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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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A Project of the Overseas Development Council

John W. Sewell, President

October 12, 1990

Dear Reader:

Like its predecessors, the third edition of the Washington Economic Watch offers you an insider's view of the most timely and relevant issues and debates emerging in the area of US-Third World economic policy over the last quarter.

Each digest is separated by tabs into six functional categories, followed by a section on issues of specific regional importance. The 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".

With this edition, we are pleased to introduce two new services. At the beginning of the digest, you will note a comprehensive table of contents which will guide you through your reading of the material. In addition, this issue inaugurates our "rapporteur's report" service. Members of the ODC staff will regularly attend seminars and meetings around Washington on pressing issues of US economic policy, summarizing the highlights of the meetings for inclusion in this digest. Through these reports, you will gain yet another "eye" into the ongoing process and debate surrounding policy-making as it occurs daily in this city. Our first such report appears in the U.S./Global Macroeconomic Trends section of the digest.

In the event that you would like to acquire any additional information on these materials, we have again provided you with a "contact list" of participating source institutions so that you might request them directly.

Sincerely,

Richard E. Feinberg
Executive Vice President
and Director of Studies

PN-ABH-215

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Foreign Policy
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International Economy
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LatinFinance
2121 Ponce de Leon Blvd.
Suite 1020
Coral Gables, FL 33134

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

TRADE

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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 BY CLAYTON YEUTTER SECRETARY OF AGRICULTURE U.S. DEPARTMENT OF AGRICULTURE BEFORE THE THAI FEDERATION OF INDUSTRIES AND BOARD OF TRADE

Bangkok, Thailand
August 14, 1990

I am very pleased to be here today with the Thai Federation of Industries and Board of Trade. It is a pleasure to meet so many people who contribute to Thailand's strong economic performance. I am also pleased to have an opportunity to discuss agricultural trade issues with you.

Thailand is the world's leading exporter of rice, and the United States is one of your customers. In fact, the United States not only imports Thai rice, but also your rubber, fruits, and vegetables.

In turn, the United States exports a variety of agricultural products to Thailand, including livestock, livestock genetics, cotton, wheat, and dairy products. Our nations are customers for each other and, in some cases, competitors as well.

Thailand and the United States have had a successful agricultural trade relationship for many years, from which both countries have benefited. If all countries of the world enjoyed similarly beneficial relationships, consumers and taxpayers everywhere would rejoice.

One of the reasons I am currently visiting Thailand and other Asian nations is to express U.S. support of the agricultural trade reforms now being negotiated in Geneva under the General Agreement on Tariffs and Trade (GATT). While the reform of agricultural trade is only one of 15 topics being negotiated in the GATT, it is critically important if all countries of the world are to experience a healthy, vigorous trading environment in the coming years.

The United States' position in the negotiations, which I share with President Bush and Special Trade Representative Carla Hills, is that without agricultural trade reform, there will be no overall trade agreement in the Uruguay Round of the GATT -- and that would be tragic for every trading nation on earth.

International business and trading configurations are changing rapidly today; agriculture is a part of that change. Unfortunately, many countries have erected barriers that hamper agricultural trade. Governments have also created production support and export subsidy policies that can be maintained only at great expense. This is waste the world can ill afford.

According to an OECD and World Bank study, if we reformed agricultural trade, developing countries would increase their annual exports by $10 to $12 billion, which in turn would spur economic growth and increase their demand for agricultural imports. Thus, almost everyone would benefit from agricultural trade liberalization.

To achieve this economic growth, however, we must first reform the rules of agricultural trade. The Uruguay Round negotiations, now underway in Geneva, are the only current multilateral mechanism through which we can achieve such reform. Only that set of negotiations can assure anytime soon that competition in trade throughout the world will be fair -- based on what markets demand -- not on how much governments are willing to spend to subsidize their products.

During the four decades of the GATT's existence, trade restrictions on industrial and manufactured items have steadily been reduced, increasing exports and increasing prosperity in almost every trading nation.

The picture for agriculture is not nearly as good. Trade distortions in agriculture became painfully obvious and costly during the 1980's. This prompted member nations of the GATT to seek systematic reform of the rules that govern agricultural trade. During the opening session of the Uruguay Round in 1986, the GATT nations agreed strongly that it was time to move ahead to free up worldwide agricultural trade. Now it's time to act.

Three weeks ago, the Uruguay Round Negotiating Group on Agriculture in Geneva agreed to forward to the Trade Negotiations Committee a text drafted by Chairman Art DeZeeuw -- to help unblock the current stalemate in negotiations on agricultural reform. In doing so, the participating countries agreed that such reform is the key to a successful conclusion of the Uruguay Round negotiations in December 1990.

For the last year or so, agricultural issues have stymied progress in the Uruguay Round, essentially because nations could not agree on the extent of reductions in three main areas: export subsidies, internal support measures, and import access barriers.

Now, as a result of Chairman DeZeeuw's efforts, participants have committed themselves to submit data on these three issues by October 1. Reductions must be achieved through specific commitments for each of these areas. Strengthened rules also must be negotiated to prevent backsliding on commitments.

As a member of the Cairns Group, Thailand has favored agricultural trade liberalization in the Uruguay Round. The United States appreciates this support and stands ready to move the negotiations forward. We encourage all our negotiating partners to do likewise. Time is running out!

We urge Thailand to continue its support of agricultural trade liberalization by upholding the structure for the negotiations outlined in the DeZeeuw text, including tariffication, completing the country plan exercise, and working with the Cairns Group to move these negotiations forward to a successful conclusion.

Thailand has much to gain through trade reform in agriculture. Your nation consistently increased its agricultural exports during the 1980's, making farm product trade a strong contributor to the Thai economy. Greater market access for your agricultural products can help fuel Thailand's continued economic growth.

Market access restrictions currently hurt all agricultural trading nations. Consumers worldwide should be able to buy agricultural products suited for their needs. Markets -- based on consumer demand -- should determine trade, not governments.

If I were to leave you with any one particular message today, it is that after nearly four years of negotiating, the 97 GATT member nations have reached a critical point in the process of achieving agricultural trade liberalization. This is an urgent moment.

Full participation of all GATT member nations is now required to achieve the ultimate goal of the negotiations. All of us must participate fully in the concluding months of the Uruguay Round negotiations -- so we can attain a vigorous, open trade environment that will propel economic growth and prosperity throughout the world.

Thank you.

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THE WHITE HOUSE

Office of the Press Secretary

(Baltimore, Maryland)

For Immediate Release August 20, 1990

STATEMENT BY THE PRESIDENT

I am pleased to sign into law H.R. 1594, the "Customs and Trade Act of 1990." This legislation is the culmination of many long hours of work. It was worth the effort, for the Act accomplishes a number of important goals shared by both my Administration and the Congress:

-- The extension and enhancement of the Caribbean Basin Initiative, which will continue to promote economic growth and democracy in that region;

-- The amendment of Jackson-Vanik procedures, which will facilitate cooperation between the Executive and the Congress to encourage reform in the Soviet Union and assist the emerging democracies of Eastern Europe; and

-- A new structure for U.S. customs user fees, which demonstrates our unfaltering commitment to the General Agreement on Tariffs and Trade (GATT).

Furthermore, the spirit of bipartisan cooperation that this Act represents bodes well for the coming months. We head into the fall facing the challenging tasks of completing the vital Uruguay Round of global trade talks by December and then drafting implementing legislation in 1991.

The results of this Round of negotiations, held under the auspices of the GATT, can be the engine that drives the United States and world economies into the 21st century. The agreement we reach will be the ultimate competitiveness initiative. It will open new markets for American business, help reduce prices and increase choices for consumers, and secure rigorous rules of fair play in international trade.

The Customs and Trade Act of 1990, therefore, is part of the cooperative process that ultimately will result in growth, jobs, and prosperity, not only for America, but also for the world.

Let me give special mention to three vital provisions of the legislation I am signing today.

First, this legislation makes permanent and enhances the Caribbean Basin Initiative, or CBI.

Since its inception in 1983, CBI has promoted stability, security, and the movement to democracy and free markets that we now celebrate not only in this hemisphere but around the world. This legislation will foster continued economic growth and opportunity in the region.

By enacting this bill we assure investors in the Caribbean and Central America that their investments will continue to earn returns on duty-free exports indefinitely. It further extends the range of products that receive preferential duty treatment under CBI.

more

(OVER)

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Because of the success of the CBI example, I announced on July 23 that I would seek legislation for limited-duration CBI-like trade preferences for the Andean countries of Bolivia, Colombia, Ecuador, and Peru. This measure would assist these countries in eliminating the production of illegal drugs and promoting competitive activity in world markets. I hope that my proposal will be given rapid, favorable consideration once it is presented to the Congress.

America's security and prosperity depend in large measure on continued progress toward democracy and economic development in the Caribbean Basin.

Second, the Act will help the United States support the emerging democracies of Eastern Europe and encourage change within the Soviet Union.

It does so by amending Jackson-Vanik procedures for approval of the historic trade agreements the United States has signed with the Soviet Union and Czechoslovakia. These agreements provide for improved access to each country's markets; facilitate business by easing restrictions on commercial activities; and offer strong intellectual property protections.

By working together to gain approval for these accords, the way is paved for continued cooperation between the Administration and the Congress on future agreements with other countries subject to the Jackson-Vanik Amendment.

Third, the Act is another demonstration of our Nation's abiding commitment to the GATT, the international constitution of trade.

A GATT panel in 1988 adopted a finding that the structure of U.S. customs user fees violated GATT rules. This Act authorizes a new fee structure that brings us into compliance with GATT rules.

This demonstration of our dedication to GATT comes at a critical point in the Uruguay Round of global trade talks. The great trading nations of the world can choose either to open their markets so that trade can expand, and thereby create global prosperity; or, they can choose to close their markets, splinter into exclusionary trading blocs, and thereby cause dangerously diminished prosperity for all.

The United States has chosen the first path. With the cooperation and support of the Congress and the private sector, we stand committed to the successful conclusion of the negotiations by December and prompt implementation of the results in 1991.

H.R. 1594 also contains a set of provisions that will be helpful both to our environment and our economy. The Act makes permanent the current ban on the export of unprocessed logs taken from Federal lands west of the 100th meridian and would sharply restrict the export of such logs taken from State lands. On June 23, the U.S. Fish and Wildlife Service listed the Northern Spotted Owl as a threatened species under the terms of the Endangered Species Act. There can be no doubt that high levels of export of unprocessed timber have contributed to the decline in habitat that has caused this species to be listed. This legislation will help to address problems related to this listing decision. While I am supporting this provision because it assists in the preservation of critical habitat, I also note that it will ease the economic transition in areas affected by the listing of the spotted owl.

Finally, I note that one of the provisions of H.R. 1594 warrants careful construction to avoid constitutional concerns. Under Article II, section 3 of the Constitution, the President has the discretion to determine what legislative proposals he will present to the Congress, as well as the discretion to determine the procedure he will follow in formulating a legislative proposal. Section 223(b) of this Act purports to require the President, in exercising his discretion to prepare legislative proposals on "rules of origin," to take into account a particular report and obtain the advice of various entities, including committees of the Congress. In light of the President's constitutional discretion with regard to preparing and submitting legislative proposals, I will construe this provision to be precatory rather than mandatory. As always, I will endeavor to consult with the Congress about our policy on such matters.

GEORGE BUSH

THE WHITE HOUSE,
August 20, 1990.

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

TEXT AS DELIVERED
For Release Upon Delivery
10:30 a.m. D.S.T.

STATEMENT BY
THE HONORABLE DAVID C. MULFORD
UNDER SECRETARY OF THE TREASURY FOR INTERNATIONAL AFFAIRS
BEFORE THE JOINT ECONOMIC COMMITTEE
SEPTEMBER 17, 1990

Thank you for the opportunity to discuss the proposed free trade agreement (FTA) negotiations with Mexico, in the context of the wider Enterprise for the Americas Initiative. We look forward to full consultations with you during your review of these initiatives.

The FTA proposal reflects the emerging global recognition that open markets for trade and investment are a powerful impetus for growth. We must not underestimate the magnitude of this change in perception. Just a few years ago, there was no such basic consensus. FTAs and other far-reaching trade and investment agreements seemed, at best, a long-term possibility.

Now we have an FTA with Canada, we are preparing to initiate negotiations on an FTA with Mexico, and we are pursuing other far-reaching trade and investment agreements in the President's Enterprise for the Americas Initiative and in other parts of the globe.

Mexico is in the forefront of this shift toward more open, market-oriented development strategies. Its courageous steps to stabilize the economy and its structural reform program have put it on the path of long-term sustainable growth. Its great potential as an economic partner of the United States is in sight. Now is the time to create a permanent economic relationship based on open markets.

We have an opportunity to do so in a manner which consolidates current progress and promotes further reforms.

Benefits for the United States

Growth in trade and investment through an FTA can be an important stimulus to U.S. growth. Already expanded ties have benefited the U.S. border regions. But there is considerable potential for greater benefits to the U.S. as a whole if barriers to U.S.-Mexican trade and investment are progressively

eliminated.

As Mexican growth accelerates and investment picks up, demand for capital goods, machinery and transportation equipment, should respond quickly. U.S. industry, in part because of its significant presence in Mexico, is in a good position to fill much of this demand through increased exports.

In addition, as Mexico develops, demand for services should rise. The FTA can be an effective vehicle for ensuring that U.S. firms can compete on an equal basis in this growing market.

But the potential benefits for the United States are not just on a sectoral basis; an FTA can help improve our overall economic efficiency. The two countries already engage in a considerable amount of complementary intra-industry trade. Lower trade and investment barriers through an FTA can make U.S. industries more competitive by promoting further intra-industry specialization, capitalizing on each country's comparative advantage.

Benefits for Mexico

In relative terms, the positive effect of an FTA, as well as the economic adjustment costs, will be considerably greater for Mexico than for the United States. This is because the expanded trade and investment flows will be much larger in relation to the Mexican economy, which is only four percent the size of ours.

For Mexico, improved export opportunities and a more open investment regime will likely lead to substantial foreign investment inflows for years to come. The Mexican Government estimates that at least $1 billion in capital inflows have already occurred since the announcement in June by the two Presidents of their intent to work toward an FTA and the announcement of Mexico's intention to privatize its commercial banks.

To some extent, this is a preview of the benefits that can flow from an FTA. Further liberalization under an FTA will solidify business confidence. The likely beneficial effect of this liberalization on Mexican economic efficiency and inflation will contribute to a positive economic environment. In the longer term, an FTA can also provide an important incentive for Mexico to maintain sound macroeconomic policies.

An FTA would strengthen Mexico's balance of payments position. Increased capital inflows should offset any short term deterioration in the trade balance. In the longer term, import and direct investment increases will contribute to expanded capacity and strengthened international competitiveness.

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Why an FTA?

Compared to more limited trade agreements, pursuit of a comprehensive FTA is the best means to ensure maximum benefits from negotiations.

First, comprehensive FTA negotiations will produce a balanced agreement with commitments on both sides for mutually beneficial liberalization. We do not intend unilateral U.S. liberalization.

Second, since the FTA negotiations will follow the Uruguay Round, these negotiations can build on new multilateral rules in such important areas as services and investment. The FTA could serve as one of a new generation of improved models for liberalization.

Third, an FTA is the most effective strategy for encouraging continued liberalization in Mexico, which is to our benefit as well as theirs. Mexico's trade barriers are already low by developing country standards. It has taken initial liberalizing steps in such areas as foreign investment regulation and financial services. We welcome such steps. But our ultimate goal in the negotiations will be the greatest possible liberalization for investors, including financial services providers.

Link with the Enterprise Initiative

An FTA with Mexico is fully consistent with our new, overall economic strategy toward Latin America, the Enterprise for the Americas Initiative, which President Bush announced in June. That initiative joins in a single endeavor the three economic issues of greatest importance to Latin America: trade, investment, and debt.

On trade, the ultimate goal of the Initiative is to establish a free trade system which links the entire Western Hemisphere. FTA negotiations with Mexico are a major first step. Others will follow. We are already negotiating framework agreements to open markets and develop closer trade ties with several countries.

On investment, the initiative includes two specific proposals which can create incentives for Mexico and other Latin American countries to liberalize their investment regimes:

- a new lending program in the Inter-American Development Bank to support investment sector reforms; and
- a $1.5 billion multilateral investment fund administered by the Inter-American Development Bank to provide support and technical assistance to carry out investment reforms.

Finally, the Initiative provides for official debt reduction for those countries which establish sound economic policies and liberalize their investment regimes to promote domestic and foreign investment. The Administration is prepared to offer reductions of concessional AID and P.L.-480 debts of eligible countries and to sell a portion of non-concessional Eximbank and CCC obligations of these countries to facilitate debt-for-equity or debt-for-nature swaps. Interest payments on the reduced concessional obligations will be accepted in local currency and dedicated to support environmental programs in the debtor countries.

In addition, we have proposed that the IDB immediately join the IMF and the World Bank in making available enhancements to support debt and debt service reduction negotiated with commercial banks under the Brady Plan. Although Mexico has already completed a comprehensive debt reduction package with its commercial bank creditors, other Latin American and Caribbean countries could use enhancements from the IDB, along with those received from the IMF and World Bank, to secure new debt instruments or engage in buybacks agreed as part of commercial bank financing packages.

Conclusion

In concluding, I would like to emphasize the importance of seizing this moment in our economic relations with Latin America. We have the opportunity to facilitate a permanent shift from decades of closed, state-controlled stagnation to open, market-oriented development and growth. With your support, the proposed FTA with Mexico and the Enterprise for the Americas Initiative can meet this challenge with decisive action.

OFFICE OF THE UNITED STATES
TRADE REPRESENTATIVE
EXECUTIVE OFFICE OF THE PRESIDENT
WASHINGTON
20506

FOR IMMEDIATE RELEASE
Friday, September 14, 1990

90-52
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USTR Announces Allocation of Sugar Tariff-Rate Quota

Ambassador Carla A. Hills today announced the country-by-country allocations for sugar imports subject to the tariff-rate quota for the period October 1, 1990 through September 30, 1991.

The total amount that may enter the United States during this period at the lower duty or duty-free levels was announced today by Secretary of Agriculture Clayton Yeutter at 1,725,000 metric tons, raw value. Any amount above this would be subject to the higher duty of 16 cents per pound, raw value.

The allocation is based on countries' historical trade to the United States and is the same basis as was used for the sugar import quota in previous years.

COUNTRY-BY-COUNTRY ALLOCATIONS

COUNTRY	PERCENT	METRIC TONS
Argentina	4.3	71,344
Australia	8.3	137,710
Barbados	0.7	11,614
Belize	1.1	18,251
Bolivia	0.8	13,273
Brazil	14.5	240,578
Colombia	2.4	39,820
Congo	0.3*	7,730
Costa Rica	1.5	24,887
Dominican Republic	17.6	292,010
Ecuador	1.1	18,251
El Salvador	2.6	43,138
Fiji	0.9	14,932
Gabon	0.3*	7,730
Guatemala	4.8	79,640
Guyana	1.2	19,910
Haiti	0.3*	7,730
Honduras	1.0	16,592
India	0.8	13,273

Ivory Coast	0.3*	7,730
Jamaica	1.1	18,251
Madagascar	0.3*	7,730
Malawi	1.0	16,592
Mauritius	1.2	19,910
Mexico	0.3*	7,730
Mozambique	1.3	21,569
Nicaragua	2.1	34,842
Panama	2.9	48,116
Papua New Guinea	0.3*	7,730
Paraguay	0.3*	7,730
Peru	4.1	68,026
Philippines	15.8	262,147
St. Kitts and Nevis	0.3*	7,730
Swaziland	1.6	26,547
Taiwan	1.2	19,910
Thailand	1.4	23,228
Trinidad-Tobago	0.7	11,614
Uruguay	0.3*	7,730
Zimbabwe	1.2	19,910

* These countries have been allocated a minimum access level.

OFFICE OF THE UNITED STATES
TRADE REPRESENTATIVE
EXECUTIVE OFFICE OF THE PRESIDENT
WASHINGTON
20506

FOR IMMEDIATE RELEASE
Monday, July 23, 1990

90-44
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SPECIAL GSP REVIEW FOR BOLIVIA, COLOMBIA, ECUADOR AND PERU

FACT SHEET:

Sixty-seven products from Bolivia, Colombia, Ecuador and Peru will be eligible for duty-free entry into the United States under a Special Review of the Generalized System of Preferences (GSP) announced today by President Bush.

The Special Review -- the first in the history of the 15-year program -- was ordered last November by President Bush as part of his Andean Trade Initiative.

The duty preferences are for products of particular interest to the Andean countries and are designed to encourage legitimate alternatives to the production and export of illegal narcotics.

The wide range of agricultural and manufactured goods granted duty-free treatment offer substantial opportunities to growers and manufacturers in the region. They include processed seafood, more than two dozen fresh and processed horticultural items, plywood and other wood products, carpets, laminated cotton products, chemicals, drawn glass, toys and several manufactured and semi-manufactured products.

A total of 129 products were considered for review. Trade with the United States in the approved products was $26.6 million

in 1989, or 73 percent of the trade for all the products submitted for approval. Trade with the United States in the 62 denied products was $9.7 million in 1989. Two of the denied products were already eligible for GSP under other tariff classifications. (See annexes I and II for the products lists.)

The Special Review preferences are in addition to the 1989 GSP Annual Review announced April 27, which provided new or extended benefits for 22 products from the four Andean countries. Trade with the United States in the 22 products was $44.3 million in 1989.

The Andean countries have also submitted several petitions for consideration in the 1990 GSP Annual Review.

Although the Special Review considered requests from only Bolivia, Colombia, Ecuador and Peru, all 130 GSP beneficiary countries will be eligible to export most of the newly designated products to the United States duty-free. Trade with the United States for all GSP beneficiary countries in the newly eligible products was $120 million in 1989. (See table 1.)

Eligibility for all products, except one, will begin August 1, 1990. For copper wire from Peru, the GSP statute requires that competitive need waivers be implemented only between January 1 and July 1 of each year after certain procedural requirements are met. The Special Review found that Peru is eligible for such a waiver. The President will make the formal determination implementing the waiver when permitted by law after January 1, 1991.

