this. The recognition that non-tariff barriers are just as damaging to trade as tariffs is important. Increasing the speed at which products are carried from the port of entry to their final markets is one example of a improvement that would benefit U.S. exports as much as any tariff reduction.

2) **Urge that APEC rely** on existing sources of information wherever possible, including private regional organizations and the business sector. Businessmen face trade barriers and restrictive regulations from both their home and host governments, and know which changes would boost trade the most. Private institutions are also valuable sources of data and analysis.

3) **Use all available avenues** for trade liberalization within the informal APEC structure before recommending the creation of an official body. With the assistance of the many private organizations promoting Pacific cooperation, there is no immediate need to establish an official APEC secretariat. Only if the informal structure proves incapable of easing trade restrictions should the Bush Administration back a permanent institution.

4) **Oppose the full membership** of any non-market country until that country begins extensive economic reforms and legally guarantees the private sector. Effective economic cooperation requires that all member countries accept similar principles for the role of the state in the economy.

5) **Inform its West European allies** of the progress of APEC discussions, assuring them that APEC will not become an economic bloc. The Bush Administration should state clearly that its commitment to free trade is stead-

fast, and that multilateral reductions of trade barriers remains a central goal in its trade policy.

6) **State that any attempt** to create a protectionist bloc within the European Community will trigger intense scrutiny by all APEC members. The EC should be warned that barriers directed at one Pacific country will affect all others and thus will be treated as a common concern by APEC.

7) **Continue to explore** other bilateral and regional efforts to reduce barriers to trade and investment, including participating in the ASEAN-U.S. Initiative and establishing bilateral Free Trade Areas. As each nation is at a different level of economic development, bilateral negotiations can be tailored to the specific circumstances much more effectively than regional or multilateral discussions. The Bush Administration should be receptive to the establishment Free Trade Areas, which is supported by Taipei and increasingly discussed in other Pacific Rim countries.

CONCLUSION

By pursuing a combination of multilateral, regional and bilateral agreements to ease trade restrictions, the U.S. has an excellent opportunity to increase its world-wide exports. This year, negotiations in the GATT will conclude in December; APEC ministers will meet twice to discuss GATT and again to promote Pacific cooperation; U.S. officials will begin a series of discussions on regional cooperation with ASEAN; and American bilateral discussions will continue with many countries, including the acceleration of tariff reductions with Canada.

Countering Protectionism. APEC is an important part of this overlapping series of negotiations. All are designed to open markets and reduce barriers to trade. By not emphasizing any one effort, the Bush Administration can increase the effectiveness of its strategy of trade liberalization, and assure the greatest benefit to American business.

APEC also serves as a strong warning to Western Europe that EC protectionist actions will have wide-ranging consequences. APEC is not an economic bloc, but could be used to form a common response to potential EC protectionism. A successful APEC process not only will strengthen international efforts at trade liberalization, but will place America in a better position to counter future protectionism.

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Executive summary

The problem

i. The objective of this report is to outline policies and issues of agricultural diversification that are likely to influence the growth and sustainability of the agricultural sector, using the experience of the rice growing countries in East Asia to provide empirical examples of how these issues could be addressed.

ii. In many countries, self-sufficiency in food grains has brought new challenges and opportunities to make agriculture more efficient and more flexible. The changing rice economies of Asia provide technical and economic lessons on how the diversification process should be structured to enhance and advance the role of the agricultural sector in national economic development.

iii. Rice is uniquely important in Asia. The labor intensity of its production, its high productivity, and its widespread cultivation throughout a country suggest that no other combination of farm crops can generate the historical growth linkages within the rural sector and to the urban sector.

With improved rice varieties and water management, farm households in areas of high population density have been able to grow rice for their own consumption and often have a surplus for sale.

iv. The rice-based rural economies of Asia began to experience new and unexpected problems in the mid-1980s as surpluses emerged forcing down rice prices in domestic and world markets. Sudden declines in incomes for rice farmers occurred in most Southeast Asian countries as governments did not have adequate budgetary resources to keep domestic rice prices above low prices in the world market. These governments sought to diversify their farmers out of rice, but such efforts were stymied by inflexible farming systems and a more general deterioration of agricultural commodity prices in world markets. Donor agencies, especially the World Bank, found their agricultural portfolios heavily invested in rice-specific irrigation systems with very low economic returns. Other projects in export-oriented tree crops also experienced unexpectedly low returns related to collapsed prices.

v. The commodity price declines in the mid-1980s were, in part, a result of the very successful agricultural production program adopted by countries in Asia. Though the impact of low prices was broadly similar across Asian countries in reducing commodity export earnings and creating distress for farmers primarily growing rice, the ability to respond varied. Moreover, some countries that were net importers of food and other commodities experienced favorable effects from the low prices. Others, like Thailand, that were already more flexible and diversified, were actually able to maintain and even expand agricultural exports while those with less flexibility, like the Philippines and Indonesia, experienced sharp declines. Across Southeast Asia and in parts of South Asia rural diversification has come to be viewed as a vehicle for alleviating the strains and distress caused to farmers, governments and donors by the collapse of world prices, especially

rice, under the pressure of large surpluses in the mid-1980s, and for advancing agricultural production systems beyond reaching food self sufficiency by increasing flexibility and productivity of agricultural resources.

vi. Design and implementation of new policies and investment strategies to foster agricultural diversification turned out to be a complicated undertaking. Two major trade-offs surfaced almost immediately as governments tried to respond. First, a concern for income distribution conflicted fairly directly with efficiency considerations, at least in the short run, and governments found it difficult to strike an appropriate balance between the two. Attempts to do both led to a second trade-off between incurring large budgetary costs by maintaining farm prices (and in some cases subsidies on inputs) and passing on the costs to consumers. The dilemma for these countries, especially the ASEAN-4 nations of Indonesia, Malaysia, the Philippines and Thailand, as well as some South Asian countries, is in reconciling their concerns to: (1) minimize the adjustment costs to the rural sector of coping with low rice prices; (2) keep budgetary costs under control; and (3) ensure that future patterns of resource allocation are not badly distorted by the policies and investments initiated to cope with short-run problems. Ultimately, the process of agricultural diversification must be consistent with longer-run patterns of structural transformation. Successful countries will find ways to use the diversification process to stimulate economic transformation within rural Asia by encouraging more efficient allocation of resources. The objectives of reducing rural poverty and improving income distribution can best be pursued when rural incomes are growing and employment is expanding. The task of this report is to find ways for the World Bank to help countries move along this path.

vii. Finding ways to cope with these short-run and long-run dimensions of agricultural diversification is not simple. There are sharp divergences in approaches. In Japan crop diversification was introduced in the 1960s under careful government direction. Thailand has in recent years adopted a free-wheeling market-oriented approach to diversification within agriculture. Taiwan, in contrast, adopted a market-oriented approach and introduced incentives for small rural enterprises to process agricultural goods for export. All these approaches have had their problems and successes, but a common lesson is that the diversification process must be market-led in the sense of pointing farmers and rural entrepreneurs towards activities with better market demand and higher potential for income. Another important policy aspect is the greater success attained by orienting production towards world markets rather than just local demand. Governments in Asian countries, especially the ASEAN-4 countries of Indonesia, Malaysia, the Philippines and Thailand have to maintain the productive capacity of the agricultural sector for the basic food staple to ensure a sufficient degree of food security when recurring cycles of shortages occur, as happened in the late 1980s. At the same time, their agricultural policies should strike the right balance of agricultural and investment priorities to effectively deal with the problem of creating urban and rural employment opportunities to absorb a still expanding rural workforce.

Major issues for Bank lending to agricultural diversification

viii. The challenge to agriculture in East Asia is to sustain rice farming while expanding into a more flexible, diverse agriculture. The objective of this process should be to keep the adjustment costs relatively small and yet diversify the agricultural economy away from its heavy reliance on rice and toward other items with more favorable income elasticities of demand—livestock products, fruits and vegetables, for example. Such demand-led diversification should be part of a broader process of developing an appropriate mix of agricultural policies and production technologies.

ix. Governments tend to allocate resources to develop commodity-specific programs and set production targets for the crops for which the country, judging from world market prices, might have a cost advantage. Target oriented diversification programs, however, run the risk of diversifying farmers into crops when their prices may fall (or even worse, the added output causes the price to fall), with farmers no better off than before. To avoid such a situation, it is necessary to think of diversification as a process of adjustment rather than the establishment of targets for cropping patterns and to shift resources at the margin from specific crop or irrigation investment to more general, and less crop-specific, rural and marketing infrastructure and institutions. Such efforts may also help close the gap that exists in most agricultural development strate-

gies in Asia—a neglect of the "intermediate" agricultural sector that is neither a basic food staple nor a traditional export crop.

x. The task for aid agencies, including the World Bank, will be to come up with suitable analytical skills and technical knowledge for the switch from commodity-based project lending to broader sectoral support. Carrying out this switch will require extensive preparatory work and feasibility analysis by Bank staff. The design and appraisal of such operations involve an entirely different set of skills and technical knowledge than are required for commodity-specific projects, and there is a need to emphasize the urgency of strengthening these skills inside the Bank or elsewhere with such a broad approach to development lending for the rural sector. Design of programs is often as critical as, if not more than, funding levels, although the two often go together. The methodology used for analysis should include the two potential benefits gained from diversification: increased flexibility of the agricultural system; and the possibility that price fluctuations would have less severe consequences for income distribution.

xi. The objective is to increase the flexibility of cropping systems so that a variety of activities can be undertaken in response to changing technology and market conditions with relatively low adjustment costs. The level at which such flexibility is created is crucial to the costs involved; creating flexibility at the individual farm level is more costly than creating flexibility in cropping patterns for the country as a whole. Regional specialization is possible within an overall pattern of national diversification, thus drawing on differences in agronomic potential and the economies of scale in marketing that are inherent in well-functioning commodity systems. Unfortunately, regional specialization cannot eliminate the vulnerability of farmers to price changes for the particular commodity they produce.

xii. National diversification through regional specialization is the efficient route to solving the aggregate problem of vulnerability to sharp changes in individual commodity demand and prices, but problems of rural poverty and income distribution remain. In marginal and upland areas of Asia, rice-based cropping systems have low returns. Pulling such land out of rice production would help reduce rice surpluses provided opportunities exist for these farmers to generate income from other crops. Shifting marginal areas out of rice into secondary food crops is seen as one solution. However, commodity-specific approaches are risky and, given the weak infrastructure and marketing base, may not achieve much for limited-resource farmers in rainfed areas. Alternative, flexible farming systems for upland farmers that feature production of more income-elastic goods like livestock and horticultural products are a means of diversifying their income sources.

For those without access to adequate land or on-farm employment, diversification out of agriculture altogether is needed. The rural nonfarm sector is increasingly becoming an important source of jobs for members of farm households. While this change is consistent with desired patterns of structural transformation, such shifts in labor allocation may engender numerous problems. In economies burdened with inefficient, inward-looking industrial sectors, job opportunities outside of agriculture are severely limited. If the rural economy is unable to absorb idle or displaced labor from agriculture, there will be an increased inflow of unskilled rural workers into low-wage urban informal sectors. Agricultural diversification is the main vehicle countries have to invest in order to increase capacity to absorb this labor. The process of diversification has good potential to increase the role of small- and medium-scale rural industry, marketing, construction and other labor-intensive services. Governments will need to give more attention to planning for expanded industrialization within rural areas, including policies required to create a favorable environment for private investors to move enterprises to rural communities.

xiii. Diversification as well as regional specializations are influenced by several technical factors. Large-scale irrigation systems were designed and constructed for production of rice; they are not geared towards crop diversification at the farm level. In irrigated areas, diversification from rice paddy to non-paddy crops (referred to as upland crops) is limited by the structure of existing irrigation facilities, growing season, soil types, drainage capabilities, and land preparation for rice. The prospects for diversification in the wet season are thus limited in most irrigated areas, particularly those with poor drainage, because the availability of water in the wet season is excessive for upland crops. On the other hand, it is possible to increase the flexibility of irrigated farming in the dry season. There are other inherent difficulties in switching between cultivation

of irrigated rice and upland crops, but farmers manage to do so when economic incentives are sufficient. In areas where there are suitable soils and sufficient water control, farmers can diversify production during the dry season. Malaysia, Sri Lanka, Indonesia and the Philippines have more dry season irrigation than do other countries in Asia.

xiv. Unlike farming in irrigated areas, rainfed farming has less control over water. So, farmers must carefully adjust the choice of crops and time of planting and harvesting to the weather. What crops can be grown depends critically on the amount and timing of rainfall. In this case, the diversification effort should be aimed at the farm level to reach the millions of small farmers cultivating marginal rice land. Farmers in these areas can grow a wide range of crops and livestock (poultry, dairy, and swine production).

xv. Income growth in Southeast Asia has caused rapid increases in demand for livestock products. A rapidly growing proportion of the population has emerged from subsistence level poverty since the mid-1960s. This demand for livestock products has the effect of multiplying the demand for grain to feed livestock. Livestock production in South and Southeast Asia has primarily meant poultry production.

xvi. However, the technical feasibility of livestock production in these areas needs careful analysis. The type of livestock, the organization and size of facilities in which to raise them, the development of supporting infrastructure and marketing systems, and comparison with likely import costs are issues that must be addressed before deciding that a particular investment in livestock is an efficient use of resources in a given region.

xvii. Regional specialization may provide the opportunity for efficient development of entire commodity systems, from input production and marketing to downstream processing, thus fostering both vertical and horizontal diversification with extensive backward and forward linkages between production, processing, and marketing. The government has a positive role in stimulating diversification and increasing regional competitiveness by making broad-based investment in regional research and extension, rural infrastructure, such as irrigation, roads and communication to facilitate the movement of goods and information to small-scale and widely dispersed farmers.

Policies towards diversification

Macroeconomic policies

xviii. At all three levels of concern—the farm level, the agricultural sector, and the macroeconomy—government policy acts to buffer or reinforce pressures and opportunities in world markets. Certain policy intervention may actually impede the diversification process; successful rice price stabilization programs seem to have that impact. Too much government intervention no doubt harms the whole development effort. A more market-oriented approach to agricultural development with greater reliance on the private sector, however, may not deal adequately with the deep-seated concern in all Asian countries for food security: the need to ensure adequate quantities of food and relatively stable prices for the primary food staple of the population. It is unrealistic to expect a government to adopt completely market-oriented policies that stimulate diversification if this conflicts with stability of food prices and objectives for food security. A government's trade and exchange rate policies and its price stabilization activities fundamentally affect the country's food security. Further studies are urgently needed in the design of effective policies for agricultural diversification that are consistent with price stabilization policies for basic food staples.

Input supplies for all crops

xix. A side effect of the heavy attention to rice intensification programs in most Asian countries has been the concomitant development of an input supply industry and infrastructure designed to reach small rice farmers with fertilizer, pesticides, seeds, credit, and machinery. Creating a modern and efficient input production and marketing system has not been as easy as developing the high-yielding seeds themselves or building the irrigation system that make them productive. Non-rice crops have little of this supporting infrastructure to deliver crucial inputs. Wherever inputs for rice production can be diverted to other crops such as corn or soybeans, few problems are encountered unless government agents try to force "rice specificity" of input use. Diversification away from rice to high-value crops such as fruits and vegetables requires more management for the distribution of inputs. Quality and timely

production are usually crucial to economic success with such high value crops.

xx. INSTITUTIONAL SUPPORT. An agenda for diversification requires government to take measures that would have an impact on various institutions and would include:

(a) Supporting research and extension to reduce cost of production. There should be no slackening in the effort to raise productivity in rice production. Lowering the cost of rice production can contribute significantly to economic growth, and lower costs might make rice a more traded commodity. Research and extension programs for food production should be strengthened and broadened to address complex patterns of farming systems.

Research should be expanded for upland crops especially at regional and local levels and for commodity research programs for both field crops and tree crops that appear to have a potential comparative or competitive advantage in regional or world markets. Research strategies should address quality and cost of production of agricultural commodities in order to increase their competitive advantages in domestic and foreign markets.

Research and development of feed technology in improving the productivity of livestock should be strengthened. National research capabilities should be consolidated to analyze and develop the structure of alternative crop and livestock systems.

Scope for cooperation with private-sector research efforts exists. These efforts can play a much larger role than in the past if governments adopt appropriate arrangements to protect patent rights and make possible the development of private marketing channels for proprietary information and products.

(b) Improving efficiency and upgrading existing irrigation and drainage systems. The feasibility of upgrading existing systems for cultivation of upland crops needs to be studied in view of the likely value of output, the adequacy of the marketing systems, and the potential for regional specialization. Betterment levies need to be linked to actual performance of the systems. An expanded program on water management and drainage is of high priority for enabling paddy farmers to diversify either by a shift out of rice or, more likely, multiple cropping with rice. Investment in modernizing irrigation systems with greater control of water delivery and drainage is essential for increasing production of high value crops, including fruits and vegetables.

(c) Reducing risks and costs of marketing. A fundamental principle of all successful diversification programs is that they are driven by market demand. There is no point in diversifying farmers into a crop for which market potential is limited. Government can take several steps to reduce risk and improve marketing facilities through improved roads and communication, rural buying stations, daily radio broadcasts, and construction of wholesale markets. Access by farmers, private traders and exporters to credit should be improved. Loans for rural cottage industry should also be encouraged, since this is likely to provide opportunities for off-farm employment. Improving quality standards and processing opportunities adds value to staple commodities, and vertical diversification in fruits and vegetables increases their market potential in domestic and world markets.

(d) Increasing the involvement of the private sector. This is especially essential in seed development and distribution, in the production and marketing of fertilizers and other agricultural chemicals for all crops. Attention needs to be paid to the legal and institutional barriers, such as licensing, land leasing, and financing to such ventures.

(e) Studying rural education and training strategies, especially vocational educational programs, to determine if they are adequate for the long-run structural adjustment required in agriculture. Appropiate educational programs may also be needed to prepare agricultural workers for jobs outside of agriculture.

xxi. This report outlines main issues and policies of agricultural diversification. The framework in which these issues are presented is based on the need to understand how success in agricultural development often creates the need for a major reorganization of resources, both within the agricultural sector and between agriculture and the rest of the economy. This process is most likely to occur when success is based on the introduction of new technology in the production of agricultural commodities.

xxii. The report purposely avoids a "pick-the-winner" approach to diversification of Asian agriculture. It argues that creation of a profitable environment for non-rice crops in Asia requires substantial technical research, innovative economic analysis and policy dialogue that focuses

on issues for which the Bank's extensive comparative experience offers insights and that remains sensitive to the objectives of government and the views and aspirations of the rural communities. The pervasive theme is the desirability of introducing greater flexibility into farming systems and of broadening the basis of the rural economy in general. A major conceptual problem for research is to determine what optimal flexibility means in different circumstances. In nearly all agricultural systems, flexibility has a cost. Balancing the need for specialization at the farm and regional levels with the right amount of systems flexibility is no easy task and will almost certainly involve a process of trial-and-error.

Operational recommendations for diversification

Recommended Strategies for the Bank

PROMOTE BROAD-BASED INVESTMENT. Lending for agriculture should be for broad-based sectoral investments and not for commodity-specific, production-oriented projects. Lending should integrate support for infrastructure, agro-industry, and manpower development, with institution building for agricultural extension, research, marketing and credit.

PROMOTE FLEXIBLE FARMING SYSTEMS. The focus of diversification should be on improving the responsiveness of farmers to changing market conditions and new technologies. Emphasis should be placed on providing farmers with a wider range of technological options and the ability to pursue a production pattern and off-farm employment that will maximize household income.

IMPROVE KNOWLEDGE OF AGRO-ECOLOGICAL RESOURCES. Development of agriculture should emphasize regional comparative advantages which are based on agronomic potential and suitability for profitable production and marketing. Lending for agriculture should include support for studies which improve the stock of knowledge about local agro-ecological resources (i.e. soil mappings, aerial surveys, hydrological surveys, climatological data, and past and present cropping practices).

USE APPROPRIATE ANALYTICAL FRAMEWORK TO EVALUATE DIVERSIFICATION. The economic analysis of diversification should include both the benefits and costs of increased flexibility of the agricultural system, and the enhanced ability of the agricultural system to mitigate effects of price fluctuations.

USE MULTIDISCIPLINARY APPROACH TO PROJECT DESIGN AND APPRAISAL. A balanced mix of skills is needed to plan strategies for agricultural diversification. There should be a multidisciplinary approach to project design and appraisal, which goes beyond economic policy analysis and includes technology assessment in production, processing and marketing. It is essential that project design incorporate advanced technological concepts which could increase farmers' options for production and management of agricultural input supply, marketing, storage and processing. Expertise is required in irrigation and water systems design and management, natural resource management, rural industry and rural infrastructure, and integrated farming systems.

Recommended Strategies for Borrowers

AVOID "PICK-THE-WINNER" PROJECT APPROACH. It is necessary to perceive diversification as a process of adjustment, not the selection of specific cropping patterns. Farmers should be provided with options which encourage them to grow crops for which they have comparative advantage based on agro-ecological and economic factors.

ADOPT PRICING POLICIES THAT ARE CROP NEUTRAL. Price stabilization policies should not be at the expense of secondary crops. Governments pursuing a policy of domestic price stabilization should minimize price distortions by maintaining appropriate relative prices between primary and secondary crops.

INCREASE CONTROL OF WATER DELIVERY AND DRAINAGE SYSTEMS. Appropriate investment should be made in irrigation systems in order to modernize water control and increase the flexibility of farming systems. Investment is required for upgrading existing irrigation systems and new approaches are required for designing future irrigation systems. The implementation of efficient water charge mechanisms are required to improve the management of water resources for flexible cropping systems.

EXPAND THE FOCUS OF SUPPORT SERVICES. The scope of research and extension, marketing, and credit should be expanded from being crop-specific and production-oriented. Support services should serve both primary and secondary crops and livestock, and be linked to production, proc-

essing and marketing. Extension workers, for example, should be trained to deliver a range of agro-technical messages for a variety of crops, and should also provide marketing and price information. Also, traders and processors should be provided assistance and information about off-farm economic activities.

EMPHASIZE LOWERING PRODUCTION COSTS AND INCREASING QUALITY OF OUTPUT. Research and extension strategies should concentrate on lowering unit costs of production and increased quality of outputs in order to be more competitive in domestic and foreign markets. Attention should be placed on minimizing agro-chemical requirements because of their negative environmental impacts, and on research strategies which are based on developing technology that could enhance local comparative advantage in production and marketing.

PROMOTE SUSTAINABLE FARMING PRACTICES. Investment in agriculture should be designed to support sustainable farming systems that reduce soil erosion by incorporating appropriate intercropping and agro-forestry. The investment strategy should integrate crop-livestock farming systems. Emphasis should be placed on improved feed grain production and feeding efficiency along with increased use of agricultural by-products and waste.

IMPROVE MARKETING FACILITIES. Governments should encourage investment in improving local marketing facilities. Rural buying stations and commodity exchanges can be improved by promoting construction of wholesale markets and by investing in improved roads, communications systems and storage.

IMPROVE MARKET INFORMATION SERVICES. Governments should design projects for the purpose of improving quality and availability of market information services for export crops. Radio broadcasts should give market information on traditional and nontraditional commodities. Governments should finance market research and information dissemination, especially for small-scale farmers, and also encourage establishment of growers' organizations. The identification of specific requirements for market niches in both domestic and foreign markets is also needed.

INCREASE ACCESS TO INTERNATIONAL MARKETS. Governments should try to increase access to restricted international markets and devise a strategy which improves its bargaining position on agricultural trade issues.

ESTABLISH STANDARDS FOR QUALITY CONTROL. Government should assist marketing agencies in establishing standards and grades for fruits and vegetables (fresh, stored and processed). The purpose should be to lower transaction costs and facilitate increased opportunities for domestic and foreign marketing and processing.

INCREASE EMPHASIS ON VERTICAL DIVERSIFICATION. Governments should support investment in value added generated through vertical diversification, by processing and/or storage for both traditional and nontraditional agricultural commodities. Investment in agricultural commodities should not end at the farmgate, but should include post-harvest handling and processing, and continue to the final consumer.

ENCOURAGE PRIVATE SECTOR INVOLVEMENT IN THE PRODUCTION AND PROCESSING OF HIGH VALUE CROPS AND LIVESTOCK. Governments should remove legal and institutional barriers that inhibit economic activity by the private sector. Attention should be placed on reducing public sector monopoly on marketing, licensing requirements for agricultural production and processing, attenuated property rights, and rationing of foreign exchange.

ENCOURAGE JOINT VENTURES AND CONTRACT FARMING. Governments should provide the right set of incentives and legal and institutional arrangements to attract foreign and domestic investors to participate in joint ventures and contract farming for the production of high value crops and livestock.

ADJUST LAND USE AND TENURE ARRANGEMENTS. Restrictions on land use and land holding size should be adjusted to encourage investments in land improvements and flexible farming systems. Land tenure arrangements should allow for secure land use rights and land markets for domestic and foreign investors.

INCREASE OFF-FARM EMPLOYMENT OPPORTUNITIES. Because of potential changes in farming patterns and in order to provide increased opportunities for off-farm employment, governments should devote more attention to promoting investment on small- and medium-scale industrialization in rural areas.

INCREASE INVESTMENT IN RURAL EDUCATION. Diversification of the agricultural sector will require a wider variety of technical skills. Vocational education programs in rural areas should be expanded to provide improved training for on-farm jobs and also for off-farm jobs in industrial and service sectors.

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NEWS INSTITUTE FOR INTERNATIONAL ECONOMICS

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STRICT EMBARGO: May 1, 1990, 10:00 a.m., E.D.T.

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Place: 11 Dupont Circle, N.W.--Eighth Floor

KOREA AND TAIWAN ACHIEVE SUBSTANTIAL EXTERNAL ADJUSTMENT

Washington, April 26---A study by the Institute for International Economics in June 1987 analyzed the steps that the East Asian newly industrializing countries (NICs) needed to take in order to adjust the excessive balance of payments surpluses that were emerging, especially in Korea and Taiwan. Bela Balassa and John Williamson have now revised their study, *Adjusting to Success: Balance of Payments Policy in the East Asian NICs,* in order to assess the results of the policies that have been adopted since 1986.

The original study recommended substantial real effective appreciations of the currencies of all four NICs: Hong Kong, Singapore, Korea, and Taiwan. Balassa and Williamson also called for major trade liberalization in Korea and Taiwan. They emphasized that these expenditure-switching policies needed to be reinforced by measures to secure a rapid expansion in domestic demand so that payments adjustment would not jeopardize continued growth.

In the event, Korea and Taiwan greatly liberalized quantitative import restrictions and lowered tariffs, although they still need to complete the process. Both also executed sharp currency appreciations. Domestic demand grew vigorously in both countries. These policies have led to notable reductions in the trade and current account surpluses in both Korea and Taiwan, although the Taiwanese surplus remains high. In view of this successful adjustment, the authors welcome the recent but belated withdrawal of the US Treasury's charge that Korea and Taiwan were "manipulating their currencies" (as defined in the Omnibus Trade Act).

The exchange rate of the won against the dollar has depreciated about 6 percent since its peak almost a year ago. However, this occurred in the context of an appreciating dollar, so that Korea's effective exchange rate has remained largely unchanged. Balassa and Williamson do not see a clear need for any further change in the exchange rate of the won at this time, but they recommend that Korea make its exchange rate policy more transparent by publishing the composition of the basket to which the won is pegged. Korea also needs to bring wage inflation under control.

Since the decline in Taiwan's current account surplus has slowed down in the past year and threatens to come to a standstill, the authors recommend a further real appreciation of around 8-10 percent for the NT dollar. Now that the NT dollar is floating, this calls for announcement of a target zone, to be achieved by intervention policies backed up by interest rate changes. The authors also argue that Taiwan should persist

with its policy of import liberalization, and encourage the growth of domestic demand through financial deregulation and public investment.

Balassa and Williamson accepted in their earlier analysis that there was a case for less rapid appreciation in Singapore than elsewhere, to help Singapore recover from its recession of the mid-1980s. But the time for such delay is past. Singapore needs to reverse its recent depreciation and to achieve the sort of real appreciation previously recommended, accompanied by measures to reduce forced saving so as to expand domestic demand.

Despite the growing surplus on goods and nonfactor services in Hong Kong, now is not an opportune time to appreciate the Hong Kong dollar in view of the recession that may result from recent events in China. Balassa and Williamson argue that the Hong Kong authorities would nonetheless be well advised to shift to a basket peg in order to reduce the future shocks that are otherwise likely to buffet the Hong Kong economy.

About the Authors

Bela Balassa, Visiting Fellow at the Institute during 1985-90, is Professor of Political Economy at The Johns Hopkins University and Consultant to the World Bank. At various times, he has been a consultant to the Organization for Economic Cooperation and Development, to United Nations organizations, and to the governments of a number of developing countries. He is the author of 19 books, including *New Directions in the World Economy* (1989), *Comparative Advantage, Trade Policy, and Economic Development* (1989), *Japan in the World Economy* (1988), and *Changing Trade Patterns in Manufactured Goods* (1988).

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 *Latin American Adjustment: How Much Has Happened?* (1990), *Voluntary Approaches to Debt Relief* (1989), *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).

About the Institute

The Institute for International Economics is a private, nonpartisan, nonprofit research institution for the study and discussion of international economic policy, directed by C. Fred Bergsten. It was created in 1981 to provide fresh analyses of major issues in this area and practical new approaches for dealing with them. The Institute receives its funding from a large number of private foundations and corporations.

ADJUSTING TO SUCCESS: BALANCE OF PAYMENTS POLICY IN THE EAST ASIAN NICs, Revised Edition
Policy Analyses in International Economics 17
by Bela Balassa and John Williamson
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China's Rural Industry
Structure, Development, and Reform

Edited by
William A. Byrd and Lin Qingsong

PUBLISHED FOR THE WORLD BANK
Oxford University Press

Preface

The emergence and recent rapid growth of rural nonagricultural enterprises (township, village, and private enterprises—TVPs) in China is a striking and in many ways unique phenomenon. Almost overnight, industrial activity has expanded tremendously and enterprises have proliferated. These changes have brought about large increases in rural personal incomes and significant shifts in the structure of the rural labor force.

China's TVP sector has several noteworthy features.

- *Dynamism.* Output has been doubling every three to four years, and hundreds of thousands of new firms have emerged each year on average.
- *Competitiveness.* The sector has gained a large share of the domestic market for many industrial goods and has penetrated some export markets as well.
- *Small scale.* Although enterprises of substantial size exist, especially in the more developed areas, most firms are small concerns with only a few score employees and about Y100,000 in assets.
- *Diversity.* There is great geographic variety in ownership, institutional arrangements, level of development, and degree of industrialization.
- *Outward orientation.* Most output, especially of manufactured goods, is sold outside the community or locality in which it is produced.
- *Community orientation.* Nearly all TVPs are tied in complex ways to their rural communities, and they would not consider relocating.
- *Factor immobility.* Like the enterprises themselves, factors of production and human talent are largely immobile across localities and communities.

These characteristics will be analyzed in detail in this volume.

Despite considerable scholarly work on China's rural industry in the 1970s and later (see chapter 2), little research of a comprehensive nature has been done. In particular, the rapid development of the TVP sector since 1984 has not been adequately documented and analyzed. In late 1985 the Institute of

Economics of the Chinese Academy of Social Sciences (CASS) and the World Bank agreed to undertake a collaborative study of China's industrial TVP sector that would involve extensive data collection, joint fieldwork, shared data processing and analysis, international comparative research, and sponsorship of an international conference. This research followed earlier collaborative work on Chinese state-owned industrial enterprises (see Tidrick and Chen 1987).

The main objectives of the project were (a) to gain a better understanding of how China's industrial TVP sector actually functions, (b) to learn about the rural communal institutional and regulatory framework within which it operates, (c) to ascertain the reasons behind the rapid growth of the sector, particularly since 1984, (d) to identify and analyze the problems and obstacles faced by the TVP sector as it continues to evolve and develop, (e) to evaluate on an informed basis different institutional and policy options for the future, and (f) to shed light on the TVP sector from an international perspective. The main topics covered by the research included the performance of the TVP sector; the TVP ownership system; roles and motivations of rural community authorities; the market environment and business practices of TVPs; the allocation, circulation, and utilization of key factors of production; labor and wage systems; and regional variations in TVP development and rural industrialization. Details on project objectives and research methods are provided in chapter 2.

This volume contains the initial research output of the project. The papers were written by Chinese and World Bank researchers on the basis of an agreed set of topics and were presented at an international conference held in Beijing, November 4–7, 1987. All of the papers were revised and edited in light of conference discussions. In addition to the two introductory chapters there are ten chapters by Chinese authors and seven by World Bank staff and consultants. All of the former and all but one of the latter focus on various aspects of China's industrial TVP sector. Chapter 19 provides an international perspective by looking at firms elsewhere in the world that are similar in some ways to Chinese TVPs. Other fruits of the project have been published elsewhere or have been circulated internally within China and the World Bank. Given the abundant data collected as part of the project, it is hoped that more published papers and longer works will be forthcoming as the materials and data are analyzed in greater depth.

Through this collaborative research project the World Bank has gained a deeper understanding of China's industrial TVP sector. The Institute of Economics of CASS and other participating Chinese research institutions have benefited from organizing and conducting the first comprehensive, systematic research on China's TVP sector—a project that has applied a wide range of analytical techniques to a large, multifaceted, and relatively complete data set. An international perspective on TVPs has also been gained from analysis of existing literature and through field visits to other countries. Finally, this research has provided a basis for analyzing the policy issues that face the TVP sector and for evaluating different policy options. The project represents a further advance in collaboration between Chinese research institutions and international agencies, and we hope that it will lead to similar endeavors in the future.

This collaborative research project would not have been possible without the help and active involvement of many people and organizations. We would especially like to thank the leaders and government officials of Wuxi, Jieshou, Nanhai, and Shangrao counties and the many TVP managers and workers who gave interviews and filled out questionnaires during the field investigations. Their assistance was invaluable and was willingly provided despite the substantial time and effort required. The research team invariably received the warmest hospitality when visiting the four counties. In addition, the help of government officials and of TVP managers and workers in Yuanping County (Shanxi Province) and Taihe County (Anhui Province) during related fieldwork is gratefully acknowledged.

Officials of the TVP Bureau of the Ministry of Agriculture and the State Statistical Bureau also met with members of the research team and provided useful information on the national situation of the TVP sector.

On the Chinese side, CASS and its Institute of Economics covered the bulk of financial expenditures. On the World Bank side, a grant from the World Bank research budget and operational funds from the China Division were the primary sources of financial support. A grant from the Ford Foundation financed international fieldwork and related costs. The financial assistance of all these institutions was essential for the success of this project and is acknowledged with thanks.

Just as important as financing was the time of the members of the research team. In addition to CASS's Institute of Economics and the China Division of the World Bank, the Development Research Institute of China's State Council Rural Development Research Center, the China Economic System Reform Research Institute, and the Sociology Department of Beijing University contributed staff time.

The project was organized under the overall supervision of, on the Chinese side, Liu Guoguang, vice president, CASS, and Dong Fureng, director, Institute of Economics, CASS, and, on the World Bank side, first Fred Levy, senior economist, China Division, and subsequently Gene Tidrick, lead economist, China Department. The respective team leaders for the project were Lin Qingsong, deputy director, Institute of Economics, CASS, and William Byrd, economist, Country Operations Division, China Department, World Bank. Others with major responsibilities for managing the research included He Jiacheng, chief, Development Division, Institute of Economics; Luo Xiaopeng, chief, Macroeconomics Division, Development Research Institute, State Council Rural Development Research Center; and Alan Gelb, senior economist, Financial Policy Division, Country Economics Department, World Bank.

In addition to the contributors to this volume, the following researchers

participated in field investigations and other parts of the collaborative research project: Gu Xiulin, Hong Wei, Hou Xueshan, Li Hanlin, Shu Yan, Christine Wong, Yang Xiaodong, and Yang Xiaodong. Their help with research design, data gathering, and other aspects of the work was invaluable. Li Lanting, Li Xiaomei, Lu Xiaoheng, Ma Changshan, Edna Monaghan, Qu Ayang, Wang Shuwen, and Zhang Yi lent administrative and related support to the project, and their help is gratefully acknowledged. The translators of the conference papers were Zhang Ciyun and others from the China Translation Corporation; Zhang Xiaogang and others from the *China Daily*; Dai Rui, He Baoyu, Wang Lina, and Zhang Zhixian. In addition to several contributors to this volume, a number of scholars helped organize the international field visits and related background work for the project: Baburao Baviskar, David Ellerman, Saul Estrin, Derek Jones, Y. Y. Kueh, Nicholas Lardy, Lin Yifu, Virginie Perotin, and Janez Prasnikar. An international panel consisting of Baburao Baviskar, Ronald Dore, Benjamin King, Dwight Perkins, and Martin Weitzman participated in the international conference and contributed valuable comments. Chinese participants not involved with the project who attended the conference included Du Rensheng, Wang Guichen, Bao Youdi, Chen Xihu, Hua Jianchun, Ren Long, Zhang Yi, and Zhou Qiren; their participation and comments are also greatly appreciated.

Abbreviations and Terminology

Chinese terms, transliterated according to the Pinyin system, are in brackets.

Abbreviations

ABC Agricultural Bank of China [*nongye yinhang*]

CASS Chinese Academy of Social Sciences

GVAIO Gross value of agricultural and industrial output

GVAO Gross value of agricultural output

GVIO Gross value of industrial output

LMF Labor-managed firm (Yugoslavia)

LSE Local state enterprise [*difang guoying qiye*]

PRS Production responsibility system (in agriculture) [*baochandaohu* or *baogandaohu*]

RCC Rural credit cooperative [*xinyong hezuoshe*]

TEC Township economic commission [*xiang jingwei*]

TIC Township industrial corporation [*xiang gongye gongsi*]. The township government organ that is directly responsible for supervising township enterprises. It has different names in different parts of the country and is sometimes combined with the township economic commission. If the two are not combined, the township industrial corporation is subordinate to the township economic commission.

TVCE Township and village community enterprise [*xiangcun qiye*]. Excludes enterprises run by production teams [*shengchan duiban qiye*].

TVP Rural nonstate enterprise (township, village, and private enterprise) [*xiangzhen qiye*]. Includes production team enterprises.

Y Yuan (currency unit). Recent average official exchange rates have been 2.30 yuan to the U.S. dollar in 1984, 2.94 in 1985, 3.45 in 1986, 3.72 in 1987, and 3.72 in 1988. (International Monetary Fund, *International Financial Statistics*.)

The Promotion of Family Planning by Financial Payments: The Case of Bangledesh

The Population Council
Working Paper No. 13, 1990

John Cleland and W. Parker Mauldin

Abstract

The Government of Bangladesh and the World Bank commissioned a Compensations Payments Study, carried out in 1987, to assess the merits and demerits of payments for sterilizations to clients, medical personnel, and intermediaries who motivate and refer clients. The study conclusively shows that the decision of Bangladeshi men and women to undergo sterilization is a considered and voluntary act, taken in knowledge of the nature and implications of the procedure, and in knowledge of alternative methods of regulating fertility. There is a high degree of client satisfaction among those who have been sterilized, although among clients who had fewer than three children, 25 percent expressed regret that they had been sterilized. Money may be a contributing factor to the decision to become sterilized in a large majority of cases, but a dominant motive for only a very small minority. Payments to referrers have fostered a large number of unofficial, self-employed agents--particularly men who recruit vasectomy cases. These agents provide information about the procedures for being sterilized, particularly to the poor. They also concentrate on sterilizations to the exclusion of other methods, and are prone to minimize the disadvantages and exaggerate the attractions of sterilization.

Strategic Issues for Watershed Development in Asia

The World Bank Environment Department
Environment Working Paper No. 30

William B. Magrath and John B. Doolette

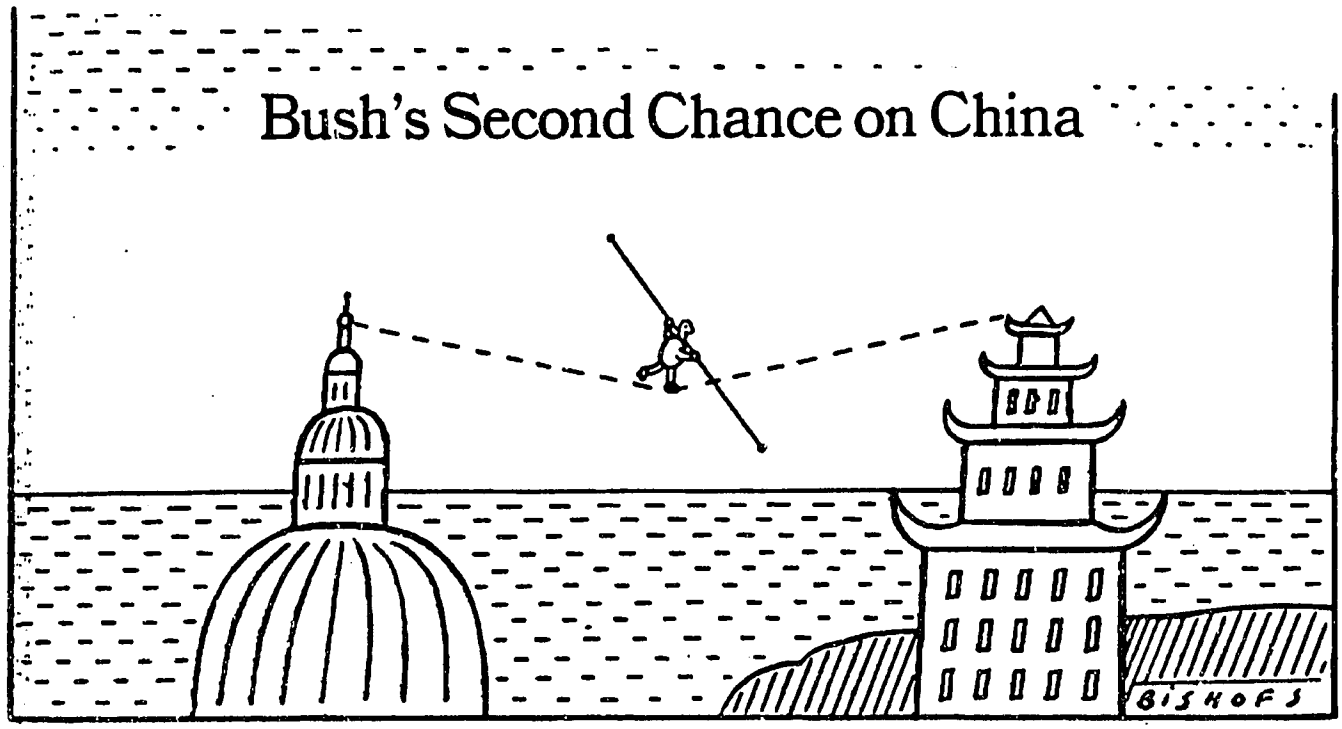
May 1990

ABSTRACT

This review of watershed development arose from the realization that a number of current and planned Bank supported projects in the Asia Region deal with the linked issues of upland productivity and environment and to a lesser extent are motivated by concern with downstream impacts such as flooding and sedimentation. The data reviewed make clear that there is no single watershed problems in the Asia Region. Rather there is a complex of issues related to increasing soil loss, rainfall runoff, land degradation, irregular stream flows and poverty that can best be understood in the framework of watersheds. Four problems stand out as being central, upland poverty, low and falling agricultural productivity, high rates of erosion and sedimentation of downstream infrastructure. The report develops the rationale for a watershed management approach by discussing the nature and significance of some of the interconnections between upland and lowland areas. Focussing on the promotion of environmentally sound on-site development the report examines constraints and opportunities for expanding output while reducing erosion. The report concludes proposing specific actions and approaches, centered on small farm development and common property management, that development agencies should pursue in their operations.

NEW YORK TIMES, May 9, 1990

Bush's Second Chance on China



By Winston Lord

June 3 marks the first anniversary of the massacre of innocents in the streets of Beijing. It is also the deadline for President Bush to decide whether to recommend continued most-favored-nation trade treatment for China.

This irony poses a dilemma — and offers a major opportunity — for the Administration. In one stroke, President Bush can close the breach between Capitol Hill and the White House on China policy, forge a common American front and promote Chinese human rights and U.S. national interests.

He should invite Congress to join him in crafting a joint statement for the first weekend in June. The essential components:

- An eloquent tribute to the Chinese who demonstrated and died for the aspirations America has supported elsewhere in the world.
- Extension of most-favored-nation trade status *for one year*, with the openly expressed purpose of supporting progressive forces in China, protecting concrete American interests and maintaining the framework for future American-Chinese relations. (This status entitles China to the standard treatment that the U.S. grants almost all other trading partners.)
- Explicit reaffirmation of such existing measures as the suspension of military ties, the freeze on liberalization of technology exports and the postponement of World Bank loans.
- Determination to move ahead on related issues, such as positive consideration of Taiwan's application to the General Agreement on Tariffs and Trade and enlarging future immigration opportunities for Hong Kong citizens.
- A substantial increase in Voice of America funding to overcome jamming of programs beamed to China.
- A meeting between President Bush and selected Chinese studying in America to exchange views on China and American policy.

There are solid grounds for revoking most-favored-nation status.

Both the preamble to the relevant statute and its legislative history include concerns for human rights.

The situation in China has greatly deteriorated this past year: executions, purges, imprisonment, surveillance, political indoctrination, the rollback of many economic reforms — all cloaked in the Big Lie.

The xenophobic regime has launched attacks on Western values and crude invective against the U.S. It muzzles foreign correspondents and jams the Voice of America.

Revoking most-favored-nation treatment, which would increase pressures on Beijing, would be the strongest signal of censure to date.

There is also the specific legislative criterion of free emigration. While many are still allowed to leave China, new restrictions have curtailed others, including students and scholars. Obviously, both dissidents in our embassy and tens of thousands in jail cannot move. Countless Chinese have no chance of getting exit papers or dare not even try.

Extend equal trade status for a year — conditionally.

In any case, the most potent argument for revocation is that extension of most-favored-nation status could be misconstrued by China's hardliners. In internal policy debates, they could argue that they can repress and reap commercial benefits, too.

Unfortunately, this view has been reinforced by Bush Administration actions: its unrequited conciliatory gestures; the double standard between China and support for democracy in Eastern Europe, Latin America and South Africa.

Beijing might conclude that there is no limit to our toleration of its abuses. So might Mikhail Gorbachev, as he contemplates his policies toward the Baltic states and his summit meeting with Mr. Bush on the eve of June 3.

For these reasons, simply extending most-favored-nation treatment would be a grave mistake. If the other steps outlined above are not undertaken, this trade status should be ended.

On balance, the arguments favor extension of most-favored-nation treatment — if imbedded in a larger package. Termination would trigger serious consequences.

First, it would hurt the wrong people in China, reducing their leverage in the struggle for its future.

The most severe impact would be on the sectors we wish to support — entrepreneurs, business people, Chinese in the coastal areas and open cities. They are the ones most dependent on foreign trade and investment and most committed to reform and contact with the outside world.

The regime, meanwhile, would use America as a handy scapegoat for China's floundering economy.

Second, termination would undermine Hong Kong. Seventy percent of China's $12 billion in exports to the U.S. passes through there. Millions working in Hong Kong and southern China would be affected. As Hong Kong residents look with trepidation toward 1997, when Britain turns Hong Kong over to China, this is no time to deal them additional economic and psychological blows.

Third, it would harm many Americans. Consumers would pay more for certain products, importers would need to look elsewhere, exporters would face retaliation by China. Business people in China and Hong Kong would lose markets and investments, perhaps permanently. Competitors in Japan, Europe, South Korea, Taiwan and elsewhere — where governments would not follow our lead — would profit, at America's expense.

Fourth, it would undercut our long-term objectives. While granting China new privileges would be wrong, we should be wary of dismantling frameworks like most-favored-nation treatment and the related overall trade agreement that were carefully constructed during the 1980's.

Once commercial and personal links with progressive forces are severed, repairing them would be difficult. We will need them in place when a more moderate regime allows us to resume full cooperation. That time is not far away.

President Bush has an opportunity to heal wounds on the single foreign policy issue where he has provoked heated debate and about which he may care most deeply. He can align himself solidly with the Chinese people for the first time and restore the bipartisan approach that marked our China policy for two decades through five Administrations. Congress, torn on the trade issue, would respond positively to a Bush initiative that made clear where this nation stood. Together, the President and Congress can send a powerful message to the transitional leaders in Beijing and to the Chinese people who herald a more hopeful future for their country. □

Winston Lord was Ambassador to China from 1985 to 1989.

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CHRISTIAN SCIENCE MONITOR, June 19, 1990

PACIFIC PERSPECTIVE

Extend the Thaw Toward Vietnam

It's too soon for normalization. But Washington can take steps to see if Hanoi wants to come around.

By FRANK MURKOWSKI

It has been 15 years since the fall of Saigon to Communist forces—long enough to start rethinking U.S. policy toward Vietnam.

Our cold-shoulder policy—diplomatic recognition coupled with an embargo on private- and public-sector economic dealings with the Socialist Republic of Vietnam—was born out of understandable American anger with Hanoi on several counts: Its disregard for the provisions of U.S.-Vietnamese diplomatic agreements that led to the withdrawal of American forces; a callous and cynical manipulation of America's anguish over its missing in action, and Hanoi's support first for a bloody Communist takeover in neighboring Cambodia, followed by a 1978 invasion and occupation.

In the last year, however, Hanoi has given indications that it has begun to change course. Most, if not all, Vietnamese forces have been withdrawn fromCambodia. Although the pace is still unacceptably slow, Hanoi has gradually become more cooperative on the painful issue of American prisoners of war and missing in action. Finally, there have been tentative and contradictory signals suggesting a possible curtailment of Vietnam's military relationship with the Soviet Union.

It is not yet appropriate for Washington to normalize relations with Vietnam. We should, however, consider whether a more positive approach to Vietnam might be more effective in promoting the changes that we want to see in Vietnam's foreign and domestic policies.

In particular, there are steps we could take regarding the economic aspects of our relationship with Vietnam that would benefit our own citizens while acknowledging that some progress has been made toward a more normal relationship between our two countries. As the Cold War fades, we can begin to put the Vietnam War behind us as well.

As a first step, I have joined with Sen. Alan Cranston (D-Calif.) in sponsoring legislation to compensate Americans who lost property in South Vietnam in 1975. Hundreds of U.S. citizens and businesses remained in that country, many at the urging of our government, long after it had ceased to be prudent. With the fall of Saigon, these people lost millions of dollars worth of property to the Communist regime. There has never been any compensation for this confiscated property. An agency of the Justice Department has adjudicated outstanding claims and has declared that 192 have merit. These claims have been on the books far too long. As a matter of fairness, they should be settled.

At the same time that the former Saigon government fell, Washington blocked South Vietnamese government assets in this country, mostly in the form of funds on deposit in U.S. banks. Those remain blocked to this day. They constitute more than enough accumulated funds to cover the adjudicated claims.

Obviously, the principal beneficiaries of the legislation would be the claimants, but American foreign policy would benefit as well. The legislation concludes some long overdue business from the Vietnam War. It signals Hanoi that Washington is losing patience with the dilatory pace by which other outstanding issues, notably MIAs and Cambodia, are being resolved. It is a reassertion of control over our own policy agenda.

The proposed legislation need not offend Vietnam. It contains a provision that, in effect, gives Hanoi credit for any vested funds in any future bilateral negotiations with the United States leading up to normalization—where all outstanding claims will be resolved. In addition, it includes a provision giving the President the authority to defer the vesting if, in his judgment, it should in any way threaten progress on humanitarian issues that are being discussed by our two countries.

As a second step I urge the Administration to review the prohibition on trade and investment in Vietnam by American firms. Americans are complaining, with increasing urgency, of their inability to compete with the Thai, Japanese, Singaporean, Taiwanese, French and others who are actively pursuing commercial ventures in Vietnam. I believe it is time to unshackle American enterprises and allow them to join the competition for opportunities in Vietnam. Such a step is entirely separate from normalization. Until full normalization, the barriers on government bilateral and multilateral assistance to Vietnam will remain. But if Washington relaxes the trade ban, it will then be up to Hanoi to respond—in Cambodia and on MIA/POWs—in a way that demonstrates a comparable desire to leave the past behind and move forward.

Frank Murkowski of Alaska is the ranking Republican on the East Asian and Pacific affairs subcommittee of the Senate Foreign Relations Committee and also a member of the Senate Select Committee on Intelligence.

EDITORIAL/OPINION

US Stalls Trade With Vietnam

Americans Miss Out On the Boom

By BARBARA STEWART

In a concerted effort to cash in on a good thing, a group of American businessmen based in Hong Kong are coming to Washington to persuade the Bush administration to lift its trade embargo against Vietnam. They believe that Washington's ban on trade and investment is leaving Americans in the dust as European, Japanese and Korean investors rush in to join what could be Southeast Asia's next boom economy.

Despite the continuing U.S. embargo, Vietnam is starting to show signs of economic recovery. The country's untapped natural resources, cheap labor supply and tourist potential attract ever-increasing amounts of foreign funds. And Hanoi's promises of tax abatements and favorable joint venture plans have piqued the interest of overseas investors. Meanwhile, American businessmen are left sitting on the sidelines of this money-making potential.

The United States is becoming increasingly isolated in its position on Vietnam. At a recent meeting of representatives from 25 countries, Thorvald Stoltenberg, the United Nations high commissioner for refugees, called for a halt to U.S.-led efforts to block foreign aid from reaching Vietnam.

The blockade, a direct cause of Vietnam's economic sorrows, has sent large numbers of able-bodied Vietnamese into exile. Some 55,000 of them linger in Hong Kong's squalid detention camps. That prompted British officials there to call for forced repatriation of the unfortunate refugees.

Only the United States protested the forced repatriation plan, contending that such a maneuver would violate human rights. All the while, the United States has continued to obstruct aid to the country whose extreme poverty caused the exodus in the first place.

To justify their quixotic behavior, State Department officials fall back on an obsolete policy of boycotting Vietnam in retaliation for its invasion of Cambodia more than a decade ago. Although the majority of Vietnamese troops have since left Cambodia, these Washington strategists have turned a blind eye to Hanoi's overtures for reconciliation. They prefer to continue the embargo, despite growing international opinion that the U.S. position on the Cambodian issue is no longer valid.

When examined in the cold light of Washington's current Asia policy, however, the bizarre logic of the continued aid-and-trade embargo is easily explained. The real motive for invoking this outdated embargo is to placate China at any cost.

President Bush's romance with China began with his stint as chief of the U.S. Liaison Office in Beijing back in 1974. It continues to this day, as evidenced by his veto last year of legislation prohibiting the deportation of Chinese students — a veto that was sustained only after hard lobbying by the president.

Basking in this American beneficence, Beijing is grateful for Washington's continued embargo against its historic enemy, Vietnam. Keeping that country's southern flank destabilized and destitute is a major objective of China's aged leaders. In the face of worldwide abhorrence of the fanatical Pol Pot brotherhood, the Chinese supply arms and ammunition to the Khmer Rouge, so long as they attack Vietnamese border towns and harry its western defenses. In collusion with the United States, China will continue to keep Vietnam besieged and impoverished.

But the cost of toadying to China is high and will get higher. American foreign policy in Asia needs to be re-examined if mollifying China, to the exclusion of all its enemies, has become the top priority.

While Washington holds Americans hostage to the political thinking of a decade ago, other nations are scrambling for a foothold in the Vietnamese market. The cheap labor available there makes good business sense. Those spring jackets appearing in the stores this month may be labeled "Made in France," but they probably were sewn in Danang.

Vietnam's 64 million people are becoming part of the new Asian prosperity in the world's fastest growing economic arena. As long as Beijing remains cemented to the stone-age politics of rigid Communism, China will not be a major center of growth. America's future trading partners will come from the economic power center of Southeast Asia.

While Washington refuses to recognize Vietnam, American businesses lose out. It is time to drop the barricade and let American business join the international rush to invest in this incipient economic dynamo.

Barbara Stewart is a journalist who lives in Hong Kong.

First, Settle Cambodia Conflict

By FREDERICK Z. BROWN

Fifteen years after the ignominious rooftop flight from the American Embassy in Saigon, the Vietnam War remains as traumatic as ever. And normalization with the Socialist Republic of Vietnam has re-emerged as a controversial topic.

The Bush administration is being pressured to end the embargo on trade relations with Vietnam, but it should wait. Lifting the embargo now would damage chances of achieving the most compelling U.S. objective in Indochina: ending the agony of the Cambodian conflict.

Some of the pressure for trade normalization comes from the private sector. The American Chamber of Commerce in Hong Kong says its members are eager to jump into the Vietnamese marketplace and join all the other Asian and European entrepreneurs jamming Saigon's hotels. American companies are prohibited from doing business there by the U.S. Trading With the Enemy Act, which was passed to restrict trade with North Vietnam in 1964 and extended to the South in April 1975.

Some congressmen have urged diplomatic recognition of Vietnam or partial relaxation of Washington's tough line. They argue that establishment of full relations, or at least an "interest section" in a third country embassy, would speed resolution of concerns about U.S. soldiers missing since the war and other humanitarian problems. Perhaps most acute is mounting criticism over the Bush administration's policy on Cambodia, which gives the impression of indirectly helping the vicious Khmer Rouge.

Why not normalize with Vietnam? Why not at least lift the trade embargo? Doing business with Vietnam will not correct the U.S. global trade imbalance, but surely American businessmen should be able to compete for a slice of that modest Vietnamese commercial pie — everyone else in Asia is doing it.

While superficially appealing, these arguments are fundamentally mistaken. Hanoi desperately wants relations with the United States and a lifting of the trade embargo for a variety of practical reasons. But withholding trade and commercial relations — in effect, hindering Vietnam's economic renovation — remains the strongest lever the United States has in securing genuine Vietnamese cooperation in the delicate diplomatic negotiations now in progress.

The primary objectives in these negotiations include ensuring power-sharing among the Cambodian factions and an opportunity for Cambodians to choose their own form of government.

After two years of diplomatic maneuvering involving dozens of countries, these questions finally are reaching the point of decision. It would be diplomatic folly for the United States, at this critical juncture, to reverse field and remove the pressure to negotiate a Cambodia settlement in good faith.

But responsibility for moving ahead does not rest solely with Hanoi. Normalization with Vietnam clearly is in the United States' long-term interests. The cause of dissatisfaction, in Congress and elsewhere, is Washington's decision "to let the situation in Cambodia run its course" — at the cost of thousands of Cambodian lives and a perpetuation of the Khmer Rouge. The administration flatly refuses to talk seriously with Hanoi about a deal that would combine a Cambodia settlement, formal diplomatic relations and an end to the embargo all in one.

The administration should not lay on additional conditions for Vietnam to meet beyond settling the Cambodian question. It would be an extraordinary blunder to delay diplomatic relations indefinitely. Once the United States, the Association of South East Asian Nations and the rest of the international community judge that a satisfactory Cambodia deal has been struck, Washington should move ahead.

Normalization is not some magical act achieved by the stroke of a pen. We have never had a normal relationship with Vietnam, either North or South. Normalization is a process, not a fixed destination. An intelligent bilateral relationship will take years to build.

Trade relations are a helpful but secondary consideration. American geopolitical interests in East Asia demand that we put the war behind us and build a new relationship with 65 million Vietnamese, many of whom, oddly enough, are favorably disposed toward the United States and would welcome an American presence in their country under peaceful conditions. It is time for Hanoi to make concessions on Cambodia, and for Washington to take Vietnam — the future Vietnam — more seriously.

Frederick Z. Brown is a senior associate at George Mason University and author of "Second Chance: The United States and Indochina in the 1990s."

Drugs, Torture — And Western Cash

By John Ralston Saul

TORONTO

How can a President who devotes much of his State of the Union Message to the war on drugs close his eyes when U.S. companies prop up the most important drug-linked regime in the world?

And why did President Bush bother sending 25,000 men to Panama to remove a minor drug dealer, Gen. Manuel Antonio Noriega, when in Myanmar (formerly Burma) the authorities get large annual payments from the drug warlords who supply America with half of its heroin?

The inconsistency doesn't stop there. The U.S. has used the Trading With the Enemy Act against Vietnam for the last 15 years, yet it has not invoked it against Myanmar. If the "war on drugs" rhetoric means something, then the regime in Yangon, its capital, is engaged in a major attack on the U.S.

Is it hypocrisy or confusion that drives Western foreign policy in Southeast Asia? Or is it willful ignorance? While the fate of six million Cambodians is agonized over, that of the 40 million Burmese next door attracts virtually no interest.

Little separates the methods of the Burmese authorities from those of the Khmer Rouge in Cambodia. Yet the U.S. and other Western governments have only cut off their little bits of aid to protest repeated acts of violence, torture and imprisonment by the Burmese Government. At the same time they are permitting the immediate replacement of that hard currency by Western corporations investing there for the first time.

The Burmese Government's deep involvement in drugs and repression is being demonstrated at this very moment. With the annual drug caravan season about to begin, Khun Sa, the leading warlord, is fighting a hill tribe called the Wa for control of a key opium trail near the Thai border. A short distance to the south, the Burmese Army has launched a major offensive to wipe out the Karen minority, who only want a less restrictive federal constitution for Myanmar.

The Government shows no intention of moving its troops north to attack the drug armies. This year's record opium harvest, reduced to the finest-quality heroin, will soon be on its way to America's cities.

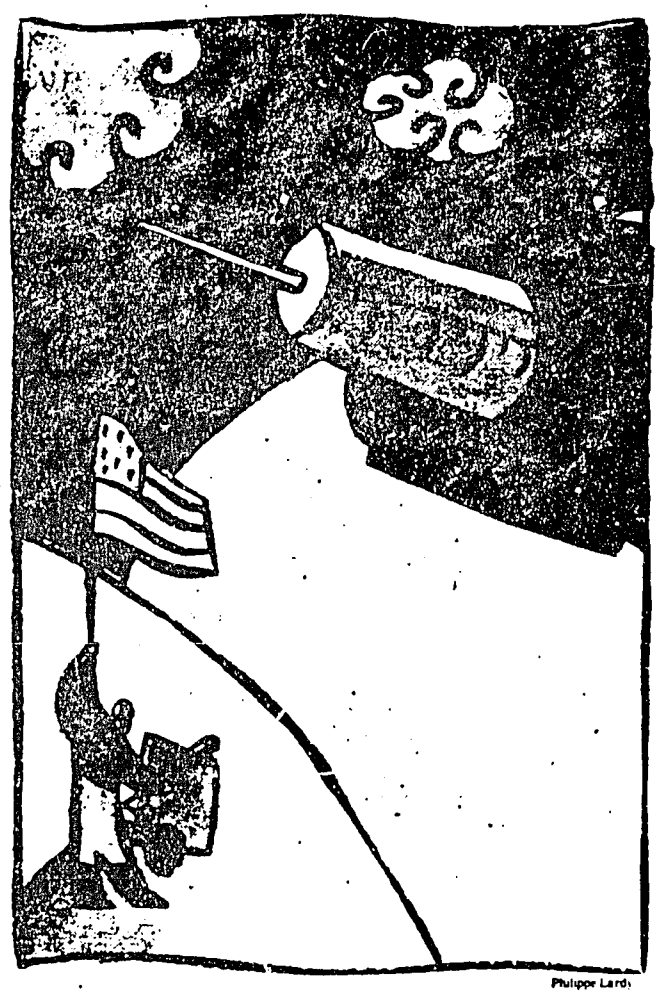
John Ralston Saul, a novelist, frequently writes about Southeast Asia.

Why are we underwriting Myanmar?

U Ne Win, Myanmar's ruler, and his generals have reduced the richest country in Southeast Asia to such an impoverished state that, with a few hundred million dollars of hard currency per year, the system can be run and enough will be left over to fill the generals' pockets. Until the repression of 1988, these funds were a combination of foreign aid and drug money. Today they consist of foreign investments and drug money.

Some people in Washington believe that opening up Myanmar to foreign investment represents an opportunity for political liberalization. They are wrong. Foreign investment is the single most important element keeping the generals in power with their repressive policies and support of the drug lords.

Have President Bush or his officials said anything to the executives of Coca-Cola about the commercial agreement they signed in Yangon? Or to Unocal and Amoco? Their recent oil exploration contracts have provided the Burmese Government with a veritable lifeline. Of course, they aren't alone.



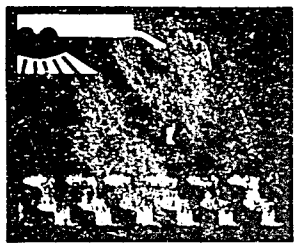
Philippe Lardy

British, Canadian, Japanese, Australian and South Korean oil companies are also involved. Nine corporations, all from countries that are both American allies and devoted to the war on drugs, are investing in Myanmar. The largest new investor is Thailand. Have Washington or its allies pressed Bangkok to restrain itself? How could they — when they are themselves guilty of the same greed?

Yangon has organized national "multiparty" elections for May 27, yet all the major opposition figures have been arrested, including Daw Aung San Suu Kyi, the leading voice for sensible change. The prisons are full, torture widespread and districts are being forcibly evacuated. There will be no foreign observers on Election Day.

The United Nations Human Rights Commission has begun an investigation of Myanmar. But the process is too slow. What is needed is drastic, immediate action. The regime is so weak that a block on foreign investment could, at the very least, force it to release the opposition leaders and permit foreign observers.

There is no hope for the Burmese or for relief from the heroin traffic unless the regime changes. Five weeks remain in which to make that change possible. □



OPINION

US Should Stay in Southeast Asia

By Perry L. Wood

> ■ *While Soviet reductions benefit US interests, they don't justify a major US reduction. A US presence in Southeast Asia preceded and is independent of the Soviet presence.*

ANNOUNCED cuts in the Soviet base at Cam Ranh Bay, Filipino disgruntlement over a continued US presence, and budgetary woes have created pressure in the US to reduce or eliminate its presence in Southeast Asia. This may appeal to US policymakers strapped for cash. But it would be a mistake. A withdrawal of US naval forces from Southeast Asia would seriously damage US interests.

Soviet cuts in Cam Ranh Bay are predictable and irrelevant to American interests in Southeast Asia. Vulnerable to superior US forces, Soviet forces in Cam Ranh Bay could only be deployed for a Sino-Soviet war without US involvement. In peacetime, Cam Ranh Bay offers support for Soviet deployments in the Indian Ocean. While the Soviets hope to keep the base as an intelligence facility and retain access to the port, Soviet rapprochement with China and cuts in their navy make it of minimal value. Rocky Soviet-Vietnamese relations make Soviet retention of the base unlikely. The Soviets, though, want to link withdrawal from Cam Ranh Bay to a US withdrawal.

While Soviet reductions benefit US interests, they don't justify a major US reduction. A US presence in Southeast Asia preceded and is independent of the Soviet presence. American interests in the region are growing; new challenges are appearing.

Most Southeast Asian nations are no longer the poor, backward lands Americans agonized over during the 1960s. In the '90s, Association of Southeast Asian Nations (ASEAN) will have some of the fastest growing economies in the world. American interests in the region are growing. In 1984, Secretary of State George Shultz observed that ASEAN was the US's fifth largest trading partner. By 1988, US investment in ASEAN totaled $9.8 billion. ASEAN's vitality has already led Indiana to establish a council to promote trade with ASEAN.

The growth of US interests in Southeast Asia has been accompanied by an increase in the region's strategic importance. US naval power in the Persian Gulf is dependent upon the Seventh Fleet in Southeast Asia and its right to travel from the Pacific to the Indian Ocean through the critical Indonesian straits of Malacca, Sunda, Lombok-Makassar, and Ombai-Wetar. Possible increased US dependency on Middle Eastern oil, coupled with expectations that the US will face security challenges from the third world (requiring rapid deployment of conventional US forces) suggest the value of the American navy in Southeast Asia will increase.

A reduction of US naval forces in Asia would reduce US capabilities and create a perception of withdrawal from the region. That could restrict US options in a crisis. The passage of a Zone of Peace, Freedom, and Neutrality (ZOPFAN) in Southeast Asia, or an Indonesian determination to restrict passage through international straits, would make US deployments between Pacific and Indian Oceans difficult. Yet such policies may offer the regional states their only form of self defense *sans* a strong Seventh Fleet.

Alternatively, an American withdrawal could lead to the rise of regional powers and a destabilizing naval arms race in the region. Historical antagonisms make the ASEAN nations most concerned about Japan – fears fed by US policies pressuring Japan to assume a larger defense role. But they are also concerned about the rapid growth of Chinese and Indian naval power.

India's interventions in the Maldives and Sri Lanka, as well as its confrontation with Nepal, attract attention. Naval experts think India, with two carriers, will soon have the most powerful third world fleet. Such a navy would seek to control the Southeast Asian straits. India now has a base on Nicobar Island, 80 miles off Indonesia – in a position to one day challenge China.

China reportedly considers India and Vietnam its likely future opponents. Since '85, China's South Sea fleet has been augmented with naval, marine, and air forces from other commands. Its bases have been improved. In March 1988, China fought a significant naval battle with Vietnam in the Spratly Islands. The Chinese claim all the South China Sea island groups – the Spratlys, Paracels, and Natunas. These claims conflict with the claims of Vietnam, Taiwan, Malaysia, the Philippines, and Indonesia. The expectation of rich offshore oil deposits in this region make these claims a source of tension.

Japanese, Indian, and Chinese naval modernizations have led the Southeast Asian nations to undertake their own naval buildups. Their growing naval power, combined with old antagonisms and competition for oil and resources, suggest a potentially volatile situation in Southeast Asian waters. Naval conflict in Southeast Asia would damage US economic interests, potentially lead to the blockage of Indonesian straits, and perhaps destabilize ASEAN. If an ASEAN nation were involved, the US might have to intervene due to the interlocking structure of alliances.

The US presence in Southeast Asia restrains regional conflicts and reduces the risk of war. US strategic capability is preserved. Soviet cuts have no effect on these concerns. Cuts to the Seventh Fleet based on perceived or actual Soviet cuts makes little sense.

■ *Perry L. Wood is a research fellow at the Hudson Institute in Indianapolis.*

EDITORIAL/OPINION

Don't Curb Taiwan's Market

By LEONARD UNGER

Taiwan's economic miracle may be in jeopardy. As part of recent efforts to reform the country's outdated financial system, some Taiwanese officials are attempting to limit the country's "curb" market.

The curb market, an informal financial system, which in recent years handled about US$4 billion in deposits, needs policing. But its demise would be an unfortunate setback to economic growth.

On the surface, all is well in the Taiwanese economy. It remains robust, having climbed about 8.5% annually during the 1980s. The country holds foreign exchange reserves of about US$75 billion, second only to Japan, and is one of the biggest overseas investors in Asia.

Per capita income in Taiwan has soared from $48 after World War II to about $7,300 today.

An annual savings rate of about 40%, one of the highest in the world, provides enormous investment reserves. Taiwan is the 131th largest trading country in the world with an annual trade surplus of about US$12 billion.

Given this island nation's development — along with similar expansion in Japan, South Korea, Hong Kong and Singapore and now in Thailand as well — many experts believe the Pacific Rim nations will dominate the global economy by the year 2000.

But the boom on Taiwan could founder on the shoals of an immature financial network characterized by an inadequate banking system and limited bond and stock markets.

Fortunately, government policymakers have recognized the shortcomings of Taiwan's formal financial institutions. A much-needed bank reform law enacted last July could open the door to the kind of innovation and risk-taking that has been painfully absent from the state-run banking industry.

The banks, and especially those run by government bureaucrats, have tended to snub homegrown innovators and made excessive investments overseas. Awash in cash because of the country's export boom, the official banks have acted like a miserly uncle who suffers pain whenever he parts with a cent.

But Taiwan can no longer prosper with a financial system designed for an early Taiwan, which had vest-pocket businesses producing unsophisticated goods with cheap and plentiful labor.

A labor shortage and growing competition from lower-wage Asian neighbors are eroding Taiwan's price advantage and mandate a switch from labor-intensive to capital-intensive industries. That requires an aggressive, innovative and open financial structure that will make effective use of incoming capital resources and also attract foreign capital. Taiwan also will have to boost domestic consumption against the day when export income declines.

Unfortunately, efforts to breathe life into the formal financial system have been accompanied by a parallel attempt by some officials to cripple the country's informal curb market.

Stepping into the gap left by official banks incapable of funding productive domestic enterprises, the curb market has provided nearly 50% of the money borrowed by Taiwan's private businesses in recent years.

Critics of the informal market say its largest investment firms threaten the economy because of their ability to manipulate Taiwan's stock market. But driving out the curb market firms and their financial resources is the wrong prescription.

A better way to tame the stock market's speculative frenzy is intelligent regulation, such as setting limits on price fluctuations and opening the market to foreign investment firms.

The curb market investment houses have also been accused of chicanery to secure high returns for their depositors. But a blanket death sentence for the informal market is no cure, the better answer is development of alternative investments and better returns for individual investors.

The best of the curb market firms differ little from the international brokerage houses in New York, Tokyo and London. They have become sophisticated players in international real estate, currency and equity markets.

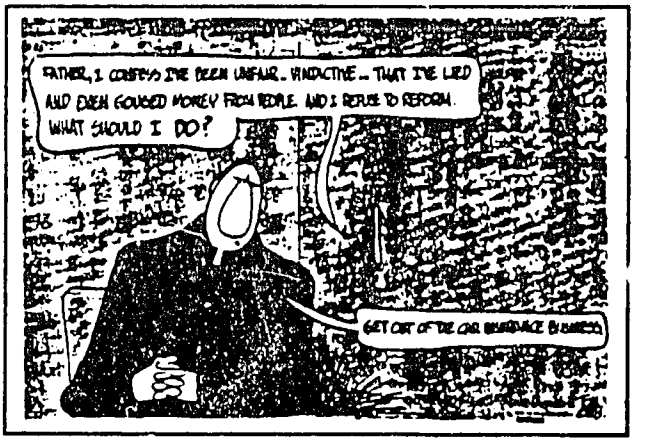
Their entrepreneurial spirit and investment expertise could give impetus to the modernization process if they were invited inside. Approval of banking licenses for qualified curb market firms could help shake the rust from the antiquated official banking system.

The government must also find an answer for foreign critics, particularly in Washington, who say Taiwan's export-driven economic growth came, at least in part, through unfair practices including theft of intellectual property and domestic markets that were closed to foreign competition. While useful actions have been taken by Taipei to correct these problems, there is more to be done.

Modernizing and opening Taiwan's financial system to international competition would be a major step in reducing the risk of retaliation by Washington and Europe.

In addressing these challenges, Taiwan must use all its weapons including the innovative skills and financial clout of its informal financial system.

Totally turning its back on the curb market would be an exercise [illegible]lly.



Leonard Unger, former U.S. ambassador to Taiwan, is a professor of international relations, most recently at the Johns Hopkins School of Advanced International Studies and The American University in Washington.

OPINION

Philippine Land Reform Stymied

By William C. Thiesenhusen

■ *Landlords, 20 percent of whom hold 80 percent of the country's agricultural land (the most inequitable distribution in Southeast Asia), have held the reform a virtual hostage.*

APPEARING crisp if a bit weary, President Corazon Aquino addressed specialists from 15 countries invited by the United Nations to share technical land-reform experiences. With diplomatic understatement, she asserted, "There is still substantial opposition to the present [land-reform] program from those whose property rights over huge landholdings will have to defer to the greater right of equity and social justice for the peasantry."

Landlords, 20 percent of whom hold 80 percent of the country's agricultural land (the most inequitable distribution in Southeast Asia), have held the reform a virtual hostage since the peaceful revolution that deposed Ferdinand Marcos in February 1986. While some have doubted Mrs. Aquino's sincerity – her family owns one of the richest farms in the country and has submitted it to only modest reform – she continues to insist that agrarian reform is the centerpiece of her antipoverty program.

Aquino is frequently accused of attempting too fervently to appease the country's right wing. While she successfully repelled the strongest-yet coup challenge to her presidency in December, she made little use of her renewed credibility to advance the country's social program. But she claims to have reduced poverty from 59 percent of the population at her inauguration to 46 percent now. While these gains are disputed, economic growth has increased on Aquino's watch (to 6 percent over the last three years), exports are up, and a mini-surge in foreign investment continues. This furthers the hope that the Philippines may be on the same trajectory as nearby Thailand and Malaysia, which also want to achieve "newly industrialized country" (NIC) status.

But the most celebrated NICs, South Korea and Taiwan – to say nothing of the region's mentor in these matters, Japan – all had thorough land reforms before beginning their heady pace of economic progress.