ANNEX I: NEW PRODUCTS ADDED TO THE GSP AS A RESULT OF THE SPECIAL GSP REVIEW
FOR BOLIVIA, COLOMBIA, ECUADOR AND PERU AND 1989 TRADE

Current HTS	New HTS (When Applicable)	Description	County Exclusions	1989 Imports Bolivia	Ecuador	Colombia	Peru	Andean Total	GSP Eligible Imports
0304.10.20.60	0304.10.30	fresh or chilled hake fillets		$0	$0	$0	$0	$0	$3,744
0304.20.40.60	0304.20.50	frozen hake fillets		$0	$0	$0	$0	$0	$48,056
0306.14.20		crabmeat, frozen		$0	$0	$3,531	$0	$3,531	$4,447,034
0306.24.20		crabmeat, not frozen		$0	$0	$0	$0	$0	$4,480,266
0709.10.00		artichokes		$0	$0	$44,868	$17,348	$62,216	$65,568
0709.20.10		asparagus, by air 9/15-11/15		$0	$2,030	$0	$172,080	$174,110	$347,315
0710.22.30	0710.22.15	lima beans entered 6/1-10/31		$0	$0	$0	$0	$0	$535,029
0711.20.15		olives in saline		$0	$0	$0	$0	$0	$43,046
0714.10.00		fresh or dried cassava		$0	$0	$0	$0	$0	$2,311,021
0804.50.60		guavas, mangoes, etc	Mexico CNE	$0	$0	$0	$0	$0	$895,272
0807.20.00		fresh papaya	ex Mexico	$0	$0	$0	$0	$0	$370,528
0810.10.20		fresh strawberries 6/15-9/15		$0	$0	$41,788	$0	$41,788	$320,270
0810.10.40		fresh strawberries other	Mexico CNE	$0	$3,907	$291,398	$0	$295,305	$2,547,344
0811.20.40		blackberries, frozen		$0	$0	$0	$0	$0	$29,975
0811.90.50		frozen pineapple		$0	$0	$15,080	$0	$15,080	$1,520,292
1102.90.60		other cereal		$0	$0	$0	$0	$0	$164,043
1104.22.00		oat bran		$0	$0	$0	$0	$0	$1,385,989
1104.23.00		corn, prepared		$0	$0	$0	$0	$0	$3,153
1212.92.00		raw sugar cane		$0	$0	$23,049	$0	$23,049	$1,380,746
1516.10.00		animal fats		$0	$0	$0	$0	$0	$0
1604.13.40		other sardines		$0	$0	$0	$375,222	$375,222	$3,830,759
1604.13.50		other sardines		$0	$29,425	$0	$876,416	$905,841	$1,240,037
1605.10.20		canned crab	ex Malaysia, Thailand	$0	$0	$0	$0	$0	$2,128,087
2001.90.25		artichokes in vinegar		$0	$0	$0	$0	$0	$0
2005.20.00		prepared potatoes		$0	$0	$12,560	$1,750	$14,310	$14,310
2008.30.37		pulp of other citrus		$0	$0	$48,913	$0	$48,913	$103,275
2008.99.45		papaya pulp		$0	$0	$0	$0	$0	$120,264
2008.99.80		other fruit pulps		$0	$0	$20,000	$3,540	$23,540	$586,254
2009.30.10.20		lime juice unfit for bev.		$0	$0	$0	$0	$0	$0
2009.30.10.40		lime juice unfit for bev.		$0	$0	$0	$12,574	$12,574	$484,973
2009.30.20.20		lime juice fit for bev.		$0	$0	$0	$0	$0	$29,550
2009.30.20.40		lime juice fit for bev.		$0	$0	$0	$8,589	$8,589	$1,183,471
2208.10.30		ethyl alcohol for bev.		$0	$0	$0	$0	$0	$957,874
2208.10.60		ethyl alcohol for bev.		$0	$0	$0	$0	$0	$30,968
2208.10.90		ethyl alcohol for bev.		$0	$0	$0	$0	$0	$0
2936.28.00		vitamin e, bulk		$0	$0	$54,754	$0	$54,754	$54,754
3004.50.30		vitamin e, dosage form		$0	$0	$0	$0	$0	$2,424
3005.10.50		other adhesive bandages		$0	$0	$0	$0	$0	$145,446
3005.90.50		other bandages		$0	$0	$0	$0	$0	$1,392,025
3302.10.20		mixed odiferous substances		$0	$0	$0	$0	$0	$2,145,461
3808.20.20		fungicide		$0	$0	$4,828,761	$0	$4,828,761	$4,828,761
3921.12.19		cotton-backed coated fabrics		$0	$0	$0	$0	$0	$3,477
4412.11.20		plywood	Indonesia CNE	$0	$2,002,432	$37,816	$0	$2,040,248	$10,901,818
4412.11.50		plywood	ex Indonesia	$0	$14,354	$0	$0	$14,354	$924,891
4412.12.20		plywood	ex Indonesia, Brazil	$0	$152,625	$0	$0	$152,625	$696,628
4412.12.50		plywood	ex Indonesia, Brazil	$0	$0	$0	$0	$0	$384,929
4412.29.30		plywood	ex Indonesia, Brazil	$59,618	$411,296	$0	$0	$470,914	$1,149,915
4412.29.40		plywood	ex Indonesia, Brazil	$0	$516,169	$0	$0	$516,169	$1,434,709
4412.99.50		plywood		$0	$0	$182,152	$0	$182,152	$552,366
4421.90.50		toothpicks	ex Brazil	$0	$0	$0	$0	$0	$20,859
4421.90.60		flat veneer items	ex Brazil	$0	$0	$0	$0	$0	$339,268
5702.99.20		other carpets		$0	$0	$0	$0	$0	$1,194,481

ANNEX I: NEW PRODUCTS ADDED TO THE GSP AS A RESULT OF THE SPECIAL GSP REVIEW
FOR BOLIVIA, COLOMBIA, ECUADOR AND PERU AND 1989 TRADE

Current HTS	New HTS (When Applicable)	Description	County Exclusions	1989 Imports Bolivia	Ecuador	Colombia	Peru	Andean Total	GSP Eligible Imports
5903.10.10		cotton with pvc		$0	$0	$0	$0	$0	$433,754
5903.90.10		cotton w plastic laminate		$0	$0	$0	$0	$0	$362,283
6406.10.75.30	6406.10.72	footwear uppers of cotton		$0	$0	$0	$0	$0	$496
6406.10.80.15	6406.10.85	other footwear uppers		$0	$0	$0	$0	$0	$0
7004.90.25		drawn glass 2<mm<3.5		$0	$0	$0	$0	$0	$19,058
7004.90.30		drawn glass >3.5mm		$0	$0	$0	$0	$0	$5,510
7004.90.40		drawn glass >3.5 mm;>.65msq		$0	$0	$0	$0	$0	$0
7318.12.00		wood screws		$0	$0	$0	$0	$0	$336,233
7413.00.10 *		copper wire		n/a	n/a	n/a	$16,335,896	$16,335,896	$16,335,896
7801.91.00		unwrought lead		$0	$0	$0	$0	$0	$295,404
7901.20.00		unwrought zinc		$0	$0	$0	$0	$0	$18,833
8301.10.60		padlocks		$0	$0	$0	$0	$0	$8,799
8714.91.10	8714.91.20	bicycle frames valued over $600		$0	$0	$17,978	$0	$17,978	$229,909
9502.10.40		non-stuffed dolls		$0	$0	$3,876	$3,129	$7,005	$40,862,470
9502.10.80		non-stuffed dolls		$0	$0	$0	$0	$0	$3,367,529
			TOTALS	$59,618	$3,132,238	$5,626,524	$17,806,544	$26,624,924	$120,056,899

Notes:
CNE = Country exceeds competitive need limit and is excluded
ex = Country graduated (excluded)
* = Peru requested competitive need waiver. Implementing proclamation must be issued after January 1, 1991.
n/a = Request applies only to Peru; all other beneficiaries currently eligible

TABLE 1: GSP-ELIGIBLE TRADE, BASED ON 1989 IMPORTS,
FOR NEW PRODUCTS ADDED TO THE GSP AS THE RESULT OF THE SPECIAL GSP REVIEW

COUNTRY	GSP ELIGIBLE IMPORTS
Argentina	$2,207,676
Bahamas	$164,986
Bangladesh	$10,471
Belize	$76,240
Bolivia	$59,618
Botswana	$1,547
Brazil	$9,635,063
Cameroon	$248,863
Chad	$43,591
Cocos (Keeling) Islands	$36,434
Colombia	$5,626,524
Costa Rica	$3,744,131
Dominican Republic	$790,002
Ecuador	$3,132,238
Egypt	$42,879
El Salvador	$233,482
Guatemala	$1,327,189
Haiti	$986,106
Honduras	$143,509
Hungary	$411,529
Indonesia	$1,239,130
Israel	$656,174
Ivory Coast	$33,568
Jamaica	$59,909
Kiribati (Gilbert Isl)	$4,560
Lebanon	$4,785
Macao	$1,222,974
Malaysia	$36,335,026
Malta and Gozo	$67,308
Mauritius	$30,416
Mexico	$11,834,053
Morocco	$115,149
Pakistan	$302,554
Panama	$49,331
Peru	$17,806,544
Philippines	$6,542,954
Poland	$38,182
Sri Lanka	$22,285
Sudan	$28,500
Thailand	$6,667,682
Tonga	$7,560
Turkey	$1,402,231
Uruguay	$5,040
Venezuela	$6,110,722
Yugoslavia	$547,282
Zambia	$902
TOTAL	$120,056,899

THE WHITE HOUSE

Office of the Press Secretary

For Immediate Release July 23, 1990

NEW TRADE MEASURES

FACT SHEET

Following his meeting at the White House today with Ecuadorian President Rodrigo Borja, the President announced a package of measures that build on the June 27 "Enterprise for the Americas" initiative by the President, and fulfill the President's commitment at the Cartagena Summit to expand economic alternatives for Ecuador, Colombia, Bolivia, and Peru.

Special Tariff Preference Regime

First, the President announced that he will seek congressional approval for a special tariff preference regime for these four Andean countries, patterned after the Caribbean Basin Initiative (CBI). This preference would provide duty-free entry for selected imports from the Andean region for a transitional period. This arrangement would be designed to complement the program of economic assistance, drug control and the economic reforms and trade and investment liberalization steps agreed with the Andean countries. This proposal is a strong message of U.S. economic commitment to those countries which are fighting to eliminate the production, processing and shipment of drugs. The Administration will move quickly to introduce enabling legislation in the Congress.

Expanded Agricultural Development Assistance

Second, the President announced that he will expand U.S. cooperation and technical assistance toward development of Latin America and the Caribbean's untapped potential for economic growth in the agricultural sector. Our goal is to encourage alternatives to narcotics production by working with the region to identify products that have potential for increased production and trade. We are also willing to help the region address phytosanitary problems that impede exports. This is a long-term program, but we are prepared to act expeditiously to send inter-agency teams to the region to develop action plans for future steps.

Special GSP Review

Third, the President today signed a proclamation giving Generalized System of Preferences (GSP) coverage to 67 products from Colombia, Bolivia, Ecuador, and Peru. Imports of these items are valued at $26.6 million, and account for 73 percent of Andean country trade in the products for which additional GSP was

requested. A formal decision on one product from Peru was deferred until February 1991 to comply with the schedule defined in the GSP law. The U.S. hopes that in the interim, the Government of Peru will move to resolve a major expropriation problem faced by a U.S. company in Peru.

Progress on Trade and Investment Liberalization

Fourth, concurrent with the transitional preferential tariff regime, the President reaffirmed his desire, as part of the Enterprise for the Americas initiative, to negotiate with the Andean countries comprehensive long-term undertakings on trade and investment liberalization. Framework agreements have already been signed with Bolivia and Colombia. A framework agreement with Ecuador will be signed today. These bilateral framework agreements are appropriate vehicles for advancing this goal.

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THE WHITE HOUSE

Office of the Press Secretary

For Immediate Release July 23, 1990

TO MODIFY DUTY-FREE TREATMENT UNDER THE GENERALIZED SYSTEM OF PREFERENCES

- - - - - - -

BY THE PRESIDENT OF THE UNITED STATES OF AMERICA

A PROCLAMATION

1. Pursuant to Title V of the Trade Act of 1974, as amended (the 1974 Act) (19 U.S.C. 2461 et seq.), the President may designate specified articles provided for in the Harmonized Tariff Schedule of the United States (HTS) as eligible for preferential tariff treatment under the Generalized System of Preferences (GSP) when imported from designated beneficiary developing countries.

2. Pursuant to sections 501, 503(a), 504(a), and 604 of the 1974 Act (19 U.S.C. 2461, 2463(a), 2464(a), and 2483), in order to subdivide and amend the nomenclature of existing provisions of the HTS for the purposes of the GSP, I have determined, after taking into account information and advice received under section 503(a), that the HTS should be modified to adjust the designation of eligible articles. In addition, pursuant to Title V of the 1974 Act, I have determined that it is appropriate to designate specified articles provided for in the HTS as eligible for preferential tariff treatment under the GSP when imported from any designated beneficiary developing country. I have also determined, pursuant to section 504(a) of the 1974 Act, that certain beneficiary countries should not receive preferential tariff treatment under the GSP with respect to certain articles designated as eligible for preferential treatment under the GSP.

3. Section 604 of the 1974 Act (19 U.S.C. 2483) authorizes the President to embody in the HTS the substance of the provisions of that Act, and of other acts affecting import treatment, and actions thereunder.

NOW, THEREFORE, I, GEORGE BUSH, President of the United States of America, acting under the authority vested in me by the Constitution and the laws of the United States, including but not limited to Title V and section 604 of the 1974 Act, do proclaim that:

(1) In order to provide benefits under the GSP to specified designated eligible articles when imported from any designated beneficiary developing country, the HTS is modified as provided in Annex I to this proclamation.

(2)(a) In order to provide benefits under the GSP to specified designated eligible articles when imported from any designated beneficiary developing country, the Rates of Duty 1-Special subcolumn for each of the HTS subheadings enumerated in Annex II(a) and (b) to this proclamation is modified as provided in such Annex II(a) and (b).

more

(b) In order to provide benefits under the GSP to specified designated eligible articles when imported from designated beneficiary developing countries and to provide that one or more countries should not be treated as beneficiary developing countries with respect to such eligible articles for purposes of the GSP, the Rates of Duty 1-Special subcolumn for each of the HTS subheadings enumerated in Annex II(c) to this proclamation is modified by inserting the symbol "A*" as provided in such Annex II(c).

(3) In order to provide that one or more countries should not be treated as beneficiary developing countries with respect to certain eligible articles for purposes of the GSP, general note 3(c)(ii)(D) of the HTS is modified as provided in Annex III to this proclamation.

(4) In order to provide for the continuation of previously proclaimed staged rate reductions on goods originating in the territory of Canada in the HTS subheadings in Annex I to this proclamation, effective with respect to goods originating in the territory of Canada which are entered, or withdrawn from warehouse for consumption, on or after the dates specified in Annex IV to this proclamation, the rate of duty in the HTS that is followed by the symbol "CA" in parentheses set forth in the Rates of Duty 1-Special subcolumn for each of the HTS subheadings enumerated in such Annex shall be deleted and the rate of duty provided in such Annex inserted in lieu thereof.

(5) In order to provide for the continuation of previously proclaimed staged rate reductions for products of Israel in the HTS subheadings in Annex I to this proclamation, effective with respect to products of Israel entered, or withdrawn from warehouse for consumption, on or after the dates specified in Annex V to this proclamation, the rate of duty in the HTS that is followed by the symbol "IL" in parentheses set forth in the Rates of Duty 1-Special subcolumn for each of the HTS subheadings enumerated in such Annex shall be deleted and the rate of duty provided in such Annex inserted in lieu thereof.

(6) Any provisions of previous proclamations and Executive orders inconsistent with the provisions of this proclamation are hereby superseded to the extent of such inconsistency.

(7) Except as provided for in paragraphs (4) and (5) of this proclamation, the amendments made by this proclamation shall be effective with respect to articles both: (i) imported on or after January 1, 1976, and (ii) entered, or withdrawn from warehouse for consumption, on or after August 1, 1990.

IN WITNESS WHEREOF, I have hereunto set my hand this twenty-third day of July, in the year of our Lord nineteen hundred and ninety, and of the Independence of the United States of America the two hundred and fifteenth.

GEORGE BUSH

A Brief Overview
of the U.S.
GENERALIZED SYSTEM OF PREFERENCES (GSP)

The Generalized System of Preferences (GSP) is an autonomous nd temporary program of duty-free tariff preferences granted by he United States to developing countries. The primary purpose f the GSP is to promote the economic growth and industrializati- n of beneficiary developing countries and promote the notion hat trade, rather than aid, is a more effective and cost- fficient way of promoting broad-based, sustained economic devel- pment. As a result, the GSP continues to be administered in a anner which recognizes that beneficiary developing countries and erritories often need temporary preferential advantages to ompete effectively with industrialized countries in the United tates market.

Twenty-six other developed nations also have GSP programs, ncluding the European Community, Canada, Australia, the Nordic ountries, Japan, and the East European nations.

The United States offers, under its Generalized System of references (GSP), preferential duty-free entry to approximately ,200 products from 130 designated beneficiary countries and erritories. Since the program's implementation in 1976, the alue of GSP duty-free imports has risen from $3.2 billion to 18.35 billion in 1988. For 1989, four of the program's largest eneficiaries, Taiwan, South Korea, Hong Kong and Singapore, were raduated (removed) from GSP eligibility. As a result, 1989 GSP mports fell to $10.0 billion. However, the graduation of the our "Asian Tigers" was intended to allow the remaining benefic- aries to increase their use of the program. GSP imports from urrent beneficiaries increased by 18 percent in 1989.

The GSP program was instituted on January 1, 1976, and was uthorized under the Trade Act of 1974 for a ten-year period. he program was renewed through July 4, 1993 by the Trade and ariff Act of 1984.

The GSP is also designed to integrate developing countries nto the international trading system (GATT) with its attendant esponsibilities in a manner commensurate with their development. he law is designed to encourage beneficiary developing countries nd territories to: (1) provide equitable and reasonable market ccess; (2) eliminate or reduce significant barriers to trade in ervices and investment; (3) provide effective means by which oreign nationals may secure, exercise, and enforce exclusive intellectual property rights; and (4) afford workers internation- lly recognized worker rights. Within the GSP program, these are eferred to as "country practices".

An important attribute of the U.S. program is its ability to dapt and adjust on a product-specific basis to changing market onditions and the changing needs of producers, workers,

exporters, importers and consumers. Modifications to the list of articles eligible for duty-free treatment are made through an Annual Review procedure. This ten-month process begins each June 1, the filing deadline for petitions requesting a change in eligibility, and concludes on or about April 1 the following year with the announcement of the President's decisions, which are implemented on July 1.

Any interested party can file a petition. Product petitions are generally filed by a U.S. or foreign industry or trade group, or a beneficiary country. Country practice petitions request that a review be conducted to determine if a country meets the eligibility standards specified by the particular practice. Petitions regarding worker rights are usually filed by labor or human rights groups; businesses usually file expropriation, market access and intellectual property rights petitions. To date, no petitions have been filed regarding investment standards. The petition process includes public hearings and written comment periods, and economic advice provided by the U.S. International Trade Commission.

Product petitions filed in an Annual Review may request that a product be added to or removed from the list of those eligible for duty-free treatment. An interested party may also request that a beneficiary country receive a waiver for those products which exceed the statutory ceilings of the program, knows as competitive need limits. Under the statutory competitive need provisions, a country loses GSP duty-free treatment for a product if its shipments of the product in the preceding calender year equaled or exceeded 50 percent of the value of the total U.S. imports of the product (25 percent in the case where a country has been found sufficiently competitive in the product) or a certain dollar amount during the preceding calender year ($88,878,327 for 1989, or $34,701,235 in the case where a country has been found sufficiently competitive in the product). Each of the competitive need limits were set by Congress, and are adjusted each year to reflect growth in the U.S. economy.

Other decisions in annual reviews that are made without petition requests include redesignation, or reinstatement, of individual developing countries for GSP benefits in specific items, and granting de minimis waivers.

On the basis of country practice petitions from the private sector the President also examined the worker rights practices of a number of countries during the course of the review. By law, the President must terminate or suspend the GSP eligibility of a beneficiary if he finds that it is not taking steps towards providing internationally recognized worker rights to its workers. This requirement was added to the law when the GSP program was renewed in 1984. The law defines internationally recognized worker rights to include:

1) freedom of association,
2) freedom to organize and bargain collectively,
3) a prohibition on the use of forced or compulsory labor,
4) a minimum age for the employment of children, and
5) acceptable conditions of work with respect to minimum wage, hours of work and occupational safety.

A worker rights review considers the full range of worker rights practices noted above, and is not limited to allegations made by petitioners. USTR works with Embassy personnel and other responsible officials to collect and evaluate information.

A more detailed description of the GSP program can be found in The President's Report to Congress on the Generalized System of Preferences (February, 1990), available on request from the USTR Reading Room.

Revised: 8/90

Agricultural protectionism in the industrialized world

Fred H. Sanderson

Domestic farm support policies have resulted in inefficient use of agricultural resources, lost trading opportunities for efficient producers, and distorted international trade flows—all at great expense to national economies. Ironically, the countries that most oppose liberalizing agricultural trade have the most to gain from doing so. Despite resistance to fundamental reform, the latest round of GATT talks offers hope for reducing the costs and adverse effects of protectionist policies.

Agricultural protectionism is not new. In Europe it reaches back to the nineteenth century. With some exceptions, it has grown steadily as a by-product of economic development. In essence, it can be seen as an effort to resist and delay the adjustments required of the agricultural sector to remain competitive with other countries and with other sectors in a rapidly changing economic environment.

Estimates of the costs of agricultural protection to consumers and taxpayers vary, depending mainly on which programs are included in the definition of support to agriculture. According to the Organization for Economic Cooperation and Development (OECD), which uses the most inclusive definition, annual consumer and taxpayer costs almost doubled between 1979-1981 and 1984-1986, from 116 billion European currency units (ECUs) to 219 billion ECUs. (The value of the ECU as a monetary unit is based on the weighted average of currencies of European Community members; debts and credits in the European Monetary System are denominated in ECUs.) Costs declined to 140 billion ECUs unit in 1988, but in the absence of significant changes in protectionist policies, this decline is likely to be temporary.

The massive costs of agricultural support have not brought commensurate benefits to farmers. Less than half of the costs end up as increased income in their hands. Further, most of the benefits go to large commercial farmers who do not need assistance. Even on the large farms, incomes benefit only in the short run. In the long run, high support prices are capitalized in the price of land, driving up production costs for new entrants and for farmers who rent their land.

The persistence and growth of agricultural protectionism has become one of the major challenges to the General Agreement on Tariffs and Trade (GATT). While successive GATT negotiations have succeeded in reducing barriers to trade in industrial products, agriculture has been left behind in the process of trade liberalization. When the latest round of GATT talks was launched in Uruguay, in 1986, governments agreed that domestic policies distorting trade in agricultural products must be brought into the negotiations. Indeed, the United States and other agricultural exporting countries indicated that they might not be able to enlist sufficient domestic support for agreements on other aspects of the negotiations if there was no significant progress on liberalizing agricultural trade. Yet as the Uruguay Round of trade negotiations draws to a close, resistance to fundamental agricultural policy reforms remains strong in Europe, Japan, and North America.

Domestic farm support policies are at the root of international agricultural trade problems.