The Philippine right has resorted to imaginative reform-blocking techniques. Consequently, little land has been given out under Aquino, though she has granted some titles to those who gained occupation of family farms under Marcos.

During the 1986-87 constitutional convention debates, landlords fixed upon the issue of "just compensation" for land transferred in the agrarian reform. They included that phrase in the country's charter, knowing that the Philippine judiciary has routinely interpreted it to mean "market price." If the strict interpretation holds, land reform could bankrupt itself in reimbursing landlords.

Subsequently, the right concentrated upon electing a Congress dominated by landlords (90 percent of House members), which made sure that the land-reform law that finally passed – after months of acrimonious debate – contained high (for Asia) retention rates for landlords and land grants of prime hacienda land to present owners' children.

Another issue for reform opponents emerged last summer. The Department of Agrarian Reform (DAR) bought a farm for reform at a grossly inflated price, which plunged the agency into months of muckraking publicity. This forced the resignation of DAR's director and other key functionaries. The administrator who followed was also quickly relieved of her portfolio and she now contends that communists have infiltrated DAR.

The right is now focusing on discrediting Aquino's newest appointee to the DAR directorship, Florencio Abad, accusing him of once favoring a more radical reform. Consequently, the Speaker of the House, Ramon V. Mitra, has seriously suggested that President Aquino herself assume the DAR portfolio.

Meanwhile, charges of deception from peasant organizations appear with regularity. One group advocates substituting a more liberal and less loophole-ridden law by petition, an alternative opened by the new Philippine constitution to bypass Congress. And the radical New People's Army, in its growing impatience, is taking land by force, occupying it, and turning it over to peasants without government blessing.

In her speech in the Malacanang, Aquino said that her agrarian reform-program stands in contrast to efforts under former administrations that were mere "limited, piecemeal efforts." Her plans are to allow land distribution to nearly 4 million beneficiary families. This indeed would be an epochal program.

Aquino's term has only two years left, but she hasn't yet figured out how to get the agrarian reform off dead center. And if she were to move it, would industrial countries come to her support with aid? So far, the US has put $50 million into the agrarian reform program, tied its disbursement to specific performance objectives, and made sure its contribution could not be used for land purchase.

As for further funding, given US overriding preoccupation with the military-bases agreement and budget stringency, its answer will probably be a resounding "No." It is worth recalling that it was with US prodding that both Japanese and South Korean agrarian reforms – largely unrecognized taproots of their current prosperity – came to pass.

□ *William C. Thiesenhusen is professor of agricultural economics at the University of Wisconsin-Madison.*

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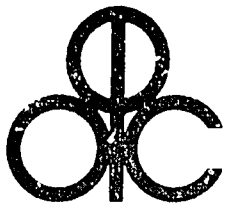

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PRESS
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April 18, 1990

AS PREPARED FOR DELIVERY

STATEMENT BY
THE HONORABLE JAMES A. BAKER, III
SECRETARY OF STATE
BEFORE THE
HOUSE WAYS AND MEANS COMMITTEE
APRIL 18, 1990

THE IMPERATIVES OF ECONOMIC REFORM: CHANGE IN SOVIET AND EAST EUROPEAN ECONOMIES

Mr. Chairman, Members of the Committee:

It is a pleasure to appear before you to discuss the progress of economic reform in the Soviet Union and in the emerging democracies of Central and Eastern Europe. It is also a pleasure to share with you our thoughts on the ways in which the various reform efforts will affect our bilateral economic relations with each of these countries.

Before reviewing the situation in detail, I'd like to make three brief observations.

First, as virtually all of the reformers have made clear, continued progress in reform will depend above all on the internal choices each government and its people make. Western policies and aid can marginally influence the prospects for reform, but the real work must be done within the countries themselves.

Second, having said that, there remains much we in the West can do. These economies have so much of a negative legacy to overcome that our help can make a difference. And the potential benefits for them -- and for us -- are great. We in the United States need to remain engaged, to help these countries make the transition to market-oriented economies, and to insure that these countries are integrated into, not excluded from, the broader Atlantic community of nations.

Third, we need to be creative in how we define "help," and we need to be flexible in how we apply it. Few of these countries are interested in outright grants or aid. Instead most are seeking what we call technical economic cooperation -- nuts and bolts help, if you will, about the transition from central planning to markets.

With these three points in mind, I'd like to turn now to discuss the state of reform in each of these countries, beginning with the Soviet Union.

SOVIET UNION

Since 1985, the Soviet Union has pursued the internal reform policies of "perestroika," "glasnost," and "democratization." Perestroika, glasnost, and democratization -- broadly understood under the heading of perestroika -- are a brew of political, economic, and legal measures. As President Gorbachev has made clear, transforming the Soviet economy requires fundamental change in the political and legal landscapes -- a true "revolution."

The changes Gorbachev has made in the political and legal structure have sought:

- -- a Presidency with wide-ranging powers;
- -- a Supreme Soviet that would enact laws and decrees;
- -- a Politburo and Central Committee that would agree to radical reform;
- -- a bureaucracy that would implement, not obstruct reform; and
- -- a general public that would embrace and sustain necessary changes.

Gorbachev and his allies have had to formulate and legitimize a new Soviet market system -- now called a "planned market." This requires not just a technically sound program, but overhauling the orientation of millions of Soviet citizens. It involves a reconsideration of Soviet doctrine in several sensitive areas. Other members of the leadership are bound to resist this assault on socialist theory and practice. We have seen signs that they could rally some support against the required renegotiation of the Soviet "social contract": The implicit agreement whereby the Soviet people have received extraordinary security and distributive equality (except for the privileged and the corrupt, a growing group), but at the price of political dictatorship, the absence of civil liberties, few economic incentives, and limited economic opportunity.

Perestroika also forces new thinking about the tradeoff between efficiency and equality. This raises the question of the roles of property and incentives. Economic incentive is the prime motivation for productivity, and private property is the key to economic incentive. The Soviets also need to reconsider the role of planners because the information explosion of the last twenty years has demonstrated that a centrally planned economy cannot compete.

As we examine the Soviet reforms, we must keep in mind the vast differences separating Soviet thinking on economic questions from our own. For instance, in the Soviet command economy, output and allocation are set through quantity targets according to a central plan, not by market prices. Prices do not signal scarcity; they are an accounting tool. Rubles are not freely convertible into goods within the Soviet Union, much less outside. In short, central allocation decisions, not money and markets, still command resources.

While the impetus to change may have been economic, it would be a mistake to analyze perestroika as simply an economic phenomenon. The course set by President Gorbachev involves changes throughout society. Much of it is experimental and ad hoc.

Previous Soviet Reform Efforts

Perestroika is not the first effort to reform the Soviet command and control economy. Prior attempts included: the "new lands" policy in the 1950's, designed to spark agricultural production; the Lieberman reforms in the 1960's, a forerunner of current efforts to increase enterprise autonomy; and Brezhnev's increased centralization and bureaucratization in the 1970's, intended to promote management efficiency by increasing cross-sector coordination. All these efforts simply tinkered with the basic Stalinist model, and all failed.

The causes of these failures may help us to understand the conditions necessary for the success of perestroika. These conditions include:*/

1. top-level political support;

2. clear recognition of the need for economic changes;

3. an openness that permits the rethinking of ideology and economic theory so as to justify change;

4. a conducive international environment;

5. consistency in the design and implementation of reforms; and

6. an ability to counter the power of the anti-reform bureaucracy.

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*/ These conditions are drawn from Anders Aslund's book, Gorbachev's Struggle for Economic Reform (1989)

As the reformers are taking on Russian as well as Soviet traditions, even these conditions may not totally suffice. Openness may bring conflict as well as progress.

The first four conditions for a successful reform effort are probably present now. But the fifth and sixth pose real challenges for President Gorbachev. At this point, there are a variety of perils facing perestroika. They include: a poorly designed and non-comprehensive program, reflecting compromises among the leadership; poor implementation due to bureaucratic opposition; public opposition due to the loss of benefits from the old system; and the failure to win a constituency for the reform, due to uncertainty about its staying power and legal protections.

Given the magnitude of the challenge, perestroika has been not one reform program, but an amalgam of many. It is an ongoing experiment ever ready to face new challenges, at times in unexpected ways. Yet it has also reflected compromises made necessary by the Soviet system of collective leadership. These compromises and contradictions have created ambiguities, which in turn have opened opportunities for bureaucratic "reinterpretations" and obstructions. It remains to be seen whether the new powers Gorbachev has assumed in the "executive presidency" will overcome these obstacles.

The Reasons for Perestroika

Perestroika arose in response to problems predating Gorbachev. Command methods swiftly industrialized the Soviet economy, if at great cost. Yet by the early 1980s, the Soviet leadership understood that some kind of economic reform was necessary. Yuri Andropov, in his few months as General Secretary of the Communist Party, outlined measures that became Gorbachev's starting point.

I believe a combination of four factors convinced Andropov and the other Soviet leaders of the need for reform.

The first was the sharp drop in economic growth. Growth rates fell from 5% in the late 1960s to 1.8% in the early 1980s. (Growth may have even been lower, or stagnant.) The period of extensive Soviet economic growth, based on expanding inputs, was over. Yet the Soviet economy could not switch to intensive growth, relying on productivity gains. In part, this reflected Soviet backwardness in developing and employing technology.

A second argument for reform was the declining position of the Soviet Union in the world economy. Instead of catching up with and passing the U.S., as Khrushchev had boasted, the Soviets were falling further behind -- behind not just the West, but the newly industrializing economies (NIEs) also. China, too, was instituting reforms that would leave the Soviet Union behind if it did not change.

The Soviet Union's international trading position was hurt. Even in trade with Eastern Europe, the Soviets were relying more on exports of raw materials. (The fall of energy prices by the mid-1980s exacerbated the situation by cutting into hard currency earnings.) The Soviets were looking at the possibility of being overtaken economically by the Asian Tigers and other Third World nations.

The military impact of Soviet economic failure was a third reason for reform. The U.S. military buildup could only be offset by siphoning off an even greater share of civilian resources. The estimates of the Soviet military's share of GNP vary, from 16%-18%, or even higher. (This compares with about 5% in the U.S.) The growth of Soviet military spending was clearly damaging the economy's ability to produce sophisticated military technology. As former Soviet Chief of Staff Ogarkov stated, technological backwardness would eventually lower military capability as the Soviet economy would not cope with the Western "revolution in military affairs."

The fourth factor was the emergence of new leadership in the Soviet Union -- a new generation. Less rooted in the old system, less dogmatic, some were readier to experiment with new answers. The new leadership understood that the Soviet economic engine required more than minor adjustments. But it was far from agreed on what new reforms were necessary.

Perestroika As Reconstruction

Following Andropov's lead, Gorbachev initially emphasized "uskoreniye" -- "acceleration" of growth through more intensive use of inputs, rather than just massing additional resources. The elements of this program included:

- -- higher growth targets;
- -- a traditional focus on more investment in equipment, modernization and machine tools;
- -- better quality by creating a new quality-control bureaucracy (Gospriyemka);
- -- a worker discipline effort, including the anti-alcohol campaign; and
- -- new decrees on wages and social benefits to cope with wage leveling and the lost link between performance and income.

The results of this program were unacceptable; growth continued to stagnate. Planning based on higher but unmet targets exacerbated imbalances. Extra investment did not improve efficiency because there were no market signals (prices and profits) to guide the allocation of capital. The bureaucracy rejected quality control because it hurt the ability to meet plan targets, which in turn would reduce bonuses.

While it had short-term positive efforts, the anti-alcohol campaign pushed alcohol production outside the legal system, which led to a major loss of state income from the tax on alcohol, increasing the budget deficit. The wage and benefit rules also turned out to be ambiguous because enterprises still focused on quantity rather than quality or the efficiency of production.

If there was any benefit from the reform, it was the recognition by the Soviet leadership that more drastic action was necessary. While not agreeing on the exact action, they knew they could not sit still.

Broader Based, Piecemeal Reforms

By 1987, Gorbachev was ready to move beyond the Andropovian approach to reform. The result was the introduction of major reform measures -- specifically the Basic Provisions for Fundamental Perestroika of Economic Management and the Law on State Enterprises -- at the June 1987 Central Committee Plenum. These measures addressed a number of sectors and issues of economic organization. While broad-based, these changes were neither comprehensive nor integrated with one another.

While designed to foster more enterprise independence, the planners did not really let go. The absence of competition and market prices meant that decentralized authority led to higher wages, not improved efficiency and quality.

Enterprise self-financing was intended to spur firms to earn their own resources, so that subsidies could be reduced. Without prices reflecting market forces, the profits (or losses) of the firms were hardly dependent on their efficiency and competitiveness. Moreover, central planners, not firms, continued to control credit and other inputs. Instead of going bankrupt, unprofitable firms were still subsidized, which contributed to the growing budget deficit.

Cooperatives were supposed to give a quick boost to sales and production by permitting groups of workers to enjoy the fruits of their labors, which could demonstrate to consumers that perestroika had a payoff. They could also be a first form of private ownership to demonstrate the rewards of hard work and ingenuity. Yet the compromises of the cooperative program produced a legal and business environment that almost seemed to be designed in order to thwart the cooperative movement.

Planners still channeled most inputs to state firms, forcing co-ops to operate through illegal, higher-priced "black" markets. This hurt the public legitimacy of co-ops. In the absence of real competition, many co-ops earned monopoly profits, further eroding public support. The government reacted to this by granting local authorities wide latitude in

taxing co-ops, which in some parts of the Soviet Union has led to harsh taxes. In addition, the government forbade co-ops from operating in certain sectors (e.g., medicine, printing) that had proven popular and profitable. What's more, the very tenuousness of the co-ops' existence has led many to distribute profits instead of reinvesting them.

Despite this, the cooperative sector has prospered. According to some Soviet estimates, co-ops now account for about 5 percent of national income and employ about 2.5% of the work force. But the future of co-ops remains uncertain. They remain a prime target of trade union complaints. Last year, the Supreme Soviet only narrowly defeated, 205 to 190, a proposal to close all trading cooperatives.

Agriculture, which led the way in the Hungarian and Chinese reforms, also has proved a disappointment. Although a new idea of "contract leasing" (long-term leaseholds to create incentive for farmers) was announced, the potential leaseholders were harassed through high taxation, refusal to deliver inputs, and a lack of legal guarantees for leaseholders. Moreover, the farmers themselves didn't know how to run farms. Their experience was as day-laborers, not small businessmen. Given the uncertainty of the new incentive system, many people were also wary of the risk of running a farm.

The Law of Individual Labor Activity was a cautious first step toward building a private sector. Yet this half measure limited entrepreneurs to the service sector and kept prohibitions on hiring labor. It was also contradicted by the accompanying campaign against "unearned income -- which cracked down on the same small business the law on individual labor activity was supposed to encourage.

In sum, the piecemeal reforms of 1987 proved inadequate. They did not activate unused reserves or substantially increase efficiency. Government spending increased and revenues fell. The large deficit was financed through printing more rubles, which sent inflation climbing (perhaps as high as 10%, according to some estimates). People no longer trusted the value of the ruble, which led to a hoarding of goods that made shortages worse. The leadership recognized that perestroika must move even further.

Latest Efforts: Two Steps Forward and One Backward?

The next major move came in October 1989, when Deputy Prime Minister Abalkin proposed a two-stage "moderate radical reform" program designed first to stabilize the economy and then to introduce some of the structural changes needed for further reform. This plan represented a major theoretical advance over previous reform efforts. It recognized the importance of:

-- the market, and particularly the pricing mechanism, for regulating the economy;

-- competition, including from imports, to promote efficiency and keep prices down;

-- ownership rights; and

-- institutional change and reform sequencing.

Abalkin's plan, though, was more impressive in theory than in practice. Its endorsement of "ownership rights" did not specifically include "private property." The timing of price reform remained uncertain and the stabilization program was too timid.

Yet even the Abalkin plan was too advanced for the Soviet political environment. As the plan was under discussion, the Supreme Soviet sought to cope with consumer shortages through traditional administrative means like a price freeze and an extension of state orders (as opposed to marked allocation) to essential foods and consumer goods. When it came time to legislate the next stage of reform in December 1989, the Soviet leadership turned to Prime Minister Rzyhkov's tepid program. While retaining the construction of Abalkin's two-step approach, Prime Minister Ryzhkov's ideas for structural reform failed to advance the status quo. Specifically the Ryzhkov program:

-- called for the re-centralization of investment decisions;

-- advocated increased investment for agriculture, instead of reliance on leasing and incentives for production;

-- envisaged a slower pace on price reform, with new wholesale and agricultural prices delayed until 1991 and a failure to commit to a timeframe for new retail prices; and

-- emphasized that major enterprises would remain "within the sphere of direct state management" and expected only 20% of Soviet enterprises to have transferred to leasing by 1995.

In sum, as recently as last December the Soviet officials were proposing increased reliance on the command-planning model as a "step" toward (but in fact away from) a more market-oriented system.

Not surprisingly, the Ryzhkov proposals did not turn the economy around. In the first two months of 1990, incomes rose 14-15%, while production rose less than 2%. Efforts to raise fuel prices for enterprises were met with protests from official trade unions and were rescinded by the government. The result was yet a third economic reform program by mid-March, shortly after Gorbachev assumed the enhanced presidency.

A Council of Minister decree outlined this reform program, which calls for the transition to a "plan-market" economy. The decree lists 28 laws and decrees to be prepared by May 10. Some items on the list are already in the works, including banking and tax reform, anti-monopoly legislation, and amending the laws on state enterprises and cooperatives. Others are new, including laws on freedom of economic activity and the development of entrepreneurship, taxation in kind, indexation of incomes, and reform of price formation.

While the scope of the new program could turn out to be impressive, we have little indication of the content of the laws and programs, or of what stage of the drafting process they are in. This program could represent a major advance over the Ryzhkov plan, but we shall have to see if it improves on Abalkin's October proposals. Indeed recent statements by Abalkin himself, "reassuring" the Soviet public that the proposed changes will not be "radical," suggest that the new program could even fall short of the October 1989 version.

Lessons from Perestroika

Perestroika to date has been comprised of a grab-bag of economic reforms. Some are striking changes from Brezhnev's economic system. Unfortunately, not much has worked in terms of economic performance.

The political changes, however, have been exceptional. Gorbachev has decided that he needs to change the political system to support economic reform. We have witnessed the rise of a Supreme Soviet with real power and of an executive presidency.

The lessons of early failures are clear:

-- The old Brezhnev model was totally discredited;

-- The Andropovian moral discipline fix was a bust;

-- GDR-type streamlining efficiency didn't work;

-- Piecemeal reforms of enterprises and industrial organization couldn't be successful as long as they operated in a system hostile to private initiative, competition, markets, and profits; and

-- Even the agricultural sector -- the leading edge for the Hungarians and the PRC -- was impervious to reform.

The positive lesson was there too. To succeed, reform must be economically and politically comprehensive. A comprehensive program might take a number of forms, each with different risks.

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There are three kinds of comprehensive strategies: (1) one-shot radical reform all at once, the "Big Bang" approach, perhaps after some basic groundwork is laid; (2) gradual changes, but sequenced carefully to enable reforms to take hold; or (3) major transformation by sector.

Each strategy requires a shift from the ad hoc adjustment of the past. And this is a problem. It will be exceedingly difficult for a collective leadership to develop a comprehensive effort. This is no surprise. It is hard for our decentralized political system to develop comprehensive programs, too. But our basic political and economic system works. The Soviet Union's does not. Some analysts suggest that Gorbachev's assumption of new, extensive presidential powers is designed to remedy this weakness.

What Is To Be Done?

There is some irony in asking, as Lenin's book did in 1902, "What is to be done?" That book called for a tightly knit, highly disciplined party vanguard with strong central control to make a revolution. But in the 1920's Lenin introduced a New Economic Policy (NEP) that envisaged decentralized economic authority, at least as a temporary expedient. Some Soviet reformers seek to trace the antecedents of their market-oriented ideas to that NEP.

Of course, Soviet society is quite different from ours, with cultural, political and ideological constraints unlike ours. And it remains in many ways, as Churchill well understood, an enigma. So any outsider should be cautious in offering advice for reform. That said, some economic points stand out to me personally.

One, there is no getting away from market prices. Whatever the problem, the solution keeps coming back to market prices, which:

-- enable markets to assess profitability;

-- guide efficient investment;

-- allow firms to compete for inputs, not rely on a planner's allocation;

-- signal the scarcity of goods and create incentives for production;

-- establish rewards for work; and

-- are a critical step toward achieving a convertible ruble.

Two, it is hard to envisage the success of price reform until the ruble's value is stabilized. The ruble overhang -- created by massive deficits financed through printing money -- means that if prices were freed at present, the demand for goods would send prices soaring.

The ruble overhang could be reduced by: selling state-owned assets (apartments, equipment, and land); issuing financial instruments with positive rates of return after inflation; and possibly selling consumer good imports at a substantial markup. The substantial Soviet gold stocks might also be used to back the value of the ruble or government bonds. As major gold producers, the Soviets could use future gold production to regulate the money supply.

It is important that these monetary policies be accompanied by fiscal restraint. Otherwise there would be a new ruble overhang. Targets for spending cuts might be: subsidies to firms, defense spending, and military aid to foreign clients (Cuba, Afghanistan, Ethiopia, Vietnam and Cambodia). Improved production efficiency, especially in the countryside, could also reduce government spending. Higher taxes, in contrast, will hinder the development of business initiative.

Three, microeconomic reforms in industrial organization must accompany market prices and macroeconomic stabilization. Enterprises and cooperatives must have the freedom to compete. Monopolies must end. State controls should not limit the ease of entry and exit of competitors. Instead of planners, market signals should determine resource distribution.

Four, the Supreme Soviet must provide legal guarantees for property rights. The new Soviet property law moves in the right direction, but it is a compromise document that avoids use of the term "private property." On the plus side, it provides the legal foundation for development of small-scale private enterprise, diversifying forms of ownership and granting some additional rights to individuals and foreign investors. It does not, however, allow private ownership of land or the direct hiring of workers, which precludes the development of large-scale private enterprise.

Five, the Soviets must move carefully in substituting tax and regulatory policies for confiscation and production directives. The power to tax remains the power to destroy, and over-regulation can choke off striving enterprises.

Six, the Soviet Union will need to ensure the social welfare of those who cannot fend for themselves in the changed economic environment. At present, social welfare is managed through enterprises and there is no real system to ease adjustments as inefficient firms adjust to meet competition, or even go out of business. Competition is likely to require unemployment insurance and worker retraining programs. There will be a need for a bankruptcy law permitting the restructuring or liquidation of failed enterprises.

These tasks pose a major challenge to perestroika. But even this brief analysis points underscores that the necessary reforms are interrelated. Action on any one element by itself will not suffice. The different measures must act in concert if the new economic system is going to work.

U.S. Policy

For some time, this Administration has made clear that it wants perestroika to succeed. Perestroika can help create a more open society, channel claims for societal resources away from the military to civilian uses, and create institutions with no interest in military adventurism. In short, perestroika can transform the Soviet Union into a cooperative member of the international community.

We have a national interest in the spread of our core values: self-determination, democracy, individual rights and freedoms, economic liberty, market economics, and the peaceful resolution of conflicts. So we welcome the Soviet Union's movement toward accepting these values.

Realism is called for, however, in assessing the actual influence we can have on perestroika. We must avoid the siren song calling for direct aid to Moscow. As President Gorbachev has stated on numerous occasions, the success of Soviet reform depends on the Soviets themselves. It was the discarded view of General Secretary Brezhnev that Western technology, credits, and know-how could produce a Soviet economic turnaround.

In our view, the best approach toward supporting both perestroika and America's interests and values is a creative search for points of mutual advantage in those areas most open to superpower cooperation: making Europe whole and free; resolving regional conflicts; negotiating stability and predictability-enhancing arms control agreements; supporting the rule of law in the Soviet Union; and working together on technical economic cooperation.

Let me focus here on the strictly economic aspects of this search for mutual advantage. We have begun a program of extensive technical cooperation with the Soviets, designed to facilitate the massive task of restructuring their economy. The President presented a list of possible projects to Gorbachev at Malta. Ongoing efforts have included:

-- Chairman of the Council of Economic Advisers Boskin recently visited Moscow to discuss Soviet reforms;

-- in March, the Soviet Finance Minister and Chairman of the State Bank visited Washington for detailed discussions with Treasury Secretary Brady, Federal Reserve Chairman Greenspan, and me;

-- in February a group of Soviet experts spent 10 days traveling around the U.S. under Commerce/SBA auspices to study small business operations;

-- in February another delegation visited New York and Washington under New York Stock Exchange auspices to study financial markets and stock exchange operations;

-- the IRS has offered tax advisory services to the USSR, aimed at establishing efficient tax administration.

-- a group recently visited Moscow to expand cooperation in developing census and economic statistics.

In addition, we are exploring a host of other steps we can take to share our experience across a broad range of sectors. In particular, if the USSR moves ahead with a major reform effort this year, as they have suggested, we might be able to offer perspectives on particular proposals.

At Malta the President presented a series of bilateral commercial initiatives designed to demonstrate our support for perestroika, serve our economic interests and, in the process, help teach the Soviets about the practical workings of market economies. The President proposed the start of negotiations on a trade agreement with a view toward completing them by the June summit. We have had three rounds of negotiations. If the Soviets pass and implement an emigration law in conformance with international standards by the time we have completed an agreement, the President has said he intends to waive the Jackson-Vanik Amendment, paving the way, with the trade agreement, for the extension of most-favored-nation status.

Also at Malta, the President told Gorbachev that once he waives Jackson-Vanik, he will explore with the Congress lifting the various restrictions on USG lending to the USSR. We have also begun negotiations on a bilateral investment treaty, which should take some time to complete, and a revised tax treaty, on which we are making substantial progress. We have agreed in principle to a new long-term grains agreement, which should be ready for summit signature. We are also pursuing negotiations on an expanded civil aviation agreement and a maritime transportation agreement.

Finally, we can continue to challenge Moscow to implement the domestic economic reforms needed for increased international economic interaction. At Malta, the President stated his support for Soviet observer status in the GATT in order to help acquaint the Soviet Union with GATT norms and procedures, and with the market-oriented trading policies on which the GATT is based. The President also supported cooperation with the USSR in the CSCE and the OECD. I am delighted to report that the Soviet Union at the recent CSCE Bonn Economic Conference joined in supporting the final document that included market economic principles. Soviet cooperation with the OECD would be through

the recently established Center for European Economies in Transition. We continue to oppose, however, Soviet membership in the IMF or the IBRD because we believe their economy is incompatible with the market norms and transparency required of the members.

Some Conclusions about Soviet Economic Reform

Perestroika and glasnost are President Gorbachev's effort to remake the Soviet Union. That may not have been his aim in 1985, but the failures of the early reform efforts convinced him and his colleagues that change must be far more fundamental. These are practical and determined men, whose aim is not freedom for freedom's sake, but the modernization of the Soviet Union. They are not the heirs of Locke and Montesquieu, but of the great Russian modernizers, like Peter the Great and Alexander II.

The failure to produce economic results has not deterred Gorbachev. As he has shown repeatedly, he uses obstacles to further consolidate his authority. Then he takes steps to press political and economic reforms further. He does not fold; he does not call. He raises the stakes.

Nevertheless, Gorbachev and his allies still must operate as members of a collective leadership with very different notions of what reform means. The development of a Supreme Soviet with some authority has merely extended these conflicting views of the reform process to a larger body. So the decisions are often compromises.

This ad hoc policy development process is a severe handicap when the objective is to overhaul a society's basic attitudes toward economic life. It would be a mistake, however, to conclude that the challenges are necessarily too daunting for perestroika. Over the years, Gorbachev has steadily secured greater power; his new presidential powers represent the latest and most extensive steps in this process. This accumulation of power creates, however, an irony given Gorbachev's claimed interest in opening up the Soviet society and power structure. I would expect it will be important to examine the steps taken up to and during this summer's Party Congress to ascertain the real direction of reforms.

We want perestroika and glasnost to succeed. But we also recognize the limits of our influence. This is an internal evolution whose success depends ultimately on the Soviet people.

Of course, the United States will continue to pursue our national interest. But that interest does not exist in isolation from the events taking place in the Soviet Union and Eastern Europe. Our task is to find points of mutual advantage where both we and the Soviets can gain. This involves full engagement across the span of issues concerning our two countries: regional conflicts, arms control, human rights, transnational relations, and bilateral topics such as economics. At Malta and in the series of ministerials leading up to the spring Summit, we have been doing just that.

Before turning to Central and Eastern Europe, I would like to make several points about the situation in Lithuania.

The people of Lithuania must not be denied their rights. We support the aspirations of the Lithuanian people for self-determination. We have never recognized the forcible incorporation of Lithuania, Latvia, and Estonia. The Supreme Soviet has called the 1939 Molotov-Ribbentrop Pact and its secret protocols illegitimate, effectively making the incorporation illegal.

It's time to engage in a dialogue, and not merely talk about having a dialogue. The Lithuanians want such a dialogue. That's the answer: dialogue, not economic boycotts or threats to invoke Presidential rule.

Our policy toward the Soviet Union is shaped by what's in <u>our</u> interest.

It's in our interest to see the countries of Eastern Europe free of Soviet forces and secure from threats that could reverse their revolution.

It's in our interest to see the Soviets destroy 40,000 tanks through a CFE agreement.

It's in our interest to lock-in major reductions in Soviet strategic forces and to create a more stable, predictable and secure relationship that reduces the risk of nuclear war.

It's in our interest to settle regional conflicts in a way that fosters peace and freedom -- as we did in Central America.

And, it's in our interest to see the reform process go forward in the Soviet Union so it will be more committed to internal progress than external expansion.

But some of our bilateral contacts with the USSR may be more directly in their interest than in ours. And those contacts are being put to risk by Soviet actions -- even short of force -- in Lithuania.

Our willingness and ability to take steps that benefit perestroika in the near term is, to be sure, affected by Soviet behavior. Perestroika, glasnost, and democratization cannot be divisible. The reform process won't go forward and succeed if it is applied in some republics and denied in others.

CENTRAL AND EASTERN EUROPE

<u>The Politics of Eastern European Reform</u>

Two months ago in Prague, I noted that the "historic, democratic movements that we are witnessing across Europe... hold great promise for all of us. ...(But) initial impulses for democracy may not be enough. If 1989 was the year of

sweeping away, 1990 must become the year of building anew." One challenge confronting the transitional governments of Eastern Europe is organizing and implementing fair and free elections that establish open parliaments with a place for opposition. In Prague I underscored the necessity for the new democracies to respect the rule of law, fundamental individual rights and liberties, and minority rights.

Since that time, free and fair elections have been held in the GDR, Hungary, and in Slovenia, a republic of Yugoslavia. A non-communist, coalition government has been formed in the GDR and a non-communist coalition is expected in Hungary now that it has completed two rounds of balloting for parliamentary seats. Open, freely contested parliamentary elections are scheduled over the next two months in Romania, Czechoslovakia and Bulgaria. Poland will hold local elections for some 50,000 positions on May 27. Election observers from the United States and other CSCE countries will be following the balloting in each country to authenticate the process.

The governments of Eastern Europe, most still transitional, demonstrate clear signs of progress toward democratic government and economies based on the market rather than central planning. Poland's Solidarity-led government has successfully begun a bold economic program which, despite the sacrifice involved, is supported by the people.

In Hungary, a coalition government formed by the Hungarian Democratic Forum will need to maintain and accelerate the economic reform program devised by the transitional government under Premier Nemeth. Among other things, that program slashes the deficit by cutting producer and consumer subsidies, trimming defense expenditures and raising rents and taxes. Parliament will shortly determine how to select the next President--through direct plebiscite or by a vote of the new parliament.

We have seen some progress in the political sphere since my visit in February to Sofia. The current government has agreed to international election observers and set a date for the elections - June 10, with a runoff June 17. Political parties are forming and holding political rallies. However, significant concerns relating to free and fair elections still remain -- including equal access to broadcast and print media by opposition parties, dismissal of opposition activists from state employment, and secret police activities in the democratic process. The National Assembly has passed legislation that permits members of the ethnic Turkish and Bulgarian Muslim minorities to reclaim Muslim names, mosques to reopen and Turkish to be spoken-- despite some opposition by the ethnic Bulgarian majority. The decision by the National Assembly to end the forced assimilation policy of the Zhivkov regime is one example of an important principle I spoke of in my Prague address, that "majority rule must respect minority rights." We encourage Bulgaria's leaders to pursue actively this commitment to minority rights and assure the legislation is effectively implemented throughout the country.

Freedom of expression, religion and travel have been declared and are being increasingly practiced in Romania. Independent political parties are building toward elections scheduled on May 20, although the ruling party continues to control the overwhelming share of media and electoral resources throughout the country. Regrettably, Romania in recent weeks has demonstrated that a newly opened political environment without established democratic institutions and principles can lead to a resurgence of historic ethnic animosities. Ethnic Hungarians and Romanians have clashed in the streets over the issue of minority rights. We are watching this situation carefully and hope that further violence will be avoided.

My trip to Prague in February confirmed the progress of democratic and economic reform in Czechoslovakia. The "government of understanding" led by Vaclav Havel has announced an ambitious program of political and economic reform to create favorable conditions for elections on June 8. President Havel himself has taken a key role in promoting a dialogue and consultation among Eastern and Central Europeans on a variety of issues of concern to the emerging democracies.

Economic

Successes in the political sphere must be reinforced by successes in the economic. For democracy to succeed in Eastern Europe it must hold out the hope of a better life for the people of this region. Economic vitality in these new emerging democracies is essential to maintaining the stability of Europe.

The countries of Eastern Europe are faced with the daunting task of creating a market while coping with the legacies -- in the form of high external debts, little or no domestic savings, inflation, low worker productivity to name just a few -- of central planning. Each of these countries must determine its own economic policies. We cannot impose a system upon them. However, we stand ready to help -- both in advising them on the policies and in helping them implement them.

A year ago tomorrow, President Bush pledged America's support to Poland in its efforts to transform its political and economic structure. This policy was extended to Hungary late last Spring. With the introduction of the "Eastern European Democracy and Free Market Act of 1990, " the President extended this policy to all of the newly emerging democracies of Eastern Europe.

Our support must be flexible. Each of the countries is going through a similar, but distinct process. For example, although Solidarity and Civic Forum are similar, their histories and the process by which they have overcome the Marxist-Leninist system are distinct. Therefore, our support must have both general approaches to support democracy and the establishment of market economies, and flexibility and distinctions adapted to each individual country.

As I outlined in Prague, we see three stages of support available to these emerging democracies:

First, we are prepared to provide short-term emergency assistance based on need. We will be there to break the fall. But we will do so in a way that does not undercut the revitalization of homegrown solutions. We have already provided such assistance, in the form of food aid, to Poland and Romania.

Second, we are prepared to help these countries make the transition from Stalinist command economies to market system driven by private enterprise. We must appreciate that in these areas the countries of Eastern Europe have embarked on uncharted waters. Therefore, assistance -- both technical and financial -- will be needed.

Third, we must integrate these new market economies into the international economic system. They, too, are eager to end their economic isolation, recognizing that they need discipline as well as the opportunities provided by regional and global financial and economic institutions.

The task before these countries and their peoples is unprecedented. They must create -- almost overnight -- an entirely new economy -- ones based on private enterprise, free competition, and market prices. We have held extensive discussions with the Governments of Poland and Hungary on what types of assistance are needed. We have also begun such discussions with the Government of Czechoslovakia. The European Commission, on behalf of the G-24, has begun such discussions with the other countries of the region. We anticipate responding to some of these needs with the funds we hope will be available next fiscal year.

SEED I

Last year, we joined with the Congress to pass the Support Eastern European Democracy Act of 1989. This Act has given the Administration the resources with which to respond to these historic events. We were able to lead the way in the creation of the Polish stabilization fund. We have launched the Polish and Hungarian enterprise funds -- funds designed to promote entrepreneurial activity in these countries. We have been able to begin providing these countries with limited technical assistance and training.

However, the SEED Act has a major fault. A fault that we believe if left uncorrected will limit U.S. efforts in coming years. The SEED Act was earmarked for a variety of specific projects. Eastern Europe is going through a very dynamic process. We cannot estimate what the needs will be three months from now much less 18 months. For example, the Polish stabilization fund, from conception to creation took three months. We were lucky that the timing was appropriate for the SEED Bill.

This earmarking threatens to deny us the opportunity to respond to the most pressing needs. That is why the Administration, in our new bill, has asked for flexibility. We want to work with the Congress to provide assistance to these countries, but we want to keep bureaucratic requirements to a minimum.

Therefore, I cannot give you a dollar-for-dollar accounting of our plans for FY-1991. I do not have one. I can, however, explain our plans and expectations.

In FY-1991, we plan to provide assistance in four general areas:

- o Humanitarian assistance and support for democratic institutions;
- o Technical training and technical assistance;
- o The environment; and,
- o Transitional economic support.

We believe funding keyed to these categories would provide us with the flexibility needed to support the transformation of these societies.

I can also promise that we intend to keep down the level of bureaucracy in our assistance program for Eastern Europe. However, to do so, I need your help. Through the office of the coordinator, Larry Eagleburger, we have reached out to all parts of the U.S. Government. We will use the most appropriate agency to implement programs. But it is not helpful to have you tell us that one agency must be used for this purpose and another agency for that.

We are also reaching out to the private sector. The Commerce Department has established the Eastern European Business Information Center. We have held conferences for non-governmental organizations. We can, and will, do much more.

We must keep in mind that the United States is not alone in this endeavor. Fortunately, the contrary is true. At President Bush's initiative, the Paris Summit asked the European Commission to coordinate Western support for political and economic reform in Poland and Hungary. This resulted in the G-24 effort, which currently includes all the members of the OECD.

The G-24 mechanism has been effective. All in all, G-24 member states have committed over $14 billion in grants, credits, credit guarantees, food aid and technical assistance to Poland and Hungary. In addition, the G-24 member states, including the United States and the EC, have improved Poland's and Hungary's access to markets in the West. The United States wants the G-24 to do even more. We will be working in the G-24 to expand coordination between donors. For example, the EC has joined with us to support the Regional Environment Center in Budapest. We expect to cooperate with the EC on other joint projects in the future.

The European Bank for Reconstruction and Development (EBRD) will be an important part of the Western response to the recent dramatic developments in Central and Eastern Europe. I believe U.S. involvement and leadership are important to demonstrate our political commitment to the reform process in Central and Eastern Europe.