The basic reason for the difficulties experienced in the trade negotiations is that agricultural trade barriers and export subsidies are rooted in domestic farm support policies that have become firmly entrenched in most industrialized countries. High price guarantees to producers—the prevalent method of farm support—stimulate uneconomic production, which has to be protected against imports or dumped abroad, displacing exports of efficient exporting countries. These countries, in turn, may be led to subsidize their own production, or exports, or both (as has been the case in the United States and Canada). This further depresses world prices and escalates budget costs.

Thus international trade in farm products is shaped by the interaction of national agricultural policies. Trade flows are distorted and destabilized by such policies, and trade becomes a balancing mechanism for policy-determined deficits and surpluses. The results are inefficiencies in the use of the world's agricultural resources; lost trading opportunities for efficient agricultural producers; costly and politically dangerous conflicts between otherwise friendly states; and the erosion of the integrity of the multilateral trading system.

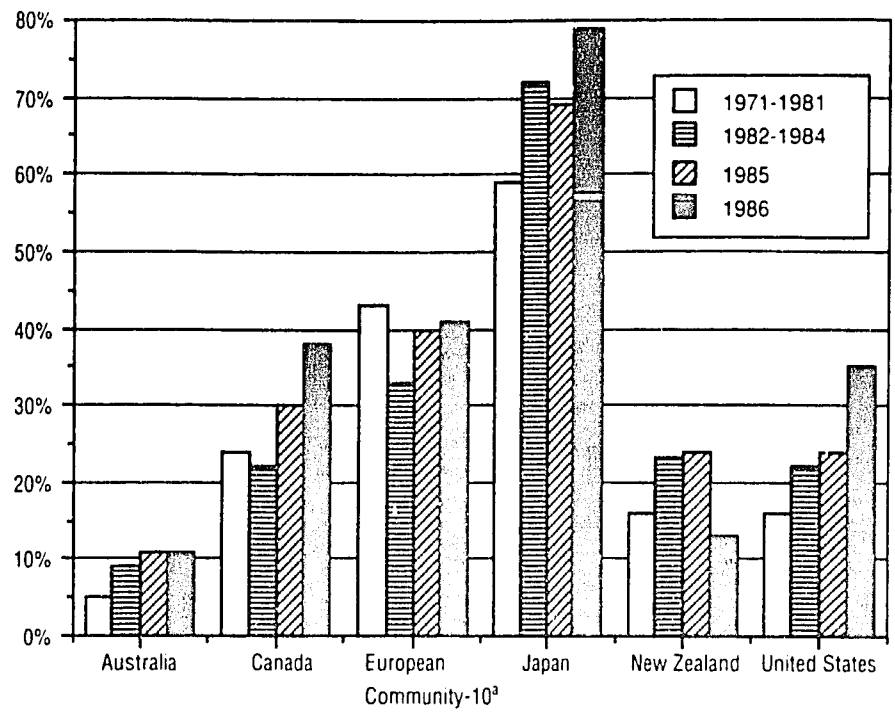
Despite these negative impacts, the trend toward agricultural protectionism has accelerated over the last decade. For the OECD, the level of agricultural protection, in terms of Producer Subsidy Equivalents (PSEs), soared from 28 percent in 1980 to 47 percent in 1986. (PSEs are defined as the net assistance provided through market price supports and government expenditures, expressed as a percentage of total farm receipts.) The level of protection is highest in Japan and in the European Community (EC), but the sharpest increases have occurred in the United States and Canada (see figure 1). Most PSEs declined somewhat after 1986, not because of changes in policy, but because of the recovery in world prices that began in 1987.

Consequences of free trade

The approach of the 1990 round of trade negotiations and a U.S. proposal for total liberalization of agricultural trade have stirred interest in what would happen if the industrialized countries did away with all market-distorting government interventions in agriculture. The available econometric models agree that free trade would increase only modestly the total volume of agricultural trade. It would, however, redistribute production and trade in favor of efficient exporters. It would also tend to raise the international trading prices of commodities now being dumped on world markets. It would be wrong to conclude from this that liberalization serves the interests of only a few traditional agricultural exporting countries, with the EC and Japan footing the bill. This is not the case even if attention is focused narrowly on the farm sectors. Because of present high levels of protection, North American producers, too, would have to accept losses, at least in the short term. Furthermore, if consumer and taxpayer interests are taken into account, all countries would gain, with the EC and Japan reaping the bulk of the benefits.

These "static" welfare gains, due to a more efficient allocation of resources, provide the most obvious economic justification for trade liberalization. Although estimates of the size of this social dividend vary, it probably would have amounted to U.S. $30 billion to $40 billion in 1986 for the OECD countries as a whole. If gains to the nonagricultural sectors are also counted, the total welfare benefits could be over $70 billion. To this should be added the unquantified but probably even more important social dividend that could be expected to accrue from the "dynamic" effects of liberalization, in terms of more rapid economic growth.

Figure 1. Agricultural Producer Subsidy Equivalents (PSEs) in major industrial countries



Note PSEs are defined as the net assistance provided through market price supports and government expenditures, expressed as a percentage of total farm receipts

Sources Organization for Economic Cooperation and Development, U S Department of Agriculture

[a] Belgium, Denmark, France, Greece, Ireland, Italy, Luxembourg, the Netherlands, the United Kingdom, and West Germany

> Social dividends accruing from trade liberalization would include more efficient allocation of resources and more rapid economic growth.

This is not to deny that there would be losers from liberalization within each country. In general, producers in highly protected countries would lose when protection was removed. One estimate, based on the hypothetical event that all developed countries had liberalized simultaneously in 1986, puts producer losses in the EC and Japan each at $21 billion and in the United States at $15 billion. Relatively unprotected producers in small exporting countries such as Australia and New Zealand would gain from liberalization. In the long run, per capita farm incomes would tend to recover everywhere because increased competition would accelerate the process of farm consolidation and modernization.

The principal gainers from agricultural liberalization would be the consumers and taxpayers of the most highly protected countries. Their gains would exceed the losses sustained by producers; thus society as a whole would be better off. The consumer/taxpayer gains could be used to fully compensate producers, with something left over to lighten the burden on the public. Alternatively, producers could be compensated in part.

Realizing agricultural liberalization will be difficult, however. At the GATT talks in Geneva in 1989, negotiators achieved a broad measure of consensus for making agricultural policies more responsive to international market signals, and providing producer support and protection in a less market-distorting manner. Among the proposed approaches for achieving these goals are multilateral cuts in overall levels of internal support and protection; changes in methods of support that would make them less trade-distorting; agreements on specific policies and commodities to implement cuts in overall support; and strengthening of the

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rules governing international agricultural trade by eliminating exceptions, ambiguities, and loopholes. Each of these entails advantages and disadvantages.

Multilateral cuts

All major agricultural trading countries expressed interest in the possibility of using, as a target or monitoring device, a modified version of the Producer Subsidy Equivalent developed by the OECD, or some similar aggregate measure of support (AMS) that would summarize in one number the trade-distorting effects of the entire complex of protectionist policies affecting specific commodities. The AMS approach would commit governments to comparable reductions in their levels of protection while leaving them with considerable flexibility in implementing the reductions. Multilateral cuts in protection would strengthen world markets, easing the adjustment problems of protected producers. Once agreement was reached by the major agricultural trading countries on target cuts, other countries might find it more difficult to refuse to participate.

However, the technical problems in reducing all trade-distorting government interventions to a common denominator are daunting. Agricultural policies involving identical measures of support can have very different trade effects. For example, supply controls offset to some degree—and may even more than offset—the output-stimulating effects of high support prices. Deficiency payments may distort trade less than market price supports do, because they do not depress domestic consumption. Countries could switch from less trade-distorting to more trade-distorting policies without affecting their AMS.

In general, the categorization of policies as trade-distorting or non-trade distorting will be contentious. Heavily subsidized stabilization and disaster relief programs, large income payments (even if decoupled from current production), lavish adjustment assistance without a firm phase-out schedule, producer cartels (even those that do not produce surpluses for export), and two-price systems (even if they limit price supports to quantities consumed domestically) are all open to challenge because they cause substantially more resources to be retained in agriculture than would otherwise be the case. Furthermore, any program that raises domestic market prices will not be workable without import barriers.

The "package" approach

Because negotiations on the definition of the AMS are bound to be difficult and time-consuming, it is likely that the negotiators will turn their attention to some of the major policy and commodity problems. Negotiations will probably focus on identifying "packages" of mutual concessions. The packages could include domestic policies affecting several or all agricultural commodities such as price supports, subsidies, and production or marketing restraints. Agreements arrived at in this way could be integrated into an AMS framework, or they could provide a fallback should it be impossible to reach agreement on a comprehensive solution.

Without a comprehensive framework, the package approach would sacrifice the political advantages that countries would gain from proceeding together on a broad front. It could encourage governments to drag their feet on sensitive concessions. And it would sacrifice some of the economic advantages of an across-the-board reduction in protection.

Reform proposals generally involve the replacement of output-stimulating producer price supports by production-neutral income payments or by some form of income insurance.

But there are also advantages to the package approach. Governments could offer selective concessions or reforms that they consider most feasible in terms of their domestic politics and available policy tools. Trading partners could focus their requests on policies that are most harmful to them. It would be left to each trading partner to assess the value of any package that might prove to be negotiable so as to ensure a rough equivalence of concessions among countries. Moreover, the package approach would be more compatible with divergent domestic policy orientations. It would not prevent the United States from moving toward greater market orientation, or the European Community from increasing its reliance on supply controls in implementing its international commitments.

Policy reinstrumentation

The current interest in policy reinstrumentation—or the reform of policy instruments—is explained by the political difficulty of withdrawing all assistance to agriculture over a reasonably short period of time. Reform proposals generally involve the replacement of output-stimulating producer price supports by production-neutral income payments or by some form of income insurance. However, almost any farm subsidy, even if decoupled from a farm's current production or not product-specific, will cause more resources to be retained in agriculture than are justified by comparative advantage. Since the degree of trade distortion (which depends not only on the general nature of the programs but also on the level of subsidization and other specific parameters) is difficult to analyze in quantitative terms, a new source of controversy would be introduced into an already difficult negotiating framework.

The analytical and negotiating problems are compounded by proposals that envisage the decoupling of farm subsidy from production only at the margin (that is, affecting only production exceeding a basic quantity that would remain eligible for price support). Nor is it clear that decoupling proposals would be more acceptable than gradual across-the-board reductions in price supports. Farm organizations are generally opposed to types of assistance that would make the nature of the income transfers more obvious and, hence, more vulnerable to budget cuts. Finance ministers, on the other hand, are wary of increased budget costs, particularly in situations where farm support is

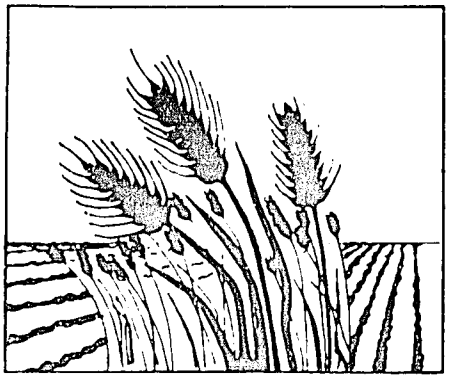
now provided by consumers rather than the budget.

Reform of GATT rules

Strengthening GATT rules on agricultural trade is a long-standing objective toward which little progress has been made in the past. Wide differences remain over what can be accomplished. The United States and other traditional agricultural exporting countries favor the elimination of the exemptions provided for agriculture in the GATT. Export subsidies would be prohibited and import quotas, variable levies, "voluntary" export restraint agreements, and other nontariff barriers would be replaced by fixed tariffs that would be reduced simultaneously with the reductions in domestic support. "Tariffication"—as this process is known—would make protection more transparent and more readily negotiable and make domestic markets more responsive to world market conditions. The EC and Japan believe that special provisions must continue to apply to agricultural trade. The EC considers variable levies to be a legitimate means of stabilizing internal markets; Japan has pleaded for exempting basic foodstuffs on the grounds of food security. Short of a radical reform to eliminate all nontariff distortions, an effort could be made to strengthen the present constraints on such measures so as to make them more effective in protecting the existing trade of other countries against adverse effects of domestic support policies.

Prospects for progress

The consensus on principles of agricultural policy reform reached in the OECD and the negotiations begun in the GATT represent the most important attempt ever made to reshape national agricultural policies and to have agricultural trade determined by market forces. Whether radical reductions in the level of agricultural subsidization and the liberalization of agricultural trade will result remains to be seen.



History is on the side of the pessimists. Agricultural protection has proved impervious to past efforts to deal with it. Although the adjustment costs of reducing protection would be attenuated if cuts were made on a phased, balanced, multicountry, and multicommodity basis, the fact is that the incomes and net worth of many protected farmers would fall if programs that transfer income to them were ended. Farmers everywhere are opposed to changes in both the level and the form of the subsidies and protection they enjoy. In addition, agricultural policy reform remains hostage to cycles in world market conditions. After the farm crisis of the first half of the 1980s, markets seemed to come back into balance, supporting the view on both sides of the Atlantic that the present farm programs are working and require only minor modifications. This attitude dims prospects for fundamental policy reforms.

Taxpayers, consumers, and national governments are increasingly disenchanted with the expenses, inequities, and failures of domestic farm support programs.

Optimists find comfort in the fact that taxpayers, consumers, and national governments everywhere are increasingly disenchanted with the budgetary expense, the inequities, the failures, and the perversities of the national farm programs that are the root cause of international agricultural trade problems. Competing demands on national budgets have brought expenditures for farm support under much closer scrutiny.

The European Community, since its transformation from a major importer to a major exporter of agricultural products, can no longer avoid mounting budget costs unless surplus production is brought under control. Japan, acutely aware of its dependence on foreign trade and its vulnerability to foreign retaliation, is relaxing its agricultural protectionism. Trade and budget deficits and falling shares in world agricultural markets have made the United States more determined to secure the benefit of its comparative advantage in agriculture.

In the final analysis, the integrity of the multilateral trading system must be an overriding concern. Both the European heads of government and the U.S. Congress have given notice that even the status quo may be in jeopardy if the agricultural negotiations fail to produce significant results. Beyond this, another failure to address the problems of agricultural trade would undoubtedly contribute to the spread of protectionism in other economic sectors. The fateful consequence for the world economy and polity is perhaps the best hope for progress in agricultural trade and policy reform. ■

Fred H. Sanderson is a senior fellow at the National Center for Food and Agricultural Policy at RFF. This article is exerpted from his introduction to Agricultural Protectionism in the Industrialized World, *published in July 1990 by RFF.*

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June 20, 1990

STRICT EMBARGO: June 25, 1990, 9:00 a.m., E.D.T.

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URUGUAY ROUND EFFORT TO LIBERALIZE TRADE IN TEXTILES COULD MARK IMPORTANT BREAKTHROUGH

Washington, June 20---Reform of trade in textiles and apparel has become a central issue in the Uruguay Round negotiations under the General Agreement on Tariffs and Trade (GATT). In fact, the success of the entire round may depend on progress in this sector. The Institute for International Economics today released an update of William R. Cline's 1987 study, *The Future of World Trade in Textiles and Apparel,* which assesses textile and apparel trade over the last three years and critically examines the proposals made by the United States, Japan, the European Community, and others in this sector.

Cline concludes that the Uruguay Round of multilateral trade negotiations offers a unique historical opportunity to return international trade in textiles and apparel to the normal rules of the GATT from the current regime of quota controls under the Multi-Fiber Arrangement (MFA)--arguably the most trade-restraining international agreement for manufactured products. He finds that the most significant aspect of the current textile negotiations may be not the choice among the various proposals for trade liberalization, but rather the apparent consensus among the major parties for phasing out the MFA. Readiness of the industrial countries to depart from the restrictive quotas of the MFA would mark an important breakthrough in one of the most contentious areas of international trade.

US negotiators have proposed elimination of quotas by the year 2001. For the transitional decade, they have suggested two modalities: global quotas and global tariff rate quotas. They have also noted a third alternative of raising levels of existing MFA quotas. Japan has proposed that textile and apparel quotas be phased out by 1999. The European Community has proposed that upon expiration in 1991 the current MFA be replaced by transitional "safeguard" restrictions, but it has not proposed a specific time limit for elimination of quotas.

Using the trade and production model from his earlier study, Cline evaluates these proposals. He finds that if either the global quota or MFA expansion is selected, it will be imperative to apply annual average quota growth rates of at least 7 percent. Otherwise, protection will intensify rather than decrease over the transitional decade, widening the gap between actual imports and their quota-free level. Political pressure would become

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intense to renege on the commitment to eliminate quotas at the end of the decade. To ensure a smooth transition out of quotas, quota growth would have to be 9 percent annually or higher. Over 10 years the additional 2 percent annual growth above baseline would close the gap between the actual level of imports and the level expected in the absence of quotas.

Cline estimates that even at unchanged protection levels, the US consumer cost of protection in apparel alone will escalate from $22 billion in 1989 to $37 billion in the year 2000 (at 1989 prices). If global quota growth is held to an average of only 3 percent, annual consumer costs by the year 2000 will escalate to $65 billion. If the rate is held to 1 percent annually as proposed in the Textile, Apparel and Footwear Trade Act of 1990 now before Congress, consumer costs will reach $85 billion by 2000. The annual consumer costs of such protection would exceed $190,000 per job created.

Cline's calculations indicate that the tariff rate quota approach would tend to achieve the greatest liberalization and the lowest consumer costs. A tariff surcharge for imports above the original physical quota level would replace the absolute quota, and the surcharge would then be phased out over the decade.

If either the global quota or the global tariff rate quota is adopted, it would be highly desirable to exempt the industrial countries and the least developed countries (so that the system would be less than truly "global"). In apparel, these two groups supply less than one-sixth of US imports in any event, and exclusion would facilitate achievement of Uruguay Round agreements with Europe on the one hand and with the developing countries on the other. Ideally, the tariff rate quota approach would be limited to countries and products currently subject to controls.

About the Author

William R. Cline, a Senior Fellow at the Institute since 1981, was formerly Senior Fellow at the Brookings Institution, Deputy Director for Development and Trade Research at the US Treasury, Ford Foundation Visiting Professor in Brazil, and Assistant Professor at Princeton University. He is the author of 19 books including *United States External Adjustment and the World Economy, International Debt: Systemic Risk and Policy Response, Trade Policy in the 1980s, World Inflation and the Developing Countries,* and *Trade Negotiations in the Tokyo Round.*

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.

THE FUTURE OF WORLD TRADE IN TEXTILES AND APPAREL, Revised Edition
by William R. Cline
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June 25, 1990 ISBN Paper 0-88132-110-9 $20.00

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TEXTILE QUOTAS ARE FUTILE, STUDY SAYS

Washington, September 12, 1990 -- "The textile bill is special interest legislation with costs that far exceed its benefits," concludes a new study from the Cato Institute.

Thomas Grennes, a professor of economics at North Carolina State University, reveals the fallacies that underlie a bill restricting imports of textiles that was recently passed by the Senate and is soon to be voted on by the House. "Textile trade restrictions already cost American consumers $20.3 billion a year (as of 1986), or $238 annually for every American household. . . . The industry's proposal would tighten quotas and extend them indefinitely, but consumer interests would be best served by abolishing quotas immediately."

Some highlights of the study follow:

* Proponents of the bill argue that the U.S. textile industry needs temporary protection to allow it to respond to competition from lower cost imports. However, "the U.S. industry has benefited from extraordinary levels of protection from imports for more than 30 years. If 30 years is not enough time to prepare for international competition, will 50 be?"

* "A consistent finding of all the published studies is that the costs of textile protection far exceed the benefits to protected workers. A typical result is that consumer costs per job saved by import restrictions are more

-- more --

than seven times the earnings per worker whose job is saved. If the welfare of those workers is the goal of the import restrictions, it can be improved at a much lower cost."

* "The analogy between international trade and games played on level playing fields is inappropriate. In a game, for each winner there is a loser, and the net win for all participants is zero. . . . Voluntary trade among individuals, business firms, or countries results in net benefits for all participants. Trade does not simply redistribute wealth, it creates new wealth."

* "The proper forum for redressing grievances is the GATT, not the U.S. Congress. There is also a case for expecting developing countries that belong to the GATT (for example, South Korea) to open their markets for textiles, apparel, and other products the same way developed countries do."

* "Country-specific quotas could be gradually converted into global quotas through annual increases in global quotas and decreases in country quotas. Countries exempt from current country quotas would retain their exemptions. The U.S. government would sell quotas in competitive auctions."

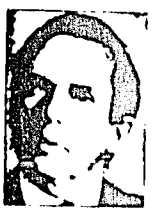
* "If instead of moving toward central planning, the United States and the rest of the world moved toward greater competition in international textile markets, all parties would benefit. That could be accomplished by phasing out the MFA. A transition period of up to 10 years would provide some protection for the domestic industry. The world textile industry would benefit from its own perestroika, or radical restructuring."

"The Collision Course on Textile Quotas," is no. 140 in the Cato Institute's Policy Analysis series. The Cato Institute is an independent public policy research institute.

LOS ANGELES TIMES, July 6, 1990

PERSPECTIVE ON HOUSTON SUMMIT

Make the Rules Match World of Global Trade



If other leaders follow Bush's lead, they can set the stage for greater prosperity into the next century.

By JAMES D. ROBINSON III

President Bush has stated that the Uruguay Round negotiations of the General Agreement on Tariffs and Trade will be his highest priority at the Houston economic summit. The President has it right. The reform of GATT this year offers an extraordinary opportunity for the world leaders gathered in Houston to set the stage for greater economic prosperity in the 1990s and beyond.

Why should the Uruguay Round, named after the country where the talks began in 1986, receive top priority at the summit? Because more than ever, trade matters—to consumers and producers around the world, to national economies, to international politics. Because trade matters, effective rules for open trade matter. That's what the Uruguay Round is all about.

Trade has become a major force in the world's economies. Since GATT was first signed more than 40 years ago, world trade has soared from roughly $60 billion to more than $3 trillion a year.

And it has become more important to the United States as well. The total of U.S. exports and imports now equals one-fourth of gross national product, compared with 10% of GNP 30 years ago. America is the world's largest exporter of goods and services. Trade is the basis for highly competitive American industries, the stimulus for American innovation and the source of millions of American jobs.

Yet, as trade has become more important, it's also become a greater source of international tension. With the collapse of the Warsaw Pact, future frictions are even more likely to center around economic disputes, not military ones. Will we be ready for this era? How will a U.S.-Soviet patent dispute be defused in 1995? What will America do if U.S.-based insurance companies are barred from a robust Mexican market? What will American farmers do if they're frozen out of a dynamic, integrated Europe?

That's where GATT comes in. Its purpose is to set the rules for international trade and to resolve disputes. Seven previous rounds of GATT negotiations have sharply reduced tariffs and planted the seeds for a thriving world trading environment.