Unlike the World Bank and other existing institutions, the EBRD has a broader purpose than economic development -- to assist the political and economic transformation of these countries. No other international financial institution has the goal of promoting democracy, pluralism and rule of law. The EBRD along with the IFC will concentrate on developing the private sector. Its charter will require that at least 60 percent of resources be devoted to private sector projects. These features set apart the EBRD from other institutions and give it a compelling justification.

We have had serious reservations about the role in the bank initially envisaged for the USSR. We believed from the outset that Soviet borrowing should be strictly limited. Most of the other participating countries agree that the USSR's size and global position make it essential to limit Soviet borrowing. Our concerns on this point have been resolved. The Soviet Union has agreed to a formula which will limit Soviet borrowing to the amount of the USSR's paid-in contribution to the capital of the bank for at least the first three years of operation. Any change in borrowing status will require the concurrence of 75% of the member countries representing at least 85% of the EBRD's voting power.

The U.S. will have ten percent of the bank's capital and be the largest single shareholder to underline the importance we attach to the bank and to our partnership with Western Europe. With an ECU 10 billion capitalization -- equal to about $12 billion at current exchange rates. The U.S. commitment over five years would be about $350 million in paid-in capital and $817 million in callable capital or $233 million annually ($70 million paid-in and $163 million callable).

The OECD also has an important role to play in assisting the countries of Eastern Europe. Last year, the U.S. proposed and the OECD has established a Center for European Economies in Transition. The Center will coordinate activities of the OECD with Eastern European countries and the Soviet Union, including seminars and technical assistance directed at specific sectors or policy areas.

Integration into the World Economy

However, assistance is only part of the solution. Successful economic reform requires private capital and a thriving private sector. As Czechoslovakia's new Finance Minister Vaclav Klaus put it, we don't need old types of cooperation, we need business.

Businesses need market prices and an opportunity to compete. It's up to each government to provide a conducive legal and economic environment to attract private capital, to seel factories to private owners, and to lift the heavy hand of excessive government intervention.

In addition, we in the West must work with these countries so that they may join the various multilateral economic institutions, including the IMF, World Bank and the GATT, as soon as they are prepared to meet the obligations of membership.

We must also seek to remove barriers to trade both bilaterally and in the GATT. In this respect, we have one important measure now pending before this committee. In the "Eastern European Democracy and Free Market Act of 1990," we proposed that Czechoslovakia and the German Democratic Republic be removed from the prohibited list for CSP beneficiaries. We hope that this committee will be able to move expeditiously on this matter.

We also expect to be working with this Committee with regard to Jackson-Vanik waivers and the negotiation of trade agreements. As you are aware, the President has waived Jackson-Vanik for Czechoslovakia and Ambassador Hills signed the commercial agreement on April 12. We continue to review the situation concerning Jackson-Vanik waivers and trade agreements for Bulgaria and Romania.

COCOM

We are also working with our COCOM allies to relax barriers to trade in certain areas, particularly telecommunications, machine tools, and computers. We are seeking assurances that COCOM-restricted technology will not be transferred without approval to third parties. Discussions on high technology trade with Poland are going on as we speak.

The EC Role

The EC must be commended on the role that it has played in this endeavor. In its coordinating role, its financial contribution, and in the removal of barriers to trade, the EC has set an example for all of the G-24 members. It has acted quickly and generously to meet emergency food needs, complementing similar steps by the U.S.

Bonn CSCE

The CSCE Conference on Economic Cooperation in Europe, just concluded in Bonn, has produced a final document which we feel meets our substantive objectives for the conference: it sets forth the overarching political and economic goals for long-term economic cooperation between East and West. As a result of Bonn, the CSCE process now provides us with a basis

for broad cooperation with the countries of Eastern Europe in overcoming the many difficult challenges in making the transition from a command system to a free-market economy. Followup activities to the Bonn Conference will ensure that Basket II of the Helsinki Agreement receives the impetus and sustained attention it deserves.

Country-by-Country Breakdown

Poland: The Mazowiecki Government has continued to set the pace in both the political and economic transformation of its society. The democratic system that was fashioned out of a compromise with the communists has proved adaptable. The Government's economic plan won the support of the IMF and has achieved tremendous success at driving inflation out of the economy, lowering interest rates, and stabilizing the currency -- at a cost, however, in terms of unemployment and the level of economic activity. U.S. support is at its highest in Poland. We played a leading role in putting together the Stabilization Fund, and our Enterprise Fund will do much toward supporting the developing Polish private sector. We have regular discussions with the government on its assistance needs.

Poland also set the pace in terms of the recent Business and Economic Treaty we negotiated. This treaty will provide U.S. businessmen with important guarantees for repatriation of profits and arbitration rights. We expect the Polish agreement to serve as a model for future agreements.

Hungary: We also expect to work closely with the new Hungarian Government. This new government will benefit from the reforms undertaken by the Nemeth regime. We expect to work with the new government on determining its assistance priorities. Already we're supporting Hungary's private sector through the Enterprise Fund, and the President's proposal for a Budapest Regional Environmental Center should do much toward helping the Hungarians and others combat their dire environmental problems. We will also reactivate our proposal for a bilateral investment treaty.

Czechoslovakia: On April 12, Ambassador Hills signed the trade/commercial agreement with the Government of Czechoslovakia. The agreement grants Czechoslovakia MFN consistent with the requirements of the Jackson-Vanik amendment. Czechoslovakia's application for re-admission in the IMF/World Bank is currently under review. A bilateral investment treaty is currently under negotiation.

Yugoslavia: We recently proposed negotiation of a bilateral investment treaty. We are awaiting their response.

Romania: Waiver of the provisions of the Jackson-Vanik Amendment will be based on improvements in the overall human-rights situation in Romania and especially on the holding

of free and fair elections. There is already a valid bilateral trade agreement between Romania and the United States, which is due for renewal this year. We are now considering if we should allow this agreement to role over automatically at mid-year. If we so decide, we will pursue a bilateral investment treaty, into which we will seek to incorporate provisions on business facilitation that are now normally included in our trade agreements.

Bulgaria: The Bulgarian Government has also given us the assurances required under the Jackson-Vanik amendment concerning free emigration. Improvement in trade with Bulgaria will be based on free and fair elections and on the overall human rights situation in the country.

CONCLUSION

It is extremely difficult to summarize the state of reform in the Soviet Union and Central and Eastern Europe. While all of the countries I've discussed must cope with the terrible legacy left by Stalinist central-planning, each country occupies a unique position in dealing with that legacy. But each -- so far -- has shown some willingness in overcoming that legacy and moving closer toward market-based systems, though the success of their efforts will be far from assured for years.

What is clear is the vital need for the United States to stand alongside the reformers as they struggle to build the institutions of economic freedom Standing with them is consistent with both our values and our interests. It is consistent with our values because free markets not only allow for but also encourage individual freedom and initiative -- hallmarks of a vigorous democracy. Free markets are also the surest guarantor of economic prosperity -- prosperity which will underpin and fuel the newly emerging democracies in Central and Eastern Europe.

Yet the success of the reforms is also consistent with our interests. For years, we in the West have been burdened by the task of containing a Soviet Union bent on external aggression and illegitimate domination of the peoples of Eastern Europe. Now those peoples are finding their freedom, and the new thinkers of the Soviet Union are encouraging internal reconstruction, instead of external adventurism. Over the long run, this can only be for the good. Beyond containment does lie democracy -- and, hand in hand, economic freedom. This truly can be the success story of the 1990s.

Mr. Chairman, this Administration is pledged to play a positive role in supporting reform in the Soviet Union and Central and Eastern Europe. To do so, we need to have the maximum flexibility possible to cope with continually changing circumstances. Together, we can do our part to make the revolutions of 1989 democratic realities well into the next century.

Thank you.

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

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Statement of the Honorable
Nicholas F. Brady
Secretary of the Treasury
before the
Committee on Ways and Means
United States House of Representatives
April 18, 1990

Mr. Chairman and Members of the Committee:

I am pleased to appear today to discuss developments in Eastern Europe, the European Community, and foreign investment in the United States. Developments in these areas will have an important bearing on the U.S. economy for the rest of this century and beyond.

EASTERN EUROPE

In Eastern Europe, economic conditions have been a critical factor behind the political changes that have swept across the region during the past year. Most of the Eastern European countries are undertaking comprehensive, market-oriented reform programs. To encourage their efforts, the U.S. Government is providing financial and technical assistance and is negotiating trade, investment, and tax treaties.

Financial Assistance

The United States responded quickly with financial assistance to the developments in Eastern Europe. In fiscal year 1990, the Support for Eastern European Democracy (SEED) Act provided $418 million in aid to Poland and Hungary. The United States, along with other donor countries, organized a $500 million multilateral bridge loan for Poland, which has already been repaid. In addition, the United States coordinated a $1 billion multilateral Stabilization Fund for Poland to provide support for the Polish zloty as the economic reforms -- including limited convertibility -- were implemented. This year the Administration has proposed legislation to expand our assistance effort to all of the emerging democracies of Eastern Europe, requesting $300 million in fiscal year 1991 for this purpose. Finally, a large variety of activities are being undertaken to support private sector development in Eastern Europe, including the establishment of Enterprise Funds for Poland and Hungary under the SEED Act.

Under U.S. leadership, multilateral institutions are also engaged in helping the region. Both the International Monetary Fund (IMF) and the World Bank are actively supporting economic reform in Poland and other countries that are members of the Fund

and Bank: Hungary, Romania, and Yugoslavia. The magnitude of this support is impressive. The IMF has committed more than $1.5 billion under stand-by arrangements with Poland, Yugoslavia, and Hungary. The World Bank is extending project and non-project loans to these three countries at the rate of almost $2 billion per year. Recognizing the key role played by these institutions, Czechoslovakia and Bulgaria have recently applied to become members.

European Bank for Reconstruction and Development

A new institution positioned to provide significant funds for Eastern Europe is the European Bank for Reconstruction and Development (EBRD). The Bank is the response of the Western countries to demonstrate their political and economic commitment to and solidarity with the Eastern European countries that had decided to undertake the transition to multi-party democracy and market-oriented economies. The Bank is also viewed as a vehicle which could, through its borrowing in capital markets, leverage contributed funds into larger loanable resources to support much needed economic reforms in these Eastern European countries. This "leveraging" will enable the EBRD to lend about $12 billion in support of Eastern Europe at a total budgetary cost to the United States of only $350 million over the next five years. The U.S. share of the Bank's $12 billion capitalization will be 10 percent, making the United States the largest shareholder.

The United States supported the concept of a multilateral Bank that would facilitate the transition of the borrowing countries to democracy and pluralism and a market-oriented economy. We saw a development bank for Eastern Europe as a unique institution and insisted that these concepts be an integral part of the EBRD's charter. This the first time these principles have been included in a development bank charter.

The charter of the EBRD also requires that at least 60 percent of the EBRD's aggregate annual lending and its lending by country for the first five years be to the private sector or state-owned enterprises that are shifting to private ownership and control.

While the Soviet Union is eligible to be a borrowing member of the EBRD, its borrowing will be limited for a three-year period to the amount of their paid-in subscriptions to the Bank and will be confined to loans for the private sector or to help enterprises operating competitively and moving to a market orientation. Any expansion of Soviet borrowing after the three-year period will require agreement by members holding 85 percent of the voting power.

Technical Assistance

Our technical assistance to Eastern European countries is likely to be more important in the long run, however, than our

financial assistance. These countries need technical assistance in virtually every sector of their economies. For example, they need help in setting up business schools to teach enterprise managers how to operate in a market economy. They need foreign expertise to set up effective farm credit programs, and to establish a legal framework for private ownership of property.

The importance of technical assistance has been recognized by the United States and other Western countries, and is reflected in last year's SEED Act and the Administration's proposal for assistance to Eastern Europe in FY 1991. As part of the overall interagency coordination of economic policy with Eastern Europe, a wide-ranging program of technical assistance to Eastern European countries has been developed. We in the Treasury are giving particular attention to financial sector reform, and we are chairing an interagency task force to guide our efforts in this area.

Trade and Investment

The United States has entered into discussions with Eastern European countries aimed at reaching agreements to improve trade, business, and investment conditions. The investment discussions are intended to result in treaties or agreements that include provisions for stable, market-oriented policies towards foreign investment, free transfers of capital and returns on investment, fair dispute settlement procedures, and discipline over the use of performance requirements.

The first treaty, a business and economic relations treaty with Poland, was signed last month. It will be submitted to the Senate for approval in the near future. This treaty goes beyond the areas in our model bilateral investment treaty by extending protection to commercial activities, such as representative offices of U.S. companies seeking sales in Poland. The treaty also includes important commitments by Poland with regard to the protection of intellectual property, expropriation, and investment screening.

We had preliminary discussions with Hungary on investment issues prior to its recent elections. We will propose negotiating with the new government a business and economic relations agreement similar to that recently concluded with Poland.

Last week, we signed a trade agreement with Czechoslovakia that mutually applies GATT rules on trade, provides for protection of intellectual property, and guarantees non-discriminatory treatment in access to currency and banking accounts. Our investment treaty discussions with Czechoslovakia are underway, but are not near agreement.

Tax Treaties

We have income tax treaties currently in effect with some Eastern European countries, and we hope to begin negotiations soon on treaties with others.

These treaties form an important economic link with Eastern Europe, as with other countries, because they facilitate bilateral investment flows and business opportunities. Specifically, such treaties reciprocally raise the thresholds of business activity necessary for a foreign country's income tax system to apply. They also reduce foreign taxes on investment income, such as dividends, interest and royalties earned by U.S. residents. In addition, and often of equal importance, the treaties provide for the elimination of double taxation, through a reciprocal guarantee of a foreign tax credit or similar mechanism and through harmonizing technical rules. Finally, treaties establish a government-to-government tax dispute resolution system to which taxpayers can turn.

By undertaking treaty negotiations promptly with the countries of Eastern Europe where treaties do not now exist or need revision, we will make it more attractive for U.S. investors to enter those markets. Other industrial countries, such as France, Germany, Japan, and the United Kingdom have been concluding modern tax treaties with Eastern Europe. We want U.S. investors to operate under conditions no less favorable.

We have income tax treaties with Romania, Poland, and Hungary. These have been in effect for more than a decade, and are close to our model and the OECD model for income tax treaties. They have stood the test of time fairly well. In the restructuring of their economies, Eastern European countries may enact new laws, or modify existing laws, in such a way that revision of the tax treaties becomes necessary. Because the treaties are close to our model, however, many changes toward a more typical income tax system by these countries will be adequately accommodated by the existing treaties.

We expect to meet with representatives of Bulgaria later this spring to begin negotiations. We hope to begin similar talks with Czechoslovakia soon thereafter, and to resume negotiations with Yugoslavia once their tax reforms are completed. Treaty issues with East Germany depend on the progress and nature of unification with the Federal Republic of Germany.

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REMARKS BY JOHN E. ROBSON
DEPUTY SECRETARY OF THE TREASURY
MID-AMERICA COMMITTEE LUNCHEON
CHICAGO, ILLINOIS
APRIL 25, 1990

Thank you, Barry [Sullivan, Host of this Mid-America Luncheon]. It's a pleasure to be back in Chicago and to meet with the Mid-America Committee.

My topic is Eastern Europe and the historic potential it presents to those who possess a commitment to political freedom and an entrepreneurial spirit. Many in this room already have visited these newly emerging democracies, as I have. You probably also returned with strong impressions of a difficult and fluid political and economic environment.

The legacy of over four decades of oppression and economic mismanagement presents a daunting challenge to overcome: a deteriorated industrial base; the absence of basic business skills and commercial institutions; massive debt; environmental decay; a tattered economic infrastructure; and, often, psychological uncertainty and aversion to risk-taking brought about by lifetimes of dependence on state-provided and state-subsidized jobs, goods and services.

In large measure the communist governments in Eastern Europe toppled because they had driven their economies to ruin. And it is from these ruins that the fledgling and largely untested democratic governments must guide difficult and uncertain transitions to political stability and free-market economic growth.

Nonetheless, as recent elections throughout the region suggest, and as indicated by the patient reaction of the Poles to the pain attending their country's bold economic reform, there is, at the present time, a widespread willingness by these peoples to confront the challenges and pay the price.

The observations of an anonymous Polish citizen are apt: "No one has done this before," he said. "It's messy. But that's what freedom is all about, and we may as well get on with it."

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The United States has a significant stake in the success of these new democracies. In the interest of European stability we have in this century fought two world wars and conducted a protracted cold war struggle to contain communist expansion. But we cannot now become complacent and permit the reemergence of communist totalitarianism or allow the region to again become a tinder box of national rivalry and political instability.

The recognition of America's vital national interest in the future of the region has led some to question whether we are doing enough to protect that interest and others to demand a 1990's version of the Marshall Plan for Eastern Europe. Politically translated, "are you doing enough" means you aren't spending enough money. But I believe such criticism is both inaccurate and reflects a misunderstanding of the nature of the economic circumstances in Eastern Europe.

First, using the same accounting methods as our allies employ to tote their assistance to Eastern Europe--that is counting loans, credits, guarantees, insurance, and debt rescheduling in addition to hard cash outlays -- U.S. overall assistance is among the leaders.

Second, unlike the immediate post World War II situation, assistance to Eastern Europe is a multilateral undertaking where we join powerful and prosperous allies who have equally substantial stakes in the political and economic stability of the region.

And third, while Europe in 1947 was devastated, it possessed the private sector skills and institutions, and the basic infrastructure to absorb and prosper from massive economic assistance. Today, in addition to the need for fundamental reform of macroeconomic policies, these skills, institutions and infrastructure in Eastern Europe must be strengthened before investment and financial aid can effectively take hold. Flooding the region with money without linking it to structural reform and technical competence will only retard change and dissipate our assistance.

So my message is that the road ahead for these transitioning economic democracies is hard but passable; that we fully comprehend the importance of their success; and that the U.S. is assisting in very material ways designed to respond to the realities of the region and a demonstrated commitment to political pluralism, meaningful economic reform and respect for human rights.

The framework for U.S. assistance to the region embraces several guiding philosophies and objectives which I shall take a moment to elaborate upon.

Foremost, is the recognition that each country in the region differs from its neighbors so that a "cookie cutter" approach won't work. Moreover, the velocity of change is such that we need maximum flexibility in our ability to respond with custom tailored assistance when and where needed. And we offer no grand "Made in America" plan for the ultimate political or economic profiles of these sovereign nations. Nothing could be less practical to achieve or more alien to the concepts of political pluralism and free-market economics.

We are, first, prepared to offer short term emergency humanitarian aid to help meet the most pressing shortages of food, medicine and other necessities.

Next, we are emphasizing technical assistance that will help build the essential political and economic infrastructure: assistance to form political parties, hold elections, run legislatures; establish independent judiciaries; create a free press; run free trade unions; develop a banking system and financial institutions; create capital markets and the accompanying regulatory framework; facilitate the privatization of state-owned enterprises; and foster the broad acquisition of basic business and financial skills.

Soon, for example, a Treasury-led financial assistance mission with representation from key U.S. agencies will visit Poland and other countries in the region to determine precise needs and develop a delivery plan that will draw substantially on American private sector expertise.

And in response to an urgent request from Polish Deputy Prime Minister Balcerowicz, Treasury has arranged to provide ten two-man management consultant teams to assist Poland in assessing existing enterprises in key industries for possible restructuring and early privatization. They will review production, personnel management, marketing, and financial management practices. Each team will have a Polish member to afford an opportunity for training.

We are drawing the men and women for these consultant teams from the roster of experienced volunteers who have registered with the International Executive Service Corps. We hope to have these consultants working in Poland within a few weeks.

Over the longer term we will provide transitional economic assistance to countries prepared to take the strong medicine associated with conversion from command economies to free market systems. This process has already begun in the provision of a substantial U.S. contribution to support Poland's currency convertibility and in the establishment of Enterprise Funds for Poland and Hungary which will seed entrepreneurial activity.

In legislation now before Congress, we have asked for expansion of these private sector growth vehicles to all of Eastern Europe. We are moving as well to help with the debt burdens of these countries. Poland has just received the most generous terms ever offered for rescheduling its official debt by the Paris Club, and the U.S. is assisting in Poland's negotiations on its debt to commercial banks.

Our strategy also contemplates a vital role for the World Bank, the International Monetary Fund and similar institutions. These bodies are equipped to support economic transitions in ways that neither governments nor the private sector can--through structural adjustment financing of social safety nets to help absorb the dislocations of price deregulation and the dismantling of state-owned enterprises, and investment in traditionally public infrastructure such as roads. The newly emerging European Bank for Reconstruction and Development will add to the transitional support arsenal.

Underpinning our entire assistance philosophy is the conviction that the success of these economic transformations will depend primarily not on the response of government, but of the private sector and the attraction of investment. To that end, programs that encourage and facilitate private investment, such as the Export-Import Bank and OPIC, are important elements of our Eastern European strategy.

We have also pointed out to Eastern European leaders and aspiring entrepreneurs that their laws, regulations, and commercial practices must offer a hospitable environment for investment and that, in the competition for outside investment, capital will flow to the places with the most attractive investment climate. We have buttressed this with active negotiations to conclude bilateral trade, investment and tax arrangements so that U.S. investors may have confidence and equitable treatment regarding pre-investment approvals, repatriation of profits, protection of intellectual property, access to the financial system, tariffs, taxes, and resolution of disputes.

When Poland's Prime Minister was here last month, we signed a business and economic relations agreement that covers many of these areas. And we have just signed a trade agreement with Czechoslovakia.

These are the governing precepts of the U.S. approach to fostering democratic capitalism in Eastern European countries. As one of three coordinators President Bush has appointed to assist in the process, I might observe that it is not one that could be described as tidy. But this should be expected in an activity that seeks to usefully funnel public resources into widely disparate and rapidly changing situations, and at the same time enlist the powerful alliance of our private sector.

But there are encouraging signs. In Poland the zloty has remained stable, inflation has significantly declined after an initial bulge following price deregulation in January. On the other hand, real wages and production have substantially declined. Yet the vast majority of Poles stand behind the economic reform program which one senior official described to me as "surgery without anesthetics."

In Hungary, private investment has been flowing from major U.S. corporations. Other countries are in earlier phases of economic reform. While it is too soon to make any reliable long-term judgments, there are reasons for optimism.

What should private business do? My advice is to get over there and take a close look.

You will see the deficiencies, the risks and the uncertainties that I have described. You will see that some of these new governments, unsteady on their political feet, may deal cautiously with economic reform. You will worry that the economic situation in the Soviet Union poses a special problem for the COMECON countries which are still heavily dependent on the U.S.S.R. for trade and industrial input. And you will find that the legal and institutional framework will test your creativity.

But you will also find a tremendous enthusiasm and eagerness for American investment and economic presence. They are very conscious of our unflagging commitment to political and economic freedom and they <u>want</u> us there. You will be impressed, I think, with their determination to create market economies coupled with a will to act. And you will find low-wage, relatively well educated workers, plenty of underutilized industrial capacity, and good geographic locations to compete in the markets of Europe.

And you will also find hundreds of Germans, French, British, Swiss, Japanese and other businessmen and women scrambling to get their firms established. While I do not subscribe to the idea that Eastern Europe markets will inevitably be "locked up" by Western Europe, if American business waits on the sidelines until the situation looks stable and tidy, it will be too late.

These will not be ventures where you can expect to make a quick buck. You will have to take a long view. But I believe the potential for profitable investment is there.

And while you will have to decide for yourselves, you cannot make an informed decision sitting in your offices in Chicago.

Think about it.

Thank you.

CIA Report Presented to the Subcommittee
on Technology and National Security of t
Joint Economic Committee
May 16, 1990

Eastern Europe: Long Road Ahead To Economic Well-Being

SUMMARY

The end of Soviet hegemony and Communist control over Eastern Europe gives the peoples of this region the greatest opportunity to take control of their own destiny since the collapse of the multinational empires after World War I. The East European states are now trying, each in its own fashion, to head in the direction of the model they believe works--democracy with market-based economies. The ability of the new fledgling democracies to improve their peoples' economic well-being will be an important determinant of political stability.

In recent months the new reform-minded governments of Eastern Europe have pressed ahead and passed unprecedented legislation designed to transform their centrally planned economies into market based economies. Real progress has been achieved toward decentralizing management, freeing prices, expanding the private sector, encouraging competition, liberalizing private and foreign investment rights, and enhancing individual incentives. Most importantly, events in Poland in recent months have demonstrated at least one country's willingness to endure hardships imposed by a popularly elected government in exchange for the opportunity for a better future. Popular response to Warsaw's reform efforts has also shown that an entrepreneurial spirit survives; there are indeed risk takers and people with vision.

Nonetheless, the realities of the economic situation facing the region are daunting. The new governments must begin by confronting the legacy of their Communist predecessors--slow or stagnant growth, declining productivity, energy-intensive and obsolete heavy industries, heavy foreign debts, poor quality goods and noncompetitive exports, massive environmental problems, and deteriorating infrastructures, to name a few. Such problems will be difficult to overcome, require tremendous energies and investment, and act as a brake on future growth.

Despite the initial success of Poland and Yugoslavia in stabilizing their economies, and real progress in legislating reforms throughout most of the region, the most formidable obstacles to reform lie ahead. Implementation of

fundamental reforms dealing with politically sensitive issues such as bankruptcy, privatization, and unemployment has not kept pace with recent legislation. Unemployment is likely to soar if the new governments vigorously pursue plans to break up large single-enterprise state monopolies, restructure their economies away from noncompetitive heavy industries to light manufacturing and consumer goods industries, eliminate state subsidies, and let the market determine winners and losers. We estimate that unemployment could easily exceed 1.5 million in Poland--nine percent of the work force--by yearend. Similarly, we estimate potential unemployment at 15-20 percent in the GDR and Yugoslavia over the next year or so, and 5 percent or more in Bulgaria and Hungary.

Price rises and falling wages--attendant hardships of the reform process--are likely to be troublesome, but the loss of jobs is certain to be traumatic both for the unemployed and the new governments that will have to answer to them. These new governments will probably be hybrid coalitions that will take some time to get their bearings and come to grips with problems severe enough to challenge even the most stable and experienced democracies. As long as aggressive implementation of austerity measures coincides with prolonged decline in living standards, there will be a risk of public protest that could set back reforms and economic recovery.

Even if governments do persevere with reform efforts and the people respond favorably, overall economic growth in the region is likely to deteriorate further in the short term. Stabilization programs designed to rein in inflation, growing budget deficits, and hard currency debt will make it difficult to sustain growth. Performance may be poorest in those countries pushing reform the hardest--Poland, Hungary, and Yugoslavia--with output slowing and even declining as efforts to stabilize the economy and implement structural reforms prove disruptive. Although many East Europeans clearly have shown impressive boldness and courage in pushing ahead with reforms--and although these reforms should remove most of the worst features of Communist central planning--significant growth and improvement in living standards in the region, at best, will take years.

Opening Eastern Gates

The Western nations have clamped down on sales of high-technology products to the Soviet Union and Eastern Europe. Now the controls are outdated, and a new system is needed.

BY BRUCE STOKES

The Cold War may be over, but the U.S. government has only begun to sort through what that easing of tensions means for high-technology trade with the countries that made up the Soviet Bloc.

Since the late 1940s, the Western industrial nations have restricted exports of advanced technologies to the Soviet Union and its satellites. In the past few years, that system of controls has begun to break down, as European and American businesses, tempted by the emergence of new markets, have pushed for permission to sell ever-more-advanced items.

The Reagan Administration resisted that pressure; so did the Bush Administration, at first, though it now grudgingly accepts a need for some decontrol. "The goal of the Administration is to thoroughly review the future of controls in light of the strategic changes now taking place in the Eastern Bloc," Dennis E. Kloske, Commerce's undersecretary for export administration, said.

But so far, that liberalization has brought only incremental action. A series of events in June showed how far the United States has come and how far it yet has to go in adjusting its controls to rapid changes in East-West relations:

- On June 3, International Business Machines Corp. said it will sell more than 13,000 personal computers to the Soviet Union for use in schools. In the past, export permits for such a sale would have been denied.
- On June 6, at a meeting with its allies in Paris, the United States proposed a wholesale liberalization of Western export controls.
- On the same day, the House passed a bill that would push export decontrol even further.
- But, also on June 6, the Commerce Department, citing national security concerns, denied export licenses to US West Inc. for equipment to build a fiber-optic telecommunications system across the Soviet Union.
- Then, on June 18, Commerce announced that starting in July, it will ease export controls on almost all U.S. sales of high-tech goods to its Western trading partners. That step seems designed mainly to help U.S. firms compete in the European Community (EC) and doesn't change the rules for trading with the East.

The Cold War philosophy on export controls remains the same: that the sale of advanced technologies to the Soviet Bloc imperils Western security. But that assumption is now under full-scale attack by business interests in light of the Soviet military pullback in Europe, the democratization of Eastern Europe and economic reforms aimed at integrating the region into the world economy.

Some U.S. trade experts now argue for a radical shift in the export control system. "The United States should develop a long-range strategy for technology-transfer controls that transcends the present preoccupation with liberalization of transfers to Eastern Europe and the USSR," Washington trade consultant Harald B. Malmgren said. "This long-range strategy must include revised concepts of what technologies should continue to be controlled and revised concepts of monitoring and verification."

And Calman J. Cohen, vice president of the Emergency Committee for American Trade, a Washington lobby for U.S. multinational corporations, said, "The new system that will emerge, given current realities, will focus on nuclear proliferation and chemical and biological weapons." That kind of system suggests a major shift in focus: from East-West to North-South. And, ironically, that system would work only if the Soviets and Eastern Europeans helped to enforce it.

Such dramatic changes don't seem to be in the offing soon. For the next few years, incremental actions are likely to be the rule, while the West reassures itself that recent political developments in the East won't be reversed.

Proponents of export controls, meanwhile, continue to fight a rearguard action. "If you buy the argument that these Eastern European countries are well-meaning and earnest democrats, then you have the luxury to indulge in the kind of risk taking you couldn't in the 1980s,"

Richard A. Bloom

Washington trade consultant Harold S. Malmgren
He sees a need for long-range strategy on controls.

said Frank J. Gaffney Jr., director of the Center for Security Policy, a conservative think tank in Washington. "But I don't think it's justified today. And if that perceived strategic environment changes, people will say we made a tragic mistake."

But even Richard N. Perle, a strong advocate of broad controls as assistant Defense secretary for international security policy in the Reagan Administration, acknowledges that the situation now is different. "The changes taking place daily in Eastern Europe justify a liberalization in the sale of sensitive technology to nonmilitary concerns in such potential democracies as Poland and Hungary," said Perle, a resident fellow at the American Enterprise Institute for Public Policy Research in Washington.

And it seems unlikely that there will be a return to the old system, which was based on America's technological preeminence and shaped by Cold War thinking. "The idea that we are the big boys and can deny the Soviets technology is naive and outdated," said William T. Archey, international vice president of the U.S. Chamber of Commerce. "This anachronistic premise begs reality. The Soviets now have the ability to get technology from countries that don't share our view of the security threat."

And so, an era is passing, and a recasting of export controls seems inevitable. And the debate over controls has become an element of a broad rethinking of how to preserve America's security when military threats from the old Soviet Bloc are receding but worries are rising over America's economic future.

RUNNING BATTLES

Controls on exports to the Soviet Bloc have existed since 1949, when members of NATO (excluding Iceland) formed the Coordinating Committee for Multilateral Export Controls (CoCom). (Japan and Australia joined the group later.)

The goal was to hamper the Soviets' ability to wage war. At first, this meant imposing controls on military technologies. But in the early 1980s, the Reagan Administration forced CoCom to include any advanced technologies that might bolster the Soviet Bloc's economies. For the past few years, these new trade barriers have provoked running battles across the North Atlantic and in Washington.

Faced with a European threat to break up CoCom, the Bush Administration has agreed to less-pervasive controls. At CoCom's meeting in Paris on June 6-7, restraints were scrapped on 38 products of little strategic importance. The list of controlled dual-use technologies—items with both industrial and strategic value—will be chopped from 116 to 8. And higher-performance computers, machine tools and telecommunications equipment can now be sold to the East.

But these changes were not enough to satisfy many Members of Congress—or American businesses that want the green light to sell Eastern Europe more-advanced technologies, especially telecommunications hardware, and quicker U.S. approval of export licenses.

The House-passed bill, sponsored by Sam Gejdenson, D-Conn., would narrow the Defense Department's role in reviewing export licenses and would set up a mechanism to resolve interagency disputes and expedite licenses.

The White House threatened to veto the bill, but it was passed overwhelmingly, 390-24. The bill now goes to the Senate, where its future is uncertain. On the issue of export controls, a Senate aide said, "The House has always been prepared to go further, and the Senate has always been more cautious."

The Senate Banking, Housing and Urban Affairs Committee is expected to produce a draft bill soon. But most analysts think that the Senate's version will be written on the floor, and that conservatives' resistance and the Administration's easing of controls will lead to a bill that's less ambitious than the House's.

With Congress working against a September deadline for reauthorizing the 1969 Export Administration Act, the legal authority for U.S. export controls, no one rules out the possibility of a simple one-year extension.

That would not be acceptable to many Americans businesses, Cohen said. "We can't afford to wait" for major changes, he said, noting that a number of Eastern European countries are considering upgrading their telephone systems. "These are big contracts, and whoever gets these initial orders for major telecommunications systems will have them for the foreseeable future."

More broadly, a rethinking of export controls is necessary, advocates of change say, because there is no longer an Allied consensus on restraints and because so many things have changed. Within the EC, trans-Atlantic trade, as a factor in its economic future, is diminishing in importance. Intra-Europe trade is viewed as the real engine of growth, and expanding that trade eastward has a natural appeal.

In addition, Archey said, "There is an

Susan M. Munak

Commerce undersecretary Dennis E. Klosko
The Administration is reviewing export controls.

exhaustion on the part of CoCom members in seeking to control so large a universe of products, and there is a lack of conviction that that which is controlled needs to be, under any reasonable definition of strategic interest."

"When one looks at Europe, it becomes painfully obvious that the United States is moving incrementally while everyone else is thinking in a more revolutionary way," a U.S. government expert on export controls said.

And Harold Brown, who was President Carter's Defense Secretary and now heads the Johns Hopkins University Foreign Policy Institute in Washington, said that the Bush Administration's change of heart in Paris "will probably not satisfy the other industrial democracies."

CHANGING PERCEPTIONS

With the diminution of the Soviet military threat, the U.S. security role in Western Europe likewise will shrink. In that environment, European nations are likely to be less willing to subsume their economic interests to U.S. concepts about restraining some business sales for the sake of Western security.

"We have to recognize that there are new trade opportunities in Eastern Europe and that the Europeans are not going to sit on the sidelines much longer," Rep. Toby Roth, R-Wis., a strong supporter of the Gejdenson bill, warned.

That push for change is already transforming CoCom. "CoCom, like NATO, is a creature of the Cold War and of the Soviet threat," Paul Freedenberg, Commerce undersecretary for export administration under President Reagan, wrote in a recent study for the Japan-U.S. Joint Study Group on Trade, Finance and Technology in East-West Economic Relations. Freedenberg, a Washington trade consultant for the Houston law firm of Baker & Botts, wrote: "As the threat perception recedes, CoCom even more than NATO is likely to seem unnecessary and anachronistic. And, unlike NATO, there is no sector of the constituent countries that benefits from its existence."

At Great Britain's insistence, CoCom members agreed to draw up a short list of key technologies subject to controls. In effect, all exports soon will be permitted unless specifically banned.

Over the years, the list had gotten longer and more technical, identifying types of products subject to controls based on technical performance—computers' speed, for instance. The list set performance levels above which any export to Eastern Europe or the Soviet Union had to be reviewed by CoCom. If a CoCom member objected, a license was denied. Exports of high-tech products to the Soviet bloc were effectively banned unless specifically permitted.

The new list is scheduled to be completed by December. Few American experts think that schedule can be met. And, Archey warned, "The danger is that people can play games with it by defining categories." Nevertheless, after the new list is in place, CoCom won't be the same.

The British also wanted an agreement to treat exports to the Soviet Union the same way that sales to Eastern Europe will be treated. But the Americans objected, and under the Paris accord, the Soviets will still be denied some telecommunications technology and computers that Eastern Europeans can get.

Gejdenson's bill also would deny the Soviet Union access to some computer and telecommunications technology until it ends its economic blockade of Lithuania and formally eases restrictions on Jewish emigration.

But treating exports to Eastern Europe one way and exports to the Soviet Union another won't work in the long run, some analysts say. The continued easing of East-West tensions is predicated on the success of Soviet economic reforms, they say, and success may turn on the Soviets' access to Western technology. As a business association executive in Washington put it, "What is the greater threat to the national security of the United States—selling to the Soviets or the economic disintegration of the Soviet Union?"

Furthermore, because of the growing number of joint ventures between Western and Soviet partners—such as the deal between Gulfstream Aerospace Corp., Rolls Royce Ltd. and the Soviet Aviation Ministry to develop a supersonic aircraft for business travel—it may become increasingly difficult to keep key technologies out of Soviet hands.

"A two-tiered concept of export controls is likely to have a relatively short life," Malmgren said. "It is likely to be replaced in due course by a general end-user certification and verification approach for all technology transfers to all countries designated as subject to CoCom controls."

CONTROLLING BY INSPECTION

Even proponents of a two-tier system acknowledge that it will be hard to sustain. "The Bush Administration has made the defense of [a dual system] infinitely more difficult by its embrace of [Soviet President Mikhail S.] Gorbachev and its repeated expression of its commitment to his programs," Gaffney said. "The logic of [the White House position] is, you won't deny him any technology he wants."

Frank J. Gaffney Jr. of a conservative think tank
A two-tiered system of controls would be difficult.

As the list of controlled technologies shrinks and more trade with the Soviet Union becomes possible, the very nature of export restraints may change—from controlling the Soviets' access to technologies to controlling the way they use them.

The CoCom agreement signals a shift in thinking. It grants access to higher levels of technology to Czechoslovakia, Hungary and Poland than it offers the other Warsaw Pact nations, based on those three nations' safeguards against the diversion of such technologies to the Soviet Union.

Conservatives grouse that by agreeing to such steps, the West is starting down a slippery slope and ultimately will grant the Soviets access to advanced technologies if they give assurances that they won't be used for military purposes.