But GATT now needs to be revised for a more complex global economy. It was designed when trade was much smaller, and traded goods were mostly agricultural commodities and natural resources. Today, trade content has expanded to include sophisticated services and new technologies. The Uruguay Round is intended to bring GATT rules of trade up to date with today's global economic realities.

The American business community has had a major role in setting the agenda. For example, business insisted that new guidelines on services—more than $600 billion worth of trade in 1989 alone—be negotiated and covered for the first time by GATT rules.

American companies have also been strong proponents of reduced tariffs, improved disciplines on safeguards and dumping, cuts in trade-distorting subsidies, better rules on government procurement, a speedier and more effective dispute settlement process and the expansion of GATT disciplines to cover intellectual property (patents and copyrights) and investment.

Major American farm organizations have similarly called for reforms. Worldwide farm trade subsidies have seriously undercut America's competitive advantage in agriculture. U.S. Trade Representative Carla A. Hills has correctly said that major reductions in such subsidies are the "linchpin" of a successful agreement.

Now, after four years of intense, generally productive but at times antagonistic debate among GATT's 97-member countries, the Uruguay Round is in its final months. With a closing deadline scheduled in December, time is running short. Trade negotiators await their final instructions. From July 23-25 in Switzerland, international negotiators will try to make their first tentative agreements to lay the groundwork for final talks this fall. It is a tall order given the divisions remaining in so many areas.

Many developing countries will only sign an expanded trade agreement for services, patents and investment unless the economic summit countries agree to provide better access for their products. But developed countries—with so much at stake—seem unwilling to make the hard choices. And differences between developed countries over issues like agricultural subsidies stymie progress on other issues.

For these reasons, clear leadership from the Houston summit is a must. President Bush, having already called the GATT round his highest priority for the summit, should ask other world leaders in Houston to join him in signaling the significance of GATT.

This is the first time that a comprehensive approach has been the basis of the GATT talks—and it may be the last. If negotiating countries fail in this round, the new trade patterns and disputes of the 1990s will be handled unilaterally or, at best, by regional trade arrangements. Neither of these approaches is compatible with the globalization of industries and trading patterns now under way. Left to these devices alone, trade disputes will tend to escalate into destructive rounds of retaliation and counter-retaliation. If that happens, international trade will stagnate and the world economy will lose a powerful engine of growth. That's the risk if the GATT talks fail.

But if the governments at the economic summit stand solidly behind a new GATT system, the world economy can build the strongest platform for lasting peace and prosperity.

James D. Robinson III is chairman and chief executive officer of the American Express Co. and chairman of the President's Advisory Committee on Trade Policy and Negotiations.

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EDITORIAL/OPINION

Decision Time for Trade Policy

By ERNEST H. PREEG

July was billed as a critical month for the Uruguay Round of multilateral trade negotiations under the General Agreement on Tariffs and Trade. President Bush made trade liberalization for agricultural products his top priority at the Houston summit and a high level GATT meeting in Geneva the week of July 23 was expected to be a key juncture for unblocking negotiations stalled on several issues.

In retrospect, the Houston summit produced an ambiguous result and the Geneva meeting was anticlimactic. Nevertheless, significant good and bad news for a successful Uruguay Round resulted.

The good news was that the 15 negotiating groups working to reduce trade barriers produced clearly defined issue "profiles" as a basis for the four remaining months of negotiation.

The most striking result was for agriculture, where the report of Chairman Aart de Zeeuw, of the Netherlands, specified substantial reductions in export subsidies, import barriers and trade-distorting domestic support programs. The report was "commended" in Houston and adopted at Geneva as a means to intensify the final negotiations.

Similar reports were adopted for the other negotiating groups. This represented a major accomplishment in synthesizing large amounts of technical material and wide-ranging country proposals.

This means that a successful conclusion of the Uruguay Round at the ministerial meeting in Brussels beginning Dec. 3 will not depend on a backlog of technical preparation, as has often been alleged. The negotiating groups, with unflagging support from the GATT secretariat, already have completed their three years of hard slog. It is now decision time at the political level in capitals.

It also means that the December ministerial meeting is a firm date for ending the round one way or the other. A few loose ends could spill over into January, but there is no need for President Bush to request from Congress an extension of his negotiating authority that expires in May of next year. Now the die is firmly and rightly cast for December.

The bad news from the July tally is widespread skepticism that the political will exists to take difficult decisions between now and December. The negotiating group reports indicate that almost all key issues remain unresolved. The Geneva meeting simply adopted the reports and pledged to negotiate on a more intensive schedule in the months ahead.

Agriculture again is the best example. While EC negotiators agreed to the de Zeeuw proposals as a basis for negotiations, they gave no indication as to how export subsidies and import barriers would be reduced. Any firm commitments to do so would mean change in the fundamental structure of the European Common Agricultural Policy, which the EC has not even begun to consider.

U.S. actions on internal support prices for dairy products and import barriers on sugar likewise fly in the face of the proposed House Agricultural Committee farm bill for increased protection and subsidies for farmers.

Commitments to liberalize textile imports also do not augur well in the United States, where 68 senators recently voted to tighten import restrictions. Absent clear commitments on textile imports, many developing countries won't be willing to make corresponding specific commitments to liberalize trade in services and to protect intellectual property.

In yet another area, anti-dumping duties are fast becoming the preferred vehicle for a protectionist fix, most notably in the United States and Europe. There was little inclination in Geneva, however, to tighten the GATT anti-dumping code to limit unwarranted import restraints. Proposals by GATT Deputy Director General Charles Carlisle were criticized from all directions, and anti-dumping could become an early casualty on the Uruguay Round scoreboard.

All negotiators obviously are positioning themselves for the final horse-trading. There was much talk in Geneva about inter-linkages among issues and the need to develop package proposals. GATT Director General Arthur Dunkel was encouraged to take initiatives in this direction and he is well disposed and ably suited to do so.

But no amount of packaging in Geneva can avoid the need for political-level decision-making in capitals. In Tokyo, there is the beginning of serious discussion about liberalizing rice imports. Even more sensitive issues need to be addressed in Washington and the 12 capitals of the EC.

At the entrance to GATT headquarters in Geneva there is a prominent sign reading "130 Days Until Brussels." The message reflects both relief and concern — relief that the long ordeal of the complicated trade negotiation soon will be over, and concern that the end result could be meager or worse. A recurring question in the halls during the July Geneva meeting was: What happens to the world trading system if the Uruguay Round fails? It is a pertinent question for top-level consideration in capitals as well.

Ernest H. Preeg holds the William M. Scholl Chair in International Business at the Center for Strategic and International Studies in Washington.

EDITORIAL/OPINION

Solving the GATT Puzzle

By JAGDISH BHAGWATI

The Uruguay Round of multilateral trade negotiations is entering its last phase: it must conclude at the end of the year. Reconstituting the General Agreement on Tariffs and Trade to accommodate the changed needs of the world economy is a task of epic proportions. It is a challenge we cannot fail to meet, because the alternatives are unilateralism, regionalism and other divisive tendencies in world trade. But how do we make a deal?

The core areas on which agreement must be reached provide the jigsaw pieces to be fitted together in an agreement. They include the new sector, services, the old sectors, textiles and agriculture, the new issues, trade-related intellectual property and investment measures, and the old issues, chiefly safeguards protection against market disruption.

The traditional view is that a bargain is possible if the developing countries agree to concessions in the new sectors, by accepting obligations in the area of services, for example, and trade them for concessions by developed countries in the old sectors, agriculture and textiles, and safeguards protection. This conception would have bargains cut across sectors and issues.

It also would require the developing countries to exercise discipline in the new areas with complex non-trade dimensions, such as foreign investment and infrastructure control. Governments undertaking reforms in those areas will face acute political difficulties. Hence a deal along this scenario may be elusive.

Even so, all is not lost. There is an alternative means for striking a bargain. An agreement could be reached using a multi-tiered approach. On one level, a binding agreement could be reached within the traditional province of GATT — the trade of goods. But on the new issues, a more flexible approach could be incorporated into the GATT constitution, allowing different layers of commitments and rights in services, investment and intellectual property.

> On the new issues, a more flexible approach could be incorporated into the GATT constitution, allowing different layers of commitments and rights in services, investment and intellectual property.

In goods, both developing and developed countries suffer from systemic failure of GATT discipline. But the failures differ sharply. The developing countries, implicitly or explicitly, invoke a GATT article that provides a balance of payments rationale for imposing trade and exchange restrictions. But this precludes effective access to their markets under a rules-based trading system.

The developed countries undermine GATT discipline in other ways. They exclude agriculture, limit textiles to the Multi-Fibre Arrangement framework and use voluntary exports restraints and the like to avoid the non-discrimination and discipline required by the GATT rules on safeguards protection. These practices certainly harm developing countries.

A bargain within goods therefore can be proposed. The developing countries would agree to discontinue their reliance on the balance of payments loophole within GATT in exchange for the liberalization of agriculture and textiles and the acceptance of safeguards discipline by developed countries. Huge gains in trade and in welfare would result from such a trade.

For the new sectors and issues, a flexible, multilayered approach can be taken. For example, in services, a compromise is possible.

In exchange for welcoming services into GATT, the developing countries would be offered a two-step deal. For an agreed period, varying by sector and country, they would accept "quantity" obligations to increase imports. For example, they might be required to allow five more foreign banks into their country annually.

But they wouldn't have to accept the feared "rules" obligations, that might force them to allow all banks in, subject to regulatory rules. At the same time, the developing countries would enjoy rules-based access in developed countries.

At the end of the "breaking-in" period, however, they must shift to rules-based obligations or lose their rules-based rights in developed countries. The GATT Negotiating Group on Services virtually has adopted this proposal, which I put forward in The Financial Times 18 months ago.

In the so-called Trade-Related Intellectual Property talks, or TRIPs, the continuous talk of "piracy" creates gratuitous conflicts. In fact, the real issue dividing developing and developed countries is a difference of opinion about the socially desirable length of patents and their design. But again, a compromise is possible.

I would urge the developing countries to accept TRIPs into GATT, but with one proviso: the pact would apply only to signatories. GATT-legal trade retribution against offending signatories would then become available. Non-signatories would be immune, but neither would they receive the benefits. Thus, if India abstained, its software would be subject to unprotected "theft," just as India offers limited protection to our pharmaceutical patents.

Accepting this flexible approach would require creative leadership from all negotiators, most of all from the developing countries and from the United States, where militant positions are pushed energetically by powerful lobbies and by a turbulent Congress.

But U.S. Trade Representative Carla Hills has shown great political acumen to date. Getting Congress to accept this flexible deal, on which further progress can be built down the road in this century, is not beyond her skills.

Jagdish Bhagwati, a professor of economics at Columbia University, is the author of the forthcoming book, Multilateralism at Risk.

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EDITORIAL/OPINION

GATT Opens Doors for Banks

By SHERMAN E. KATZ

Amid the flurry of reports about higher profile subjects in the Geneva trade talks, such as agriculture and textiles, some U.S. banks may not see the coming competitive challenge and opportunity presented by a global agreement on financial services.

Such an agreement, now taking shape under the General Agreement on Tariffs and Trade negotiations for a framework agreement on services, would make it easier for banks from the United States and other countries to establish operations elsewhere in the world.

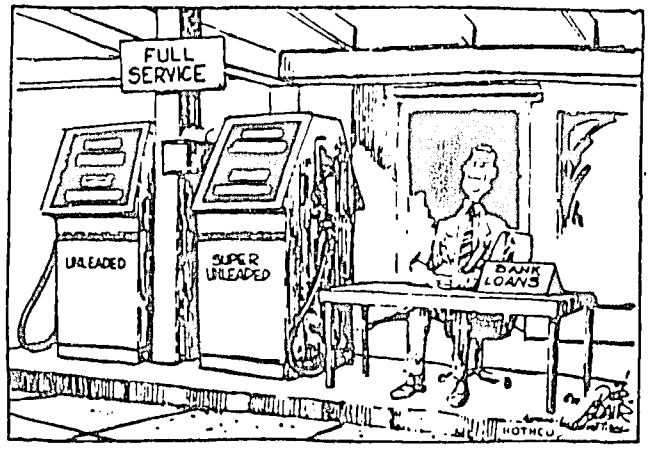
This summer Treasury Department negotiators in Geneva have circulated a draft proposal for an agreement designed to liberalize trade in financial services while safeguarding appropriate regulatory authority. The draft would give foreign financial institutions, including banks, securities firms and insurance companies, the right to establish and operate on terms no less favorable than those applied to domestic institutions.

In Treasury's view, simply giving foreign banks identical treatment to domestic banks would not be enough. So the proposal also would require "equality of competitive opportunity" to avoid situations where both foreign and domestic banks are barred from entering a market already dominated by domestic firms.

Treasury also includes related provisions, such as a requirement to permit payments and transfers related to banking and the temporary entry of personnel essential to establish and begin the operation of a bank, to ensure that the right of establishment is truly meaningful.

At the same time, Treasury's draft tries to preserve adequate ground for bank regulators to act when necessary. Regulatory authorities would not be prevented from taking "reasonable actions" on prudential or fiduciary grounds. Under the proposal, differences over the meaning of that term would be left to a special dispute settlement mechanism for financial issues.

In Treasury's view, only finance ministry officials, presumably expert in the financial services field, would decide such issues. Under existing dispute settlement procedures, trade ministries try to appoint knowledgeable persons to resolve these disagreements, but Treasury believes appointment by finance ministries is more likely to get disputes resolved properly.



The U.S. Trade Representative hasn't accepted Treasury's view because of its potential to create a precedent for special dispute settlement. That could complicate liberalization in many other services sectors under negotiation.

Treasury takes its case for separate and distinct treatment of financial services one step further. The proposal would prohibit retaliation against banking for unrelated trade barriers such as limits on imports of citrus products. Treasury believes that to preserve the relatively open current global financial system the banking sector shouldn't be drawn into disputes about beef, rice, textiles or semiconductors.

Finally, the proposed agreement would allow any country to deny the benefits of a liberalization agreement to a country that has not liberalized its own financial services sector. Treasury believes that countries should not get national treatment in the U.S. financial services market unless they provide others the same legal rights. At the moment the United States is alone in this view among the 13 negotiating parties.

In addition to these thorny questions, a very basic question remains open. Should a financial services agreement be integrated into a more general, so-called framework agreement on services now under negotiation in Geneva?

This framework agreement would help establish as basic obligations key principles, such as the right of establishment and national treatment. Three and a half years of negotiations so far have failed to produce wide consensus on such principles.

But if consensus can be reached, Treasury wants to be sure the application of these principles is spelled out in detail in a sectoral agreement on financial services. That's why Treasury put forward its own sectoral proposal, which takes into account some of the unique aspects of the global financial service system, before the framework agreement even has been negotiated.

It's ironic that the United States is taking the lead in seeking to liberalize trade in financial services at a time when many of the U.S. banks previously active outside the United States have been withdrawing from the field. Of course, much of the explanation for that withdrawal lies with troubled Third World loans, as well as problems in the energy and real estate sectors.

But U.S. banks continue to enjoy significant competitive advantages over their foreign competitors in areas such as new product development and efficient delivery of service to retail customers. Since many U.S. banks recently have been struggling for financial soundness, now may be the perfect time for some long-term strategic planning.

Global liberalization will provide an unprecedented expansion of opportunities. If U.S. banks aren't planning to take advantage of those opportunities, our competitors in Europe and Asia certainly will.

Sherman E. Katz practices international law in the Washington office of Coudert Brothers. A number of international banks are among his clients.

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THE NEW YORK TIMES, WEDNESDAY, SEPTEMBER 19, 1990

Textile Bill: Unfair and Unneeded

By Carla A. Hills

WASHINGTON

The only good thing to say about the textile bill that passed the House yesterday is that the margin of approval fell short of the two-thirds needed to override an almost certain Presidential veto.

In all other respects, the bill is a disaster. It would expand three decades of protectionism, not only raising already artificially high U.S. apparel prices but also undermining global trade negotiations, now nearing completion in Geneva.

The bill, which would apply quotas to new items and make existing protections permanent, would badly hurt consumers, particularly at lower income levels. During the next five years, textile and apparel protection would cost about $160 billion, taxing every family of four about $2,600 a year.

What's more, the added protection is unnecessary. Economic indicators show that the U.S. textile and apparel industries are doing well.

Domestic shipments were up 7 percent and exports were up 27 percent in 1989. Factories are running at an all-time high; a higher rate, in fact, than the average for all U.S. manufacturers. Unemployment in the major textile producing states is generally lower than the national average.

Worst of all, the legislation violates our international commitments under the General Agreement on Tariffs and Trade, the Multi Fiber Arrangement and individual agreements with 38 of our trading partners.

Thus, at the very moment we are seeking to forge an historic alliance to confront Iraqi aggression, we are telling our allies that the U.S. is willing to ignore its international obligations. Indeed, the bill would violate recent agreements with Turkey and Egypt, two countries indispensable to our international efforts in the gulf.

Passing the bill also sends precisely the wrong message at a time when we are trying to convince other nations to dismantle their trade barriers. Approving such protectionist legislation after four years of negotiating to open world markets will be seen as the height of hypocrisy — in essence saying to the world "Do as we say, not as we do."

In Geneva, where negotiators are in the final stages of the Uruguay Round of talks on a new G.A.T.T. agreement, we are urging all nations to open their markets so that trade can expand. But on the verge of completing this agreement to open others' doors, we are closing our own.

In effect, the measure puts a tax of $2,600 on every family.

If the bill were to become law, the Uruguay Round would collapse, with staggering economic costs. We would lose the $125 billion in increased U.S. output we expect to gain in the first year alone from greater access to foreign markets. The $60 billion that U.S. entrepreneurs lose annually from the theft and counterfeiting of their ideas would continue to grow out of control.

New markets would be lost for U.S. services firms, which export $90 billion annually and create 9-out-of-10 new jobs. We would lose the opportunity to get an agreement opening world markets to investment, which helps generate more than $240 billion annually, or two-thirds of total U.S. exports. And we would lose the chance to bring the developing world into the global trading system, which could increase U.S. exports by as much as 50 percent, or $200 billion, between now and the year 2000.

Beyond the economic tragedy of a failed Uruguay Round, we would squander a vital, proven framework of international collaboration. The collapse of the round would lead inevitably to increased protections and political instability.

Failure to come to an agreement also could destabilize poorer nations, including the emerging democracies. Without an agreement, these nations will continue to be drained by the costs of protections now imposed on them — costs that total two-and-a-half times the aid they receive.

How tragic it would be if the reform governments seeking to replace command economies with market-oriented systems were to fail because of restrictions erected by the world's trading nations, and were then replaced by authoritarian regimes.

The Uruguay Round presents 100 nations with the extraordinary opportunity to forge a new trading system that could trigger an economic renaissance. The 1990 textile bill risks all that. Those who are selling it to the American people are trying to pull the wool over their eyes. ❑

Carla A. Hills is the U.S. Trade Representative.

EDITORIAL/OPINION

Fine Print Threatens Exports

By GILBERT E. DWYER

Picture this The federal government learns that several of America's most powerful economic rivals — Japan, France, Great Britain and West Germany — are financing efforts to influence developing nations to erect trade barriers against U.S. imports.

How does our government react to such a revelation? What measures do the president, the Congress, the Commerce Department take to counter the move and protect America's international trade?

Almost none.

In fact, this scenario has existed for more than 15 years. Our government, until recently, has done little to combat it. As a result, American products soon may be shut out of some foreign markets, unless our government and industry step up efforts to keep some harmless-looking regulations from becoming effective barriers to American exports.

These regulations are known as technical product standards They govern the uniformity, material and performance requirements for all goods sold within a particular country, covering everything from the shelf life of chicken to the length of air conditioner cables. With a few exceptions, these regulations are established and enforced by national governments, which can bar any import that does not comply.

In most industrialized nations, product standards have evolved over the course of decades, and continue to evolve as new technologies and new products are introduced There are also several significant international standards organizations which try to maintain order and "harmony" in the standards field

However, many developing nations still lack comprehensive sets of product standards and are seeking Western assistance to develop them.

Case in point The government of Saudi Arabia first invited U.S. and European assistance in this area some 17 years ago. West Germany, Great Britain, France, Australia, Japan and others responded by sending teams of standards advisers to Riyadh to work with Saudi Arabia Specifications and Standards Organization, which plans eventually to develop more than 42,000 technical standards. The United States declined several invitations.

Since 1973, the Saudi organization's foreign advisers have helped it adopt more than 400 mandatory standards, some of which now exclude certain American electrical and chemical products and threaten to bar many others.

Following recommendations from European teams, the Saudis adopted the European electric voltage standard of 127 volts. This permits imports of European and Japanese power equipment, which is rated at 125 to 130 volts, but excludes American products with their 110-120 voltage rating. Hence, no more American-made electrical equipment will be accepted in Saudi Arabia or the countries of the Gulf Cooperation Council, which automatically adopt Saudi standards — all because no one was present to argue for the U.S. voltage standard

In India, where $40 billion will be spent on telecommunications equipment during the next decade, Europeans have spent over $16 million to ensure that locally made electronic components meet European specifications. Meanwhile, Japan's Ministry of International Trade & Industry has technical experts working abroad on five nations' standards programs, and has even brought standards personnel from 28 developing countries back to Japan for language and technical training.

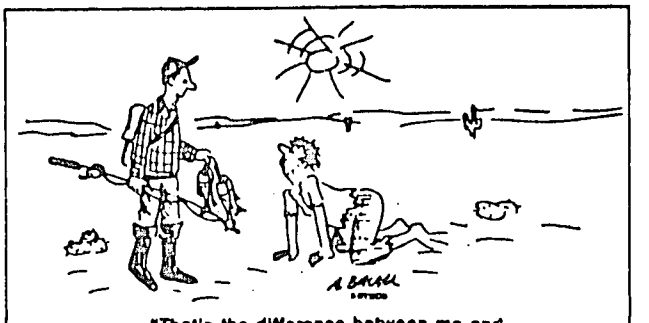
In the main, U.S. business and government leaders recognized the importance of product standards as a potential ally or enemy, but failed to create programs that gave the United States a voice in shaping other countries' standards. Essentially, government and industry could not agree on whose job it was to promote U.S. product standards abroad and who would provide the funding.

In Saudi Arabia, a joint effort of U.S. companies and the Commerce Department's National Institute of Standards and Technology to correct the problem got started earlier this year A procedure for review of proposed standards by U.S. industry and standards organizations is now in place. Interested parties in the United States have a mechanism for registering comments and recommendations with standards writers. Saudi standards writers will be trained in the United States to gain familiarity with U.S. standards processes

It is hoped that the Saudi project will serve as a model that can be expanded to other countries requesting U.S. help in developing domestic standards. But expansion of the program will depend on the resources made available.

Unfortunately, the United States does not have the history of private/public sector cooperation that is driving the export machines of countries like Japan and West Germany Therefore, it may be necessary to invent one Congress presently is considering appropriations under the new American Technology Preeminence Act, passed in March, which would provide funds to match private-sector contributions to pilot projects such as that in Saudi Arabia.

It is no longer enough to talk about "protecting" America's share of international markets. Business and government must work together to develop mechanisms that actively promote products and services overseas. In the case of product standards, this means helping to shape the rules and define the "playing field" before the game gets under way.



"That's the difference between me and you. I have a positive attitude."

Gilbert E. Dwyer is president of the American/Saudi Roundtable, a U.S. industry group working to enhance business relations between the United States and Saudi Arabia.

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THE JOURNAL OF COMMERCE, July 6, 1990

EDITORIAL/OPINION

How Mexico Should Talk Trade

By ROSEMARY PUGH PIPER

In positioning Mexico for free trade talks with the United States, much can be learned from the bilateral negotiation process that preceded the Canada-U.S. free trade agreement of 1988.

The Canada-U.S. free trade agreement offers benefits in both its symbolism and real effects. It eliminates nearly all tariffs between the two countries over a 10-year period, including such protected sectors as textiles, clothing, petrochemicals and steel. It relaxes regulations on bilateral investment and addresses other important bilateral issues, including energy security, temporary immigration and customs fees. In perhaps one of its more important contributions, it introduces an innovative bilateral dispute settlement mechanism that may serve as a model for multilateral trade negotiations.

In some ways, an agreement with Mexico will be easier to reach than the one with Canada. Mexico does not have to fight the intense regional battles that continually tied the hands of the Canadian negotiators. And the United States has much more at stake in helping Mexico grow, or perhaps more accurately, has more to lose because of Mexico's failure to grow.

Still, the talks are bound to be difficult. Here are some points the Mexicans should keep in mind:

1. Be sure to include Canada. An agreement including Mexico, Canada and the United States would create the largest free trade area in the world. But the United States, with 240 million people, is more than twice as populous as the other two nations combined. Both Mexico and Canada could use an ally to keep their powerful neighbor in check.

Canada, like the United States, complements Mexico in terms of its very different demographic picture and its wealthy consumers. Including Canada in an agreement also would enhance Mexico's prospects of diversifying its trade and foreign investment. While the United States buys over 70% of Mexico's exports, Canada buys less than 4%. Canada has not invested much in Mexico, which could use its expertise in such areas as mining.

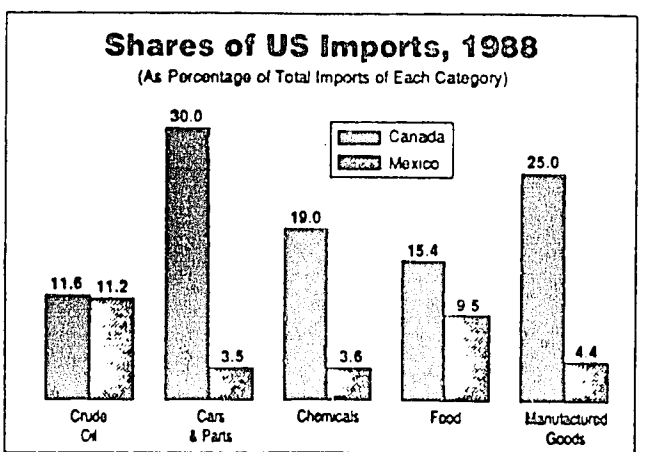
Also, Mexico and Canada are deeply dependent on the same industries, such as autos, agriculture, mining and beer. Neither country should like to see the other negotiate a more favorable trade deal with the United States governing such products.

2. Incorporate GATT. Follow the Canadian-U.S. example and ground the agreement in the principles of the General Agreement on Tariffs and Trade. Several provisions in the U.S.-Canada accord embody the exact language of GATT or even tighten the language and give it some enforcement power. Although Mexico joined GATT in 1986, it has been given nine years to bring some of its policies in line with GATT rules. A Mexico-U.S.-Canada accord could be one more step in Mexico's progression to full adherence.

3. Be flexible with your goals. Canada entered into negotiations with the Americans in reaction to threatening "unfair trade" laws, among other reasons. It sought an agreement that would establish a bilateral code to govern subsidy and anti-dumping practices. Canadian officials were able only to convince the Americans to study the issue.

Nonetheless, the Canada-U.S. agreement brought significant benefits to Canada in this area. For example, it established a binational panel to consider cases, imposed strict time limits on the review process and made the panel's judgments binding.

4. Take advantage of U.S. "fast track" procedures. The 1988 U.S. trade law authorized the president to enter into bilateral agreements negotiated under a "fast track" approach. Under this special procedure, Congress agrees not to review an agreement line-by-line after the negotiations are finished and, in exchange, the president promises to include Congress in the negotiating process. This provision helps keep a potential agreement from being sidelined by special interest groups in the ratification process. U.S. law will have to be amended to extend "fast track" procedures to trilateral negotiations.



SOURCE: U.S. Dept. of Commerce

DOUG PINKERTON/Journal of Commerce

5. Emphasize "national treatment" language. Like Mexico, Canada is very concerned about any agreement that potentially infringes upon its independence. Consequently, the U.S.-Canada accord relies heavily on the principle of "national treatment," allowing each country to have different laws as long as those laws are applied equally to domestic and foreign goods and investment. A trade accord based on national treatment would not require that Mexico pattern its laws after those in the United States.

6. Pre-empt future protectionism. With respect to foreign investment, Canada secured a provision prohibiting any future legislation that would discriminate against Canadian investment in the United States, a major success given increasing hostility in the U.S. toward foreign investors. In areas where negotiators could make no progress, Canada and the United States agreed at least to prohibit any new impediments to trade. With the rising trend of protectionism in industrialized countries and the expansion of Mexican trade, these sorts of provisions alone may make a Mexico-U.S.-Canada agreement worthwhile.

7. Offer minor concessions to domestic groups if necessary. To date, Mexico's reforms under President Carlos Salinas de Gortari have been accomplished in the face of opposition from local special interests. Through negotiations toward a North American free trade area, Mr. Salinas moves the reform debate out of the domestic political arena.

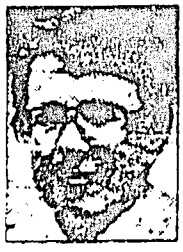
Nevertheless, concessions may be needed to appease special interest groups. The Canada-U.S. Free Trade Agreement granted favorable provisions to such industries as automobiles, logs, unprocessed fish and beer. These small exceptions, which mock the title of the accord, may be the price that must be paid for the more substantial free trade benefits of the overall agreement.

Rosemary Pugh Piper is a research fellow at the Hudson Institute, Indianapolis.

H6

PERSPECTIVE ON THE EMBARGO

Hunger Shouldn't Be a Weapon



Not only is a food blockade immoral, it could backfire, costing the United States much international support.

By ARTHUR SIMON

Seldom has the temptation to use food as a key weapon been so strong as it is in the case of Iraq. But the temptation should be resisted.

Iraq is particularly vulnerable to a food blockade. The nation is dependent on imports for 75% of its food, and President Saddam Hussein, having underestimated the international reaction to his aggression, appears not to have taken extraordinary precautions to stock food. The country is already beginning to feel the pinch, and Hussein has sternly warned that the hoarding of food by merchants is a crime to be punished by death. Although the U.S. Department of Agriculture estimates that the combination of supplies and harvests should enable the Iraqi population to fend off famine for at least several months, the anticipation of widespread hunger could bring a quicker conclusion to the crisis than the shortages themselves warrant.

Further, Hussein is not only a blatant aggressor, but a dangerous and ruthless head of one of the world's more powerful war machines. He has used poison gas against Iran, as well as against Kurdish rebels in his own country, and has threatened to use it against Israel. In addition, he is believed to be only a few years away from fully developing nuclear weapons.

Given these realities, clearly now is the time to stop Iraq, and if a total blockade of food will help to do so, why not impose it?

The reasons for not doing so are compelling.

Food is a basic human right, acknowledged to be so in the Universal Declaration of Human Rights and by overwhelming vote of the U.S. Congress in the 1976 Right to Food Resolution. To use it as a weapon against innocent civilians is morally abhorrent and would quickly be seen that way if Iraqis began to starve. Why hand this moral argument to Hussein?

Success in our response to Iraq, especially in a protracted standoff, is dependent upon maintaining unified international support. U.N. Security Council Resolution 661 supporting the blockade explicitly exempts "supplies intended strictly for medical purposes, and, in humanitarian circumstances, foodstuffs." Any blockade of food must make an exception for shipments to prevent people from going hungry. Violation of this principle would almost surely erode support for the blockade, divide the international community and make a sustained and successful effort more difficult.

A hunger- or famine-provoking food blockade would especially invite erosion of support from within the Arab world, where that support is most vulnerable and where Hussein is already exploiting a widespread impression of the United States as a foreign imperial power propping up oil barons who keep the masses of Arabs impoverished. If we were to win in a showdown but emerge in the minds of Arabs as intruders willing to starve them to obtain cheap oil, the long-term consequences would almost certainly turn against us.

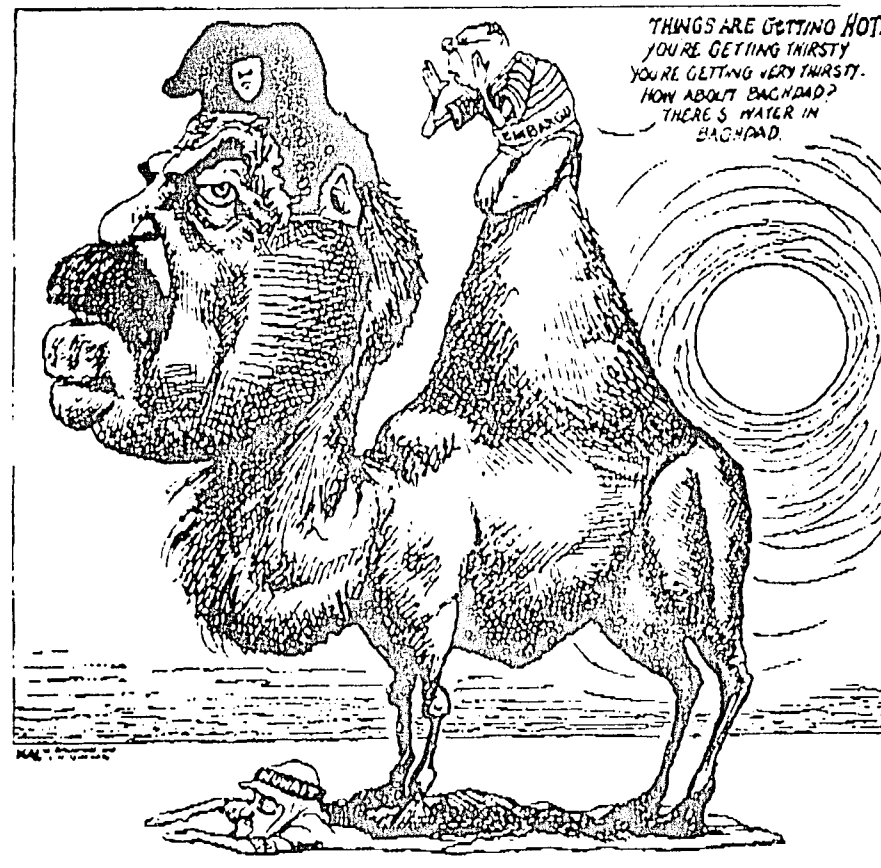
We can assume that American hostages and those from other countries participating in the blockade would be among the victims of hunger—an exceedingly difficult posture for us to maintain on purely political grounds.

In short, the prospect of widespread hunger in Iraq and Kuwait—abhorrent in its own right—beamed into households and villages around the world each day by television would diminish respect for the United States and probably be self-defeating even for immediate strategic purposes.

Of course, the blocking of Iraqi exports constitutes an indirect use of food as a weapon because it cuts off a financial lifeline and limits Iraq's ability to purchase food. The blockade of Iraqi imports further restricts its access to food, but the action of the U.N. Security Council draws a clear line: Civilians must not be forced to go hungry and life or health must not be jeopardized. President Bush should publicly promise to respect that distinction, so there can be no doubt that in the heat of confrontation we will do what is right, not what may seem expedient.

One cannot be sure of outcomes. It is remotely possible that a tight food blockade in violation of the Security Council resolution would bring Hussein more quickly to his knees and have none of the unintended consequences named above. But that is not a chance worth taking or worthy of us. Far better—even if it means a longer, more costly struggle—to stay on high moral ground and honor the principle that food is a right and should not be used as a weapon. The international mandate must be respected.

Arthur Simon is president of Bread for the World, a Washington-based citizens' lobby.



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ARDS OF GOVERNORS • 1990 ANNUAL MEETINGS • WASHINGTON, D.C.

INTERNATIONAL MONETARY FUND
WORLD BANK GROUP
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MULTILATERAL INVESTMENT GUARANTEE AGENCY

Press Release No. 2

September 25, 1990

EMBARGOED FOR RELEASE until 10:00 a.m. Washington, D.C. time
Tuesday, September 25, 1990

Address by M. Camdessus
Chairman of the Executive Board and
Managing Director of the International Monetary Fund
to
the Board of Governors of the Fund

Mr. Chairman, Governors, Ladies and Gentlemen, I welcome you to our Annual Meetings, and in particular I would like to extend a warm welcome back to Czechoslovakia, which played an important role in the early years of the Fund. I welcome also the delegations of Bulgaria and Namibia which will become members during these Meetings and the delegations of Mongolia and Switzerland which have applied for membership. Welcome, also, to our special invitees from the Soviet Union.

The prospects for the world are cloudy, at the end of this summer, but let us pause a moment, and join the celebration of the people of Namibia, who have reached the end of their long road to independence: express our whole-hearted readiness to support the Eastern European countries in their efforts to reform and participate more actively in the world economy: and congratulate our German friends for creating the vision of a peaceful and unified Germany, by the momentous step they will take on October 3rd.

The extraordinary developments in Europe, the recent spread of democracy in every continent, and the progress by many countries in their economic strategies, had led us to look forward confidently to the future. But the crisis in the Middle East has reminded us all that peace is fragile and that economies are always vulnerable.

So let us address three questions this morning:

How to face the crisis?

What policies are needed to keep the world economy on a trend of sustainable growth?

How to improve the trade and monetary system?

* * * *

I. The Fund must be prepared for the unexpected, and give confidence to its members that it is ready to help meet the financing needs associated with their efforts to adjust to new circumstances.

The impact of the Middle East crisis will be adverse for most of the Fund's membership. They will experience both lower growth and higher inflation this year and next, than would otherwise be the case. Provided the situation does not deteriorate further, our best estimate is that it will remain manageable for all of the industrial countries and most of the developing countries.

While we should not overreact to the crisis, we have to recognize that a number of countries are especially harmed by the crisis. They deserve special attention. They include some of the least developed countries, several developing countries that are heavily dependent on oil imports, and the countries of Eastern Europe that are at a particularly vulnerable stage as they embark on major systemic reforms and will be affected simultaneously by the shift to world prices for intra-CMEA trade. These groups of countries are expected to feel a severe adverse impact, compounding seriously their existing difficulties and reinforcing their need for strong policies. They cannot cope with the additional burden on their own. This is a time when the international community of nations, in a spirit of solidarity, should come together to extend and coordinate its assistance.

The Bretton Woods Institutions will do their share. For the Fund, I do not propose the creation of any new oil facility. The Fund has the adaptability needed to cope with a situation of this sort, with its existing facilities. Our resources are, at present, adequate to enable us to look after the expected needs of the bulk of our members: and they will remain so for some time when the agreed quota increase comes into effect. Nevertheless, some strengthening of existing instruments could enhance the speed and flexibility of the Fund's response and make more effective its assistance to the membership.

I am particularly concerned about a limited number of countries for whom the regular credit facilities of the Fund are too costly. Common sense suggests that we should be prudent about extending such financing to countries that might experience difficulties in servicing such new debt. I am satisfied that the Interim Committee has invited the Executive Board to develop expeditiously the modalities of "adaptations of its existing instruments." And they have asked us "to take account of the requirements of current circumstances in tailoring members' access to Fund resources, including ways to address the problems of certain members in servicing such debt." I share the Committee's hope that all members that are in a position to do so will collaborate in these efforts. For these hopes to be translated into action, we will need financial contributions from each of these members, and urgently. It is with some hesitation that I once again

request their contributions, especially since they are subject to other demands. But how could we do otherwise? The IMF has been created to help avoid situations in which members are obliged to restrict drastically their imports or, to quote the Articles of Agreement, to resort to measures "destructive of national or international prosperity." In the absence of such financing, what else could these countries do? Therefore I am confident that the Governors of countries that are able to contribute will bear in mind the high leverage of their contributions, both in promoting good policies and in catalyzing financing from other sources.

* * * *

Our collective response to the present crisis will produce only short-lived benefits, however, unless it is accompanied by an unflinching resolve by members, particularly the major industrial countries, to maintain sound economic policies. This is the essential precondition for restoration of a healthy global environment.

The industrial countries face this heightened challenge at a sensitive time--when concerns are being expressed in some of them about both a possible recession and an upsurge of inflation. In the immediate future, their objective must be to resist inflation and to improve the prospects for sustained non-inflationary growth. The developments of recent weeks give <u>increased</u> importance and urgency, <u>not less</u>, to the implementation of a strategy to contain inflation and raise national and global saving and investment.

In these circumstances, a relaxation of monetary policy would yield neither an enduring reduction in interest rates nor a lasting improvement in employment. Instead, the market's concerns should be allayed by providing clear and credible signals that the authorities are determined to reduce inflation. Market confidence in the authorities medium-term strategy can help the recovery. This is the surest way to improve the prospects for growth.

This being said, the increased demand for resources associated with unification in Germany and reform in Eastern Europe, together with the pressing needs of the indebted countries, underscore the importance of increasing world saving. Serious consideration should be given to the removal of distortions that discourage private saving. However, the most effective way to boost national saving would be fiscal consolidation, particularly in those countries where fiscal deficits remain high, such as the United States, Canada, Italy, and several of the smaller industrial countries. A particular urgency attaches to the decisions to be taken in the US budget summit in the next few days which should make credible and lasting reductions in the fiscal deficit and strengthen the budgetary process. A reduction in the absorption of saving by governments of industrial countries would tend to lower interest rates, thereby encouraging private investment and helping to reduce the debt-service burden of

developing countries. This must be a key component of a medium-term strategy to reduce and reverse the net transfer of resources from the developing to the industrial world.

* * * *

II. I am struck by the similarity of economic strategies followed by the more successful developing and industrial countries. The following main elements are commonly found:

o policies are pursued steadfastly within a medium-term framework and with the focus on producing sustainable growth, low inflation, and a viable balance of payments. The government seeks to create and maintain a sound economic and legal framework that is conducive to growth.

o financial policies maintain firm discipline at both the macro- and micro-economic levels. In particular, fiscal policy aims at controlling expenditure effectively, at raising revenues in ways that minimize distortions, and at avoiding troublesome fiscal deficits. Monetary policy strives consistently to bear down on inflationary pressures.

o governments attempt to control expenditures effectively, and to allocate resources in accordance with society's priorities. Increased attention is given to the quality of expenditure. By this I mean that more value is given to expenditures on health and education, for example, that help develop that most precious of resources, human capital. More scrupulous care is given to protection of the most vulnerable members of society, through provision of adequate safety nets. Preservation of the environment is increasingly recognized as essential to the future of our planet and all who live on it. And the citizens of many countries are becoming more critical of expenditures that are clearly wasteful or counterproductive.

o structural policies are designed to enhance the productive capacity and efficiency of economies. Here the range and diversity of measures is very wide, reflecting the special circumstances of each country. But we see recurrent themes: reform and simplification of tax and subsidy systems, to create an incentive structure that encourages work, saving, and productive investment: a removal of excessive regulation, and a reduction of bureaucratic red tape: in many cases, privatization of state enterprises, and removal of the government from direct participation in commercial activities that can be more efficiently performed by the private sector: and a greater exposure of the economy to international trade and competition.

o governments of many countries have been pursuing reforms of the financial sector, to raise saving, improve intermediation, and allow a higher level of investment. Deregulation of the financial sector can produce major benefits, but it can also pose serious dangers. It should not

be implemented in ways that allow unsound practices to flourish. Therefore deregulation should be accompanied by active supervision to enforce proper standards of behavior, transparency of transactions, disclosure requirements, and adequate prudential standards of capital adequacy.

Taken together, these elements amount to a substantial change in the role of government to give more scope to market forces. In some cases it results in a reduced role of government, but in all of them the emphasis is on better government.

* * * *

Let me comment now on policies in three groups of countries that presently face challenges of historical magnitude--those undertaking systemic reforms, the heavily-indebted, and the least developed.

Firstly, the countries in Eastern and Central Europe and elsewhere that are introducing systemic reforms.

These countries are still at the early stages of transforming their societies. Their reforms hold out the promise of a better life for their peoples. Yet they are fraught with dangers and difficulties, not least because their starting point is a weak one and the required adjustment is considerable.

Their task is daunting. Success is by no means certain. They will need help financial and technical assistance in the transitional period. And in particular it is now more important than ever for the international community to open its markets to imports of the goods from those countries that show a comparative advantage in producing them. And the efforts by these countries to raise their domestic savings must be accompanied by an adequate inflow of foreign capital.

The initial results of the programs being implemented in Eastern Europe are encouraging. They testify to the wisdom of a comprehensive and bold approach in transforming an economic system. Comprehensive, in the sense that reforms have to be broad based to put in place all the main interconnected elements of a market system. And bold, because governments have to break new ground, while avoiding two traps--a half-hearted gradualism or the excesses of simplistic shock therapies. These countries are not making either of these mistakes. Nor are they aiming to return to a crude old fashioned system of laissez faire. Rather they wish to create a system for themselves that works, by implementing their reforms in a pragmatic way, and in directions consistent with the model, which many other countries are reaching toward, of a limited and better role for government.

The Soviet Union is not a member of the Bretton Woods institutions. Yet we are all watching with interest, and sympathy, the efforts of the Soviet Union to move toward a market-oriented and more efficient economy.

As you know, the heads of state or government of the G7 major industrial countries have requested a detailed study of the Soviet Union's economy to make recommendations for its reform and to establish the criteria under which Western economic assistance could effectively support these reforms. The IMF has been asked to convene this work, which is being undertaken with the World Bank, the OECD, and the designated president of the European Bank for Reconstruction and Development, in collaboration with the EC.

We hope that this work will contribute constructively to a sustained economic dialogue between the Soviet Union and its partners.

Secondly, the heavily indebted developing countries. The collaborative debt strategy is producing favorable results for those countries that were quick to introduce strong programs and have persevered in implementing them firmly. But the overall record has been mixed. A number of countries were slow to accept the necessity of reforms. Others were half-hearted in implementing their programs. Opportunities were lost. But I am happy to note that more and more countries have recently introduced major programs, and are tackling their problems decisively, with our assistance. I am optimistic that we will be able to report more successes in the coming year.