These objections may be well-grounded. In November, Soviet deputy prime minister Leonid I. Abalkin suggested in Brussels that the USSR would accept some form of Western end-user verification in return for access to more Western technology.

Commerce's Kloske said the Adminis-

Richard A. Bloom

Colman J. Cohen of the Emergency Committee for American Trade "We can't afford to wait" for major changes in export controls laws.

tration does not take Abalkin's proposal seriously. But Malmgren said that the Soviet suggestion, which seemed to be a surprising turnaround, has an internal logic. "The Soviet economic reformers are eager to prevent the USSR defense enterprises from acquiring Western equipment which might better be applied to production of consumer goods," he said. Thus, he said, Soviet reformers have their own reasons for wanting the West to ensure that new technologies aren't put to military use.

Effective verification may demand inspection—Western observers wandering around factories to ensure that machine tools are making cars, not tanks, for example. Today, that sounds like an unacceptable infringement of sovereignty, but such inspections may become a fact of life. Compliance with new arms control agreements, for instance, will require increasingly open societies.

Nevertheless, it will not be easy to regulate high-tech exports by certifying how they're used instead of controlling their shipments across borders. Western Europeans object to verification, worrying that Washington might also want to inspect their operations.

The new, shorter control list will also undoubtedly be difficult to enforce. In the past, whole categories of goods couldn't be exported. In the future, permission to export will depend on judgment calls of how technology could be used.

A new system of inspection and verification will only be as good as its ability to impose sanctions if violations are found. History suggests that Western governments are often reluctant to rebuke the Soviets for violations for fear a confrontation will jeopardize efforts to improve strategic relations.

Moreover, it isn't easy to punish those who violate export controls—as the United States found out in 1988 when it tried to penalize Toshiba Corp. because one of its subsidiaries sold advanced machine tools to the Soviets. That incident led to a crisis in U.S.-Japan relations and resulted in little more than a slap on the wrist for Toshiba.

Ultimately, the most revolutionary change some expect in CoCom is a shift from a focus on the Soviet bloc to a concentration on the control of regional conflicts and terrorism. As East-West tensions subside, there is growing concern that countries such as Libya and Iraq may gain access to nuclear weapons, missile technology and the wherewithal to conduct chemical and biological warfare.

CoCom is the logical multilateral organization to impose new controls on the flow of these technologies. The enforcement bureaucracies of CoCom's members are the only organizations with the necessary experience and trained personnel. And the breakdown of national controls—as illustrated by revelations of West German sales of chemical-weapons technologies to Libya—suggests that international rules are needed.

Kloske said that the Administration will soon address this issue. But CoCom members alone cannot halt such proliferation: The Soviet Union and the nations of Eastern Europe have also been responsible for selling technologies with military applications to the Third World and may be sorely tempted to enter into more such deals.

"There may be a convergence of interest between CoCom and the Soviets over what goes south," Archey said. "I think we are heading more and more toward seeing a CoCom that involves the Soviet Union in the process."

Archey quickly added that he does not now advocate such a union. And observers don't expect such a move soon. But "that is the revolutionary implication of the changes we have begun for the export control system," Cohen said.

A bigger problem in the short run, former Defense Secretary Brown said, may be differences within CoCom over proliferation issues. "There is greater cohesion among CoCom member states in their attitude toward the Soviet Bloc than with respect to out-of-area countries," he said. "It may take some ghastly incident to force a change in the present attitudes."

These questions are likely to be addressed in a National Academy of Sciences report, due next February, that is expected to go far beyond the Administration's current position or Gejdenson's bill.

The potential changes in export controls are momentous but by no means inevitable. They could be derailed by a switch in the Soviet leadership. Or a high-visibility case of technological piracy could sour Western public opinion, which now favors greater trade with the Soviets.

Opponents of export decontrol warn that the West is moving too fast. "The threat is, we are taking essentially irreversible steps, and it will be too bloody late to establish the kind of security arrangements we need," Gaffney said. Western economies could become so tied to Soviet trade that they would be reluctant to cut it off even if the Cold War returned, he said.

Critics also say that advocates of change assume that U.S. industry will be able to take advantage of new openings, but that European and Japanese firms may get there first. West German companies, for example, are investing much more heavily in Eastern Europe than American companies are. If the U.S. economy doesn't see much benefit from lifting controls, U.S. businesses' ardor for export decontrol may cool.

Given the problems and uncertainties in the Soviet Union and Eastern Europe, the liberalization of controls on high-tech products is likely to be slow. The Administration's proposed changes will take some time to digest and, according to many CoCom observers, have for the moment dampened proposals for further action. And whatever new system may be installed, restraints on militarily significant technologies are likely to stay in place so that the West can keep a comfortable strategic lead over the Soviet Union.

Nevertheless, Malmgren said, "Now is the time to begin thinking about what we really want to achieve and how we go about it." ■

Is the Scandinavian Welfare State a Model for Eastern Europe?

Policy Forum

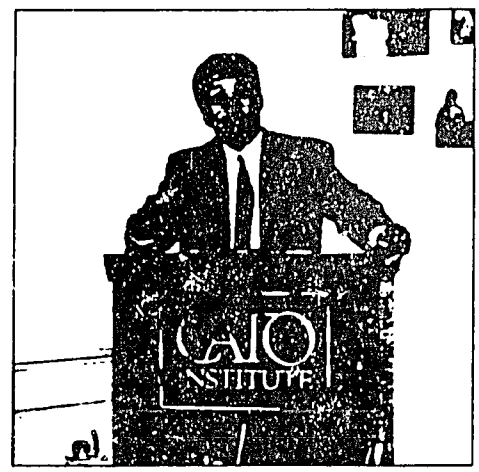
The Cato Institute regularly sponsors a Policy Forum at its Washington headquarters, where distinguished scholars and policymakers present their views to an audience drawn from government, the media, and the public policy community. A recent forum featured Carl I. Hagen, the leader of Norway's Progress party.

Carl I. Hagen: As communism is dismantled in Eastern Europe, social democrats all over the world are urging the new regimes in the region to adopt a Scandinavian welfare-state model, not a pure free-market system. Having spent most of my life in such a "utopia" —"the most perfect of all systems," Norwegian social democrats love to call it—I want to warn the East Europeans not to heed that siren song.

The most obvious failings of the welfare state are that it is too expensive and has not produced the results it was intended to produce. But a closer look reveals that the welfare state has begun to destroy the work ethic and a sense of personal responsibility, on which every society depends in the long run. It has already distorted people's understanding of some basic concepts, the most important of which is the connection between production and consumption—between performance and rewards.

The attitude embodied in the Marxist dictum "From each according to his abilities, to each according to his needs" —which is nothing other than that one has a right to other people's property or production but not one's own—still dominates the philosophical and political scene in Scandinavia. The definition of so-called welfare rights—that is, of what people are "entitled to," regardless of their efforts—has been expanded constantly. Years ago most Scandinavians believed that what the state should provide was enough food, shelter, and clothing to allow people to get by. Later it was a larger flat and a television set, and this year it is a color TV, a videocassette recorder, and a vacation abroad. What will it be next year?

The intellectual basis of that development is the determinism of the left. If the individual is not responsible for raising his own standard of living, it is unfair for one person to have more than another. If society, upbringing, or class determines one's station in life and wealth can be attributed to luck or exploitation, there is no reason that the tax system should not be used to soak the rich and extend "compassion" to not only the poor but also the middle class. Such thinking is common among the intellectuals in Scandinavia but less so among the voters at large.



Carl I. Hagen: "The Scandinavian welfare state has little to offer either East or West."

Many Scandinavians believe that wealth should be a function of ability and hard work yet also believe that it is right for the government to claim the responsibility of providing welfare programs for the poor. I would like to see the state's role confined to providing a minimum safety net for the really weak. Moreover, that safety net should not be so generous that it takes away their motivation to get off welfare and improve their lives.

During the election campaign last fall I questioned the fairness of the government's supporting single parents. Why, I asked, should the state guarantee that an individual's choices have no adverse consequences? Why should it reward irresponsibility? Never have I received so much abuse! Many people thought that I had turned into some sort of "moral majority" crusader. They missed the point. I do not want to interfere with anyone's personal life, nor do I consider single parenthood intrinsically immoral. However, I believe that people should take responsibility for their actions.

In his remarkable book *Losing Ground*, Charles Murray concludes that the American welfare system has made it more lucrative to be a nonworking single parent than to be a married worker and thus has been instrumental in breaking up families. The Norwegian welfare system is having the same effects. I advocate a strong family structure because I believe that the individual is not strong enough to protect himself from the state. Such protection requires a lot of voluntary associations, both inside and outside the market. The family is such an association.

Scandinavians' attitudes toward social benefits have changed considerably over the past few decades. The architects of the welfare state wanted to remove the social stigma of being on welfare, which is one of the reasons that it has been transformed from a safety net for the truly needy to a universal system. Now that everyone is viewed as a welfare-state client, being on welfare is not considered shameful. Perhaps it should be, not because we should be unfeeling but because it is other people's money that the state is giving away. More important, in the long run welfare is not in the interest of the recipients. They become trapped and lack incentives to escape—as most of them could, and thereby improve their lives.

The government's decision to provide financial security to all citizens, not only the poorest and the weakest, has made the Scandinavian welfare state far more expensive and obscured its effects. Although redistributing wealth to the poor is the main objective of the tax system, one of the results is what public choice economist

Gordon Tullock called "welfare for the well-to-do." It may be that the net short-term effect of the government's welfare programs is to benefit the middle class, not the poor, the disabled, or the elderly, but the net long-term effect is to make everyone a loser.

Besides making it easier to rely on other people's efforts, the tax system has made it harder and less attractive to be self-sufficient. Taxes now account for more than 50 percent of Norway's gross national product (excluding oil revenue). The most damaging aspect of the Norwegian tax system is a high marginal tax on middle incomes. The top rate, 59.3 percent, is applicable to incomes above 205,000 kroner (about $32,000). Likewise, many Swedish families cannot live decently on their after-tax incomes. The tax system has been pushing middle-class Scandinavians into the welfare queues.

So what have we achieved by imposing high taxes on ordinary levels of income and providing extensive social benefits? What have we achieved by ridiculing such traditional values as self-sufficiency, thrift, and hard work and brainwashing people into believing that they are entitled to welfare? The answer, of course, is less employment, less production, and more welfare recipients.

A particularly disturbing result of the welfare state is the destruction of the individual's personal, direct, and voluntary responsibility for the less fortunate. When people get sick or grow old, their children are paid by the state to take care of them. Indeed, most sick or elderly people prefer having the state take care of them to "burdening" their families. The "compassionate" welfare state is in fact destroying compassion by socializing it. People are beginning to refrain from helping the less fortunate unless they are paid to do so.

Although direct welfare payments are perhaps the most damaging aspect of the welfare state, the largest amounts of money are spent on entitlements, such as health care and pensions. Some people think that Norway spends too little on health care; it spends less than 7 percent of GNP, compared with a U.S. expenditure of more than 11 percent. The problem is that almost all of the money is spent on health-care providers in the public sector. As a result, there are long waiting lists not only for those who need minor operations and treatments but also for those who have life-threatening illnesses.

Moreover, although the health-care expenditure has grown tremendously during the past few years (as in most other Western countries), a large percentage of the money has been used to improve the working conditions of the employees, not to secure more and better treatment for the patients. That situation, of course, is typical of a public-sector enterprise without competition—the customer is of little importance.

The Progress party wants to shake up the health-care establishment by adopting a voucher system that resembles America's Medicare prospective payment system and letting hospitals, public and private alike, compete for customers. Government financing would still be available for most health services. That might not seem like a radical free-market idea in the United States, but believe me, it is in Norway!

Edward H. Crane welcomes Carl I. Hagen to a Cato luncheon.

I'm sure you are familiar with the problems posed by Norway's pension system. Like America's social security, it is a pay-as-you-go system. The composition of the Norwegian population is changing rapidly, so there will be far more pensioners and fewer workers to support them. On top of that, considerable supplementary-benefit obligations are being built up, but no money is being set aside.

The only real solution is to adopt a fully funded system, but that would be politically impossible in the short run—today's workers would have to pay for both their own pensions and those of today's pensioners. The Progress party has therefore proposed to phase in a system under which a minimum pension for all workers would be financed by the state, but any extra benefits would be provided by private (and hence fully funded) pension funds.

We made that proposal during the election campaign last fall, and we probably lost several percentage points as a result. Bravery is a dangerous thing in politics, and many of the voters didn't appreciate our telling them the truth about the coming social security crisis. Looking back, I have mixed feelings. It is never nice to lose votes, but the issue had to be confronted. Lately various experts and the popular media have been saying that a system involving private pension funds should take over some of the government's responsibilities, which is basically what we were saying last fall.

If the Scandinavian welfare state is a failure, why hasn't it been dismantled? Let me first say that Norwegian voters are beginning to demand an alternative, as evidenced by the growth of the Progress party's mandate over the past three years—from 3–4 percent of the vote to 12–15 percent—and the decline of both the Labor party and the Conservative party. One of the reasons the Norwegian welfare state has survived is that the establishment has backed it so strongly. An overwhelming majority of the intellectuals in Norway are socialists; many of them are outright Marxists.

Norway doesn't have a strong free-market intellectual tradition like that of the United States. The conservatives in Norway have always been very "wet," to use a British term, and had always been on the defensive, accepting and adopting most of the socialists' basic positions. However, last year Norway's chief social democratic think tank published a report concluding that the left was on the defensive and that dissatisfaction with the welfare state was spreading.

Another reason the Norwegian welfare state has survived is the windfall tax revenue from North Sea oil and gas, which constitutes 10 percent of Norway's revenues. It has enabled the government to pay for a growing wel-

(Cont. on p. 8)

Eastern Europe (Cont. from p. 7)

fare system without increasing taxes. If Norwegians had been forced to pay for all the social benefits out of their own pockets, they probably would have become disenchanted with the welfare state much earlier.

I must also stress that the welfare state is a kind of time bomb. As the population ages and Norwegians demand still more services, the health-care and pension systems will undergo some real crises. Moreover, the consequences of destroying the individual's incentives to be self-sufficient have yet to be fully felt. I believe that the failings of the welfare state will become even more apparent over the next few years and that there will be opportunities for real reform. We might soon see the turn of the tide.

An important lesson, especially for the new regimes in Eastern Europe, is that a strong productive sector is needed to support a large welfare state. Consider the case of Sweden. Prewelfare Sweden was one of the world's richest societies. At first the Swedish government managed to keep the economy going while expanding the welfare state. But in the 1970s and the 1980s Sweden experienced some of the lowest economic growth rates in the Western world—not because its industries were inefficient but because they were not strong enough to bear the heavy burden of financing the welfare state. Norwegians would have been even worse off without the oil revenue.

My advice to East Europeans is therefore to keep welfare benefits to a minimum and provide a safety net for only the truly needy. After you have built productive economies, you can consider redistributing wealth. It would still be a bad idea, but at least it wouldn't bankrupt your societies.

My advice to Westerners is to take a closer look at the Scandinavian model. We Scandinavians are growing disillusioned with the welfare state and ceasing to believe that it can deliver what was promised. The moral hazard of the system—its encouragement of unproductive and antisocial behavior—is becoming evident to us. The Scandinavian welfare state has little to offer either East or West. Neither should adopt a model that we have begun to reject. ■

TRADE

U.S.-Soviet Pact May Falter Over Baltics, Emigration

With the summit between President Bush and Soviet President Mikhail S. Gorbachev less than two weeks away, a trade pact expected to be a central feature of that meeting is generating more doubt than enthusiasm on Capitol Hill.

"I'd put it high on the list of things that are without momentum right now," said House GOP Chief Deputy Whip Steve Gunderson of Wisconsin.

As recently as April 26, Julius Katz, deputy U.S. trade representative, announced that negotiators for both sides were in "virtual agreement" on a trade deal.

The pact would be the first between the two superpowers since their military alliance ended with World War II. It would grant the Soviets most-favored-nation status (MFN) and subject Soviet goods to the usual import duties. For some Soviet goods, duties are now 10 times higher.

But on May 15, White House spokesman Marlin Fitzwater refused to confirm that the agreement would be signed during Gorbachev's May 30-June 3 visit to Washington.

"I don't know if the agreement itself is in trouble, but I can picture trouble for it in Congress," said Bob Packwood of Oregon, ranking GOP member of the Senate Finance Committee.

The most obvious obstacle is confrontation between Moscow and the Baltic States of Lithuania, Latvia and Estonia. A non-binding resolution in the Senate already has linked approval of the trade agreement to Soviet behavior in Lithuania. *(Weekly Report, pp. 1334, 1084)*

But Packwood immediately paired that problem with another that could kill the agreement faster: emigration rights of Soviet Jews. That is the same issue on which the last effort at a U.S.-Soviet trade agreement foundered in the early 1970s. *(Story, p. 1538)*

The Soviet Union has loosened restraints on emigrants recently, allowing the number of visas to hit new heights. But the United States has insisted that the freer practice be given statutory permanence.

By Ronald D. Elving

Lloyd Bentsen

Bob Packwood

"Lithuania by itself might not be enough to stop [the agreement]," said Senate Finance Chairman Lloyd Bentsen, D-Texas. "But if the Soviets have not passed that [emigration] law by the time we see the agreement, that agreement will be in very, very serious trouble."

Promises and Postponements

Bentsen said that during a visit to the Soviet Union in January, he received promises that the new emigration policy would be codified "soon." The passage of time, he said, has been troubling. "I have heard rumors, and they're just rumors, that the codification is in question," Bentsen said.

"We've been understanding they were about to do it almost weekly for the past three months," said Rep. Bill Frenzel, R-Minn. "I'm just going by smell, but obviously they've got problems. My guess is they're having second thoughts about losing a lot of high-powered people [to other countries]."

Among the dates the Soviets have mentioned most recently for final action on the law by the Supreme Soviet are May 26 and even May 31, in the midst of the summit.

Congressional objections to Soviet limits on emigration in the early 1970s led to passage of the Jackson-Vanik amendment to the 1974 trade act. That language, still in effect, stipulated that no communist country could enjoy MFN status until the president assured Congress that the country's citizens had free rights of emigration. The amendment also limited credits for such countries. The president was empowered to waive the law when he was convinced that the country in question had revised its emigration policies.

Interest in normal trade relations with the Soviet Union has increased during the Gorbachev years, and the numbers of Jews allowed to leave has soared. In 1989, more than 60,000 Jews were allowed to go. Thus far, it appears 1990 will see even more leave the Soviet Union. The more than 10,000 who left in April alone represented a new high, according to Rep. Charles E. Schumer, D-N.Y.

"The numbers are terrific," said Schumer, who has opposed an early waiver of Jackson-Vanik. "The concern is, will it continue? How precarious are the policies and even the government that's behind the policies?"

Schumer also acknowledged that while playing the MFN card too early risks a loss of leverage, holding the card too long could cause the Soviets to give up in exasperation. "But the economic imperatives are different now than in 1973 and 1974," he said. "There was less urgency then."

A Conflict of Urgencies

As urgent as the Soviets' desire for MFN status may be, Gorbachev has so far refused to let Lithuania, Latvia and Estonia follow Eastern Europe to independence.

These states were absorbed into the Soviet Union in 1939, but the United States has never recognized them as such, treating them instead as "captive nations."

"Without some resolution of the problem in the Baltic States I'd say it was almost impossible to get most-favored-nation status for the Soviets," Gunderson said.

As of May 16, Bush still seemed willing to take that chance. "I'm unhappy about the state of play in the Baltics," he said at a White House news conference, "because I'd like to see them obtain their desire of freedom as soon as possible. But I feel it's important from our standpoint ...

and indeed [that of] the whole world that we have these discussions with Mr. Gorbachev." *(Text, p. 1591)*

Immediately following the announcement of the trade agreement on April 26, Sen. Alfonse M. D'Amato of New York and eight other Republicans sent a letter of protest urging Bush to renounce the agreement while the Soviets maintained their embargo against Lithuania.

The initial protesters were soon joined by Democratic Sens. Barbara A. Mikulski of Maryland and Dennis DeConcini of Arizona. Senate GOP leader Bob Dole of Kansas sent a note of support.

D'Amato followed up with a resolution attached to the 1990 supplemental appropriations bill (HR 4404), warning that the Senate would reject any trade agreement until the Soviets lifted the embargo against Lithuania and began negotiations aimed at giving the state its independence.

Some senators characterized that vote as a pressure valve that allowed lawmakers to let off steam without actually affecting policy. The Bush administration did not extend itself to battle the amendment.

But Packwood gave the vote weight. "That vote expressed the feelings of the Senate," he said. "I wonder whether the president would even want to bring the agreement up for a vote. I don't think he wants to get himself in that situation."

One of those voting against D'Amato's resolution was Max Baucus, D-Mont., chairman of the Senate Finance Subcommittee on International Trade. "I just didn't think we should be making foreign policy on the Senate floor," Baucus said.

Baucus pointed to the mood created not only by Lithuania but by sputtering efforts at negotiating controls on nuclear and conventional forces.

"By the time an agreement gets signed and sent up [to Congress]," Baucus said, "I fully expect these situations to have been resolved. It's so much in the interest of both countries that we do this."

Fuzzy on Details

The actual agreement has not been made public by the Office of the U.S. Trade Representative (USTR), although a broad outline has been shared with the media and congressional staff members.

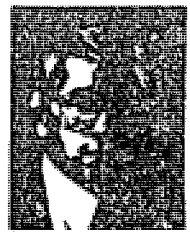
In general, the agreement sets forth basic mechanisms for expanded trade, a kind of framework for further negotiations. It does provide for satisfying the Jackson-Vanik conditions, according to the USTR, apparently by having the president waive them for some period of time.

The agreement provides for trade officials of each country to have commercial offices in the other. It also contains commitments to keep all rules and regulations under the accord open to scrutiny on both sides.

Like other trade agreements, this one reportedly includes several "side letters" of understanding that are not part of the formal pact. These are said to contain some of the concessions sought by the U.S. negotiators.

Beyond this, the agreement provides financial regulations for currency exchange, return of profits to the profit-maker's country of origin and protection of intellectual property. It also reportedly allows either country to bar certain imports from the other if those imports are seen as "flooding" a particular market.

"I'd put it high on the list of things that are without momentum right now."



—Rep. Steve Gunderson, R-Wis.

Under the original Jackson-Vanik amendment, either the House or the Senate could kill a grant of MFN status by passing a resolution of disapproval.

But that provision ran afoul of a 1983 Supreme Court decision (*Chadha v. Immigration and Naturalization Service*), which essentially ruled one-chamber congressional vetoes unconstitutional.

A new set of rules making its way through a conference committee as part of a customs and trade bill (HR 1594) would eliminate the *Chadha* problem by having both the House and Senate pass a joint resolution if they wished to disapprove of a Jackson-Vanik waiver or of the granting of MFN status to any other country.

Such a resolution would have to be presented to the president, who could veto it. The House and Senate could then attempt an override.

China Question Open

One more trade-policy tripwire lying ahead for Bush is the expiration of China's MFN status on June 3.

China has enjoyed a burgeoning U.S. trade and already runs a considerable surplus, up nearly 80 percent in the first two months of 1990. At the current rate, the Chinese surplus could hit $11 billion this year, making it second only to Japan's.

But Bush has been under pressure from human rights groups and others who see renewal of China's MFN status as tacit approval for last year's massacre in Tiananmen Square and the brutal repressions of the past year.

In a floor speech May 18, Senate Majority Leader George J. Mitchell, D-Maine, said renewal of MFN status would "sacrifice our principles to temporary dictators." Mitchell said Bush's conciliatory efforts to date had been "a dismal failure" and urged him not to "compound the mistake."

"It isn't an easy call," Bush had said May 16, "because I don't want to send a signal that we are happy with the human rights record."

The same day, Stephen J. Solarz, D-N.Y., chairman of the House Subcommittee on Asian Affairs, held a hearing on the issue at which human rights and trade groups presented their views.

The National Association of Wheat Growers argued for an extension of MFN for at least a year to cover grain sales already negotiated. Business groups from Hong Kong warned that removing MFN status for China would hurt their economy as well.

Others, such as former U.S. Ambassador to China Winston Lord, argued that Bush could retain the benefits of MFN status without signaling approval for the regime in power. Lord said Bush should offer a year's extension of MFN "with the openly expressed purpose of supporting progressive forces in China . . . and maintaining the foundations for longer-term American-Chinese relations."

Congressional anger over the crackdown in China resulted in passage last year of a bill (HR 2712) that would have permitted Chinese students who were in the United States at the time of the massacre to seek permanent resident status without returning to China. The measure, sponsored by Rep. Nancy Pelosi, D-Calif., passed the House on a 403-0 vote and the Senate by voice vote. Bush vetoed it in November; the Senate sustained the veto in January. *(Weekly Report, p. 245)* ■

IMF WORKING PAPER

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Macroeconomic Adjustment and Reform in Planned Economies

Prepared by Thomas A. Wolf*

Authorized for distribution by Massimo Russo

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Abstract

This paper examines the relationship between macroeconomic stabilization and market-oriented reform in planned economies. It emphasizes that market-oriented reform should enhance the likelihood that adjustment to exogenous disturbances will involve genuine adjustment in the sense of actually eliminating or at least reducing both internal and external imbalances. Market-oriented reform should also increase the ability of the authorities to carry out stabilization policies relying on indirect rather than direct instruments. The paper argues that the sustainability of such reform may critically depend on the pursuit of policies that contain inflationary pressures, but that the environment for adoption of such policies will depend in turn on the appropriate sequencing of reform measures.

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THE WALL STREET JOURNAL FRIDAY, APRIL 6, 1990

A Recipe for a Free-Market Hungary

By BRUCE CHAPMAN

"Communist" is openly a dirty word in Hungary now, the epithet cabdrivers shout at others who get in their way. Karl Marx, whose name recently was removed from the University of Economics, is shown in one campaign poster as a plaster bust dropped into a trash can, next to Mao's Little Red Book and a Medal of Lenin.

But, despite Hungary's heady political atmosphere, inflation still exceeds 20%, most workers need at least two jobs to survive, collapsing state enterprises threaten high unemployment, and Hungary's $20 billion foreign debt – at $2,000 per capita – is Europe's highest. The government formed after Sunday's elections will find itself in charge of an economic crisis.

In anticipation of this moment, several Hungarian economists attached to rival parties, and an expatriate, Paul Marer of Indiana University, last fall came up with what, for Hungary, was a novel idea: a private Blue Ribbon Commission of prominent domestic and international figures to give a new government an integrated program for transforming Hungary into a market economy. Hudson Institute, an Indianapolis-based think tank, and East West Forum, the Bronfman Foundation's policy center, became the chief international organizers.

The commission report is likely to be implemented in some form by the new Hungarian government. Experts from the outgoing government participated, thereby helping neutralize future opposition. Commission members from nine foreign countries will help provide international credibility. Most important, leaders from the two top parties (both non-Communist) in Sunday's runoff are members of the commission and have signed the report.

The report, excerpted nearby and to be released today in Budapest and Washington, echoes the advice given recently on this page by former New Zealand finance minister Roger Douglas – "package reform: into large bundles" and implement them quickly. Here are a few of the bundles:

Privatization: The previous government's efforts at "privatization" were mishandled, causing public scandal when it turned out that some enterprise managers used the process to enrich themselves. So the commission proposes an agency under the prime minister to speed and guard the new privatization process and promote competition. A more enforceable bankruptcy law is advocated to help flush out those state enterprises with non-performing loans, especially those participating in the notorious queuing gambit, wherein essentially broke outfits keep going by means of chains of credit extended to one another. The commission also calls for broad restoration of private agriculture and for bringing private competition to life in banking, medicine, education, and even local garbage collection.

Foreign investment: Even with the programs it proposes to spark domestic savings, the commission makes clear that Hungary must acquire much of its capital from foreign private investment. Approval procedures, it says, should be simplified and an Invest Hungary agency set up to help outside investors get inside.

Entrepreneurship: Laws that overregulate entrepreneurs should be repealed, according to the plan, and a new government office should constantly monitor the financial regulators to find out what kinds of burdens are being imposed. Schools are to teach the merits – and morality – of entrepreneurship, along with bookkeeping, cost accountancy, and other requirements of new businesses. Sales of government enterprises to foreigners are to help establish venture capital funds for Hungarians, as well as to help pay off the foreign debt.

Taxes: The report describes personal and business taxes as punishingly high and makes a consensus call for "significant reductions" in taxes. American Commissioner Pete du Pont and U.S. Chamber of Commerce adviser Richard Rahn argued for targeting specific rates, but lost out on that point.

Currency: Commissioners agree that the forint should be made fully convertible and tied to a strong European currency, but divide on timing and sequencing. Most of the international members favor swift conversion, within, for example, one year, as do some Hungarians. But other Hungarians fear a political backlash if conversion gets ahead of other restructuring. Disagreement on this point, may presage controversy within the new government. Meanwhile, the report offers only a dead line of three years for full conversion.

Political change: Americans may consider obvious the call to hold public hearings to explain the government's plans and to hear citizens' concerns, but it is an unusual concept in a former dictatorship. So are the proposed Freedom of Information Act, a depoliticized civil service, and devolution of taxing and spending authority for local functions to local elected officials.

To reduce government spending, the commission would cut public subsidies of consumer prices, business and housing (which chiefly benefit the better off Hungarians, it turns out) from 13% of gross domestic product in 1988 to 5% in 1992. Unemployment compensation and job retraining programs – more novelties – are proposed to help cushion inevitable layoffs as uncompetitive enterprises fail.

The commission argues that if Hungary follows the model plan, it should be eligible for a program of catalytic support from the International Monetary Fund, foreign government loan guarantees for investors, easing of import restrictions, and technical assistance in tax administration, the statistical system, public administration, entrepreneurial training, labor laws, and an expansion of the volunteer sector.

Such help, surely, is in the West's interest. Hungary's victory, however difficult, will be ours, as well.

Mr. Chapman is one of Hudson Institute's advisers to the Commission on Hungary's Transformation.

Beyond Half-Measures

Excerpts from the Blue Ribbon Commission's report on Hungary's transformation to a free market

Since 1968's New Economic Mechanism, which decentralized (some) decision-making, Hungary has seen repeated half-measures to reform the exhausted command economy. Politics did not permit full transformation. But an economy only partially free, like a people only partially free in their political life, ultimately is demoralized when false hopes are dashed by experience.

Any large program will take years to put into place even at maximum speed. The keys are a preannounced path and a firm timetable. . . . Certain benefits should be apparent within months – for example, improved quality and availability of consumer goods and services, cuts in waste and inefficiency, and better employment opportunities for skilled, diligent employees.

Practically all retail trade, service establishments, workshops and similar sized firms should be privatized within one year. . . . Parent companies should be forced to sell their outlets and shops to private buyers who will obtain real assets in exchange for cash and real payment obligations.

A new Act on Agricultural Land (should) guarantee the right of private ownership and the right to dispose of land. . . . Land transferred earlier to the cooperatives, or similar land, should be offered for repurchase to the original owners.

Convert present import restrictions into temporary tariffs and concurrently announce a firm timetable for the reduction of such tariffs.

The current proportion of foreign ownership in many small West European countries is about one third of the country's industry. At the beginning of 1990 foreigners own only about 2% of Hungary's industry, so there is ample room for expansion, by any reasonable standard.

Hungary's (past loans) were not used for sound investments that could generate foreign exchange earnings to service the debt. Hungary (now) has to obtain additional capital imports of about $1.5 billion a year for each of the next three years in order to turn a potentially large net outflow into a net inflow. . . . In large part, this current account gap can be financed though an aggressive policy of foreign investment.

The central government should retain broad planning responsibility for the railroad system, and for the national networks, e.g., main roads, oil and gas pipelines, electricity grids, and the telephone system. But it should look for innovative ways of cooperating with the private sector to finance, build, and operate (them).

The entire sector of state-owned apartments should become globally self-financing in three years. Rent should be adjusted to reflect real conditions based on location, size, and quality. Any subsidies should be given upfront to people because they are poor and not because they occupy particular dwellings.

Free market rents should be allowed to emerge for state-owned apartments of the best quality. . . . The current process of selling off state-owned flats should continue, though prices should be set closer to real market values. . . . The government should not enter into any more mortgage contracts which involve interest subsidies.

Initiate steps to seek associate membership in the European Community.

In East Europe, Only Poland Makes Hard Decisions

By KAREN ELLIOTT HOUSE

WARSAW – If, as an Italian Communist Party leader once said, "there are many roads to socialism," these days there are at least as many roads back from it. All of them are full of potholes and other pitfalls.

Every country in East Europe has now embarked on such a journey – or is at least discussing what bags to pack. The desired destination in each case is some nebulous mix of democratic institutions, the alluring but confusing benefits of capitalism, and the social safety net to which they've all become accustomed during more than 40 years of Marxist stagnation. They start, however, from very different stages of political sophistication and economic development and have significantly different chances of success.

Recent travel in Czechoslovakia, Hungary and Poland leads to the perhaps surprising conclusion that it is Poland – the country starting from farthest behind and traveling the rockiest road – that stands the best chance of actually making the transition to genuine capitalism. Poland already has packed its bags and set off while its wealthier neighbors are still planning their voyage.

In any analysis of East Europe these days, one must set aside East Germany. Though it shares the past miseries of Marxism, it has a unique future as an integral part of an enlarged German nation. At the other extreme, Bulgaria and Romania, despite recent and enormous change, start from so far back that they are destined to remain laggards. Thus, the focus on problems and potential for Czechoslovakia, Hungary and Poland.

Chained to Soviet Economy

Clearly there are commonalities. All three have the burdensome legacy of ossified, uncompetitive economies. All three have also been chained to the rigid Soviet economy. To a degree generally overlooked by Americans, all three still count the Soviets as their largest trading "partner." The Lilliputians in this case remain tightly tied down by Gulliver. There simply isn't any quick way out of dependency on Soviet raw materials, nor an immediate alternative to the Soviet market, which, unlike the West, is willing to barter for frequently shoddy goods made by unmotivated workers in antiquated factories.

"We trade our stray dog for their blind cat," says Peter Bod, a youthful, market-oriented economic adviser to Hungary's new prime minister.

The three countries also share officials mostly new to government and overwhelmed by the challenge of creating capitalism. A visit to the finance ministry in Czechoslovakia is typical. "Czechoslovakia is a madhouse," says Dusan Triska, a frantic, forty-ish economist with an Einstein-like coiffure. He is responsible for privatization programs. "We are trying to do everything at once. New laws are being introduced every day; we can't keep up with it all."

All three countries covet German markets and money. Yet, on the one hand, they fear it won't materialize as German resources pour into East Germany; on the other hand, they fear becoming German economic satellites.

Also, to a degree that ought to concern Americans, officials in all three countries are surprisingly reconciled to the general irrelevance of America to their immediate economic futures. They may look to America as a source of inspiration, but they have reluctantly concluded that it isn't going to supply much practical financial support. The surprising thing to an American visitor is how infrequently America is even mentioned in the offices or coffee houses of Eastern Europe.

If such similarities cut across all three ex-satellites, there also are significant differences in atmospherics and substance.

Czechoslovakia, which statistically enjoys a per-capita standard of living well beyond Poland's $1,100, still is so desperate for foreign currency that all visitors are forced upon arrival to exchange $16 for every day they will be in the country. While Poland is coping with the consequences of last January's sudden conversion to market, rather than centrally administered, prices, Czechoslovakia's officials continue to meet weekly to debate what economic reforms to pursue. Its president seems more interested in making peace between Arabs and Israelis than in resolving economic policy disputes among his own ministers. Debate drags on in government while Parliament busies itself changing street names and discussing whether the name Czechoslovakia should be hyphenated – or whether Czechs and Slovaks should inhabit the same nation at all.

East Europeans may look to America as a source of inspiration, but they have reluctantly concluded that it isn't going to supply much practical financial support.

Some Czechs already are suggesting that perhaps socialist economics, absent Soviet overlords, isn't so bad after all. Since the Czechs have more to start with, they fear they have more to lose. With a degree of comfort has come a higher degree of complacency.

The Czechs are searching for a route to risk-free capitalism. For example, they continue to debate a national voucher system whereby citizens each would receive a paper "right" to buy equity in various state enterprises. Among the problems with this paper privatization, however, is that vouchers couldn't be freely traded, meaning that both vouchers and enterprises will lack real market value. What should happen to uneconomic enterprises in which no Czech chooses to invest vouchers? "We can sell those to the Japanese," says Mr. Triska.

Vladimir Dlouhy, Czechoslovakia's new minister of planning, who really would like to become the country's minister of unplanning, sits in Prague's largest bastion of bureaucracy, and says with a smile, "Welcome to the heartbeat of communist planning."

Increasingly frustrated by political indecisiveness, Mr. Dlouhy says, "We know what steps we have to take, but the politicians aren't ready to take them." Optimists here believe Czechoslovakia's direction will be set following national elections Friday. But it's far from clear that much will really change.

At this point, Czechoslovakia, with its pre-war industrial base, its artistic and intellectual tradition and its telegenic president, is quite clearly the world's daring. But the world's daring risks ending up one of the world's economic orphans if it continues to delay hard decisions.

In Hungary's capital of Budapest a different kind of disillusionment is setting in. Hungary over the last decade managed to move significantly further toward a mix of Marxism and market economics than any other state in East Europe. It operated on a looser leash from Moscow, established more trade with Western Europe, and built a reputation with Western banks.

Hungary is perplexed by several paradoxes. Precisely because they managed to advance under communism, external expectations these days are higher for the Hungarians. Westerners arrive expecting a functioning market economy. Hungary, however, was never a highly industrialized nation and it never was willing or able generously to privatize its economy. Hungarians are reluctant to yield elements of their socialist safety net for the risks of greater economic freedom.

Frustrations exist in daily Hungarian life, like a six-year wait to take title to an automobile. But the frustrations aren't so great as to prompt strong public demand for sharp change. The winners of this spring's divisive election pledged to move the country "compassionately" toward capitalism. The party promising more economic pain en route decisively lost.

"We've gone halfway on economic reform for 20 years and it hasn't worked," says Ferenc Bartha, chairman of the Hungarian National Bank.

Indeed, if complacency is the problem in Czechoslovakia, gradualism is the difficulty in Hungary. "I warn against the philosophy of gradualism," says a senior executive of Germany's Deutsche Bank. "Gradualism nourishes the illusion you can avoid pain."