The strengthened debt strategy has the potential to make debt a manageable problem, and no longer an obstacle to growth. But it will require considerable leadership from each of the partners who share responsibility for the strategy.

Each of them faces tough challenges.

o Tough challenges for debtor governments. In the face of increased difficulties, they have to implement strong and comprehensive growth-oriented structural adjustment programs. Such programs should lead to a strengthening of confidence, a return of flight capital, a reduction in interest rates, and in so doing contribute to their eventual success. This is the sort of virtuous circle that can be started by a careful design and implementation of programs that will attract support, at home and abroad.

It is time now to build on the potential for sustained and vigorous growth over the medium term, that is made possible by these strong programs --and with it the restoration of a credible capacity for debtors to make regular payments on a debt that has been renegotiated in a realistic way.

o Tough challenges also for the banks! Their interests have become more divergent with the passing of time. While the development of a wide menu of options is helping to make the debt strategy workable, it increases the complexity of the negotiating process. This is not, however, a valid reason for long delays, which can lead to derailment of a program, and loss of an opportunity to resume normal business relations. These delays are not in the best interests of any of the parties.

It is time for debtors and banks to find new ways to negotiate, expeditiously, debt agreements that are mutually acceptable and realistic, that underpin adjustment, and that restore creditworthiness.

Official creditors have continued, within the framework of the Paris Club, to develop techniques for assisting in the debt strategy, including a variety of steps to help ease the burden of external debt on low-income and lower middle-income debtors. I welcome very much the various proposals that have been advanced including the most recent ones by France, the Netherlands, and the United Kingdom to address better the problem of official bilateral debt. I am confident that these ideas will be considered carefully and will contribute to solutions that are durable and that support adjustment and growth in the debtor countries.

Thirdly, the least developed countries. We need to create a supportive environment for growth in all developing countries. Sustainable growth for all members is the central objective of the Fund's activities and conditionality. This applies particularly to the poorest countries.

In promoting growth in the low-income developing countries, the IMF's main financial instruments are our concessional facilities, the SAF and the ESAF. A particular virtue of the SAF/ESAF arrangements is that they involve especially close collaboration with the World Bank.

It is most encouraging that 26 countries are now implementing such programs. Many of them are doing so in the face of severe difficulties, with rising interest rates and deteriorating terms of trade. Despite this, they are achieving positive real growth per capita, thus reversing the tragic downward trend over the previous two decades. But their progress remains uneven and insecure. One cannot make up for many years of negative growth in only a few years. Their per capita income growth is fragile, and still insufficient. Even relatively minor external shocks, or a relaxation of their efforts, could easily threaten their modest gains. More must be done to put these countries solidly on the path of sustained vigorous growth and reduction of poverty. The IMF's latest medium term scenarios for these countries show clearly that sustained strong growth will require a bolder effort by these countries. This should be matched by a proportionate increase in support by the international community. Forgiveness or alleviation of part of their public debt, in conjunction with internationally-supported and monitored programs, would be desirable.

A demonstration of international solidarity is especially needed for a small but important subgroup of countries that are trying to normalize relations with the Fund and other international institutions. Some of them will be taking advantage of the "rights" approach, which the Interim Committee endorsed last Spring, to secure support for those countries that are in a particularly distressed situation, and which have accumulated financial arrears to the Fund. I trust that the necessary support will be forthcoming for these countries.

* * * *

III. One common feature that these three groups of countries share with the rest of the members, is that they would benefit greatly from a strong and open international trading and monetary system.

I do not need to remind Governors that the international trade and monetary system evolved during the 1980s in ways that have worked to the advantage of the world community. The system has permitted a healthy expansion of world trade and has underpinned the long phase of economic expansion. It has shown itself to be resilient, by weathering several storms, including the debt crisis, the problem of exchange rates between major currencies which led to the Plaza Agreement of 1985: the stock market crises of 1987, which had no lasting adverse effects thanks partly to a speedy policy response: and most recently the Middle East crisis, to which the system is responding quickly, and we hope effectively.

But each of these shocks has demonstrated the vulnerability of the international system, and the value to all of a quick and cooperative approach in responding to threats. In view of the Fund's role in this process, you will not be surprised if I suggest some additional ways to reinforce the system.

First, foreign trade. The last decade witnessed a resumption of rapid growth in world trade. This contributed substantially to sustained economic growth in the industrial and many developing countries. Yet trade remains distorted by restrictive practices in many countries. Pressures to restrict market access remain strong. This is harmful to all countries. Restrictions work to the disadvantage of those who impose them: vested interests are protected and perpetuated: consumers pay higher prices for a smaller choice of goods and services, and the efficiency of their economies is eroded by continued rigidities. And of course restrictions harm the countries against whom they are aimed, because they are prevented from producing according to their comparative advantage.

The resilience of the world economy, and the success of countries' market-oriented reforms, hinge on a liberal and open trading system.

The international trading system is now at an important crossroad. Its future is tied to the outcome of the Uruguay Round of multilateral trade negotiations. It is the most ambitious Round in recent history, and rightly so. Trading rules need to be clear, predictable, and non-discriminatory. They need to support the worldwide move to allow market signals to allocate resources. And they must cover all major sectors of economic activity that in the past have largely escaped the multilateral framework. The Uruguay Round seeks to devise trading rules and disciplines that will take the GATT into the 21st century.

A successful conclusion of the Round would have far-reaching favorable consequences. It would significantly enhance the efficiency of agriculture production. It would improve market access. And it would improve existing multilateral disciplines and extend them to important new areas, such as services, intellectual property rights, and trade-related investment measures and make trade in textiles and clothing subject to normal GATT disciplines. This would unlock new trading opportunities, to the benefit of all countries.

It is therefore of concern that much remains to be resolved in the negotiations, in a very short time. Member governments have it in their power to make the necessary political commitment and provide their negotiators with the guidance needed to complete the Uruguay Round successfully by the end of this year. It is of high importance that they do so.

Second, the international monetary system has been improved. We have established, over time, a more effective set of arrangements for policy consultation and coordination between countries. This is most noticeable in the improved collaboration among the main industrial countries, including the policy coordination within the Group of Seven, to which the Fund contributes: this is a complement to, not a substitute for, the Fund's broader surveillance role. If one reviews the evolution of the policy consultation process, including the Plaza Agreement of 1985 and the Louvre Accord of 1987, one can see it as a series of pragmatic steps toward more meaningful and effective collaboration on such issues as exchange rates, interest rates, adjustment of external imbalances, and the structural policies of the major industrial countries.

The world is moving gradually toward an international monetary system that will be different and hopefully better:

o it will be reinforced by the move toward monetary unification in Europe;

o it will be more truly universal, thanks to the expected progress of the Eastern European countries and the Soviet Union towards convertibility of their currencies. The IMF will, of course, assist this important transition, in accordance with our basic mandate.

o it will be a system that gives sufficient emphasis to the correction of excessive exchange rate volatility, by careful monitoring. And, by making better use of the techniques of surveillance and policy coordination, it will help to establish a "low inflation club" among the major industrial countries. This movement toward a monetary system with a growing area of stability should help to sustain world growth.

o it could be further strengthened by a more careful monitoring of the creation and distribution of international liquidity and of international

capital flows 1/ and a more effective coordination of policies to allow the world to benefit more fully from greater freedom of capital movements.

This outline of some of the emerging features of the international monetary system of the 1990s, also suggests an agenda for the future work of the Fund itself. The role of the Fund, as the central institution of the system, must be to ensure that the efforts of the member countries are mutually compatible and complementary. The Fund must maintain a constant vigil so as to be able to respond to possibly disruptive movements. It must promote a cooperative response to the major problems of any members, or to unexpected global shocks. These functions are as essential today, as when the Fund was established.

Governors, when you approved the quota increase for the Fund, you demonstrated again the importance you attach to the Fund as the guardian of the stability of the international monetary system. The timing of each of the last three quota increases has been fortuitous. Each of them was soon followed by an unexpected challenge to the global system which gave rise to exceptional demands on the Fund's resources. To help us face the present challenge, it is important that all Governors do all that is needed to expedite the legislative and other processes in their own countries, so that the quota increase and the associated Third Amendment of the Articles will come into effect as soon as possible, and preferably before next Spring, when our provision of assistance to countries affected by the present crisis will probably be reaching its peak.

* * * *

Mr. Chairman, Governors, we face a world that is very different than a year ago. The challenges and risks are formidable. But the opportunities for progress are real. Recent events have demonstrated again that sound policies by each, and close collaboration by all in a multilateral framework, are essential. Through renewed and stronger efforts, we can work together to make the 1990s a decade of progress for all.

1/ I am most grateful to former Governor Godeaux for agreeing to chair a high-level task force to investigate the problems of the measurement of international capital flows.

TREASURY NEWS

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

Remarks by
Secretary of the Treasury
Nicholas F. Brady
at the Morning Session of
the Interim Committee
of the International Monetary Fund
Washington, D.C.
September 23, 1990

The World Economic Outlook and the
International Debt Strategy

The Persian Gulf crisis has presented governments and international institutions with a host of challenges: political, military and economic. Together we must meet the economic challenges, and I am optimistic we can do so.

The process of international economic policy coordination has helped to sustain the expansion in the industrial world into its eighth year. That process must now be employed to minimize disruptions to continued economic growth with low inflation and adjustment of external imbalances.

The current environment is very different from the situation in the 1970s. Unlike the 1970s, the oil price increases have not taken place in the context of a generally inflationary global economy. Our economies are more energy efficient: we use considerably less energy per dollar of GNP than we did then.

Notwithstanding oil price developments, industrial countries as a group still expect solid growth. The pattern of growth -- more rapid in Germany and Japan, slower in North America and the UK -- is conducive to continued adjustment of external imbalances.

We have, in fact, seen considerable adjustment of trade and current account imbalances, particularly in the United States and Japan, but now also in Germany. We expect some additional adjustment in the largest economies in the next year or so, given relatively strong economic growth in the surplus countries and moderation in the deficit countries. Current exchange rates for the major currencies are also broadly conducive to further reduction of imbalances.

The task for international economic policy coordination is to sustain growth without reigniting inflation, in an environment characterized by oil market uncertainties. This will be difficult. But it is achievable. We in the United States must make substantial progress in reducing our federal budget deficit. The Budget Summit in which the United States is presently engaged is intended to provide a meaningful and lasting multi-year reduction of the fiscal deficit. We do not intend to set aside our budget deficit reduction program for any reason. We believe it is essential for securing long term growth.

The reduction of trade imbalances, however, is a shared responsibility. Countries with large external surpluses must ensure that strong, non-inflationary growth continues. We all need to work to reduce structural rigidities in our economies which hinder growth and adjustment.

In addition, there is particular urgency this fall in completing negotiations for a successful and ambitious agreement in the Uruguay Round. Industrial and developing countries alike must contribute to this effort if we are to preserve the world's free trade system.

I am aware that many countries outside the industrial world are being adversely affected by the crisis in the Gulf and our collective efforts to deter aggression. The front line states will incur very large economic losses. The international community has rallied to provide support for them. Thanks to our collective efforts, progress in the mobilization of assistance is encouraging.

Many others throughout the world, in Eastern Europe and the developing countries, are seriously affected as well. The IMF and World Bank must stand ready to assist those countries adversely affected by recent developments in the Gulf and adjust their policies to make the institutions more flexible and responsive to the needs of members seriously affected by the crisis.

Thus, we call upon the IMF to undertake an immediate comprehensive review of the Compensatory and Contingency Financing Facility (CCFF) with the aim of adjusting and expanding where appropriate both windows of the facility to provide assistance in a more timely fashion. Also, the Fund should consider measures on a temporary basis to increase access. Also, to enable the IMF to fulfill its responsibilities, it will be important for all of us to move forward in implementing the quota increase and suspension amendment no later than the end-1991 deadline.

We encourage continued implementation of the international debt strategy. For those countries which have embarked on courageous reform programs, commercial bank packages should be negotiated promptly. We welcome the recent success in marketing the Venezuelan bank package and urge Brazil to resolve its arrears with external creditors as it's IMF program is put into place. Official creditors are also providing new support. The U.S. "Enterprise for the Americas Initiative" will promote investment reform, trade liberalization and enable substantial debt reduction on obligations to the U.S. government. This will complement

efforts already underway for Sub-Saharan Africa. We also welcome the recent Paris Club decision to lengthen maturities for four lower middle income countries. And we are committed to reviewing additional options for addressing debt burdens, including recent proposals for the poorest countries.

In conclusion, Mr. Chairman, the worldwide support for a decisive response to aggression in the Persian Gulf is right, and shows what coordinated effort can achieve when the will is there. We need to ensure that the Fund and the Bank respond promptly to the needs of countries adversely affected by the crisis. In parallel, we need to continue the economic policy coordination process of the major industrial countries to bring us through the current economic uncertainties. I am confident we will achieve this goal.

INTERNATIONAL MONETARY FUND

PRESS RELEASE NO. 90/35

FOR IMMEDIATE RELEASE
July 2, 1990

The Board of Governors of the International Monetary Fund has adopted a Resolution, effective June 28, 1990, approving proposals for a Third Amendment to be incorporated in the Fund's Articles of Agreement. The proposed amendment would add new provisions to the Articles under which a member's voting rights and certain related rights may be suspended by the Executive Board, by a 70 percent majority of the total voting power, if the member, having been declared ineligible to use the general resources of the Fund, persists in its failure to fulfill any of its obligations under the Articles.

The adoption of the Resolution required a majority of votes cast. In accordance with the Articles of Agreement, the Fund must now ask all members whether they accept the proposed amendment. When three-fifths of the members, having 85 percent of the total voting power, have accepted the proposed amendment, the Fund will certify that fact by a formal communication addressed to all members. The amendment will enter into force for all members as of the date of the Fund's certification.

Under the Resolution on the Ninth General Review of Quotas, also effective June 28, 1990, no increase in the quotas of members can take effect before the effective date of the Third Amendment of the Articles (see Press Release 90/34).

External Relations Department • Washington, D.C. 20431 • Telephone 202-623-7100

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DEVELOPMENT

Panel Approves Debt Relief, Development Bank Funds

The House Banking Committee on June 26 approved a bill (HR 5153) that would authorize spending for international development activities and U.S. export financing, and promote debt relief for Third World countries.

The bill also contains language critical of China's human rights practices that is intended to pressure the administration to hold firm on a policy severely restricting World Bank loans to China.

The full committee fought over two elements of the bill, the China loan restrictions and the debt-relief provision. But in the end, most substantive amendments to those sections were rejected, and the measure was little changed from the version approved June 20 by the International Development Subcommittee.

Committee Chairman Henry B. Gonzalez, D-Texas, avoided a fight over Treasury Department and Federal Reserve exchange rate activities by withdrawing an amendment that would have allowed General Accounting Office audits of the Treasury's Exchange Stabilization Fund. *(Story, p. 2038)*

The committee approved the bill by voice vote, and Gonzalez said he hoped to have it to the House floor shortly after Congress returns from its July Fourth recess.

The measure would authorize $1.2 billion in contributions to a new development bank being created to aid the emerging democracies of Central and Eastern Europe. The U.S. contribution to the European Bank for Reconstruction and Development would equal 10 percent of the bank's capitalization. The United States would pay about $70 million a year over five years into the bank. The remainder would be "callable capital," available only in case of a bank default.

The bill would also authorize payment of $3.2 billion over three years to the World Bank's concessional lending arm, the International Development Association (IDA). But in cases where IDA makes loans to China that are not for "basic human needs," the Treasury secretary would be required — with some exceptions — to withhold U.S. contributions equal to the U.S. share of those loans.

By John R. Cranford

BOXSCORE

Bill: HR 5153 — Development bank authorizations.

Latest action: House Banking Committee approved June 26.

Pelosi

Next likely action: House floor.

Background: Banking subcommittee approved bill June 20 with restrictions on World Bank loans to China similar to those in the foreign operations appropriations bill (HR 5114).

Reference: Subcommittee action, Weekly Report, p. 1947; European Bank for Reconstruction and Development, World Bank loans to China, p. 1781; foreign operations appropriations, p. 2077; tied aid, 1989 Weekly Report, p. 2371; Brady plan, p. 2303.

The fiscal 1991 foreign operations appropriations bill (HR 5114), which the House passed June 27, contains similar language on China.

The bill would also authorize the Export-Import Bank to make loans for purchases by certain Central and Eastern European countries not currently eligible for Ex-Im Bank credits. It would increase the Ex-Im Bank's "tied-aid" war chest to combat the practices of countries that combine foreign aid grants with conventional export loans to promote purchases of their products.

The war chest would be authorized through fiscal 1992, and its current $300 million authorization would be increased by $500 million in fiscal 1991 and again in 1992.

China Loans

Committee members disagreed little over the desirability of restricting U.S. contributions to IDA should the organization make new loans to China that are not necessary for food, housing or other basic human needs.

But several Republicans tried to blunt the provision by extending the restriction to other countries that deny internationally accepted human rights to their citizens.

Jim Bunning, R-Ky., offered an amendment to add Ethiopia, Laos, Vietnam, Cambodia and South Yemen as countries for which the U.S. should discourage IDA loans.

Democrats opposed Bunning's language, at least in part because of the inclusion of Ethiopia. They also argued that China is a special case because of its size and the likelihood that resumed World Bank lending to Beijing — limited after the June 1989 crackdown on the country's pro-democracy movement — would spark a flood of new commercial bank loans.

"We are at a critical place in our relationship with China," said Nancy Pelosi, D-Calif., chief advocate of the restriction on China's loans.

"We're only playing domestic politics with this bill," countered Steve Bartlett, R-Texas.

Bunning's amendment was defeated 17-24 on a near-party-line vote.

Debt Relief

The bill calls on the Treasury secretary to negotiate with other industrialized countries to reduce the government-to-government debt of the poorest Third World nations.

It would direct the Treasury to urge other members of the so-called Paris Club of creditor nations to write off on a case-by-case basis loans that they have made to very poor countries. It would also authorize the president to write off U.S. loans to poor countries if such write-offs were in the national interest and were used to implement an international debt-relief agreement.

Committee aides said it is uncertain whether such write-offs would require specific appropriations.

The committee made one key change in the debt-relief language by extending the provision to Latin American countries and others that meet specific poverty-level criteria. Previously the bill focused only on Eastern Europe and sub-Saharan Africa.

That change, sponsored by Jim Leach, R-Iowa, corresponded with President Bush's call the following day for official debt relief for Latin American countries. *(Story, p. 2037)*

Gonzalez Backs Off

House Banking Committee Chairman Henry B. Gonzalez, D-Texas, backed away from a showdown with one of his favorite villains — the Federal Reserve System — during debate over an omnibus international development authorizations bill June 26.

The bill (HR 5153) had nothing to do with the Fed and the Treasury Department's international currency exchange rate activities. But Gonzalez came to the markup prepared to do battle on that subject anyway. *(Story, p. 2038)*

He proposed an amendment that would have authorized the General Accounting Office (GAO) to audit the Exchange Stabilization Fund, which the Treasury uses to intervene in world currency markets when it tries to bolster or weaken the dollar relative to other currencies.

The Fed does the government's buying and selling of currencies through the open market operations of the New York Federal Reserve Bank. That is the same system used by the Fed to control the nation's money supply and direct the movement of bank interest rates.

Gonzalez said he was concerned because the stabilization fund, which is composed of the government's foreign currency holdings, has grown from $17 billion to $46 billion since the start of 1989. An increase in the value of the Japanese yen in recent months, he said, has cost the fund over $1 billion. The administration has maintained that exchange rate activities are not subject to detailed examination. Treasury Under Secretary David C. Mulford asserted the Treasury's right to withhold information about the exchange rate fund in a strongly worded April 23 letter to the GAO.

And Fed Chairman Alan Greenspan sent Gonzalez a letter June 25 noting that Congress has long agreed to exempt Fed monetary policy activities from GAO oversight. Allowing an audit of foreign currency transactions, he said, was a step in that direction.

"These exemptions were carefully crafted by Congress ... to protect important daily contacts and exchanges of information with foreign monetary authorities," Greenspan wrote. He noted that the New York Fed does report quarterly to Congress about activities involving the fund and that Fed and Treasury officials have testified about it.

In the face of strong administration opposition and at the request of Stephen L. Neal, D-N.C., who chairs the committee's Monetary Policy Subcommittee, Gonzalez withdrew the amendment. Neal said he was sympathetic to the idea but would like to hold hearings on the subject first.

The Fed, whose independence from Congress and the executive branch in setting benchmark interest rates has long irked the populist Gonzalez, remains in the Banking chairman's sights.

"This was a shot across their bow," Gonzalez said after the markup. He said the Treasury had promised to try to reach an accommodation on some kind of additional congressional oversight of exchange rate activities. If that does not happen, he said, he might offer the amendment when HR 5153 reaches the House floor.

—John R. Cranford

An effort by Joseph P. Kennedy II, D-Mass., to require the Treasury to submit detailed evaluations of debt-reduction efforts involving commercial bank loans was defeated.

Kennedy and others have long complained that commercial banks are being subsidized by multilateral lending to Third World countries. Treasury Secretary Nicholas F. Brady in March 1989 announced a plan for reducing commercial bank debt that involves negotiations and subsidies paid by the World Bank and the International Monetary Fund (IMF).

Kennedy offered an amendment that would have required the Treasury to evaluate and report to Congress on Brady plan negotiations a year after their completion. The Treasury would have been required to assess the changed economic conditions of a country resulting from debt-reduction negotiations and its ability to repay the World Bank and IMF. The amendment was defeated 14-23.

MEMORANDUM

July 12, 1990

TO: ODC Staff

FROM: Laura Rawlings

SUBJECT: Hearing on Debt-for-Nature Swaps as part of the Enterprise for the Americas Initiative

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House Foreign Affairs Subcommittees on Human Rights and International Organizations and Western Hemisphere
Members in Attendance: Chair Peter Kostmayer (D-PA), Robert Lagomarsino (R-CA), Ted Weiss (D-NY), Ileana Ros-Lehtinen (R-FL), Porter Goss (R-FL)
Testimonies: Richard Nuccio, Inter-American Dialogue; Geoffrey Barnard, Nature Conservancy; Alvaro Umana, Central American Management Institute and former Forum speaker

Summary
Kostmayer and Lagomarsino introduced a bill (HR 5088) calling for official bilateral debt-for-nature swaps, which has now been incorporated into the larger context of the Bush Administration's Enterprise for the Americas Initiative. Latin America's bilateral debt to the government of the United States is currently $12 billion. The impact of this proposal is more relevant for Central American countries, given that their share of bilateral debt owed to the U.S. government (as opposed to commercial debt, multilateral debt, and bilateral debt owed to countries other than the U.S.) is higher than the share held by South American countries. If this proposal materializes, it will be the first bilateral debt-for-nature swap.

Umana stressed that the fate of the world's tropical forests will be decided in the next decade and that this initiative presents "one of the most innovative and powerful ways" to redress the environmental degradation of this valuable resource. However, he warned that this initiative is hardly a panacea for Latin America's economic and environmental ills (an analysis shared by the other panelists).

He also warned against the possible inflationary consequences of accumulating funds too rapidly because the of the debt conversion instruments maturing within a short time frame. He suggested that a type of long-term trust be established, which would generate interest to be used for the conservation project. However, in response to Kostmayer, Umana stated that this provision should not be included in the legislation as it would jeopardize negotiations and limit the use of funds for some necessary short-term projects.

In response to Kostmayer, Umana said that whereas this proposal

does in fact serve as disincentive for repaying the debt, one must examine the question from the perspective of performance as to whether the debt would have been paid at all. Kostmayer added that there are global environmental benefits being accrued from this proposal which will benefit U.S. taxpayers.

Barnard stated that this proposal presents a tremendous opportunity because it is the lack of financial resources that has limited Latin American nations' ability to preserve their 225 million acres of parks. In terms of the scoring process, Barnard used a formula based on the Toronto terms established for debt forgiveness for Sub-Saharan Africa. Based on these calculations, he said that the cost of the conversion would be 5 to 10% of the benefit (ie-a $200 million debt conversion would require an appropriation costing the U.S. Treasury $10 to $20 million; $1 billion of African debt was actually scored at $17 million).

Nuccio praised the initiative because it asks the government to join the ranks of the commercial banks in forgiving debt and because it represents a bipartisan and executive-legislative consensus. In response to Lagomarsino's question about why commercial banks have not engaged in debt-for-nature swaps, Nuccio pointed out that reporting requirements in the tax structure act as a disincentive and that the U.S. Internal Revenue Service should change these laws to encourage private debt-for-nature conversions.

Congressional Staff Forum
on
International Development

Director
William E. Hellert

MEMORANDUM 7-31-90

TO: ODC Staff

FROM: Mark Sanders

SUBJECT: Caribbean Debt for Development Act of 1990--HR 5196
House Foreign Affairs Committee

COMMITTEE MEMBERS IN ATTENDANCE: Co-Chair Gejdenson (D-CN), Co-Chair Crockett (D-MI), Johnston (D-FL), Bereuter (R-NB), Kostmeyer (D-PA), Meyers (R-KN)

TESTIMONIES: Sally Shelton-Colby, former Ambassador to Barbados
Thomas C. Gibson, CARE Small Bus. Asstnce. Corp.
Richard Bernal, Workers Bank of Jamaica

BACKGROUND:

HR 5196 absolves Caribbean countries from repaying AID development loans, provided an equal sum is deposited local banks for local development projects. This bill, as introduced, is non-partisan. The president decides whose, and how much, debt will be forgiven. While Undersecretary of the Treasury David Mulford has stated that all converted debt from the Enterprise for the Americas Initiative will be used for environmental projects, Rep. Crockett proposed this bill in order to allow Caribbean debt to be converted generally as "debt for development"--since the environmental needs of Caribbean countries are not as great as those of Latin America. The Caribbean countries, Crockett said, have both the most and the least to gain from Bush's EAI. They have the most to gain since their share of bilateral debt is disproportionately large. They have the least to gain, since Caribbean countries have little need for the environmental work that has been proposed by the initiative.

DISCUSSION:

To begin her testimony, Ms. Shelton-Colby articulated her strong support for the EAI. Such thinking will encourage the economic re-structuring process in Latin America and the Caribbean and eventually expand trade and investment in the hemisphere, she said. Ms. Shelton-Colby was also pleased that the US government was demonstrating its commitment to a partial debt forgiveness program through actions, rather than just words. In addition, Ms. Shelton-Colby stated that, while she supports the idea of debt for environment swaps, she prefers HR 5196 and other plans which encourage the use of debt to finance swaps for general development purposes. These programs, she said, make her optimistic that the 1990's will be years of higher growth and lower inflation for the countries of Latin America and the Caribbean.

Richard Bernal stated that resuscitation of economic growth in the Caribbean is imperative if these countries are to extricate themselves from the stifling economic deprivation which engulfs the majority of people and threatens social

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stability and peace in that region. If the "stranglehold" of debt on development is not broken, he continued, it could create an environment conducive to the emergence of political instability as witnessed by recent events in Trinidad and Haiti.

The U.S., he continued, "cannot be an oasis of well being in a sea of poverty." The economic malaise of the Caribbean will reflect itself in declining markets for US exports, fewer investment opportunities, increasing susceptibility to involvement in drug trafficking, burgeoning migration, the necessity to increase US development assistance and political instability, he said. Debt for development swaps, Bernal concluded, "would have a significant impact" on the economies of the Caribbean, because they would save foreign exchange which could then be used for economic growth. They would also reduce fiscal expenditures deviated from economic projects, health, education and infrastructure to meet scheduled debt payments. Finally, Bernal said, debt relief provided now would impact on the Caribbean at a critical juncture, and, furthermore, could obviate the need for much larger development assistance programs in the future.

Thomas Gibson articulated his support for HR 5196. He recommended, however, that the "local currency for development" and "waiver of deposit requirements" provisions of HR 5196 should also be extended to other countries outside the Caribbean on a case-by-case basis. In addition Gibson suggested that the selection of specific projects be based on the participation of bilateral committees composed of private and public sectors as well as NGO representatives.

SELECTED TOPICS

Macroeconomic Discipline, Structural Reforms Can Help Reverse Capital Flight

The flight of private capital from developing countries has caused policymakers much concern, especially since the emergence of the debt crisis. Such flight has been viewed as a constraint on economic growth because it implies a loss of resources that could be used for domestic investment.

In the following article, Liliana Rojas-Suárez of the Fund's Research Department reviews trends in capital flight since 1978 for developing countries with recent debt-servicing problems, discusses the determinants of such flight, and considers policies that might reduce it.

Increased risks in the domestic economic environment help fuel capital flight, and appropriate macroeconomic and structural policies are key elements in decreasing these risks. These are the main conclusions of a study of the experiences of 13 developing countries with debt-servicing problems during 1978–88: Argentina, Bolivia, Chile, Colombia, Ecuador, Gabon, Jamaica, Mexico, Nigeria, Peru, the Philippines, Venezuela, and Yugoslavia.

Measuring Capital Flight. Capital flight has been measured in various ways. While some authors have defined it narrowly as short-term, speculative capital outflows, others have viewed it more broadly as total private capital outflows. An alternative measure identifies capital flight as that part of a country's stock of external claims that does not yield recorded investment income. This provides the most direct estimate of the loss to an economy of resources that could potentially be used for domestic investment.

By this measure, capital flight for the group of 13 indebted countries mentioned above increased to $184 billion at the end of 1988, compared with $47 billion a decade earlier. This increase was not stable throughout the period, however. During 1978–83, expansionary fiscal and monetary policies coupled with an increasing overvaluation of exchange rates resulted in high rates of increase in the stock of capital flight, which reached 24 percent, on average, in 1983. With the adoption of economic stabilization programs in some countries over the next two years, this increase slowed to 3 percent by 1986. But it picked up again in 1987 (to 18 percent, on average), when many countries abandoned adjustment programs with the result that their fiscal deficits and inflation rates rose. The growth of capital flight slowed the following year, however, as some major countries embarked on new stabilization programs.

The ratio of the stock of capital flight to total external debt for the 13 countries also fluctuated over the decade to 1988. This ratio declined at first, to 38 percent in 1982, from 42 percent in 1978 as large inflows of foreign capital more than offset the increase in capital flight. But during the next five years, the trend reversed: the ratio of capital flight to total external debt increased to 51 percent in 1988, from 43 percent in 1983 because of both a continuous rise in the stock of capital flight and a decline in new private foreign lending to developing countries.

Causes of Capital Flight. There are two broad explanations for the causes of capital flight. One is that capital flight occurs because of differences in the relative returns on domestic and foreign assets, owing to the effects of domestic macroeconomic variables. According to this view, controls on domestic interest rates, overvalued exchange rates, rapid inflation, and inconsistent and unsustainable fiscal and monetary policies are major causes of capital flight.

Econometric studies relating capital flight to purely macroeconomic variables have yielded mixed results. One problem is that macroeconomic policies are likely to influence both normal capital outflows and capital flight. Moreover, this approach cannot explain the simultaneous occurrence of capital flight from developing countries and the increase in foreign loans to such countries during the 1970s and the early 1980s.

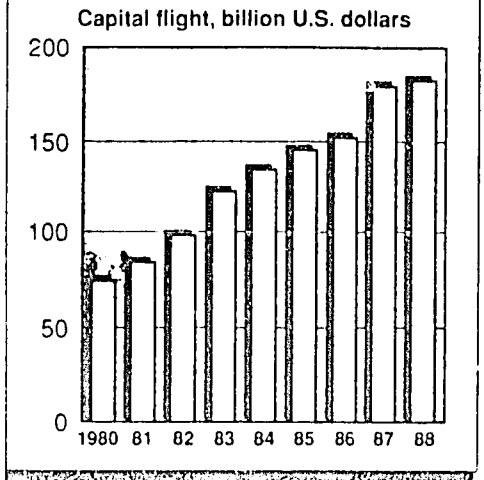
A second view attributes capital flight to differences in the perceived risks of holding domestic and external financial instruments of indebted developing countries. Such differences are thought to explain the simultaneous decision of domestic residents to finance investment with foreign borrowing and to hold their wealth in the form of foreign assets. For example, it has been argued that the risk of the authorities of indebted developing countries not being able to service their domestic debt would be perceived to be higher than the risk associated with servicing foreign obligations, because the cost of default on the latter would be higher.

While both approaches emphasize the role of domestic policies in influencing capital flight, the risk differential approach also stresses the role of legal and institutional rigidities in developing countries.

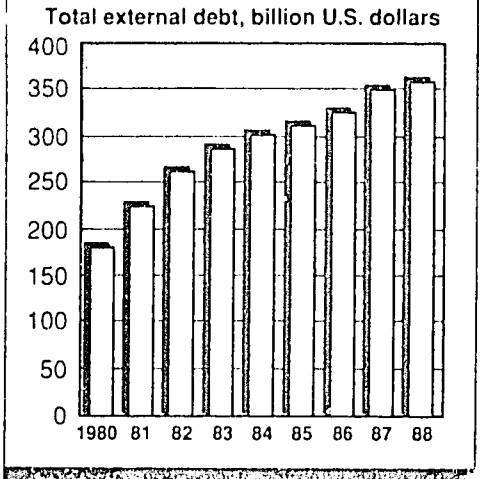
Since 1982, capital flight has been accompanied by a drastic reduction in the inflow of new private external credit available to heavily indebted countries. Moreover, the difference in the perceived default risks between domestic and external debt has narrowed because growing fiscal deficits, rising inflation, and limited access to international capital markets have reduced the costs of not meeting foreign obligations relative to the costs of not meeting domestic obligations. However, the *total* default risk associated with holding debt—either domestic or external—issued by heavily indebted countries has increased. Therefore, the lack of external creditworthiness (which prevents countries from borrowing in the international capital markets) and the persistence of capital flight are both reflections of the same fundamental phenomena. It follows that policies that improve the attractiveness of holding domestic financial instruments of indebted developing countries would also help restore external creditworthiness and reverse capital flight.

Policies to Prevent or Reverse Capital Flight. Given the key role of expansionary monetary and fiscal policies in fueling capital flight, sound macroeconomic policies and appropriate structural reforms are likely to be important in preventing or reversing such flight. In many countries, a

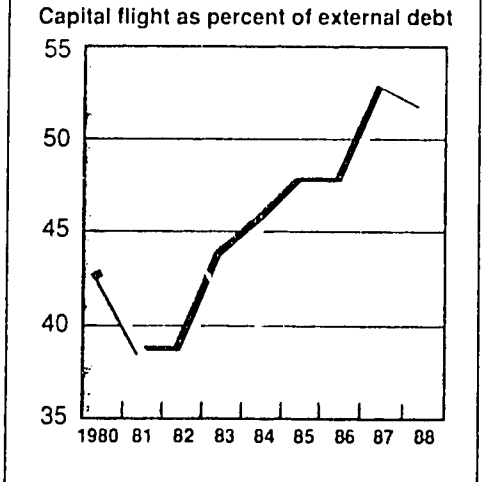
Capital Flight Rose in the 1980s



So Did External Debt



But Capital Flight Rose Faster



Note: Data are for Argentina, Bolivia, Chile, Colombia, Ecuador, Gabon, Jamaica, Mexico, Nigeria, Peru, Philippines, Venezuela, and Yugoslavia.

Data: World Bank, *World Debt Tables* (various issues), IMF, *Balance of Payments Yearbook* (various issues), and IMF staff estimates.

sustained reduction of the fiscal deficit is an important first step in reducing the perceived risks of holding domestic debt. Large fiscal deficits financed with nonindexed domestic debt are likely to create expectations that the government will eventually use an inflation tax and/or a devaluation of the currency to reduce the outstanding real value of the debt.

Consistency between exchange rate, monetary, and fiscal policies is also crucial to stem capital flight. For example, fixed exchange rates—which many governments use to provide an anchor for the domestic price system—coupled with wage and price rigidities and inefficient tax systems often prevent a government from being able to adjust its fiscal deficit quickly in response to an external shock. Such rigidities suggest the need for structural reforms together with sound macroeconomic policies to stem capital flight.

The recent experiences of several Latin American countries highlight the role of appropriate macroeconomic and structural policies in reducing and reversing capital flight. For example:

- In Argentina, capital flight was reversed following the adoption of a comprehensive adjustment program in June 1985, although, subsequently, sustained fiscal deficits led to renewed inflation, and capital flight accelerated.
- In Brazil, the introduction of the Cruzado Plan in early 1986 was followed by a decline in capital flight. However, such flight increased in 1987, when inflation rose sharply.
- In Mexico, a comprehensive economic program introduced in December 1987, which included front-loaded fiscal and monetary measures and a peso devaluation, led to a net repatriation of flight capital in 1988 for the first time in the 1980s.

In addition to sound macroeconomic policies and structural reforms, many countries have used other measures to stem or reverse capital flight. One of these is *capital controls*. Such controls have been viewed as a means of ensuring that domestic savings are invested domestically. A problem with this view, however, is its assumption that capital that is not invested abroad will be invested domestically. This might not happen. In particular, the announcement of capital controls might create expectations of further government intervention, which would discourage domestic investment and raise consumption.

Countries' experiences suggest that, although capital controls have, in some cases, helped in the short run to stem capital flight, their costs outweigh their benefits and they tend to lower domestic savings. Moreover, when they are used on a discretionary basis, expectations of their imposition encourage capital flight. Capital controls therefore might reduce the resources available for investment in the long run.

Debt-equity swaps, which involve buying assets in debtor countries with external claims on these countries purchased at a discount on the secondary market, have been effective in reversing capital flight in some cases. Their ability to increase net capital inflows might, however, be limited for two reasons. First, if the secondary market for developing country debt is thin, increases in the demand for claims on such countries would raise the prices of those claims and reduce the profitability of debt-equity swaps. Consequently, only a limited number of swaps would be undertaken. Moreover, if commercial banks are willing to sell claims on debtor countries at a discount, they would have few incentives to voluntarily lend new money to such countries. As a result, the net inflow of funds to debtor countries might not increase significantly. Second, because some debt-equity swaps involve the reselling of discounted paper for domestic currency at preannounced exchange rates, the money supply can increase as the swap occurs. If inflation rises as a result, this would increase the risks associated with holding domestic assets and encourage capital flight, which might offset the original inflow resulting from the debt-equity swap. Countries' experiences suggest that one of the key determinants of whether debt-equity swaps can be successful in reversing capital flight is whether they are accompanied by an appropriate monetary policy.

Foreign currency deposits—that is, local deposits denominated in foreign currency—have been used as a means to prevent capital flight in several countries, including India, Mexico, Turkey, and Uruguay. Although such deposits offer some protection against exchange risk, they will not be seen as less risky than other local deposits if authorities have, in the past, acted to freeze or limit withdrawals on them. Nevertheless, foreign currency deposits can help to stem capital flight if they are accompanied by sound macroeconomic and structural policies.

Liliana Rojas-Suárez,
IMF Research Department

Fostering Direct Investment in Latin America

Institute of International Finance
July, 1990

EXECUTIVE SUMMARY

In recent years, the ten largest Latin American countries have received net flows of foreign direct investment, relative to GDP, of only about one-half those registered by Southeast Asian countries, Portugal and Spain. This performance has been disappointing since as international credit flows have declined, Latin America has become more dependent on direct investment. Success in attracting foreign investment varies considerably from country to country with Chile the most successful case. Debt-for-equity swaps have been important in foreign investment in Chile, Brazil and Mexico, and, to a lesser extent, Argentina.

The bulk of foreign direct investment in Latin America has been in manufacturing, partly because of restrictions to investments in mining and petroleum, and in the financial sector and other services. Historically, the United States has been the largest source of foreign investment in the region, although in the last ten years European and Japanese companies have played a growing role.

During the 1980s, reinvestment out of retained earnings accounted for 34 percent of foreign investment, including swaps, in the ten countries. The sizable fall in real reinvestment since 1982 is a major factor explaining the stagnation of foreign investment in the region.

Foreign investment is encouraged by a reasonable rate of return, by access to markets and by growth opportunities. Although the rate of return on investment in Latin America has almost doubled since 1986, it remains well below that of other developing countries, as gauged by U.S. government data. Statistical analysis shows that foreign investment in Latin America has been encouraged by rising profits, export growth and swap mechanisms, but that arrears to commercial creditors are negatively correlated with foreign investment.

Debt-for-equity programs in Latin America peaked in 1988 when $4.3 billion was invested. New programs in Argentina and Mexico and proposals for similar action in Brazil focus on the use of swaps for privatizations. This redirection of swap programs has come in part because critics have centered their attention on possible inflationary effects and not on the overall benefits to be derived from the programs. As the example of Chile shows, it is possible to use a wide variety of debt conversion techniques without compromising fiscal and monetary discipline.

The host government's economic policies have a critical effect on foreign investment. In Latin America, the highest priority of policymakers must be to bring inflation down. Hyperinflation discourages all investment, foreign and domestic. Lifting of restrictions on foreign ownership and on limits to profit and capital remittances remains another priority, even in countries which have made great strides forward in recent years.

Investment and loan capital are complements rather than substitutes. In the ten largest Latin American countries, the estimated stock of foreign investment in 1989 amounted to only 23 percent of foreign debt. Projects financed with foreign investment may provide mechanisms to obtain loan capital, sometimes with the guarantee of the parent company. High transfer risk presents a more difficult barrier for commercial lenders than for foreign direct investors but where the conditions are right, banks will follow their corporate customers.

Countries in Latin America are increasingly committed to opening their economies to foreign trade and investment. If the major economies can achieve inflation control, the share of foreign investment in domestic capital formation in the ten major countries could reach 10 percent in 1993, double the average of the last five years. For 1990, the Institute is projecting that foreign direct investment will increase by close to 40 percent from the depressed level of 1989 and exceed the previous peak registered in 1988.

FINANCIAL TIMES, July 6, 1990

The political debate in the US is being fuelled by a bestselling book, writes **Lionel Barber**

Rich pickings for a prophet of populism

Americans are taking a second look at the 1980s, and many do not like what they see. Once acclaimed as the decade when the country regained its strength and self-confidence, the 1980s are increasingly portrayed as a period of greed, self-indulgence, rising debt and false prosperity.

Now comes a new book* to stoke the debate. Mr Kevin Phillips, a prominent Republican political theorist, argues that the 1980s amounted to the triumph of Upper America. It was an era of "too many stretch limousines, too many enormous incomes and too much high fashion," when inequality intensified and the Republican Party lost touch with ordinary middle-income Americans.

The result, writes Mr Phillips, will be a populist backlash similar to those that followed other periods of unfettered capitalism. Just as progressivism followed the gilded age of robber barons in the late 19th century, and the New Deal followed the speculative binge of the 1920s, so too an anti-elitist economic populism will follow in the steps of Mr Michael Milken, Mr Donald Trump, Mrs Nancy Reagan and Mr George Bush.

Mr Phillips has stronger credentials than most political pundits. More than 20 years ago, as a precocious young Republican operative, he helped Mr Richard Nixon devise the "southern strategy" of wooing conservative white voters by painting the Democratic Party as liberal, elitist and remote from "Middle American values."

This cultural populism has helped the Republicans win five out of the last six presidential elections, including Mr Bush's crushing defeat of Mr Michael Dukakis in 1988. Mr Phillips's defection has infuriated Republicans, but it has given heart to the Democratic Party which – in terms of presidential as opposed to congressional elections – is about as weak as the British Labour Party after the defeat of Mr Neil Kinnock in 1987.

In the 1980s, Mr Phillips writes, money did not talk – it shrieked. It was an age in which economic inequality increased dramatically.

The income of the wealthiest 1 per cent of Americans now averages $550,000, and rose a mind-boggling 75 per cent in the 1980s, according to a recent study by the House Ways and Means Committee. The same 1 per cent's after-tax share of US income rose from 7 per cent in 1977 to a projected 11 per cent in 1990.

The 70 per cent of Americans who describe themselves as middle class also fared better in the 1980s, but far more modestly than the super rich. Mr Phillips exaggerates the disparities by including some of the late Carter years where the middle class was caught in the pincers of high taxation and high inflation.

For married couples, the median income rose 9 per cent between 1980 and 1988 to just over $36,000 – but was offset by cuts in social services, rising tuition, housing and health-care costs. Even more pronounced was the impact on the poor, whose median income fell in real terms by between 3 and 9 per cent. At the same time, under the 1986 tax reform law, top individual tax rates for millionaires fell from 70 per cent to 28 per cent.

The question is this: if economic populism was so potent, why did the Democrats fail to use it in 1988 against Mr Bush? After all, the evidence was widely available; and Mr Bush, the Yale-educated country club Republican who comes from the "watercress sandwich wing of the party" would seem to have offered an inviting target.

Mr Phillips contends that the Democrats were the Great Collaborators in the 1980s, supporting Mr Reagan in his legislative agenda which favoured the rich. In 1988, the Democrats merely flirted with populisin. Only at the end of his campaign did Mr Dukakis finally start talking about income disparity, the "bi-coastal economy," and being on the right side of working men and women. But, after all, he was the "ethnic yuppie" who had made it.

Will the new populism sell in the 1990s? For tactical reasons, the Democrats certainly intend to pick up some of Mr Phillips's themes. The savings and loan debacle could create a populist backlash. The stigma of collaboration could also persuade the party to choose someone from outside Washington to run in 1992. More immediately, Mr Bush's acknowledgment last week that new tax revenues were needed to help reduce the budget deficit has already set off a debate on whether the top 1 per cent should pay more tax.