Prime Minister Jozsef Antall recently sought to reassure Western bankers who have financed Hungary's $20 billion foreign debt. "Our mandate of election means we have the moral trust to make the public accept hard decisions." But, he added, "Harsh measures can be executed only in parallel with the creation of a social safety net."

It's not surprising that Hungarian officials want it both ways. Genuine economic change would require harsh measures for which there could be a political price. Any political instability would scare off creditors and investors, leaving Hungary bereft of external private support. One further complication: Hungarians are engaged in divisive politics over minorities in neighboring countries. To foreigners looking in on East Europe, there are a number of distinct countries with defined borders. But to many in East Europe, there are rather a number of distinct nationalities who transcend postwar borders. The issue of Romanian treatment of Hungarian minorities dominates Hungarian politics more than issues of socialism and capitalism.

While the Czechs and Hungarians are seeking painless paths to prosperity, the Poles are accepting genuine economic sacrifice.

In January, Poland's Solidarity government launched what it calls its "leap to the market." The government slashed the budget, including a wide range of subsidies. It tightened the money supply. It radically devalued the zloty. It largely decontrolled prices, though not yet – wages. It encouraged foreign competition at the risk of bankrupting state enterprises.

The effects were predictably quick and traumatic. Costs of such basic necessities as electricity rose by more than 300% within a matter of weeks, and even the price of a bottle of vodka doubled. Inflation soared – to 80% in January – but has subsided since to roughly 5% a month. Wages, deindexed from price increases, dropped sharply in real terms. Polish unemployment rose to roughly 300,000 (still less than 3%) and is predicted to rise to one million by year-end; by contrast, the Hungarians fret about 4,000 jobless.

As the money supply shrank, the monthly interest rate shot to 40% in January – though it, too, has since fallen to 8% in April and 5.5% in May. The zloty was devalued 35% but the result is a freely convertible currency that enables Poland's economy to engage in internationally competitive commerce. Indeed, few Poles any longer demand payment in dollars, as the zloty is readily redeemable by any citizen at a local bank for hard currency. Six months ago a hotel maitre d' would chase down patrons offering to tear up the zloty equivalent of a $50 dinner check in exchange for a $10 bill.

The immediate downside of this high-stakes program has been a significant decline in industrial production and fears of a major recession. "We expected a drop of production," says Wojciech Misiag, deputy finance minister and an architect of the economic reform plan. "Once you create a real market, a lot of production here isn't salable; some Polish products are too costly to produce." Industrial production fell 30% in January and February but has stabilized, and Mr. Misiag believes the downward trend is reversing.

The signs of robust commerce on Warsaw's main streets seem to support Mr. Misiag's optimism. If some old enterprises are foundering in the newly competitive marketplace, new entrepreneurial activity is flourishing. This city now teems with sidewalk sellers offering everything from formerly unattainable fresh fruit to fashionable Italian footwear.

The Kulibab Model

Typical is Jan Kulibab, a sidewalk shoe salesman, peddling his total inventory of two dozen pairs of Italian shoes from behind a table on a Warsaw street corner. Mr. Kulibab is selling the shoes for $19 a pair; he buys them at $16 a pair from a wholesaler who travels back and forth by bus to Germany, where he buys the shoes for $12 a pair. Mr. Kulibab, however, doesn't intend to remain a sidewalk shoe salesman. His ambition is to save enough zlotys to rent a vacant sausage shop where he can display a wider range of shoes and undercut the shoddy merchandise at the state-owned department store down the street. "Last month I made an 800,000 zloty profit [about $80] but with a shop I could do much better," he says.

In addition to the enterprise of its Kulibabs, Poland also benefits from a degree of political unity still unknown elsewhere in East Europe. In Hungary and Czechoslovakia – and even more so in Romania and Bulgaria – the "new" political leadership consists of at best a handful of former opposition politicians who sit atop layer upon layer of politicians and bureaucrats, who may have changed their party affiliation but not necessarily their Marxist mentality. In the rest of East Europe political reformation runs only skin deep. But in Poland there is genuine political revolution.

That revolution, of course, has been under way for nearly a decade – since Lech Walesa and his Solidarity movement first challenged the monolithic power of the Polish Communist Party. Here the pressure for political change has come from below – from shipyard workers rather than playwrights.

Skeptics, and there are many, still argue that there is little in Poland's long history of division to justify much optimism about transition to long-term democracy and prosperity. But the facts support some optimism. Few outsiders believed back in the dark days of martial law suppression of Solidarity that the movement could rise again to challenge communist control. More recently, many doubted whether the Solidarity government would have the guts to take what amounts to a free fall into market economics. In each case, Poles confounded skeptics.

With all they've been through, Poles are not dreamers about the future, but neither are they whiners or worriers about the present. The clear impression is that they have resolutely embarked on a rocky road back from communism and that they mean to see the journey through.

Ms. House is vice president, international, of Dow Jones & Co., publisher of The Wall Street Journal.

ECONOMY **PAUL STAROBIN**

INSTANT CAPITALISM

In Eastern Europe, the collapse of Communism has the local population dancing on the remains of the Berlin Wall. In this country, it has classically schooled economists doing an ivory-tower jig in celebration of what is seen as proof that free markets work best.

Their euphoria is understandable. After all, many economists toil at abstract tasks that have little apparent connection to the outside world. It is not often that history serves up a verdict, still less such an unambiguous one, on an academic school of thought.

What's more, the fun seems to be just starting. Now comes one of those rare opportunities to put a theory into practice. Having shaken off the chains of a centrally planned economic system, East European countries aspire to become market economies.

Not surprisingly, there's no shortage of American analysts ready and willing to proffer advice. And it's hard to imagine that their services ever have been in higher demand.

Probably the best-known guru is international trade professor Jeffrey D. Sachs of Harvard University. Among other things, the peripatetic Sachs is an adviser to Witold Trzeciakowski, a top economic policy maker in the new Polish government. Sachs is also a leading exponent of what is variously called the "big bang" or "shock therapy" approach to market development: the view that East European countries need to adopt market reforms quickly and in big doses.

"Very little can be achieved going slowly," said David Lipton, a Washington-based associate of Sachs who studied economics with him at Harvard and who is also an adviser to the Polish government. The pair are busy with plans for a summer internship program whereby economics graduate students from Harvard and elsewhere will go to Warsaw and prepare research papers for Trzeciakowski.

A similar line of thinking comes from the RAND Corp., the Santa Monica (Calif.) think tank that pioneered the use of systems analysis in defense planning. Charles Wolf Jr., director of RAND's international economic research, recently presented Congress's Joint Economic Committee with a chart showing seven boxes representing the "components" of market reforms in nonmarket countries—such things as price and wage deregulation and property rights revisions. Lots of arrows were drawn back and forth between the boxes—the point being, Wolf testifed, that the individual parts of market reform are linked and should be put in place together.

"In this sense, reforming the economies of Eastern Europe is analogous to restructuring any large system: for example, in education, in the military or in the health care industry," Wolf said.

Uh-oh. First the Pentagon, now Poland? Have we already reduced Eastern Europe to the sterile abstraction of a system—a Tinkertoy or erector set for economic modelers?

If so, a couple of warning signs flashed recently—one in a survey of *perestroika* by *The Economist* of London, the other in an assessment of the Eastern Europe economies by the CIA—ought to give pause. In particular, both analyses point to the potential dangers of an approach toward East European market reform that stresses the economics, without regard to the politics, of the problem and that is directed toward an all-at-once transformation.

Consider, for example, the political ramifications of unemployment. "There is little doubt that the vigorous pursuit of industrial restructuring will precipitate unemployment," the CIA report said. "Populations accustomed to lifetime jobs will experience new uncertainties," and "there will be a risk of public protest that could set back reforms and economic recovery." That's the political analysis—but, as commonsensical as it sounds, it's not how economic analysts talk.

Listen to what RAND's Wolf has to say on this subject. "What is manifest as unemployment is really making visible the unemployment that was 'hidden' by the make-work, featherbedding, pay-without-product regime of the command economies of Eastern Europe," he told lawmakers. Maybe so, but tell that to a person who for the first time is without a job.

Price decontrol is another favorite of Western economists, who view it as an essential step toward rational production and consumption. But as *The Economist* pointed out, decontrol is not likely to work unless governments first shift property into private hands. Otherwise, in perverse fashion, state-controlled monopolies, to maximize revenues, may simply raise prices and cut production. And, like rising unemployment, that too could have unattractive political consequences.

"A failed attempt to implant market economics could set exaggerated extremes of wealth and poverty against the familiar background of economic decay," *The Economist* warned. "That would prepare the way for populist authoritarian governments of the traditional Latin American sort."

Of course, as Lipton pointed out, leaders of many East European countries have asked U.S. economists for help—and certainly can reject the economists' advice. Poland's lurch toward deep reforms was "not a decision made by some technocrats," Lipton said. And, as he noted, the hyperinflation experienced in Poland before its leaders adopted "shock therapy" itself made for political instability.

Still, economists might be of more use if they put down their models and thought in more-modest and practical terms. And instead of congratulating themselves on the triumph of the market, they might think about how to help Eastern Europe avoid the mistakes that the not-so-perfect stewards of the capitalist system have made.

Economist Charles L. Schultze of the Brookings Institution may be on the right track. The analysts at the think tank have been swamped with requests for advice from East European economists, journalists and others, and they have talked among themselves about how best they could help.

According to a Brookings spokesman, "Charlie said we could tell them how not to screw up in certain areas—such as financial institutions." ■

Los Angeles Times

WEDNESDAY, MAY 23, 1990
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A Giveaway Out of Touch With Reality

U. S. aid: Without structural reforms, our tax dollars will do little for Eastern Europe.

By DAVID DREIER

Thought you had seen the last of inefficient, centralized economies in Eastern Europe? Think again. Congress is plodding forward with a multibillion-dollar aid package designed to reward even the most committed centralized planner.

In fact, what started out as a legitimate effort to assist the emerging democracies has become a contest to see who can spend the most tax dollars in the shortest period of time. These efforts ignore past experience with our foreign aid budgets, as well as current fiscal and political realities.

While direct U.S. aid will certainly play a valuable role in the developing economies of Eastern Europe, aid without structural reform will be ineffective. Britain, the largest recipient of U.S. aid from the Marshall Plan, continued to rely on socialist economic policies during the postwar era. As a result, it remained economically stagnant throughout much of the 1950s. West Germany, which adopted more aggressive market-oriented policies in 1948, received far less U.S. financial aid but recovered in a matter of a few years.

The United States cut off economic assistance to South Korea in the early 1960s, believing its economy to be hopeless. Today, as a result of structural reforms, South Korea has one of the strongest economies in Asia. The lesson is that money is no substitute for sound market-driven economic policy.

The United States, the World Bank and the International Monetary Fund have already committed more than $2.1 billion to Poland alone. Japan and other Asian and European countries have pledged billions more.

Meanwhile, legislation for the multibillion-dollar giveaway moves along. Some experts are now concerned that the economies of the region may have difficulty absorbing these vast resources. Asst. Secretary of State Lawrence Eagleburger told the House Budget Committee in March: "We may get more out of spending less each year for the next several years."

President Vaclav Havel of Czechoslovakia expressed similar concerns. "We do not want direct aid," he said during his visit to Congress. Another Czech official was even more blunt. "Foreign aid," he said, "is for Third World countries."

So why isn't Congress listening? Unlike the new leaders of Eastern Europe, many still fail to grasp the benefits of private enterprise and free markets. The cure for any ailing economy is free trade, not aid. We need creative, private sector means of helping our friends in Eastern Europe.

To spur U.S. investment, Congress should provide tax incentives for American businesses who hold business management conferences in Eastern Europe.

To improve human capital, a fellowship training program should be established to bring young leaders from Eastern Europe to the United States to work with Congress, businesses and the media.

Small business development is the engine that drives any free-market economy. Retired American business executives are a valuable resource. The Small Business Administration's Senior Corps of Retired Executives program, which consists of volunteers willing to share their talents and expertise, could be expanded to provide management assistance for emerging entrepreneurs in Eastern Europe.

And the U.S. government should practice what it preaches. If the goal is to encourage private sector development in Eastern Europe, it makes no sense to expand our own bureaucracy to do it. American aid should be funneled through private organizations whenever possible. Last November's aid bill contained more than $938 million for Eastern Europe, but much of it was sent through the already overworked U.S. embassy system.

The United States has a critical role to play in Eastern Europe's transition from centrally planned economies to free markets and private enterprise. In our zeal to pass along America's secrets to success, great pains must be taken to ensure that we don't also pass along our mistakes. International welfare programs only increase dependence and remove incentives for individual initiative. As the old Chinese proverb says, "Give a man a fish, and he will eat for a day. Teach him to fish, and he will eat for a lifetime."

David Dreier (R-La Verne) is the chairman of the House Republican Task Force on Foreign Policy.

NEW YORK TIMES, June, 13 1990

Democracy on Hold

By Edward J. Markey

WASHINGTON

If the Bush Administration has its way, the people of Eastern Europe and the Soviet Union will hear the sounds of democracy with one ear.

At a meeting in Paris last week, the Administration convinced U.S. allies to accept the bulk of its proposals to restrict high-tech exports to the former East bloc. The agreement is being touted as a major breakthrough in liberalizing high-tech export controls. Yet in the field of telecommunications, all it does is afford the new democracies in Poland, Czechoslovakia and Hungary about the same access to technologies that we allow the old dictatorship in China.

The Soviet Union, along with Bulgaria and Romania, would be held to an even lower level of technology. Already, a $500 million proposal by a U.S. telecommunications firm to install a fiber optic line to connect the Soviet Union, Europe and Asia — for civilian long-distance phone service and business data communications — is imperiled.

We Americans know about the power of communication. It is an article of faith among us that free and open communications is the best guarantee of democracy. The old Stalinist regimes that once ruled throughout the East bloc paid homage to that faith: they systematically denied their people access to modern telecommunications.

Yet the Bush Administration's shortsighted policy refuses to acknowledge the fundamental opportunity for democracy in tearing down the Sonic Wall that now divides Europe. The practical result of this policy will be that Eastern Europe and the Soviet Union will only be able to communicate with the world in the technological equivalent of whispers.

It is the U.S. intelligence community that represents the key stumbling block. Its representatives argue that eavesdropping on civilian communications systems in these countries will become more difficult if we grant them access to more modern, and more secure, telecommunications technologies. They are correct: it will.

Bush bars telephones for Eastern Europe.

While the interests of the intelligence community should not be dismissed lightly, we must remember that they exist to serve, not dictate, America's broader national interests. In Eastern Europe and the Soviet Union, our overarching interest must be to actively encourage the transition to pluralistic, democratic societies with market-oriented economies.

Do we want to deny emerging democracies access to these technologies simply because it makes it harder for us to listen in on a civilian telephone line? The Soviets already maintain a separate, dedicated telecommunications system for sensitive Government communication; civilian telecommunications equipment is largely resistant to diversion for military uses.

We want to encourage democracy. If these nations are to succeed in making their transition to freedom and free markets, their antiquated civilian telecommunications systems — some consisting of rotary phone equipment dating back to the 1930's — must be upgraded. While the U.S. has about 90 phone lines per 100 people, and Western Europe has about 60, Eastern Europe averages only nine phones for every 100 people. Even today, a Polish citizen must wait 13 years to get a telephone in his home.

Telecommunications tools are a vital part of the infrastructure of a free, open and economically viable society. We should be encouraging Eastern European and Soviet citizens to shout democracy from the technological rooftops rather than eavesdropping on their every whisper.

Instead of the Bush Administration's half-hearted policy, we should enact the legislation adopted by the House of Representatives last week. Among other things, the bill would:

- Decontrol exports of less sophisticated civilian telecommunications products and technology. This would give Eastern Europe and the Soviet Union access to items already available to China.
- Allow the Western nations and Japan, at their discretion, to decide which sophisticated civilian telecommunications equipment and technology to export to Eastern Europe.
- Encourage continued progress toward reform in the Soviet Union by allowing exports of sophisticated equipment on the basis of national discretion. However, the lifting of more restrictive controls on technology transfer would be contingent on further democratization.

With these policies in place, America can take pride in laying the technical foundations of democracy in the modern world. We will have provided a precious gift to the people of Eastern Europe and the Soviet Union: the power of communication. □

Edward J. Markey, Democrat of Massachusetts, is chairman of the House telecommunications and finance subcommittee.

GREEN REVOLUTIONS IN EAST EUROPE

János Vargha

The half of Europe that many people had virtually forgotten — the Eastern half — has suddenly become the focus of attention in the West. The whole region is currently in a state of flux and change, making it very exciting but also very unstable.

The danger is all the greater since continued instability would affect not only society and the economy, but also the environment. Under the command economies of "socialism", the more aggressive technologies — those which need a great deal of energy and natural resources and cause extensive environmental pollution — represent a large percentage of industrial production. As a consequence, a remarkably large number of harmful substances have been polluting the environment.

The following articles give a long list of the symptoms of Eastern Europe's ecological crisis: forests being destroyed, lakes and rivers being polluted, environmental diseases, declining life expectancy, and growing mortality rates.

Our reports also show that, in recent years, public opinion in Eastern Europe has linked the crisis of the environment with the political system. Among the list of crimes brought about by the political system, low standards of living and suffocating, polluted air are linked together. People concerned about the environment have had to fight for their basic human rights — exactly as have the politicians in opposition.

Ordinary people, however, are only slowly becoming aware of the dangers, because information has been fiercely suppressed. Research funds — virtually a state monopoly — left very little money for research and teaching in ecology and environmental science.

In East Europe and the USSR, the revolutions of 1989 marked the biggest political upheavals which they — and perhaps the whole world — have seen for decades. Possibly for the first time, environmental problems were one of the main causes of the unrest.

From January to June 1990, these changes are being followed by more-or-less free elections in a score of countries and republics.

Panoscope asked journalists from throughout the region to respond to three questions: What are the main environmental issues? How important do people think they are? And what do some of the main parties in the elections plan to do about them?

The 10 authors include communists and greens, socialists and free-marketeers, and their articles are more overtly political than is usual in *Panoscope*. They paint a unique picture of societies which are now able, for the first time in 40 years or more, to say what they think about the environments in which they have to live.

The crisis of the political-economic system in Eastern Europe is risky, but it is also necessary: without melting away the old structures, there is little hope that a more sensible social system will emerge. The break with the totalitarian system and the return to the tradition of European political democracy is now within reach. It is also an essential step for bringing about the end of the ecological crisis.

For these reasons, a strong bond has developed between the civilian environmentalists and the democratic political movements. The question is: How long will this alliance last?

Eastern Europe still has to learn by experience that parliamentary democracy will not in itself solve today's global ecological problems. Even those societies which are more successful in guarding their democratic traditions are mainly concerned with the non-human and non-biological effects of technology — like profit, for example.

The serious environmental problems in Eastern Europe can probably only be partially resolved by a return to democracy. Can there be a solution which does not reproduce the crisis, or spread it to more and more areas of life? Can there be a solution which ensures in the long term that the biosphere and society will survive and that fundamental resources will be preserved? Eastern Europe must find the answer soon.

At the same time, answers must also be found for the new problems that the inevitable reconstruction of the market economy will cause. In our countries, the underdeveloped state of civil society, and an inadequate ecological consciousness, will make it difficult to limit effectively the use of aggressive technologies.

Obviously, the approach of the new, democratic political parties will be different from the approach of the civilian environmental movements. Just as their temporary strong alliance was necessary, so will the divergence of their paths be inevitable.

János Vargha founded and led the Danube Circle, the NGO which successfully campaigned against the Nagymaros Dam. He is Director of Panos-Budapest.

Kay Bishop

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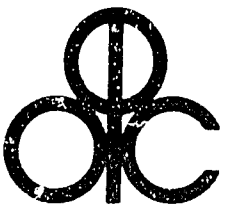

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PN-ABH-214

October 2, 1990
Latin America

WASHINGTON ECONOMIC WATCH

A Digest of Development Policy Information

A Project of the Overseas Development Council

THE WHITE HOUSE

Office of the Press Secretary

For Immediate Release June 27, 1990

ENTERPRISE FOR THE AMERICAS - INICIATIVA PARA LAS AMERICAS
A NEW PARTNERSHIP FOR TRADE, INVESTMENT, AND GROWTH

FACT SHEET

Introduction

As nations in Latin America and the Caribbean turn increasingly to democracy and market-oriented economic reforms, the President has proposed a new partnership to encourage growth in the Americas. This partnership will be based on three core initiatives addressing trade, investment, and debt. In addition, it will strengthen environmental policy in the hemisphere.

During the past decade Latin America and the Caribbean have faced a series of difficult economic challenges, reduced growth and lost opportunities. This difficult economic period has coincided with revolutionary political change. Democracy and freedom are now the clear choice of the peoples throughout the hemisphere.

In view of these developments, Treasury Secretary Brady was asked to lead a review in the Economic Policy Council of U.S. economic policy toward Latin America and the Caribbean. That review is now complete and we are proposing a new economic partnership in the hemisphere to meet the challenges ahead.

The Trade Initiative

- The first pillar of this program is a broad-based trade initiative which sets forth a vision and a challenge to Latin America to move toward a broad regime of free and fair trade within the hemisphere.
  - Barriers to trade continue to be a serious obstacle to growth and trade within our hemisphere which seriously lagged the pace of growth in world trade during the 1980's.
- The most effective way of promoting long-term trade growth in Latin America and the Caribbean and more fully integrating these nations into the global trading system is to successfully conclude the Uruguay Round.

- The trade initiative contains three elements:

  (1) A comprehensive Free Trade Agreement (FTA) for Latin America is our long-term goal. We are prepared to enter into FTAs with other markets in Latin America and the Caribbean -- particularly with groups of countries that have associated for purposes of liberalization.

  As we have begun to see in our trade with Canada and hope to see with Mexico, such agreements can offer significant and lasting benefits for both sides.

  (2) As an initial stepping stone toward this end -- and for those which are not yet positioned to embrace a free trade agreement -- we are prepared to develop bilateral framework agreements.

  Such agreements can help establish principles for bilateral cooperation on trade issues.

  (3) We are also prepared to work with Latin countries to help address their specific trade concerns within the Uruguay Round. To show our commitment, we will seek authority for deeper tariff cuts on specific products of interest to them.

<u>The Investment Initiative</u>

- The second pillar of our program is an investment initiative to unlock the potential for domestic and foreign investment, encourage capital flows, reduce debt burdens, and improve the environment.

- To encourage appropriate policies and help the nations of Latin America and the Caribbean attract indispensable capital, the United States is prepared to pursue a program on several fronts.

- First, we propose to work to develop a new investment sector loan program in the Inter-American Development Bank.

  -- The program could provide both technical advice and financial support for privatization efforts and liberalization of investment regimes -- possibly in conjunction with the World Bank.

- Second, in a parallel effort, we will seek support to establish a multilateral investment fund to advance comprehensive investment reforms in Latin America and the Caribbean.

  -- This Fund would provide grants of up to $300 million annually in response to broad investment reforms.

-- It would also support efforts to privatize government-owned industries and to finance worker training, education, and health programs to develop vital human capital.

-- The IDB would administer these funds, which would complement both IDB and World Bank sector lending programs.

The Debt Initiative

o The third pillar provides additional support for debt and debt-service reduction in Latin America and the Caribbean in an effort to provide further incentives to investment reform and a more flexible basis for hemispheric growth.

o The first part of this initiative builds on the progress already being made in addressing the debt problems of the region by proposing that the IDB become an additional source of enhancements under the existing debt strategy.

-- These enhancements would be used to back specific transactions negotiated by Latin American and Caribbean countries with their commercial banks.

-- As in the IMF and World Bank, the availability of these resources would be tied to economic reform efforts.

o Second, to address the growing problem of official debt, we will propose legislation to permit substantial reduction and restructuring of existing U.S. concessional loans to Latin American and Caribbean countries with serious debt servicing difficulties.

-- Action would be taken on a case-by-case basis for countries in the region which adopt strong economic reform programs in conjunction with the IMF and World Bank, pursue comprehensive investment reforms with the Inter-American Development Bank or other multilateral institutions, and complete commercial bank debt-reduction programs as appropriate.

-- We expect this program to produce substantial debt reduction on concessional U.S. AID and PL-480 claims, particularly for the smaller countries of the region. At the same time, new flows of foreign assistance to the region would be maintained.

THE WHITE HOUSE

Office of the Press Secretary

EMBARGOED FOR RELEASE
UNTIL 2:45 P.M. EDT
WEDNESDAY, JUNE 27, 1990

TEXT OF REMARKS BY THE PRESIDENT
ON THE ENTERPRISE FOR AMERICAS ADDRESS

The White House
East Room

June 27, 1990

In the past 12 months, every one of us -- from the man in the White House to the man on the street -- has been fascinated by the tremendous changes -- positive changes -- taking place around the world. Freedom has made great gains -- not just in Eastern Europe -- but right here, in the Americas. We've seen a resurgence of democratic rule -- a rising tide of democracy never before witnessed in the history of this hemisphere.

With one exception -- Cuba -- the transition to democracy is moving towards completion. And we can all sense the excitement -- that the day is not far off when cuba joins the ranks of the world's democracies -- and makes the Americas fully free.

The political transformation sweeping Latin America and the Caribbean has its parallel in the economic sphere. Throughout the region, nations are turning away from the Statist economic policies that stifle growth -- and are now looking to the power of the free market to help this hemisphere realize its untapped potential for progress. A new leadership has emerged -- backed by the strength of the people's mandate -- leadership that understands that the future of Latin America lies with free government and free markets. In the words of Colombia's courageous leader -- president Virgilio Barco: "The long-running match between Karl Marx and Adam Smith is finally coming to an end" with the "recognition . . . That open economies with access to markets can lead to social progress."

For the U.S., these are welcome developments -- developments we're eager to support. But we recognize that each nation in the region must make its own choices. There is no blueprint -- no one-size-fits-all approach to reform. The primary responsibility for achieving economic growth lies with each individual country. Our challenge in this country is to respond in ways that support the positive changes now taking place in the hemisphere. We must forge a genuine partnership for free market reform.

Back in February, I met in Cartagena with the heads of three of the Andean nations. I came away from that meeting convinced that the U.S. must review its approach not only to that region -- but to Latin America and the Caribbean as a whole. I asked Treasury Secretary Brady to lead a review of U.S. economic policy toward this vital region -- to make a fresh assessment of the problems and opportunities we'll encounter in the decade ahead. That review is now complete. The results are in -- and the need for new economic initiatives is clear and compelling.

All signs point to the fact that we must shift the focus of our economic interaction -- towards a new economic partnership: Because prosperity in our hemisphere depends on trade -- not aid.

I've asked you here today to share with you some ideas on ways we can build a broad-based partnership for the 90's. To announce the new enterprise for the Americas Initiative that creates incentives to reinforce Latin America's growing recognition that free market reform is the key to sustained growth and political stability.

The three pillars of our new Initiative are trade, investment, and debt. To expand trade -- I propose that we begin the process of creating a hemisphere-wide free trade zone; to increase investment -- that we adopt measures to create a new flow of capital into the region; and to further ease the burden of debt, a new approach to debt in the region -- with important benefits for our environment.

Let's begin with trade. In the 1980's, trade within our hemisphere trailed the overall pace of growth in world trade. One principal reason: Over-restrictive trade barriers that wall off the economies of the region from each other, and from the United States -- at great cost to us all. These barriers are the legacy of the misguided notion that a nation's economy needs protection in order to thrive. The great economic lesson of this century is that protectionism stifles progress -- and free markets breed prosperity.

To this end, we've formulated a three-point trade plan to encourage the emerging trend toward free market reform now gathering force in the Americas.

First, as we enter the final months of the current Uruguay Round of the world trade talks, I pledge close cooperation with the nations of this hemisphere. The successful completion of the Uruguay Round remains the most effective way of promoting long-term trade growth in Latin America -- and the increased integration of Latin nations into the global trading system.

Our aim in the Uruguay Round is free and fair trade. Through these talks, we are seeking to strengthen existing trade rules, and to expand them to areas that do not now have agreed rules of fair play. And to show our commitment to our neighbors in Latin America and the Caribbean, we will seek deeper tariff reductions in the Round on products of special interest to them.

Second, we must build on the trend we see toward free markets -- and make our ultimate aim a free trade system that links all of the Americas -- North, Central and South. We look forward to the day when not only are the Americas the first fully free democratic hemisphere -- but when all are equal partners in a free trade zone stretching from the port of Anchorage to Tierra del Fuego.

I am announcing today that the U.S. stands ready to enter into free trade agreements with other markets in Latin America and the Caribbean -- particularly with groups of countries that have associated for purposes of trade liberalization. And the first step in this process is a free trade agreement with Mexico.

We must all recognize that we won't bring down barriers to free trade overnight. Changes so far-reaching may take years of preparation and tough negotiations. But the payoff -- in terms of mutual prosperity -- is worth every effort. Now is the time to make a comprehensive free trade zone for the Americas our long-term goal.

Third, I understand that some countries aren't yet ready to take that dramatic step to a full free trade agreement. That's why we're prepared to negotiate with any interested nation in the region bilateral framework agreements to open markets and develop closer trade ties.

Such agreements already exist with Mexico and Bolivia. Framework agreements will enable us to move forward on a step-by-step basis to eliminate counter-productive barriers to trade -- and towards our ultimate goal of free trade. That's a prescription for greater growth and a higher standard of living in Latin America -- and right here at home, new markets for American products, and more jobs for American workers.

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Promoting free trade is just one of three key elements in our new enterprise for the Americas Initiative. Our second pillar is increased investment.

The competition for capital today is fierce. The key to increased investment is to be competitive -- to turn around the conditions that have discouraged both foreign and domestic investment. Reduce the regulatory burden -- clear away the thicket of bureaucratic barriers that choke off Latin America's aspiring entrepreneurs. In one large Latin city, for instance, it takes almost 300 days to cut through the red tape to open a small garment shop. In another country, the average overseas caller has to make five phone calls to get through -- and the wait for a new telephone line can be as long as five years. That's got to change. Investment reform is essential -- to make it easier to start new business ventures -- and make it possible for international investors to participate and profit in Latin American markets.

In order to create incentives for investment reform, the U.S. is prepared to take the following steps: First, the U.S. will work with the Inter-American Development Bank to create a new lending program for nations that take significant steps to remove impediments to international investment. The World Bank could also contribute to this effort. Second, we propose the creation of a new investment fund for the Americas. This fund, administered by the IDB, could provide up to $300 million dollars a year in grants in response to market-oriented investment reforms and progress in privatization. The U.S. intends to contribute $100 million to the fund -- and we will seek matching contributions from Europe and Japan.

But in order to create an attractive climate for new investment -- we must build on our successful efforts to ease the debt burden -- the third pillar of our new enterprise for the Americas Initiative.

Many nations have already undertaken painful economic reforms for the sake of future growth -- but the investment climate remains clouded by the heavy burden of debt. Under the Brady plan, we are making significant progress. The agreements reached with Mexico, Costa Rica and Venezuela are already having a positive impact on investment in those countries. Mexico -- to take just one example -- has already seen a reversal of the destructive capital flight that drains so many Latin American nations of precious investment resources. That's critical: If we restore confidence -- capital will follow.

As one means of expanding our debt strategy, we propose that the IDB add its efforts and resources to those of the International Monetary Fund and the World Bank to support commercial bank debt reduction in Latin America and the Caribbean. And -- as in the case of World Bank and IMF -- IDB funds should be directly linked to economic reform.

While the Brady plan has helped nations reduce commercial bank debt, for nations with high levels of official debt -- debt owed to governments, rather than private financial institutions -- the burden remains heavy. Today, across Latin America, official debt owed to the U.S. Government amounts to nearly $12 billion dollars -- with $7 billion of that amount in concessional loans. And in many cases, the heaviest official debt burdens fall on some of the region's smallest nations -- countries like Honduras, El Salvador, Jamaica.

That's a problem we must address. Today -- as the key component in addressing the region's debt problem -- I am proposing a major new initiative to reduce Latin America and the Caribbean's official debt to the U.S., for countries that adopt strong economic and investment reform programs with the support of international institutions.

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Our debt reduction program will deal separately with concessional and commercial types of loans. On concessional debt -- loans made from aid or food for peace accounts: W will propose substantial debt reductions for the most heavily burdened countries. And we will also sell a portion of outstanding U.S. commercial loans to facilitate debt-for-equity and debt-for-nature swaps in countries that have set up such programs. These actions will be taken on a case-by-case basis.

One measure of prosperity -- and the most important long-term investment any nation can make -- is environmental well-being. As part of our enterprise for the Americas Initiative, we will take action to strengthen environmental policies in the hemisphere.

Debt-for-nature swaps are one example -- patterned after the innovative agreements reached by some Latin American nations and their commercial creditors. We will also call for the creation of environmental trusts -- where interest payments owed on restructured U.S. debt will be paid in local currency and set aside to fund environmental projects in the debtor countries.

These innovative agreements offer a powerful new tool for preserving the natural wonders of this hemisphere we share. From the vistas of the unspoiled Arctic, to the beauties of the barrier reef off Belize, to the rich rain forests of the Amazon -- we must protect this living legacy we hold in trust.

For an increasing number of our neighbors, the need for free market reform is clear. These nations need economic breathing room to enact bold reforms. And this official debt initiative is one answer: A way out from under the crushing burden of debt that slows the process of reform.

I know there is some concern that the revolutionary changes we've witnessed this past year in Eastern Europe will shift our attention away from Latin America. I assure all of you here today -- as I've assured many democratic leaders in Central and South America, the Caribbean and Mexico -- the United States will not lose sight of the tremendous challenges and opportunities here in our own hemisphere.

Indeed, as we talk with the leaders of the G-24 about the emerging democracies in Europe, I have been talking to them also about their supporting democracy and economic freedom in Central America. Our aim is a closer partnership between the Americas and our friends in Europe and Asia.

Less than two years from now, our hemisphere will celebrate the 500th anniversary of an epic event -- Columbus' discovery of America: Our new world. We trace our origins -- our shared history -- to the time of Columbus' voyage, and the courageous quest for the advancement of man.

Today, the bonds of our common heritage are strengthened by the love of freedom and a common commitment to democracy. Our challenge -- the challenge in this new era of the Americas -- is to secure this shared dream and all its fruits for all the people of the Americas, North, Central and South.

The comprehensive plan I've just outlined is proof positive the United States is serious about forging a new partnership with our Latin American and Caribbean neighbors. We're ready to play a constructive role at this critical time -- to make ours the first fully free hemisphere in all of history.

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THE AMERICAS IN THE 1990s: FORGING A PARTNERSHIP FOR GROWTH AND OPPORTUNITY

An address by
Ambassador Carla A. Hills
United States Trade Representative
Before
The Organization of American States
General Assembly
Asuncion, Paraguay
June 4, 1990

Introduction

I am honored to represent President Bush and the people of the United States of America at the inauguration of this year's General Assembly of the Organization of American States. I bring you his warm greetings and the best wishes of my fellow citizens.

President Bush was particularly disappointed that he could not attend because, as he wrote to President Rodriguez, "The celebration of the 100th anniversary of the Inter-American system in a country that has recently rejoined the ranks of democratic governments, has very special meaning."

For the first time in the history of the Americas, we share a common economic and political vision. That vision is of the extraordinary achievements possible when the imagination and industry of the individual are allowed to emerge from the dark shadow of government control into the bright light of liberty.

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That light now dawns each day across the length and breadth of our hemisphere, from Tierra del Fuego to the Northwest Territories, and from Natal to Nome. It is a light that illuminates a new path; it beckons us like a beacon to a new era of growth and prosperity.

The nations of Latin America and the Caribbean are following this light. Your courage and resolve to make profound changes in your economies causes it to burn even more brightly. Your boldness and determination is an inspiration, and encourage us in the United States to revitalize our economic relationship with the region.

Therefore, today, as the President's special representative to this historic 100th anniversary celebration of the Inter-American system, I call on the nations of the Americas to forge a new hemispheric partnership to fulfill our shared vision. Let us work together to make the decade of the Nineties the decade of the Americas, the decade of growth and opportunity.

More than two centuries ago, the French jurist and philosopher, Baron de Montesquieu, wrote, "Commerce cures destructive prejudices.... The spirit of commerce unites nations." A hemispheric partnership that breaks with the old and forges a dynamic new relationship based on a balance of obligations and benefits, can be a unifying force for the region and an engine of growth for all of our economies.

It is this new partnership that I want to talk to you about today. First, let me explain how it fits into U.S. trade policy. Second, the benefits that will be derived from our partnership. Third, why we stand ready to work with you to achieve this objective. And finally, how best to go forth from here.

U.S. Trade Policy

The Bush Administration's trade policy is straightforward: it is to unlock once-sealed markets, so that trade can expand, and to negotiate a clear set of enforceable rules that will curb unfair trade practices worldwide.

At the top of our agenda is our goal to achieve, by December, an ambitious result in the Uruguay Round of global trade talks ongoing under the auspices of the General Agreement on Tariffs and Trade -- known as the GATT.

GATT is the Constitution of Trade, and the world's most important trade agreement. Its participants include nearly 100 nations accounting for more than 85 percent of world trade. We want to crown this four-year round of talks with an agreement to modernize our aging system of international trade rules.

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An unprecedented eleven countries are now applying to join the GATT. Six of the eleven are from Latin America, including our host nation, Paraguay. All of these countries are transforming their economies to more market-oriented systems. Each seeks to join the GATT for a single reason: To secure the enormous benefits that derive from partnership in an open global trading order.

These countries know that when nations open markets to trade, the real winners are people -- consumers, workers, taxpayers, farmers, entrepreneurs -- men and women who live in Cedar Rapids, Asuncion, Saskatoon, Rio de Janeiro, and thousands of other cities and towns around the world.

People win because open markets mean new jobs. Trade barriers limit the growth of a country's most competitive industries, and thus reduce the number of productive, high-paying jobs. Opening global markets will benefit all exporters, but particularly small businesses, which account for a growing percentage of exports and new jobs.

Open markets also mean lower prices and greater choice for people. Free trade is not just about getting rid of foreign trade barriers. It also is about reducing, and eventually eliminating, restrictions on our own markets. This will benefit our consumers and industrial users through lower prices and an even greater variety of goods and services in the marketplace.

And, open markets mean opportunity. When trade barriers are removed, ambitious young entrepreneurs are able to start new companies, produce new products, offer new services. Factories are filled, houses constructed, schools opened, and hospitals built.

Many Latin American countries are discovering the benefits of open markets, and launching astonishing economic revolutions. For example, it is fitting that we hold this meeting in Paraguay, a country which recently began a remarkable transformation. Last year, the new Rodriquez government abolished the country's crippling system of official export prices and multiple exchange rates. In its place was instituted a unified, floating exchange rate without currency controls.

Just 12 months later, Paraguay's registered exports had doubled to more than $1 billion. Roughly 80 percent of that growth was due to a shift in exports from the informal economy to the mainstream economy. Exporters no longer were penalized by having a portion of their export earnings confiscated through unrealistic exchange rates and artificially set export prices.

We see other budding signs of progress. Reform governments throughout Latin America are dismantling economic barriers, seeking to recharge their economies with new commercial freedom. President Menem in Argentina and President Collor in Brazil are boldly casting off the shackles of economic regulation in favor of free enterprise and open markets.

Led by the examples of their own neighbors -- such as Bolivia, Chile, Costa Rica, and Mexico -- other countries are adopting new macroeconomic policies, opening markets, and freeing the private sector to encourage entrepreneurial activity.

The results reveal vast potential:

- Costa Rica is now a major producer of cellular telephones for the region;

- The island states of the Eastern Caribbean are creating a regional stock exchange;

- Venezuela is selling new petrochemical products to Japan, financed and developed by joint ventures in the private sector; and

- Tijuana is known as the world's "capital of television manufacturing;" its exports to California are roughly equal to the two-way trade between the United States and Poland and Hungary combined.

Several countries also are returning state-run businesses to the private sector, making them more competitive and ending years of capital-draining dependence:

- In Mexico last month, President Salinas announced the privatization of his nation's banking system, opening the door to progress in that all important service sector.

- In Uruguay, the government is ending its monopoly on insurance, and demonstrating a commitment to an open market for services.

- Chile has transferred twice the value of state assets to the private sector than has Britain, and in half the time.

- In Brazil, the Volta Redonda Steel plant -- once a symbol of state-supported industrialization -- is to be privatized.

- And in Argentina, efforts are underway to privatize ENTEL, the massive state telecommunications monopoly.

U.S. Interests

This is an impressive record of success accomplished with vigor in a short time. The United States stands ready to work with our trading partners in this hemisphere to achieve even more. We do so not simply because it is good for them, but also because of our considerable economic interests in the region.

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The "Lost Decade" of the 1980s was not only your tragedy, but also ours: It is estimated that U.S. exporters lost as much as $130 billion in the region from 1982 to 1988. It wasn't until 1988 that our exports climbed back to their 1981 level.

Many of the most successful companies in the United States and the world have a stake in this region; many more have substantial interests. Over 300 of the U.S. Fortune 500 companies are invested in Brazil alone. Total direct U.S. investment in Latin America at the end of 1988 was nearly $50 billion. That figure is an increase of nearly 25 percent from just two years before, and represents almost 60 percent of all U.S. direct investment in developing countries. Our total merchandise trade with the region is now well over $100 billion a year.

Despite the intense involvement we have with Latin America, many in this hemisphere worry that, to their detriment, the world has become spellbound by the changes in Eastern Europe. I do not agree. I am convinced that as barriers to foreign investment are dismantled, as providers of essential services are welcomed, and as intellectual property is protected in Latin America, investors will view this region as offering as many, if not more, exciting new opportunities as any in the world.

Our Hemispheric Partnership

To make this a reality, we should take charge of our destiny and act now to forge a new hemispheric partnership for growth and opportunity. Our purpose should be to tear down barriers to trade and investment. Let us allow commerce to be a unifying force, liberating the imagination and energy of our people to create new jobs and wealth.

The partnership I envision is one based on a balance of benefits and obligations. It is founded on a firm commitment to the multilateral trading system and the principles on which it stands -- non-discrimination, freedom of choice, and respect for the rule of law. It seeks to expand trade within the region, looking toward a hemispheric zone of open trade. And it seeks to expand trade between the region and the rest of the globe, making the Latin American nations world class competitors.

As an element of this partnership, the United States launched an Andean Trade Initiative, designed to help boost the legitimate trade of those nations fighting in the front lines in the war on drugs.

We have also introduced legislation to enhance the trade - expanding Caribbean Basin Initiative by making this program permanent.

And I am here to say that the Bush Administration stands ready to work in partnership with you as you free your economies:

- We are ready to liberalize trade and investment by negotiating new commercial agreements with you, as we have with Eastern Europe. Agreements such as our bilateral investment treaties, promote economic opportunity by promoting economic reform.

- We are ready to negotiate bilateral or regional framework agreements, like those we already have with Bolivia and Mexico. These agreements provide a forum for resolving trade friction and for facilitating market-opening initiatives.

- We are ready to encourage and support additional Latin American applications for membership in the GATT. We will assist with GATT accession any country in the region that has demonstrated a firm commitment to free and open markets.

- Finally, and most important, we are ready and eager to work as partners to strengthen the international trading system through the Uruguay Round negotiations in the GATT. No set of nations has more to gain from these trade talks than those in the Americas.

The Uruguay Round

That is why President Bush has made a successful conclusion of the Uruguay Round by December our nation's number one trade priority. Over the past 40 years, the GATT has sponsored seven successful rounds of tariff cuts by the world's great trading nations. As a result, world trade has soared from $60 billion in 1950 to break the $3 trillion mark last year. The global economy has grown faster in the last four decades than in any other 40 years of recorded history.

The problem today is that world trade has outgrown the GATT. Areas inadequately covered by GATT rules like agriculture, or not covered at all like services, investment, and intellectual property, are of much greater importance than they once were.

Compounding the problem, the success of some developing countries means that they are no longer at the margin of the trading system. However, some still claim exemption from the rules that we already have. These countries now account for more than $500 billion in world trade annually.

Thus today, nearly one-third of world trade -- or more than $1 trillion in goods and services -- is not adequately covered by internationally agreed rules.

Our goal in the Uruguay Round is to develop rules that will guide us in the areas not now covered, and to involve all countries fully in the trading system.

Listen to what we can achieve by working together:

First and foremost, we seek to reform agricultural trade, a market badly discorted by subsidies and trade barriers. According to the Organization for Economic Cooperation and Development (OECD), the cost to taxpayers and consumers worldwide of these subsidies is $245 billion a year.

The United States, the Cairns group, and other agricultural exporting countries would benefit enormously from the fundamental reform we envision. That reform will require progressive and substantial reductions in barriers to market access, in internal supports, and in export subsidies. We should put an end to the astronomic export subsidies by which governments bribe the marketplace. Unfortunately, the European Community refused to confront this issue at last week's meeting of the OECD in Paris. If, by working together, we can cause our reform proposal to prevail, the developing world will no longer have to compete against the treasuries of the developed world.

I recognize that for many of the countries in this room, agriculture is the issue in the Uruguay Round. Because it is so vital to you and to the United States, President Bush is solidly committed to achieving agricultural reform in the Round. Just last month in a speech to top American business executives and Congressional leaders, the President bluntly said: "There simply cannot be a successful conclusion to the Uruguay Round without fundamental agricultural reform."

Second, we want to expand market access for trade in goods of all descriptions. We have challenged our trading partners to envision a future tariff-free world, and we are prepared to negotiate increased access in all areas, from tropical products to textiles. Improved market access coupled with internal reforms, should help to draw business into the mainstream of this hemisphere's economic life.

Third, the United States wants to rein in the hundreds of billions of dollars of trade-distorting subsidies that governments pay to industry. Entrepreneurs should compete on the basis of price and quality, not on the depth of their government's checkbooks.

Fourth, we want to develop comprehensive rules of fair play for the $600 billion of world trade in services. Services are an increasingly important sector in our economies, whether construction services in Brazil, financial services in Mexico, or computer services in Uruguay. And while services are important in themselves, agriculture and manufacturing would grind to a halt without them. You cannot grow grain without financing, market it without advertising, or export it without transportation.

Fifth, we want new rules governing investment. Entrepreneurs should be able to invest overseas without being forced to take a local partner, export a given percentage of their output, use local parts, or meet any one of a dozen investment restrictions that make them less of a world class competitor. In the Nineties, there will be extremely stiff competition for investment resources -- whether it be dollars, yen, or deutschmarks. The countries with the most attractive investment climate will be the big winners.

Sixth, we want improved protection for intellectual property to shield producers of fine chemicals, pharmaceuticals, movies, texbooks, and high technology from the theft of their ideas. Entrepreneurs throughout the Americas depend on their ability to take a good idea, develop it, and reap the rewards of their creativity.

Companies in the United States estimate their losses in theft of basic know-how at $60 billion annually, but developing nations lose, too. Without strong intellectual property protection, talented domestic scientists and entrepreneurs cannot develop their own innovations. Adopting strong intellectual property protections also provides enormous incentives for individuals and companies to locate new facilities, produce new goods and services, create new jobs, and increase the flow of investment and technology.

Seventh we want to create a swift and effective means to resolve our trade differences before the inevitable dispute escalates into a regrettable war.

And finally, we want to ensure that the rules that we have, and those that we are negotiating, apply to developing countries. A vibrant trading system is a global ticket to prosperity. But that means that every country represented here must assume greater responsibility for that system, a responsibility that if shouldered, will provide enormous benefits to all our citizens.

The objectives we seek in the Uruguay Round of trade talks should not be viewed in a North-South context. Rather, a successful Uruguay Round will benefit every nation in the world, particularly the countries of Latin America and the Caribbean. By working together for sweeping reforms of trade rules in the GATT, we believe that we can put the world's economy into high gear, not just for the rest of this decade, but well into the 21st century.

Without question, this round of the GATT is a bold and ambitious undertaking. It is our last, best chance this century to create the trading rules we need for the next century.

The vision underlying all of our efforts in the Uruguay Round is the same as that which energizes our hemispheric relations. It is a vision of commerce as a unifying force and an engine of growth.

A solid agreement coming out of this round of GATT talks can be the force for integration in world capitals from Budapest to Brasilia. Only through such an agreement will each nation alone, and the world as a whole, gain the assurance that can come from a strong set of fair and enforceable global trade rules.

Conclusion

Yet, even as we achieve success, we must be on guard, because the political will to keep markets open is always under attack.

There are those in my country, in each of your countries, and all around the globe, who think that they can solve their problems by building barriers to trade.

But as Nobel laureate Milton Friedman says, "Protection is really a good label for a bad cause." Protectionism hurts people. It stifles innovation and entrepreneurship. It does nothing to aid the people it is intended to help. It insulates them from the market and makes them increasingly less competitive. And it robs us of opportunities and choice.

Choice is the indelible link between our political and economic systems. As so many of the countries in this room are boldly demonstrating, political freedom and economic freedom go hand-in-hand. Our people should have the ability to choose how, when, and where to buy or sell goods and services freely in a fair market. That is competition: the freedom to do <u>most</u> what each of us does <u>best</u>.

Therefore, we must welcome open markets, not fear them. We must be confident of our ability, not uncertain. Together the nations of the Americas have abundant natural resources, financial resources, and labor resources. And we have creative, competitive, and confident people. Our opportunities are boundless.

We should demand an open trading system that does most to develop our assets, not one that stifles them.

We must not allow the siren-song of protectionism to lure us off course. We must heed the call of President Menem in his inaugural address when he said: "I am here to call you to the birth of a new era, of a new opportunity, perhaps the last one."

This new era, this new opportunity, this decade of the Americas, is ours for the taking. Let us make it not the last opportunity, but the best. Let us go forth from here and forge, in the crucible of commerce, a vibrant hemispheric partnership to ensure lasting prosperity for all of our people.

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STATEMENT OF
KENNETH W. GIDEON
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to address this Subcommittee on the status of the "section 936 program" in the Caribbean Basin Initiative (CBI) countries.

I. Use of Section 936 Funds in the CBI -- General

Section 936 of the Internal Revenue Code effectively grants an exemption from federal income taxes on certain income earned by certain U.S. corporations doing business in Puerto Rico and other possessions ("section 936 corporations"). The exemption applies to the corporations' active business income from Puerto Rico and to certain passive income ("qualified possession source investment income" or "QPSII") from Puerto Rican sources which the corporations derive from qualifying reinvestment of their Puerto Rican business profits.

It is estimated that the Puerto Rican banking system currently holds almost $10 billion in qualifying reinvested funds. Eligible persons can borrow from these funds at a below-market interest rate because of the tax exemption provided to the section 936 corporation, which is the ultimate lender.

The Tax Reform Act of 1986 added income derived from certain investments in qualified CBI countries to the definition of QPSII. This change was perceived to be a means by which Puerto Rico could share its benefits under section 936 while the United States furthered its CBI objectives. Under that 1986 legislation, income from investments by section 936 corporations in Puerto Rican financial institutions is entitled to the same preferential treatment as other QPSII to the extent used by those

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financial institutions to invest in qualified projects in CBI countries. As part of the compromise to obtain Administration support for section 936 in the 1986 Act, the Puerto Rican government pledged to make a good faith effort to make $100 million of these "936 funds" or "QPSII funds" available for CBI purposes each year.

Congress placed clear limits on which CBI countries and what projects in those countries would qualify. Only CBI countries having an effective Tax Information Exchange Agreement ("TIEA") with the United States are eligible. In addition, QPSII funds may only be invested in development projects or active business assets.

To ensure that the funds are being used properly, potential investments must be reviewed and approved by Puerto Rican authorities. Beneficiaries and lending institutions also must certify to the Internal Revenue Service that the proceeds will be used promptly for authorized purposes. Furthermore, beneficiaries and lending institutions must allow the Internal Revenue Service to inspect their books and records. Congress made clear its intent to monitor the progress of the CBI program.

Since enactment of the 1986 Act changes, approximately $167 million has been lent to projects in CBI countries under this program. Treasury and the IRS have negotiated TIEAs with a number of countries. Temporary and proposed regulations under section 936(d)(4) were issued in September 1989.

II. Tax Information Exchange Agreements - Progress and Problems

A. TIEA Policy

As noted above, a CBI beneficiary country must have an effective TIEA with the United States to be eligible for section 936 funds as well as certain other CBI benefits. The trade-off required is quite explicit: CBI tax benefits are not available for economic development where the economy being aided relies on tax haven activities. Bank secrecy and bearer share laws are explictly noted as tax haven attributes inconsistent with effective TIEAs and the CBI tax benefits that accompany them. The Administration supports this fundamental policy.

The United States' tax interest under the Code extends beyond its borders. U.S. citizens and residents are taxable on their worldwide income. Moreover, under the subpart F, foreign personal holding company, and passive foreign investment company provisions of the Code, a U.S. shareholder in a foreign corporation may be subject to current U.S. tax on income measured by the earnings of the foreign corporation, even though the foreign corporation may not conduct any business in the United States and even though the income has not yet been distributed to the U.S. person. In addition, the Internal Revenue Service has broad authority under Code section 482 to reallocate income,

deductions, or credits between two or more businesses owned or controlled directly or indirectly by the same interests. Administration of these provisions requires that the United States be able to obtain information with respect to international transactions. TIEAs are an important source of this information.

The need for international exchange of tax information also extends to information which may be used in criminal tax cases. In some international transactions it is impossible to uncover unreported income without the assistance of a foreign country in obtaining information which permits U.S. authorities to trace the funds earned or to determine the ultimate ownership of the entities involved.

We believe that TIEAs are beneficial to other countries as well as to the United States. By encouraging countries to open their banking and corporate systems, a TIEA can add to the integrity of a country's tax system. This openness can help to assure a more stable revenue base for infrastructure and other governmental projects and services, which in turn provide a foundation for economic growth.

B. Recent Progress

The last few months have seen an encouraging trend in TIEA activity. Until September 1989, we had effective TIEAs with only four CBI countries eligible for section 936 funds: Barbados, Dominica, Grenada and Jamaica. In October 1989, a TIEA with the Dominican Republic went into effect, and in February of this year a TIEA with Trinidad and Tobago became effective. In addition, our TIEA with Costa Rica is at the ratification stage in Costa Rico, and we anticipate having a TIEA with Guyana shortly. It appears that specific economic development projects that could make use of section 936 funds were a motivating factor for some of these new beneficiary countries to enter into a TIEA.

New projects with section 936 financing in CBI countries with TIEAs could produce momentum to move negotiations forward with other CBI countries.

Progress on TIEAs with non-CBI countries may also provide momentum. In January 1990, a TIEA went into effect with Mexico, and at the Cartagena drug summit we signed a TIEA with Peru. We have received inquiries from other Latin American countries as well. These countries are not CBI countries and want TIEAs solely for the benefit of enhanced tax administration and enforcement. The high level of interest is illustrated by the model tax information exchange treaty recently formulated and approved by the Inter-American Center of Tax Administrators with Treasury and IRS participation, which is expected to be used as a basis for tax information exchange among all the countries of the Americas. When CBI beneficiary countries, and particularly the Central American countries, see that other Latin American

countries believe TIEAs are beneficial even without the CBI benefits, they may become more interested in a TIEA.

III. Approval Process For Borrowing Section 936 Funds

A potential investor in a CBI country desiring to borrow section 936 funds must obtain approval from the Commissioner of Financial Institutions of Puerto Rico and the Economic Development Administration (FOMENTO). FOMENTO performs an economic impact test and will approve the transaction if it determines that the transaction will not have a negative impact on the Puerto Rican economy. The Commissioner of Financial Institutions determines whether the proposed CBI investment is consistent with the Puerto Rican regulations governing investment in CBI countries. Once the project is approved by Puerto Rican authorities, the investment will qualify as a 936/CBI investment, as long as it also complies with the regulations issued by the Internal Revenue Service under section 936. The borrower need not obtain an approval from the Internal Revenue Service.

Before the regulations were issued last September, the Treasury Department and the Internal Revenue Service reviewed potential CBI investments submitted to us on a case-by-case basis. This was done in order to assist potential investors in the absence of published regulations, but such approval was not required. Nevertheless, it was often sought by potential investors for assurance that an investment would indeed qualify as a 936/CBI investment. During that period, twelve cases were submitted to us for review. Of these, seven cases were approved. The review process ranged in length from several weeks to several months, depending on the complexity of the case. Transactions which were obviously consistent with the Congressional intent as reflected in the statute and the legislative history were approved promptly. Some transactions, however, needed to be restructured several times to make them consistent with the goals of the CBI program. Most of the cases that we did not approve involved the arbitraging of section 936 funds and did not go beyond the planning stage.

We believe that the 936/CBI program benefited from our review of specific transactions. From the review process, we were able to identify many problems associated with CBI investments. As a result, we were able to provide more relevant and practical guidance in the regulations. Some of the major issues that we faced during the approval process and covered by the regulations are summarized below.

Refinancing. The goal of the CBI program is to promote economic development in CBI countries by encouraging new investments. We learned, however, that some investors were planning to use section 936 funds only to refinance existing facilities. Refinancing does not generate any appreciable new assets in a CBI country. Therefore, the regulations provide that section 936 funds generally may not be used to refinance existing

facilities.

Privatization. Some industries in some CBI countries are nationalized. International development agencies, such as the World Bank and the Agency for International Development (AID), have promoted privatization as a means of revitalizing the economies of CBI countries. It has been proposed that section 936 funds should be eligible for use in privatization cases. Although many privatization cases involve refinancing of existing facilities, we believe that there are sufficient developmental benefits from privatization transactions to warrant approval for some privatization efforts. We are working with OPIC, AID and the State Department to develop a useful definition of privatization projects and procedures for covering appropriate cases. Pending resolution of those issues, the regulations reserve on the issue of the use of section 936 funds in privatization cases. We expect to complete the work in the near future.

Federal Guarantees. Many CBI countries are already burdened with excessive debt, and several potential lending institutions have already lost money lending to CBI countries. Therefore, most lending institutions are reluctant to lend for investments in CBI countries unless the institutions receive a guarantee from OPIC or some other federal agency. An issue arose as to whether section 936 loans may be guaranteed by a federal agency and still retain their tax-exempt status. The concern was whether section 936 funds should be analogized to tax-exempt municipal bonds. The Code rules governing the tax treatment of interest on municipal bonds prohibit a federal agency from guaranteeing the obligation. The rationale is that a double benefit -- in the form of a tax exemption and a federal guarantee -- would involve an excessive tax expenditure. We ultimately concluded that the federal guarantee of section 936 funds should be allowed because the purpose of the section 936/CBI program is sufficiently different from that of municipal bonds.

Arbitrage. The review process illustrated that there exists an opportunity to "arbitrage" section 936 funds, i.e., invest section 936 funds in obligations that yield higher interest than the borrower owes on the section 936 funds that it received from a Puerto Rican bank. If arbitrage were permitted, the higher yielding investments would likely be such obligations as Eurodollar obligations and guaranteed investment contracts issued by insurance companies. The purpose of the section 936 program is to keep the funds invested in business assets in Puerto Rico and CBI countries to promote economic development in those jurisdictions, and not to permit financial profits by speculation. Therefore, the regulations try to curb arbitraging of section 936 funds by requiring a CBI borrower to use borrowed funds promptly for authorized purposes, and by restricting the types of investment that can be made with the funds in the temporary period before their final use.

Use of Financial Intermediaries. Some of the projects we reviewed proposed to use several financial intermediaries in CBI countries before an ultimate borrower would obtain the use of the section 936 funds. It was argued that such an arrangement is necessary to disseminate section 936 funds more easily in the local market. However, the goal of the CBI program is to make financing available to ultimate users of section 936 funds at the lowest cost possible. If the ultimate borrower has to go through several layers of financial intermediaries to obtain section 936 funds, at least some of the benefit of a reduced section 936 interest rate would not accrue to the ultimate borrower but, in effect, to the intermediary institutions. Furthermore, while the interest rate charged by a Puerto Rican financial institution is subject to supervision by the Office of the Commissioner of Financial Institutions of Puerto Rico, there is no means to monitor the interest rate charged by non-Puerto Rican financial institutions. However, in recognition of the fact that a financial intermediary in a CBI country indeed may be in a better position to reach the local market than a Puerto Rican financial institution, the regulations permit one such intermediary.

Conduit Investments. Many of the potential investors in qualifying CBI countries are section 936 companies or their U.S. or foreign affiliates which wish to set up complementary operations in the CBI countries as part of Puerto Rico's "twin plant" policy. CBI loans are required by the statute to be made through a Puerto Rican financial institution because, among other reasons, the interest must be from a Puerto Rican source to qualify as QPSII. In order to comply with that requirement, the parent corporation deposits a specified amount of section 936 funds with a financial institution in Puerto Rico, which in turn lends the same amount to the subsidiary on substantially identical terms. An issue arose as to whether this type of transaction should be recast as a direct loan from the parent to the subsidiary under the general "conduit" or substance over form rule. If the conduit rule applies, the interest from the subsidiary will be sourced outside Puerto Rico and, as such, would not qualify as QPSII. We believe that when Congress amended section 936(d) to provide that investments in certain CBI countries will be deemed to be used in Puerto Rico, it intended to treat the income from such investments as derived from sources within Puerto Rico. Therefore, we anticipate that regulations will be issued under section 936(d)(2) to provide that income received from a CBI obligor in such a case will be treated as Puerto Rican source income for purposes of determining whether such income qualifies as QPSII.

IV. Evaluation of the Section 936/CBI Program

You asked Treasury to address whether the section 936/CBI program has been effective in promoting investment and employment in the CBI region and how the program could be improved to better achieve these goals.

Because the section 936 funds available for lending are private deposits in financial institutions, not public funds, the success of the 936/CBI program must be evaluated in light of the commercial reality of the CBI market. Financial institutions have been reluctant to make section 936 loans for CBI projects due to the perceived risks involved in investments in the region, except when the institution can obtain a comprehensive guarantee providing commercial and political risk coverage. The Overseas Private Investment Corporation (OPIC) may provide such a guarantee. However, OPIC involvement is generally limited to transactions that do not have an adverse impact on the U.S. economy or jobs. Also, the problem of a mismatch between potential lenders' and borrowers' needs is more pronounced in the section 936/CBI market than in the non-section 936 market. In particular, there is substantial volatility in the short term corporate deposits on which section 936 lending is based. Therefore, while development projects require long-term financing, financial institutions have been generally reluctant to lend on such terms when they are not assured of a long-term deposit base.

These unavoidable commercial restraints have affected the section 936/CBI program. The program could be improved if a comprehensive guarantee mechanism existed for CBI investments. The legislative history of the Tax Reform Act of 1986 makes it clear that the section 936/CBI program should operate without additional cost to the United States. It provides that the funds for such program should be made available from a variety of sources including possessions corporations (in exchange for future Puerto Rican tax concessions), Government Development Bank funds, and grants by the Government of Puerto Rico. See H. Rep. No. 99-426, 99th Cong., 1st Sess. 413, 420 (Dec. 7, 1985); and H. Rep. No. 99-841, Vol. II, 99th Cong., 2d Sess. 631, 632 (Sept. 18, 1986). We have been informed by Puerto Rican authorities that they recently created a public corporation, called the Caribbean Basin Financing Authority, which will make section 936/CBI loans and provide guarantees for such loans. The future success of the section 936/CBI program may depend on the Caribbean Basin Financing Authority's ability and willingness to provide guarantees for section 936/CBI loans.

Conclusion

The efforts of the last few years are just beginning to bear fruit. We have more TIEAs in place now, and several projects are in development. In the next two years we will see whether the program will work as intended. I am hopeful that, economic circumstances in the CBI countries permitting, we will see positive results.

I thank you, Mr. Chairman and Members of the Committee, for the opportunity to testify concerning this issue of great importance to the Treasury Department.

TREASURY NEWS

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Testimony of the Honorable John E. Robson
Deputy Secretary of the
Treasury before the Senate Foreign Relations Committee
April 27, 1990

I would like to thank the Chairman and the Committee for this opportunity to update you on activities of the Department of the Treasury to combat international money laundering.

My testimony today will touch on the work of the G-7 Financial Action Task Force on Money Laundering and related initiatives, measures that the Endara Government in Panama has taken against money laundering, and current progress in pursuing agreements under section 4702 of the Anti-Drug Abuse Act of 1988.

The overall message I would like to convey to the Committee is that we are seeing advances in the international community in helping countries to understand the nature and global scope of the money laundering problem and the steps necessary to address it. The United States is committed to the ultimate goal of a worldwide network of countries linked together with a common resolve to close the doors of our financial institutions to money launderers. We also recognize that forging this chain of dozens of sovereign nations with different laws, practices, and financial systems is not quickly or easily achieved.

Treasury Role

Before turning to these matters, I would like to discuss the role of Treasury in the area of money laundering and financial enforcement.

Money laundering is a complex economic crime that demands a thorough understanding of how our financial institutions operate in order to prevent their abuse. Treasury brings to the problem the perspective of a law enforcement agency, a financial institution regulatory agency, and the agency concerned with the overall condition of our domestic and international financial systems. Our recent experience with the G-7 Financial Action Task Force, which I will discuss, demonstrates that Treasury's understanding of law enforcement and the financial system is very useful in dealing with our foreign counterparts, many of whom are grappling with developing anti-money laundering programs for the first time.

We understand not only law enforcement concerns, but the

necessity to balance law enforcement needs with other legitimate considerations affecting the financial system. Achieving this balance is one of the challenges facing the Administration and Congress as we seek solutions to the problem of money laundering.

Among the key elements of anti-money laundering efforts are the reporting and recordkeeping requirements of the Bank Secrecy Act so that the trail to the money can be followed. Treasury has worked over the years to refine regulatory requirements for reporting and recordkeeping to reflect changing law enforcement needs and to enhance compliance by financial institutions.

The currency reporting system has become an essential component of the U.S. financial enforcement program against money laundering, tax evasion and other criminal activity. It is relied upon by law enforcement agencies, not just to target suspicious activity, but to support ongoing investigations, prosecutions, and forfeiture actions in a variety of ways.

The U.S. Customs Service and the Internal Revenue Service (IRS) have been delegated authority to investigate criminal violations of the Bank Secrecy Act -- IRS with respect to domestic currency reporting and Customs with respect to the reporting of international transportation of currency and monetary instruments. Reporting violations are frequently indicative of money laundering activity, carry severe criminal sanctions, and can be prosecuted without proof of the source of the money. Both Customs and IRS also have authority to investigate the crime of money laundering.

Among the most successful of international drug money laundering cases are Operation C-Chase initiated by Customs and Operation Polar Cap developed jointly by IRS, Customs, FBI, and DEA. The details of the cases are well known to the Committee, but the degree of cooperation from foreign governments in the cases should be noted. In Operation C-Chase, involving the Bank of Credit and Commerce International, Customs was able to meet with targets in France and the United Kingdom with the knowledge and assistance of those governments. The United Kingdom and France issued search warrants and seizure warrants and the United Kingdom arrested suspects in London. Similarly, in Operation Polar Cap, Uruguay arrested a suspect and later extradited Canada and Switzerland effected seizures. IRS and Customs report that there has been a marked upsurge in cooperation in money laundering cases generally as our allies come to appreciate the common nature of the money laundering threat.

Based on the success of joint efforts in Operation C-Chase, U.S., British, and French Customs have established an arrangement designated "C-Chase International." This is an informal arrangement to promote sharing of investigatory information and

cooperation in all types of Customs cases with special emphasis on money laundering cases.

Through the Italian American Working Group, Customs also has created a joint operation with Italy called "Primo Paso" (First Step). U.S. Customs and Italian authorities work together to identify information about organized crime operating in Italy and the U.S. Their work is facilitated by on-line access to the currency reporting information in the Treasury Financial Database available to our Customs attache in Rome. Our Customs attaches are working to replicate the success of Primo Paso with similar operations in other European countries.

Secretary Brady has applied Treasury's years of experience in financial analysis and investigation in the creation of the Financial Crimes Enforcement Network, "FinCEN." FinCEN has been established within Treasury to provide a multi-source data access and financial analysis service to Federal, State, local and foreign law enforcement which will assist them in the investigation and prosecution of money laundering and other crimes.

FinCEN represents a fresh approach to financial analysis. For the first time, experts from law enforcement, regulatory agencies and the private sector will work together routinely to apply their collective expertise to the issue of money laundering and other financial crimes. We look forward to testifying in the future that the creation of FinCEN was a watershed event in the history of the government's war on drug money laundering.

International Cooperation

G-7 Financial Action Task Force on Money Laundering

Our most important recent initiative was the U.S. participation in the G-7 Financial Action Task Force on Money Laundering. This Task Force was convened at the direction of the 1989 G-7 Economic Summit in Paris. The heads of state and governments of the G-7 gave the group a mandate to study measures that have been taken to prevent utilization of financial institutions by money launderers and to make recommendations on how to improve international cooperation against money laundering.

The Financial Action Task Force was born of the ideas that narcotics trafficking and money laundering are inextricably linked and that money laundering is an international problem that must be addressed through international solutions.

The Task Force met under French chairmanship and consisted of sixteen members: the seven Summit participants (Canada, France, Germany, Italy, Japan, the United Kingdom and the United States), eight other industralized countries, (Australia, Austria,

Belgium, Luxembourg, the Netherlands, Spain, Sweden, and Switzerland), and the European Community. The Task Force brought together over 130 experts from finance ministries, financial institution regulatory agencies, foreign affairs and justice ministries, and law enforcement agencies of the member countries.

I had the privilege of serving as the chairman of the U.S. Delegation which consisted of delegates from Treasury, including Customs and the Office of the Comptroller of the Currency, the Department of State, the Department of Justice, FBI, DEA, and the Federal Reserve Board.

After monthly meetings from September 1989 through February 1990, under the able direction of our French Chairman, the group issued an excellent report with 40 action recommendations. The report was published in the United States last week and will be a topic of discussion at the Houston Summit this summer. Treasury has provided the Committee with the report. I would like to submit the report and its annexes for the record.

These recommendations, as they are implemented by the member countries, should establish a nucleus of comprehensive programs to address money laundering and will facilitate cooperation in international investigations, prosecutions, and forfeiture actions. I think it is fair to characterize the report as the single most comprehensive, forceful international declaration on money laundering to date.

The report reflects recognition by the Task Force members that in order to wage an effective war against money laundering each member must have an effective domestic program to attack money laundering and that we must cooperate with each other in the many cases that traverse international borders through both formal and informal mechanisms. The group also recognized that financial institution secrecy laws should not stand as barriers to effective financial crimes enforcement.

Most importantly, the Task Force recommendations reflect the fact that money laundering is a complex crime that cannot be effectively attacked by conventional law enforcement methods alone. Law enforcement authorities, finance ministries, financial institution regulators, and financial institutions themselves must work together to prevent financial institutions from being used by money launderers.

With these tenets in mind, the Task Force made a number of recommendations, including the following:

- Countries should criminalize drug money laundering and consider criminalizing other types of money laundering.

- Countries should adopt effective seizure and forfeiture

laws.

- Financial institutions should not have anonymous accounts and should be required to identify their customers when accounts are opened and when conducting transactions, in particular when performing large cash transactions.

- Financial institutions should maintain adequate records of transactions, including currency transactions, for five years, so as to be able to provide evidence in future investigations and prosecutions.

- Financial institutions should be alert to suspicious transactions and be able to report such transactions to law enforcement authorities free from liability under secrecy laws.

- Financial institutions should develop comprehensive anti-money laundering programs with employee training and audit procedures.

- Financial institution regulators should cooperate with law enforcement authorities and insure that financial institutions have adequate money laundering prevention procedures.

- Countries should provide the widest possible assistance in money laundering cases at every stage from investigation and prosecution through extradition.

While the Task Force recommendations may cause us to do some fine tuning of U.S. financial enforcement, by and large the recommendations reflect policies and programs already in place in the United States. This is not surprising given the fact that the United States has been addressing money laundering enforcement issues for many years longer than most of our allies, and our system was frequently looked to as a model.

The degree to which the Task Force was able to reach consensus on the recommendations is worth noting. Some of the recommendations, such as active participation by bank regulators and reporting of suspicious transactions, are major departures from legal and banking traditions in many of the countries.

This is not to suggest that the recommendations rubber-stamp the U.S. system. For instance, while the report has a number of recommendations dealing with large cash transactions, and takes specific note of the U.S. currency transaction reporting system, the report recommends that each government should individually consider the feasibility and utility of such a system.

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The United States views routine currency reporting as one of the important components of our financial enforcement program, particularly in view of the complexity of our financial system, the number and diversity of United States financial institutions, and our geographic size. However, other countries may be able to achieve an effective enforcement program without routine reporting through programs that combine currency recordkeeping, customer identification, the availability of records to law enforcement authorities, and suspicious transaction reporting. In time, some of these countries will come to adopt routine currency reporting, as Australia has.

In the meantime, Treasury has extended an invitation to foreign government and banking officials to visit us for a demonstration of the effectiveness of our program. Treasury's Office of Financial Enforcement regularly arranges multi-day "tours" for delegations of foreign officials to view Treasury facilities at FinCEN and elsewhere and to discuss enforcement issues. This year to date, we have hosted several such delegations from various countries. In addition, Customs and IRS participate regularly in bilateral money laundering seminars and training of foreign officials.

Recognition by the Task Force member countries of the need for a united front against money laundering is a major step, but only a first step. We must keep working to encourage other countries -- large and small, developed and developing -- to embrace the Task Force recommendations and move forward to address the problem from a concerted, multilateral approach.

FATF-Related Initiatives

We shortly will have just such an opportunity to encourage other countries to endorse the recommendations. President Bush has accepted the invitation of Prime Minister Oduber of Aruba for the U.S. to participate in a conference inspired by the success of the Financial Action Task Force, focusing on money laundering in the Carribean area. On behalf of Secretary Brady, I will chair the U.S. Delegation with assistance from the Departments of Justice and State and our law enforcement and bank regulatory agencies. We hope that the countries participating will endorse the recommendations of the FATF as well as deliberate on other recommendations appropriate to addressing the money laundering problem in this region. The first organizational meeting of this Aruban Task Force took place in Washington yesterday.

A related undertaking is underway in the Organization of American States ("OAS"). On April 17 - 20, 1990, the OAS convened a Meeting of Ministers on the Illicit Use and Production of Narcotic Drugs and Psychotropic Substances and Traffic Therein. This "Alliance of the Americas Against Drug Traffic" unanimously adopted a resolution for the formation of an Inter-American Group

of Experts to draft model regulations in conformity with the U.N. Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances.

The mandate of this experts group is to develop model legislation to criminalize drug money laundering to prevent the use of financial systems for money laundering, to enable authorities to identify, trace, seize and forfeit illicit proceeds, to change legal systems to ensure that bank secrecy laws do not impede effective law enforcement and mutual legal assistance, and, finally, to study the reporting of large currency transactions to national governments and to permit the sharing between governments of such information. It is expected that the OAS will soon convene this group and that Treasury will play a central role in its work.

Panama

Next, I would like to address measures taken by Panama.

Recent history dramatically demonstrated to the Panamanians the pernicious effect of money laundering on the Panamanian political, economic and social structure. With this backdrop, the Endara government has taken a number of steps that show its resolve to address drug money laundering. These steps have been taken with U.S. encouragement, but at the initiative of the Panamanian government.

In January, the Endara government entered a Mutual Cooperation Agreement on Narcotics with the United States (a so-called "Chiles" agreement required under P.L. 100-690). Under the terms of this agreement, both governments committed to take a variety of cooperative measures related to narcotic matters, including steps to combat drug money laundering. Panama also accepted an invitation to participate in the Aruban initiative.

Panama has begun to use its anti-narcotics legislation which was dormant for many years and to interpret its bank secrecy provisions in drug cases to allow access to bank records by both domestic and foreign law enforcement authorities. Following the fall of the Noriega regime, the Panamanian government froze over 200 bank accounts related to drug and drug money laundering cases based on information provided by U.S. law enforcement agencies. The accounts remain frozen to their owners and the Panamanian Attorney General has begun to share information about these accounts for use in U.S. investigations and prosecutions, including the Noriega case. These documents were important in the investigations that led to the freezing last week of a number of U.S. bank accounts last week arising out of Operation Polar Cap. This is to be contrasted with the lack of cooperation U.S. authorities received from Panama in past years in drug money laundering cases.

The Panamanian government also has taken steps to enlist its banks and bank regulators in the fight against money laundering. On February 13, 1990, the Panamanian Cabinet issued Decree No. 41, mandating that the National Banking Commission require banks to identify their customers and to record currency and certain negotiable instrument transactions in excess of $10,000. The decree gives authority to the Commission to examine banks for compliance, and provides for civil penalties and criminal fines against banks and their directors, officers and employees for failure to adhere to these requirements.

The provisions of Decree 41 and the regulations that have been issued under it appear to be a major step forward for Panama to safeguard banks against money laundering. It also represents the first time that Panamanian regulatory authorities have been actively engaged in the struggle against money laundering.

Finally, in mid-February 1990, the Endara government approached the U.S. about its desire to enter into an exchange of information agreement to facilitate the sharing of information and records, including bank records, in drug and drug-related investigations and prosecutions, including money laundering. A joint State, Treasury, and Justice team has been discussing this agreement with officials of the Panamanian government.

While I hope the Committee will understand that we cannot discuss the details of the course of these discussions, both the U.S. and Panama are intensively pursuing an agreement. We can add that we seek provisions for the sharing of currency recording information maintained in Panama under Decree 41, and consider this aspect of the discussions to be under the authority of section 4702.

In summary, the news from Panama is encouraging and reinforces the Administration's commitment to do everything possible to assist the Endara government to help stabilize democratic institutions to insure that the nightmare of the Noriega regime cannot be repeated. We want to continue to send a message of trust and friendship to the government and people of Panama.

Section 4702

Next, I would like to turn to an integral part of our international anti-money laundering strategy, section 4702.

Under Section 4702 of the Anti-Drug Abuse Act of 1988, the Secretary of the Treasury negotiates with countries that do business in U.S. currency to require their financial institutions to keep records of large dollar currency transactions, and to share those records with U.S. law enforcement authorities upon request. The Secretary, in consultation with the Attorney General and the Director of the Office of National Drug Control

Policy (ONDCP), is to place highest priority on those countries whose financial institutions may be engaging in transactions involving the proceeds of international narcotics trafficking, particularly U.S. drug sales.

On November 18, 1990, the Secretary reports to Congress and to the President on the status of the negotiations. The President is to apply sanctions against any country that has not reached an agreement or is not negotiating in good faith unless he certifies that sanctions would not be in the national interest. Sanctions include virtually closing off access to the U.S. banking system to the financial institutions of a country.

In enacting section 4702, Congress recognized that it is essential that financial institutions adequately identify those engaging in large cash transactions, record those transactions, and make the information available to law enforcement in drug-related cases.

The Financial Action Task Force Report reached the same conclusion about the need for financial institutions to keep records of large currency transactions, to identify their customers when conducting large transactions, and to share financial institution records with foreign law enforcement authorities. In this regard the Financial Action Task Force report should serve as a foundation for future section 4702 agreements. If properly implemented in the member countries, this will facilitate our ability to reach agreements under section 4702.

Treasury has given priority to the negotiation of these agreements. Our first accomplishment was the complex task of assessing which countries should be given highest priority for negotiation. After solicitating the views of federal law enforcement and intelligence agencies and our embassies abroad, and consulting with the Director of ONDCP and the Attorney General regarding priority countries, and careful review of all available information, we initially selected eighteen countries for negotiation of 4702 agreements. Three countries have been added to the list since our interim report to the Committee last November for a total of twenty-one. We do not regard the list as fixed, and we will adjust the list of countries as appropriate.

Next, we determined what resources would be needed to get the job done. We determined the task could be best accomplished by a multi-agency approach. So, under the direction of the Assistant Secretary for Enforcement, we have assembled a team to work on this project. The team includes four full-time international specialists detailed from IRS and Customs, an administrative officer, officials from Treasury, (Office of Financial Enforcement and General Counsel) State (International Narcotics Matters and Office of Legal Advisor), and Justice (Office of

International Affairs and the Deputy Assistant Attorney General, Criminal Division).

Treasury is working closely and meets regularly with the Departments of State and Justice to discuss our strategies for section 4702 agreements and to coordinate these initiatives with other drug and money laundering initiatives, especially any ongoing or planned Mutual Legal Assistant Treaties (MLATs) with any of the countries. I think Justice and State would agree inter-agency cooperation in this project has been excellent.

The negotiations with and approaches to the countries are at various stages. Our embassies abroad have been very helpful in making formal approaches to appropriate foreign officials and in fielding questions for Treasury that these officials pose regarding currency recordkeeping or the operation of the agreements. Over the next months, we will send negotiating delegations to many of the priority countries. Where it might facilitate the negotiating process, I intend to personally to visit my foreign counterparts.

This is a major undertaking through often uncharted waters. At this point, it is not possible to predict the course of any particular negotiation or a time when we can consider the project completed. While Treasury will report back to Congress in November on the status of negotiations, we see the process continuing beyond that time. However, our goal is clear: an international network of countries with stong anti-money laundering programs and broad colloboration among law enforcement authorities.

Several factors contribute to the uncertainty of these predictions. First, we are asking countries to adopt requirements that are often unprecendented for their financial institutions and governmental authorities. While we take the currency transaction recording and the connection between currency and drugs and drug money laundering for granted, there is an educational process to go through with many of these countries, which takes time. This is the case even for countries that are genuinely determined to have effective drug and money laundering enforcement programs.

Second, we are asking countries in most cases to amend statutory or regulatory provisions both to require currency recording and to authorize information sharing. Finally, the U.S. experience with law enforcement agreements generally is that negotiations can be protracted. For instance, as the Justice Department can attest, Mutual Legal Assistance Treaties often take a number of years to negotiate.

Let me assure the Committee that we are firmly committed to forging a network of section 4702 agreements. We are optimistic

that countries will be persuaded to conclude these agreements as we help them to understand the money laundering problem and the relation of these agreements to effective enforcement programs.

I hope the Committee will understand that, because of the sensitivity of negotiations and the source of the information upon which we have based our selection of countries for negotiation, we cannot now report in more detail on the discussions or name the countries selected. We believe that to do so would be harmful to the negotiation process.

Conclusion

Our experience has taught us that we cannot make progress against drug trafficking and the international money laundering that sustains it with traditional law enforcement methods, applied within national boundaries. What is needed is painstaking, sophisticated financial analysis to uncover the tangled web of financial dealings of drug organizations, followed by determined action to deprive the organizations of their holdings. This cannot be achieved without two partnerships working together -- a partnership among financial institutions and government authorities and a partnership among nations. As money launderers know no national boundaries, countries must work together to insure that international boundaries will pose no impediments to enforcement efforts.

WASHINGTON UPDATE

Policy and Politics in Brief

TRADE TALKS WITH MEXICO FACE HURDLES

BY BRUCE STOKES

Mexican President Carlos Salinas de Gortari was back in Washington in mid-June looking for a commitment from the Bush Administration to negotiate a free-trade agreement between the United States and Mexico. He went home with half a loaf.

Faced with the daunting task of trying to successfully complete the current round of multilateral trade negotiations that have been going on for four years, all President Bush would agree to in his meeting with Salinas was further consultations between Washington and Mexico City.

These talks will lay the groundwork for formal free-trade negotiations sometime after December, when the two Presidents are scheduled to meet again in Monterrey, Mexico.

The timing is significant because the talks on the General Agreement on Tariffs and Trade (GATT)—an attempt by nearly 100 nations to reduce agricultural subsidies, to develop new rules for trade in services and to protect intellectual property and foreign investment—are slated to end that month.

Both sides are officially optimistic that comprehensive U.S.-Mexican trade negotiations can begin next year. "There is a virtually unstoppable dynamic towards closer integration," an Administration official said.

But the U.S. business and labor interests likely to be affected by an agreement with Mexico have yet to be heard from. And many U.S. trade experts warn that gaining congressional approval for such a pact may prove much more difficult than was the case for the agreement with Canada, which took several years to negotiate and was finally signed in 1988.

Mexican President Salinas and President Bush
They agreed to meet again later this year.

Mexico's sudden interest in a trade agreement appeared to catch the Administration by surprise. Sectoral trade negotiations—discussions that had concentrated on agriculture, automobiles, steel, textiles and services—had been going on for some time, but Mexico had blown hot and cold on the idea of creating a full-fledged free-trade area.

Why the change of heart? "The changes in Eastern Europe showed me that the [world] competition for resources and markets will strengthen," Salinas said at a June 11 press conference in Washington. He said that he's concerned about the influence of regional trading blocs that are forming in Europe and Asia; to ensure that Mexico does not find itself cut out of world markets, he decided Mexico had to strike a deal with the United States.

"The Europe of 1992 will be the largest market in the world if we don't get an agreement," he warned; a North American free-trade area, including Canada, would be bigger.

Recent trade figures reinforced Salinas's conviction that the time to act had arrived. The United States bought $15.7 billion of Mexican exports in 1989, accounting for more than two-thirds of Mexico's trade (Mexico is the third-largest trading partner of the United States). But the healthy $4.1 billion trade surplus Mexico ran with the United States in 1987 slipped to a $2.2. billion deficit in 1989, with prospects that the red ink would get deeper.

The Administration has been aware of Mexican concerns, but U.S. trade negotiators have been preoccupied with other matters. "The trade bureaucracy is up to its ears in the GATT process, and they will have difficulty pulling this together in very quick order," said John St. John, who used to head the State Department's Mexican desk and is now an international business consultant in Washington with St. John-Villarreal Associates.

The 1988 Trade and Competitiveness Act also requires the clock to start ticking on a 60-day period of consultation between the Administration and Congress after free-trade talks begin, something neither the U.S. Trade Representative's Office nor Congress wants at this time for both logistical and political reasons. In a recent letter to the Administration, Ways and Means Committee chairman Dan Rostenkowski, D-Ill., said that he supports free-trade talks with Mexico, but he cautioned against starting the process now, presumably because of concerns that the GATT discussions could be hampered

Nevertheless, "we must be responsive to the needs of the Mexican government," a U.S. trade official said in explaining the artful wording of the Presidents' joint communique, issued on June 11, that allowed the Mexicans to say progress had

been made, though the Administration in fact kept things on a back burner.

Once free-trade talks begin, "the actual negotiation should be simpler than Canada," predicted Stephen L. Lande, president of Manchester Trade Ltd., a Washington-based trade consulting firm. "The technical aspects of the negotiation could be done in six months if there is some political will to do so."

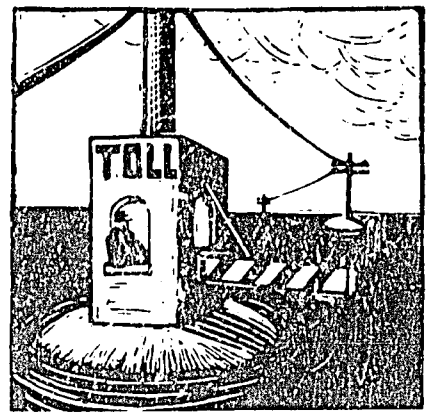
Many border-state Members of Congress, many of whom met with Salinas during his stopover in Washington, sounded enthusiastic. "We have assured the President [Salinas] that we will do all we can to help with the [free-trade] discussion," said Rep. Ronald D. Coleman, D-Texas, who represents a border district.

But interest elsewhere doesn't seem that strong. The Business Roundtable, a New York City-based group that represents more than 200 major U.S. corporations, has called for a comprehensive U.S.-Mexican trade agreement. But reconstituting the business coalition that orchestrated congressional approval of the trade agreemen with Canada could be more difficult. "It will be much harder to get the same coalition for Mexico," predicted William T. Archey, international vice president of the U.S. Chamber of Commerce. "The cost to companies of being out front will be greater."

For example, Salinas told reporters he envisioned an agreement that focused on freer trade in goods and protection of intellectual property rights. This is music to the ears of some major manufacturers looking for low-wage production sites; it's a sour note to many small and medium-sized producers of such items as automobile parts. Auto parts are now one of Mexico's principal exports to the United States, and the prospect of even more production heading south of the border is bound to engender industrial states' opposition.

Salinas also acknowledged that some sectors of the Mexican economy may be off limits to free trade. Alluding to American-requested exemptions from the U.S.-Canadian agreement, he said: "If you are going to leave out maritime and telecommunications, we will certainly leave out oil, electricity."

Experience with the Canadian agreement demonstrates that such exemptions may be necessary to defuse domestic political opposition, trade specialists say, but when both parties to an agreement begin



Peter Kuper/INX

to engage in a tit-for-tat exemption exercise, support for a free-trade treaty may be rapidly undercut.

In addition, opponents of a trade agreement are likely to be able to tap growing public concern in the United States about Japan's widening sphere of influence south of the border. "Are we opening the backdoor for Japanese investment?" Archey asked. Though Japanese investment is still a small portion of over-all foreign investment in Mexico, Salinas will soon travel to Asia to urge more companies to come to Mexico. "I hope [a free-trade agreement] will be an additional stimulus for investment into Mexico," he acknowledged.

C. Michael Aho, director of economic studies at the Council on Foreign Relations in New York City pointed out that "a critical dimension of a free-trade agreement will be rules of origin—what is truly a Mexican product and what is Japanese." Neither side would relish engaging in that technically difficult and politically explosive exercise, he said, but opponents of the agreement might demand it.

There is ample precedent for such an effort. A long-standing U.S.-Canadian auto pact, which allows newly manufactured autos to be hauled over the United States's border with Canada duty-free, exempts recent foreign auto investment in Canada from the agreement's benefits.

Salinas left uncertain in his remarks to what extent the expected treaty would cover service trade—such things as insurance or banking. The booming American service industry was a prime backer of the agreement with Canada; if it stays on the sidelines during any talks with Mexico, its absence would be felt.

If the American business community is divided, the expected opposition to a free-trade agreement by textile producers, some farm interests and organized labor takes on greater signifigance.

Textile manufacturers are likely to mount a spirited opposition. They are unwilling to give up in a free-trade agreement with Mexico the protection from cheap imports that they now enjoy. And fruit and vegetable producers in the Southwest are expected to cite examples of Mexican use of pesticides and other dangerous chemicals to bolster their arguments against imports of cheaper Mexican produce.

American union leaders, who haven't had much influence on trade policy in recent years, would go all out to preserve U.S. jobs. "More than 450,000 Mexican workers [are] working in plants producing solely for the U.S. market," AFL-CIO economist Mark A. Anderson said. "We would expect a free-trade agreement to increase that number significantly and that those jobs are, by definition, ones that would be here if we were producing for our own consumption."

Even those who support freer trade warn against moving too fast. "The United States ought to be wary in going into this process," Aho said. "The status quo ante will not be the same in the wake of failed negotiations. Business interests will change their behavior." (Economists say that increased Japanese investment in Mexico in anticipation of easier access to the U.S. market is likely to lead to an increase in U.S. imports from Mexico whether a free-trade agreement succeeds or fails, for example.)

Moreover, Aho pointed out, "no negotiator wants to go down in history as having failed to complete an agreement. If they can't overcome the manifold differences between the two countries, they are likely to try to paper them over."

Salinas acknowledged all these problems, but he argued that "a growth in the market of 81 million people [the population of Mexico] will mean additional exports from the United States to Mexico." And he reminded his listeners that his goals are not that ambitious. "We do not want a common market type of agreement," he said. "For that means a common parliament and a common currency. We merely want a free-trade agreement." Yet he firmly believes that an arrangement must have some substance. "We are not looking for symbols but practical solutions," he said. ■

INSTITUTE FOR INTERNATIONAL ECONOMICS

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New Books

Latin American Adjustment: How Much Has Happened?

John Williamson, editor

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. This book provides a comprehensive, country-by-country analysis of the reform efforts to date and assesses the challenges ahead.

An introductory chapter by John Williamson examines the "Washington consensus" on how ten major policy instruments–including fiscal deficits, tax reform, exchange rates, and deregulation–should be used to address Latin America's current problems. Ten country studies and accompanying commentary assess public attitudes in each country toward these reforms, examine the progress made since 1982 in implementing them, and measure the impact of policy changes on economic performance.

In a summary chapter, Williamson concludes that the reforms are much more extensive than is generally recognized, which provides a ray of hope from a region where most of the economic news continues to be grim. This concluding chapter is published separately as *The Progress of Policy Reform in Latin America*, POLICY ANALYSES IN INTERNATIONAL ECONOMICS 28. The study is based on a conference held at the Institute for International Economics in November 1989.

CONTENTS: Introduction • What Washington Means by Policy Reform • Three Policy Experiments: Bolivia, Chile, and Peru • The Three Major Debtors: Brazil, Mexico, and Argentina • Colombia and Venezuela • The Smaller Countries: The Caribbean and Central America • Panel Discussion on Latin American Adjustment: The Record and Next Steps • From Policy Consensus to Renewed Economic Growth • The Progress of Policy Reform in Latin America.

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April 1990. Tables. Figures. Index.
480 pp. ISBN paper 0-88132-125-7 $34.95

The Progress of Policy Reform in Latin America

John Williamson

POLICY ANALYSES IN INTERNATIONAL ECONOMICS 28

Although reform in Latin America has been much more extensive than is generally recognized, Latin American countries now need to sustain and complete their historic transition to free-market democracies. This will require the help of the industrial countries, particularly through a definitive settlement of the debt problem for countries that implement and sustain reform. Success in this effort will put the countries of Latin America in a far better position to address the region's appalling problems of poverty and income inequality as well as concerns about environmental degradation. This study is included in the book *Latin American Adjustment: How Much Has Happened?*

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IMF WORKING PAPER

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This is a working paper and the author would welcome any comments on the present text. Citations should refer to an unpublished manuscript, mentioning the author and the date of issuance by the International Monetary Fund. The views expressed are those of the author and do not necessarily represent those of the Fund.

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INTERNATIONAL MONETARY FUND

Fiscal Affairs Department

Trade Liberalization, Stabilization, and Growth: Some Notes on the Mexican Experience

Prepared by Alain Ize */

Authorized for Distribution by Mario I. Blejer

March 1990

Abstract

While inflation slowed sharply in Mexico during 1988, imports surged. Although the growth of domestic absorption could be attributed to a higher fiscal deficit, deriving from sharply higher domestic interest rates, this paper argues that the recovery of private investment was the main driving force, as the private sector saved most of its interest income on public debt. The paper also analyzes some of the costs and benefits associated with trade liberalization. While there is no evidence yet that trade liberalization contributed decisively to price stabilization, it may have played an important role in stimulating exports and investment.

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THE NEW YORK TIMES, MONDAY, MAY 7, 1990

U.S. Joins Peru's Dirty War

By Juan E. Mendez

WASHINGTON

Under the guise of drug interdiction in Peru, the U.S. is rushing headlong into one of the dirtiest wars being fought anywhere in the world today. If past experience in Vietnam and El Salvador is any guide, the U.S. presence will exercise virtually no restraint on the murder, torture and other human rights abuses that are now routine in Peru. Instead, the U.S. will become a party to the crimes.

Administration officials candidly acknowledge that the left-wing Sendero Luminoso guerrillas are well entrenched in the Upper Huallaga region — where most of the coca consumed in the U.S. is produced. Moreover, the most recent disclosures by the Administration make it clear that the Peruvian armed forces are to be assisted with matériel, weaponry and training specifically to fight Sendero.

The plan includes a permanent base for U.S. Green Berets in the contested jungle area, fighter planes, helicopters and boats and the training of virtually every Peruvian soldier to combat Sendero. This would turn the struggle against Sendero into a U.S., as well as Peruvian, war.

The war against Sendero is already 10 years old, yet this strange Maoist-Andean revolutionary organization continues to grow. Sendero is now attacking the Peruvian state in virtually every region of the country. It recruits easily among the young and the poor, its appeals undoubtedly enhanced by the collapse of the Peruvian economy and the steep deterioration of living standards.

Peruvians across the political spectrum know that Sendero threatens democracy and society. Yet hardly anyone in Peru — and certainly not the presidential candidates in the runoff election scheduled for early June — has proposed a way to deal with the insurgency. That, it seems, is left to the Peruvian Army.

Regrettably, the army is just as brutal as Sendero. For the third year, Peru heads the list of "disappearances" reported to the United Nations. In 1989 there were nearly 600 new cases, double the 1988 figure. In addition, the Peruvian Army occasionally reacts to ambushes and attacks by invading a community and killing dozens of young and old males, sometimes in full view of relatives.

Drugs aren't the real enemy.

The armed forces further complicate matters by encouraging villagers to form self-defense militias known as "rondas campesinas." If a village forms a ronda, Sendero punishes it for collaborating with the army; if it refuses, the army considers the community "red hot," meaning that it supports Sendero. In several massacres in recent weeks, Sendero units have murdered "ronderos" and ronderos have killed suspected "senderistas."

In the cities, the police arrest students and shantytown dwellers and charge them with terrorist crimes. The detainees are routinely and brutally tortured, while the court cases against them either languish or have to be dismissed for lack of evidence.

Human rights abuses by Peruvian authorities are almost too numerous to catalogue. In the process of putting down a June 1986 mutiny by Sendero inmates in three large jails in the Lima-Callao area, the armed forces killed almost 300 prisoners — most after they had surrendered. A lengthy investigation in the military courts has just ended in a whitewash.

In addition, right-wing death squads that have been linked to the governing party or to the army have targeted journalists, lawyers and human rights monitors; the headquarters of three prestigious human rights organizations were bombed in Lima in the last few weeks.

U.S. laws governing foreign aid are explicit in prohibiting assistance to forces that engage in a consistent pattern of gross violations of human rights. If the Bush Administration has considered this ban at all, it has not explained Peru's exemption. Congress should insist on an explanation.

If Peruvians need help in fighting Sendero, the authorities in charge of the fight should show that they have changed their ways. Promises won't do. A commitment to fighting a "clean war" must first be demonstrated in practice.

Once such a strategy is in place, the Peruvian authorities may succeed in reducing the appeal of Sendero, and American involvement may not be necessary. □

Juan E. Mendez is executive director of Americas Watch, a human rights organization.

Prescriptions for Latin Growth That Won't Kill the Patient

The Americas

By Haroldo J. Montealegre

MANAGUA—Taking a cue from Peruvian economist Hernando de Soto, President Bush lectured Latin and Caribbean diplomats in the White House Wednesday on what is stifling Latin American development: "In one large Latin city . . . it takes almost 300 days to cut through the red tape to open a small garment shop," said Mr. Bush. "That's got to change . . . . The future of Latin America lies with free government and free markets."

Today, few in Latin America would argue with that prescription. The only question is how to administer the medicine. A microcosm of what has gone wrong—and what is possible—in Latin economies exists in Nicaragua. As the new government struggles to revitalize Nicaragua's moribund economy, it's worthwhile to see how it got there and how it can free itself of the interventionist ties that bind it—and other Latin economies—to underdevelopment.

During the 1980s, Nicaragua combined the import substitution model with a "command" approach to economics. Property rights were not respected, regulations were excessive and market prices were distorted. Productive activity was burdened by extremely high tariffs, punitive marginal tax rates, and a wide variety of selective consumption taxes. Statist monopolies and cartels replaced the Somoza monopolies that dominated production before the Sandinistas came to power in 1979. Moreover, the state became the primary force in the economy through a system of enterprises that controlled most imports, exports and distribution, as well as key industries and banking.

By the end of the past decade, Nicaragua's real salaries were less than 25% of what they had been 10 years before. Real output fell nearly every year in the 1980s, and unemployment soared to nearly one-fourth of the labor force, despite massive emigration. The real volume of exports last year was only about one-fifth of what it had been 13 years earlier. The current account deficit reached one-fourth of GNP. And Nicaragua's foreign debt amounted to nearly 40 times its shrunken exports. Sadly, more than 10% of the population left the country, including a sizable proportion of Nicaragua's most skilled, energetic and talented "human capital."

The previous government began a policy of frequent, large devaluations of the Nicaraguan currency, designed to eliminate the spread between official and black-market exchange rates. But each devaluation creates expectations of another, so the black-market exchange rate drops in anticipation of the next official devaluation, requiring an endless series of inflationary devaluations. The fear of holding Nicaragua's repeatedly devalued currency results in an enormous increase in "velocity," as people treat the currency as a "hot potato" to pass on to someone else. Inflation, therefore, has risen even faster than the runaway money supply.

The main economic objectives of Violeta Chamorro—inaugurated president on April 25—include securing property rights, initiating substantial deregulation, liberalizing trade, structural adjustment (including tax reform) and stabilizing the currency. Her government will have to move rapidly in all of these areas. Piecemeal reform will not suffice.

In some cases, conventional macroeconomic adjustment plans may, in the very short run, appear to be in conflict with essential structural adjustments. For example, sharply reducing protectionist tariffs might seem to conflict with the budgetary need for revenues. Yet the dramatic reduction of tariffs in Mexico and Chile did *not* weaken the fiscal position of those countries, but instead strengthened it by expanding employment, profits and sales. Once businesses face reduced tariff expenses—particularly on needed materials and equipment—the profitability and capacity of Nicaragua's future export industries can be improved enormously.

Excessive concern with short-term budget estimates likewise could thwart an appropriately drastic reduction in Nicaragua's steep marginal tax rates, which now top off at 70%. The income thresholds at which those tax rates apply must be made competitive with those of the U.S. (the main beneficiary of Nicaragua's flight of human capital). Moderate tax rates can attract back the many professionals, entrepreneurs and technicians who have left the country, as well as attract foreign investment. And since we are starting with such a small tax base—Nicaragua's tax revenue as a percentage of GNP was about 4% in 1989—we would have everything to gain and very little to lose by a steep reduction of tax rates.

A very important part of the reform package would be that the only state enterprises allowed to borrow from the banking system would be those that are profitable and current in their tax obligations. Any projected deficit of unprofitable state enterprises would have to be explicitly approved as part of the projected deficit of the central government. Such a requirement, combined with deregulation and liberalization, will accelerate the necessary privatization or closing of state enterprises. The Central Bank should not extend credit or subsidies directly to any state enterprise, and should program a significant reduction in the growth of credit extended to the central government (and to the banking system).

These reforms will restrain the rate of growth of the money supply. But lasting monetary stability also requires increasing the demand for Nicaragua's currency. That objective requires anchoring the currency to the U.S. dollar, while explicitly conducting monetary policy with the exchange rate as the nominal target. If necessary, a temporary alternative could be a gradual depreciation of the exchange rate according to a predictable schedule, similar to the crawling peg in Mexico. In either case, existing exchange controls must be gradually lifted. A more-stable currency is not inconsistent with maintaining purchasing power parity, since it contributes to reduced inflation.

Nicaragua will need substantial foreign resources over the next three years to help finance a legacy of external and internal imbalances while constructive, growth-oriented reforms are being put into effect. Important assistance has been received already, including $300 million from the U.S., as well as aid from the donors conference in Rome, and partial financing of oil imports from Venezuela. Nicaragua also will request financial support for its program from the International Monetary Fund in the form of a standby and extended fund facility, and from the World Bank in the form of structural and sector adjustment loans, with co-financing from the Interamerican Development Bank (IDB). As a necessary step, Nicaragua will have to meet arrears with the World Bank and IDB in excess of $250 million.

Starting from such a weakened state, the Nicaraguan economy has enormous potential for dramatic recovery, with sound money, competitive tax rates, liberalized trade and deregulation. As Mr. Bush emphasized on Wednesday, the old days of massive U.S. aid pushing statist "development programs" clearly are over. And no one should mourn their passing. Internal development spurred on by deregulation and openings to the global economy is the key to Latin America's future.

Mr. Montealegre, chairman of a Miami-based investment bank, was appointed the external economic adviser for Nicaragua by President Chamorro.

THE WALL STREET JOURNAL WEDNESDAY, APRIL 4, 1990

President Salinas on Mexico's Economy

In the past two weeks, reports have come out of Washington and Mexico City about new free trade talks, possibly opening the way to a North American common market. These reports have renewed the debate within Mexico about whether the country is prepared to make a clean break from its protectionist policies of the past.

In the wake of this controversy, Mexican President Carlos Salinas de Gortari met Monday with David Asman of the Journal's editorial page. The interview, in English, was held at Los Pinos, the presidential residence. Excerpts follow.

On Foreign Investment:

WSJ: Are foreign investors responding to the new, liberalized foreign-investment law?

President Salinas: After we changed the law last May, in one semester we got the investment we expected in one year. But yes, we would like to see more foreign investment.

I believe that a trade relationship with the U.S. and Canada on a more certain horizon would give foreign investors in Mexico an additional stimulus to come. It would provide them with a guaranteed access to each of these markets.

We have been very specific on what we want on trade with the U.S. We've been walking on a very clear line, which is: Mexico has opened unilaterally its economy for foreign trade. And we haven't received the reciprocity which we believe we are open to. That's why I am emphasizing with the U.S. and Canada, with Europe and Japan, rules that would allow permanent access to the markets.

President Salinas

WSJ: Do the Mexican people support a further opening of trade relations with the U.S. and Canada?

President Salinas: Up to now, the opening of the economy has meant lower prices for Mexicans. So now they know that by opening the economy, we literally have forced domestic producers with tradable goods to have prices equivalent to international prices. This—along with the macroeconomic changes we have installed—has helped us very much to reduce inflation from almost 200% in 1987 to less than 20% last year.

If with the opening of the economy Mexicans find out that there are more job opportunities, that the economy is growing, that inflation is kept down, then, yes, I'm sure they will continue supporting the opening of the economy. If, on the other hand, we open the economy and do not get reciprocity in other markets—and therefore our economy is not able to export and not able to grow at high enough rates—then I'm sure public opinion will be adverse, and the public will say, "Let's go back to the past—to the time of a closed economy."

On Migration:

Many Mexicans are crossing the border because they don't find jobs in Mexico. But many others are crossing the border because the U.S. economy demands this labor. For the first group, I want to create jobs in Mexico. For the second group, I want their labor rights and human rights protected in the U.S.

The Simpson-Mazzoli bill was against economic realities. The economy has shown that the reality is demanding this manpower. On the other hand, I would prefer them to remain in Mexico—all of them. Why? Because they are courageous to take the risk to travel that far; they are energetic and young.

Mexico has opened unilaterally its economy for foreign trade. And we haven't received the reciprocity which we believe we are open to.

On Mexico's Tax Policy:

WSJ: Have you gained revenue by lowering rates and broadening the tax base?

President Salinas: Yes, we have. On the one hand we made tax rates competitive on international levels. I believe in the U.S. the corporate rate is 35%; in Mexico it's 36%.

We have also broadened the base: 20% of GNP was tax-exempt in Mexico. Imagine the loopholes. Farming was tax-exempt. So you used to find industrialists who owned a farm and all the profits went to the farm, which was tax exempt, and the industry was in the red. And intellectual rights were tax-exempt. So you could find businessmen who designed a logo and charged a million dollars for the copyright. So we broadened the base and the revenue is growing.

On Mexican Agriculture:

WSJ: By almost all accounts, the *ejido* system in Mexico—the system of strictly monitored communal farming—is not an effective system for feeding the people of Mexico. There are deficits in basic foods here that shouldn't be. What about the idea of changing the structure of agriculture in Mexico to make the country more self-sufficient.

President Salinas: We are changing it. The problem is that 50 years ago, with 25 million people, you could have this structure. But today, with almost 85 million, we must improve the efficiency of the ejido (even though the ejido will remain as a system of property and social relations). With plots of one acre or half an acre, we will not be able to have the productivity we need. At the same time, we are giving guarantees to private owners in the rural areas so that they can invest and take the risks knowing that their rights will be protected. We are also strengthening relations between the private farmers and the ejido workers.

We have to provide alternatives of work for the peasants who cannot live off the land. But giving individual titles to ejido workers has not been contemplated.

On the Internal Credit Market:

WSJ: Mexico's banks were nationalized in 1982. But is there going to be an easier access to credit through private institutions?

President Salinas: Yes, there is. We've been stimulating regional groups to create their financial organizations so that they can participate more in the financial system. The stock exchange is almost totally privately owned. And now the insurance companies that are publicly owned are being sold to private enterprises. So we are opening new fields of participation in credit to the private sector, and fields that were previously opened are being expanded.

On Privatization:

WSJ: Privatization is getting increasingly complicated as more and more state-run companies are put on the market: world-wide; there are now as many as 10 national telephone companies for sale. Is this becoming a difficult component of your privatization efforts?

President Salinas: It is. But nevertheless, we are privatizing companies that are profitable.

Take the case of the telephone company. This year we will show profits of $1 billion. We want to be sure that we have a sale that will maximize profits. At the same time we want to be sure that the new owners will have the capacity to expand the company. And although the new owners will have the one company, with the cellular phones, there will be competition in that field. The new company will have the obligation to connect the cellular connections to its main system.

The privatization process is welcomed in two senses. First, [it] involves the workers in the companies. I announced the privatization of the phone company in the union hall. And the workers put it to a vote. It was the only decision they had ever taken that passed unanimously; 50,000 workers voted in favor of privatization. They were asking for better wages and the permanence of their positions, and I told them that the only way to achieve these things was for the company to expand. But the government cannot expand the company, because of budget restraints. And they understood. Besides, they will share in the ownership of the company; they will participate in the capital ownership.

Also, the money we get from privatization is being channeled into a program called "solidarity." It's answering demands in slums, Indian communities and rural villages for water, paving the roads, electricity, health centers, better schools, etc. So now the Mexican people know that privatization means improvement in their daily living. So, I am not printing money to solve social problems. Thus, it is not a populistic program. It's a truly popular program in the sense that you answer social demands with real resources—not those artificially created by the central bank. That's how you can match the purpose of keeping public-sector deficits down and at the same time answering social demands of the population.

On Relations With Latin America:

We are strengthening our relations with the rest of Latin America. Recently I went to Chile and Ecuador to emphasize this relationship. We also are renewing our economic relations with Chile. The minister of foreign relations of Argentina said recently that every gain Mexico gets in relation to the U.S. means the strengthening of all of Latin America.

WSJ: Will Mexico continue to provide oil to Nicaragua on the same terms as it did with the Sandinista regime?

President Salinas: I would say we will renew our original policy with Nicaragua. We certainly will be ready to help to contribute to restore the Nicaraguan economy. They have a huge debt with Mexico, and we are looking for ways to help them overcome this burden.

On Europe's Economic Integration:

WSJ: In your recent travels to Europe, did you see the economic integration of Europe as something the Western Hemisphere should fear or welcome as it affects our wealth and trade?

President Salinas: The changes in Eastern Europe introduced two new elements that were not present before: First, the unification of Germany, which we certainly welcome; it's the right of the people to decide. This will create really massive economic changes.

Second, the changes in Eastern Europe will provide the people of Western Europe with a tremendous pool of skilled labor and cheap labor. So the competitiveness of Europe will improve tremendously. This is something that you do not see in the U.S. Canadian situation.

We must have the capacity to penetrate those markets efficiently. It's going to be tremendously formidable. We better be prepared. The sooner, the better.

JOURNAL OF COMMERCE, June 20, 1990

A Surge of Trade Regionalism

WASHINGTON — Melvyn Copen is encouraged. He may even be vindicated.

Mr. Copen is rector of Instituto Centroamericano de Administracion de Empresas. Based in San Jose, Costa Rica, it is the region's premier business administration school.

Last weekend the leaders of five Central American nations — Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua — embraced an anti-inflation program of open markets and private enterprise, within the context of a revitalized common market.

TRADE SCENE

Richard Lawrence

Their goal is to work together to lift their region to an era of economic prosperity through ways Mr. Copen and his institute have long taught.

Their joint statement also is the latest sign of surging economic regionalism through much of the hemisphere. It comes only a week after President Bush and Mexican President Carlos Salinas de Gortari endorsed the notion of a U.S.-Mexican free trade pact. In South America, the five-nation trade bloc known as the Andean Group is talking of more meaningful economic cooperation. Next month, 12 Caribbean island leaders are due to meet to rebuild their common market.

Central America, said Mr. Copen in an interview, is probably at its "most critical point" in recent history. The question: Can it achieve prosperity, largely through a revitalized common market?

The key, Mr. Copen says, is stability — political and economic, particularly in Nicaragua and El Salvador. He believes that without it, Central America as a whole can not thrive.

The obstacles, he allows, are formidable, notably Nicaragua's debt, inflation and lack of basic inputs, and the continuing guerrilla assaults in El Salvador.

Still, there is much new hope, as Isaac Cohen, director here of the United Nations Economic Commission for Latin America, points out.

Except for El Salvador, the region is at peace. New governments head four of the common market countries and Guatemala will elect a new leader in December. "A new generation" of U.S.-educated Central American leaders has arrived, Mr. Cohen says.

And, Mr. Copen notes, Nicaragua's new finance minister — a Yale graduate — used to be on his institute's faculty.

But no matter how enlightened Central America's policies, they may not work without foreign assistance.

There is encouraging news. The United States is proposing a new aid group, headed by the United States, Japan and the European Community, to promote trade and investment in the region, similar to recent efforts for Eastern Europe.

The United States and Europe already are boosting aid. Nicaragua will get $300 million from the United States this year, partly to help the country pay debts and borrow again from international aid agencies.

The EC recently committed $144 million to help finance trade imbalances within the Central American common market — a key, says Mr. Cohen, to expanding that trade.

The Inter-American Development Bank reportedly is considering more financing of Central American exports, and the World Bank, long skeptical of the Central American common market, is reviewing its policies toward the group.

The U.S. government is trying to assist in other ways. An investment mission, led by the Overseas Private Investment Corp., is in Nicaragua this week. Within a month, officials say, Nicaraguan products again may become eligible for U.S. duty-free preferences.

And Mr. Copen's institute expects to help yet more Central American policy-makers and businessmen understand the "magic of the marketplace."

Meanwhile, the heads of the 12 Caribbean common market countries, which include Barbados, Guyana, Jamaica and Trinidad, may make decisions next month similar to those of the Central Americans.

Michael Manley, the Jamaican prime minister, is pushing for an EC-style common market in the Caribbean by 1993.

Caribbean common market countries, given their preferential trade access to the United States, Canada and Europe, would seem to offer, as a Jamaican businessman recently put it, a potential "springboard to world markets."

Caribbean leaders already have stated ambitious goals. By December, they want to strengthen the financing of intra-regional trade and by January reach an agreement on new common external tariffs, rules of origin and fiscal incentives.

By July 1991, they plan to remove all remaining barriers to trade within the common market; by 1992 pool their countries' air and maritime transport resources; and by 1993 allow for the free flow of capital within the trade bloc.

If anything, the U.S.-Mexican free trade-area initiative should spur both the Caribbean and Central American common market nations to try harder.

In the long run, if everyone succeeds, these efforts could help lead to hemispheric free trade and, yet further in the future, to a much freer world trading system.

Richard Lawrence is a senior correspondent in the Washington bureau of The Journal of Commerce.

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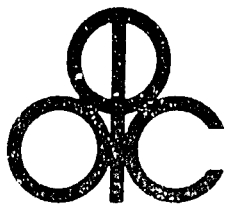

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