But as one top Democrat official points out: "We can't come across as the party that wants taxes, nor can we argue that we should tax the rich for the purposes of redistribution. We have to argue on the grounds of fairness."

By far the most important contribution that Mr Phillips has to make – and the reason his book has risen within two weeks to the Top Ten Bestseller list in the Washington Post – is the way he has exposed the current vacuum in American politics at the end of the Reagan era.

The search for a New Politics concerns Republicans as much as Democrats. Under the "kinder, gentler" leadership of Mr Bush, the Republicans have turned a little mushy. One measure of the party's desperation is its embrace of emotive but empty issues such as opposition to flag-burning and public funding of controversial art such as the homo-erotic exhibition of the photographer Robert Mapplethorpe.

But it would be foolish to write off the Grand Old Party in 1990, or the incumbent Mr Bush in 1992. The state of the economy will prove far more important in influencing voters than any vague backlash from Main Street.

The Democrats, too, should be careful about embracing Mr Phillips as the prophet who can lead them out of the wilderness. His book fails to identify a new role for government in correcting some of the excesses of the 1980s, whether at state or federal level. What is clear is that Mr Phillips, the man whom the conservative commentator Mr William F. Buckley once described as a "Country and Western Marxist," has at least given the party an opening.

** The Politics of Rich and Poor. Kevin Phillips. Random House, $19.95.*

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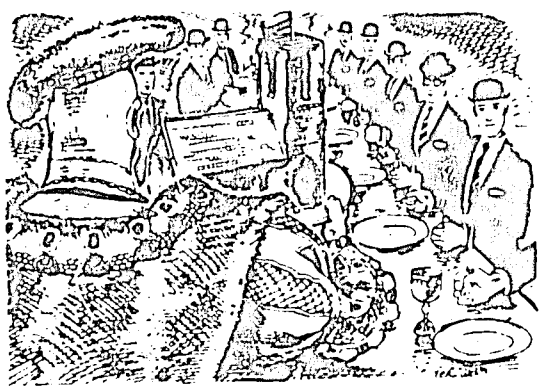
FINANCIAL TIMES, July 11, 1990

Privatising eastern Europe

Making it safe for capitalism

Olivier Blanchard and **Richard Layard** on the lessons to be learned from Henry VIII



Eastern Europe is becoming capitalist. Or is it? On present plans privatisation will be dangerously slow. The reason is simple. Governments (egged on by foreign stockbrokers) want to get the "right price", and few people in eastern Europe have the wealth to afford it.

This slow pace greatly adds to the political uncertainty of the region, increasing the risk of a tragic end to the reform process. If capitalist governments want to establish capitalism in a way that is irreversible, they need to create millions of capitalists - and to create them fast. In other words they should give the nation's capital to its citizens, for free.

In this respect Henry VIII knew what he was doing. When he wanted to abolish the Catholic church irreversibly, he gave away its property to everybody who mattered. Today that means giving it to every voter.

But how clearly can this be done, and what are the objections to it? Clearly there is huge uncertainty about the value of almost every enterprise in eastern Europe. In fact some enterprises have negative value. So fairness requires that every citizen be given a share in every enterprise. This can only be done through holding companies. Enterprises should be grouped into, say, five holding companies and every citizen be given shares in every holding company.

These shares would be traded and the daily publication of the holding company's price would put pressure on the holding company managers to secure the best use of the capital which they controlled. The managers' pay would also be performance-based.

But the holding companies should not last for ever. Their job would be to reorganise the enterprises, establishing efficient management, and then progressively sell them off over a 10-year period - distributing the proceeds to their shareholders. Since citizens would now own substantial private wealth (in holding company shares), there should be no difficulty in finding buyers for the reorganised enterprises, willing to buy at the right price.

There should also, of course, be sales to foreigners. If these were made by holding companies, the proceeds would go directly into the pockets of the citizens. This should greatly ease the political problem of selling to foreigners. Contrast it with the normal situation where the proceeds disappear into the Treasury and citizens feel no direct gain.

This approach combines two essential desiderata. First, private ownership needs to be established fast - in order to generate the right incentives in the system and (perhaps) in order to make sure that we get there at all. But at the same time there must be a prolonged period during which enterprises are reorganised and eventually sold into the hands of direct private owners, domestic or foreign. Restructuring too fast would only increase unemployment to intolerable levels.

So what are the objections? We have encountered four. First, "people ought not to get something for nothing." From an ethical point of view this objection makes no sense, since the people have already paid for the nation's capital in past taxes. From an efficiency point of view, it is of course desirable that capital be managed efficiently. But this is a matter of organisation. The Abbey National will not be better or worse run because so many of its shareholders got their shares free. What matters is that there are enough major shareholders to be able to sack the managers, or that there be a takeover mechanism. Here the holding company device is a good interim method of ensuring a major shareholder. The alternatives are control by *nomenklatura* members, who have had the time and the opportunity to accumulate wealth, or by foreign firms.

The next obligation is that "the government cannot afford to give the stuff away." It is true that east European countries have primitive tax systems and negligible bond markets. Privatisation proceeds would therefore help to finance government expenditure without printing money. But the scope for such proceeds is minute. In Poland the whole of accumulated private savings equals roughly 10 per cent of one year's national income. So the potential annual flow of domestic privatisation proceeds is very small. Lending people the rest of the purchase price does not affect this argument, and adds an unbearable administrative burden of debt collection. If capitalism has to be postponed until it is "affordable", it will have to be postponed into the next century.

There is, however, a genuine public finance point. A part of present government revenue comes form the dividend of state-owned enterprises. But, in Poland at least, this is both small and irrationally distributed between enterprises. The same revenue could be readily raised some other way. The same point relates to macroeconomic control. If people's capitalism made people feel richer and consume more, there are other instruments to offset the inflationary results of such a welcome uplift.

Next, there is the worry about wealth distribution. If everyone gets shares, poor people will sell them early on at low prices, to feed their families, while richer people accumulate shares which appreciate in value as economic performance improves and financial markets thicken.

No doubt this will happen. But what are the alternatives? If all shares are sold, the poor will receive nothing, not even towards their groceries. And capital gains will still go to the rich - unless public ownership is prolonged for decades and there are thus few capital gains. Another possibility is to give shares to the workers. This is of course manifestly unfair. It gives nothing to nurses, teachers or any worker who remains publicly employed. And it gives wildly varying amounts to those workers who get anything. It is also unlikely to promote the efficient redeployment of economic activity (in so far as workers are enabled to appoint and dismiss managers).

But if the alternatives are poor, it is still important to think of safeguards. One very important safeguard could be this. Equal numbers of shares are given to everybody including children but children cannot sell theirs. In this way the young adults of the next century would enter adult life with a solid birthright and the independence it brings.

Would foreign creditors object if the governments of eastern Europe pay little interest, yet give away their assets? We hope not. For the credit worthiness of eastern Europe depends on whether their economies are working. They will not work unless they establish private ownership, and do it fast. The only way to do this is to establish people's capitalism. Remember Henry VIII and the monasteries.

Professor Blanchard is from MIT and Professor Layard from the Centre for Economic Performance at LSE. Their essay on eastern Europe will be published on July 19 by the Centre for Research into Communist Economies.

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THE JOURNAL OF COMMERCE, August 28, 1990

Investment Pitfalls in the East

By MIRIAM WIDMAN

EUROPE VIEW

FRANKFURT, West Germany — "Now's the time to invest in East Germany! 8,000 firms offer you a stake in their activities." Or so said the ad that ran in major English-language European newspapers last week.

With the 3 a.m. decision last Thursday by the East German Parliament to accede to West Germany on Oct. 3, the German Democratic Republic has a shelf life of five more weeks. But whether you call it East Germany, or the eastern part of a united Germany, investors must ask themselves if putting in their money is really worth the risk.

First the most positive point: geography. East Germany borders Poland and Czechoslovakia and historically has had strong trade relations with those countries and with the Soviet Union. The assessment that it is a good jumping-off point for doing business in other East European countries is probably correct.

There are other positive factors, but most of those go hand-in-hand with major drawbacks. East German workers, for instance, are relatively well educated. But technology in the German Democratic Republic is so far behind the West that several West German computer businessmen recently had to ask whether it wouldn't be better and easier just to start all over in East Germany, rather than renovate the backward industry.

Forty years of socialism have left East Germans far less industrious than their Western counterparts, and productivity is about 30% of levels in the Federal Republic. Ignoring that fact, East German unions, guided by their Western mentors, have obtained 25% to 30% pay increases, in many cases with one-year job guarantees.

Nearly everyone in the West German business sector, from industrialists to monetary policy makers, has warned that the wage difference will play a key role in East Germany's ability to attract capital. Potential investors looking at the two Germanys might very well decide that salaries in West Germany better reflect workers' productivity and invest there instead.

But above all, the key problem that must be resolved before any investor can take a serious look at East Germany is property rights. In the nine months since the Nov. 9 revolution, political change has been so rapid that Germany will be unified in less than a year following the fall of the Berlin Wall.

In contrast, next to nothing has changed with regard to property rights. The only move toward speeding up a settlement of the confusion was East Berlin's decision to advance the date for claims on property from January to mid-October. This means that if you owned property in East Germany from 1949 onward and your land was expropriated, you have until mid-October to make a claim to get that property back.

Just how fast actual decisions will be made remains to be seen. One thing is clear: Don't expect mass investment until investors can be assured that when they buy a piece of property, it's theirs.

Another major obstacle to doing business is the telecommunications system — or lack thereof. Making a phone call within East Germany works more often than not, as long as you're willing to put up with static background noise and the more than occasional crossed line. But try calling a business partner in Western Europe. Your fingers will get lots of exercise dialing the number repeatedly, but it's never certain you'll make a connection.

It would be nice to be able to wholeheartedly recommend investing in East Germany. With unemployment easily approaching the forecasted 2 million, the country sure could use it. Yet this is the market economy, and companies have to weigh benefits and risks.

West Germany's largest company, Daimler Benz AG, recently did so, and decided against East Germany. The market for the mid-sized trucks it said it wanted to assemble in East Germany collapsed with the introduction of the deutsche mark as East Germany's currency on July 1.

Is now the time to invest in East Germany? That would largely depend on your industry, and the deal you can cut with an East German company or the trust company working to privatize East German industry. It also depends on your level of tolerance for working in a somewhat chaotic business environment.

Now is definitely the time for politicians to resolve the property questions and to create an infrastructure that will leave Western investors with a list that has more positive than negative points.

Miriam Widman is Frankfurt correspondent for The Journal of Commerce.

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U.S. DEPARTMENT OF STATE
Office of the Assistant Secretary/Spokesman

PRESS CONFERENCE
BY
SECRETARY OF STATE JAMES A. BAKER, III
AND
SOVIET FOREIGN MINISTER EDUARD SHEVARDNADZE

IRKUTSK, USSR
THURSDAY, AUGUST 2, 1990

FOREIGN MINISTER SHEVARDNADZE: Good morning. Once again, I would like to welcome the press here on the soil of Irkutsk in Siberia. The Secretary and I have thought that it is necessary to report to you on what we've been doing here over these two days. So I've got a listing here of what we've discussed, of what we have been able to discuss and decide.

Here in Irkutsk, the Secretary and I have spent almost 10 hours in discussion and talks. And since Irkutsk is in Asia, we have decided to give a more detailed and thorough consideration to the problems of Asia and the Pacific. The place, the venue of the meeting itself had made possible to choose this main direction (as) one of the main themes of our discussions. For the first time, we have given what I would call a very comprehensive consideration to the general problems of Asia and the Far East--the question of overall stability in this vast region, the problem of security in Asia and the Pacific, the problem of eliminating the remaining military confrontation, and ways of establishing bilateral and multilateral cooperation in this region.

Now what are the results of these discussions? We have a high degree of mutual understanding on the basis of the very fundamental understanding that in Asia, too, the Soviet Union and the United States do not regard each other as adversaries. This is a statement of a general nature made it in Washington, noted in Washing as regards the entire world, and, of course, it extends also, to the Asian region. And this defines our new perception of all the big problems of this region. And so we are convinced, and we agreed, we have recognized that the competition between the East and West is no longer valid. There is an outdated stereo-type no longer valid for the situation now.

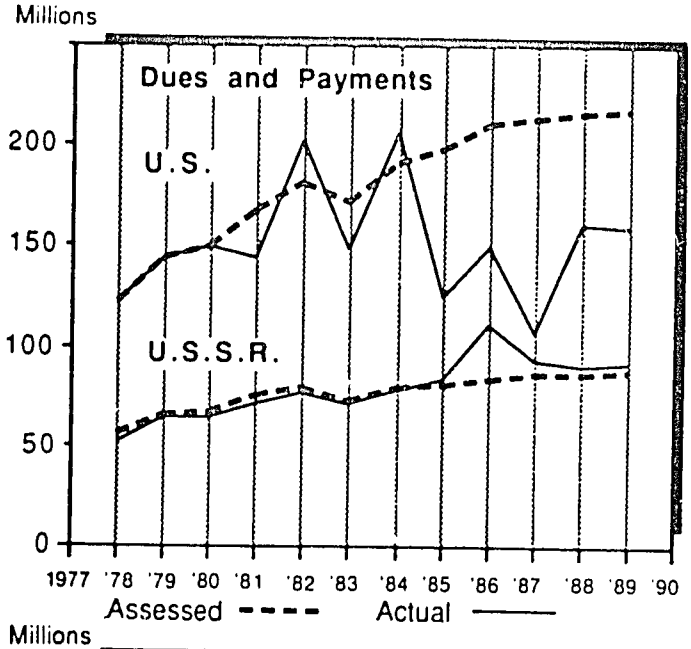
SECRETARY BAKER: Let me simply say that is a full and complete summary or listing of the various categories of issues that we have discussed during the course of about six and a half hours that we have spent working on those issues. We've got another hour to go, of course, while some of you file. I'd like to join with the Minister in thanking the citizens Irkutsk and the people of this area and the MInister himself and his delegation for hosting us here and permitting us to see this area in addition to permitting us to do some rather productive work. I think the point that the Minister made about efforts to cooperate in view of the changed circumstances around the world--efforts to cooperate in Asia as we have been able to cooperate in Europe is important. And we did spend a fair amount of our time on Asian issues and regional conflicts in Asia. One other thing that I would say is that I think that as we move this relationship between the United States and the Soviet Union forward, we have greater potential to work together to address and to deal with regional conflicts around the globe. Because to a lesser and lesser degree are these conflicts seen in East-West terms, or in U.S.- Soviet terms or dimensions.

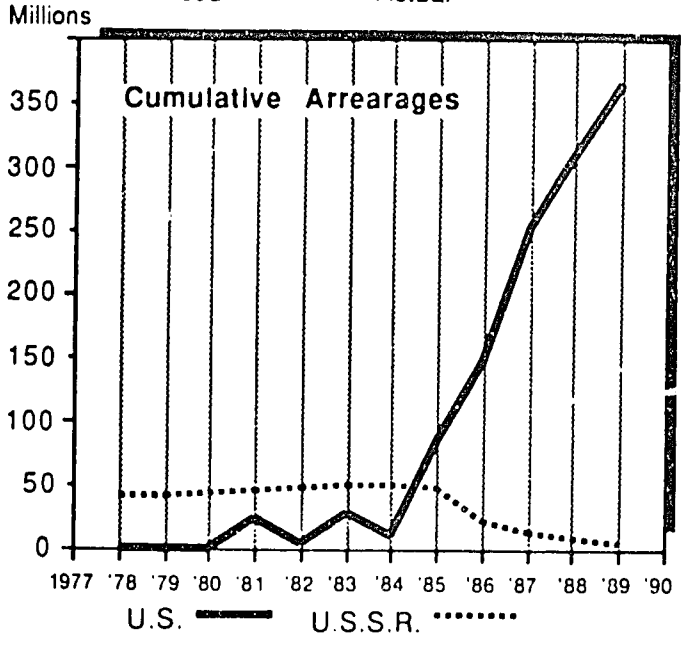
"Non-Security Problems"

From Congressional Quarterly, July 27, 1990, Editorial Research Review, p.439

U.S., Soviet Contributions

The top graph shows U.S. and Soviet dues assessed by the United Nations and how much each country actually paid. Before Congress passed the Kassebaum Amendment in 1983, the United States generally paid its full dues (although it occasionally did so late, which accounts for the overpayment in some years and the underpayment in others). After 1983, the United States cut its payments sharply. Note that despite the cutback, the United States has consistently paid more each year than the Soviet Union. In the late 1980s, the Soviets started paying more than their annual assessment in order to make up for dues owed from previous years. By doing so, as the bottom graph shows, the Soviet Union has nearly eliminated its arrearages. The United States, by contrast, now owes a huge amount in back dues. The data for these graphs were provided by the United Nations. Although the State Department calculates the arrearages differently, it does not deny that they are large.





Editorial Research Reports / July 27, 1990

Front Lines , July 1990
Agency for International Development

Roskens Orders Restructuring

Bureaus Reorganized, Management Responsibilities Shifted

In a move to reapportion management duties within AID, Administrator Ronald W. Roskens has transferred responsibility for carrying out Agency programs in most Asian countries from the Bureau for Asia, the Near East and Europe (ANE) to the Bureau for Private Enterprise.

The former ANE bureau, renamed the Bureau for Europe and the Near East (ENE), remains responsible for Agency programs in Europe, North Africa, the Near East, Afghanistan, Pakistan, Cambodia and the Philippines. Carol Adelman remains assistant administrator.

Programs in the other Asian countries in which AID operates will be the responsibility of the newly named Bureau for Asia and Private Enterprise (APRE), which Henrietta Holsman Fore will continue to head as assistant administrator. Included are India, Nepal, Bangladesh, Sri Lanka, the Maldives, Burma, Thailand, ASEAN, Indonesia and the South Pacific.

"I see this as an opportunity to be innovative in delivering development assistance through the private sector," says Fore.

Roskens ordered the reorganization to address a growing imbalance in management functions at AID, where the ANE bureau was responsible for countries over a broad geographic area, including rapidly growing activities in Central and Eastern Europe.

The integration of resources from the Asia portfolio and the PRE bureau will benefit all areas of the new bureau, according to George Laudato, the new deputy assistant administrator for APRE. "This is clearly a situation in which the whole will be substantially greater than the sum of its parts," he says.

The Office of Housing and Urban Programs, which previously reported to the administrator, will now report to Fore.

The Office of the Science Advisor, which also formerly reported to the administrator, will now come under the direction of the Bureau for Science and Technology.

Roskens also has initiated a broad review of the Agency's management. He has appointed a group of senior AID task forces to address a series of management issues and has tightened contracting procedures for overseas projects.

One task force is working to identify duplication and overlap between AID bureaus that run overseas missions and those responsible for central scientific and technical programs.

Other AID teams are examining how foreign assistance programs and projects in the field are planned, carried out and evaluated, how communications between Washington and the field missions are handled and how personnel assignments are made.

The changes in contracting for overseas projects are designed to ensure that the Agency is more directly involved when countries receiving U.S. assistance make their own arrangements to carry out programs and projects.

FPI

Policy Consensus Reports

August 1990

THE PEACE DIVIDEND AND FOREIGN AID

David Abshire
John Brademas
Harold Brown
Alexander Haig
Barbara Jordan
Melvin Laird
Charles McC. Mathias
Edmund Muskie
Charles Percy
Peter Peterson
Elliot L. Richardson
Alice Rivlin
James Schlesinger
Cyrus Vance
Paul Volcker

The conclusions below, and the general thrust (though not necessarily every paragraph), of the following working memorandum on The Peace Dividend and Foreign Aid have been endorsed by David Abshire, John Brademas, Harold Brown, Alexander Haig, Barbara Jordan, Melvin Laird, Charles McC. Mathias, Edmund Muskie, Charles Percy, Peter Peterson, Elliot L. Richardson, Alice Rivlin, James Schlesinger, Cyrus Vance, and Paul Volcker.

1. The political changes that have taken place in Eastern Europe and in the Soviet Union during the latter part of 1989 and in 1990 are transforming the conditions of international security. Should the promise engendered by these changes be fulfilled over the coming years, the once well-founded concern about Soviet ability to mount a conventional attack in Europe will be greatly reduced, both because the conventional military balance will have been altered in forces and geography to make such an attack much more difficult, and because the USSR will have greatly reduced the weight it has placed on military capability as an instrument of international relations. In consequence, a real reduction in defense spending by the United States can be expected and is justified: beyond peace itself, this is the peace dividend.

2. If all goes well, we estimate that U.S. defense spending at the close of the coming five-year period will be at least $50 to $60 billion a year less in real terms than it is now. Measured from a defense budget that otherwise would have been kept flat in 1990 constant dollars, and assuming smaller reductions in the first two years than in the following three years, the likely savings over the next five years will total about $150 billion. Other estimates are possible; but, reflecting the favorable developments of the recent past, they all show a large difference between the level of expenditures previously deemed necessary and the lower levels now deemed sufficient for national security.

3. Pressing domestic objectives and programs have legitimate claims on a significant share of the funds made available by such projected reductions in defense spending. The continuation of large budget deficits suggests that, in a very real

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Chairman: Harold Brown—Executive Director: Simon Serfaty

sense, the peace dividend has already been spent several times over during the past decade; accordingly, in determining the potential benefits and possible uses of this dividend, deficit reduction certainly merits priority consideration. Also deserving high priority are those claims made on behalf of important domestic needs that serve the most fundamental purposes of our society.

4. Yet we strongly urge that some of the peace dividend—which derives from the success of our past investments in national security—also be reinvested in the new internal and regional political and economic structures that are emerging in Eastern Europe, Central America, Africa and Asia. Such use of even a modest percentage of the peace dividend would allow a substantial increase in U.S. nonmilitary assistance, especially as that level is so low relative to other domestic items with a pressing claim on budget allocations. The nation has done too much in the past to absent itself from the reconstruction effort at the very moment when the international scene is taking on a form sought by, and made possible through, the sacrifices of two generations of Americans.

5. The American people inevitably will expect, as they should, that their political leaders view foreign assistance through the discriminating prism of self-interest. Thus, while the U.S. economy will surely benefit from the overall growth in world production and trade that will result from the recovery of the regions most affected by the end of the Cold War, this benefit will not immediately compare in magnitude to that which resulted from the recovery of Western Europe after the end of World War II. Even so, the rate of return on our renewed investment in international security will remain high, especially as the other industrialized economies, then the recipients of American aid, will now each contribute as much as or more than the United States, so that the U.S. commitment overall will be much smaller in constant dollars, and even less as a percentage of U.S. gross national product, than it was for the Marshall Plan.

6. More important, by assisting the economic and political recovery of these regions we also contribute to international stability and security, making further defense savings possible, and producing still higher peace dividends in later years. Conversely, our failure to engage in the reconstruction effort risks both a loss of U.S. influence and further economic decline for the countries involved. If political instability, regional chaos, and ultimately international conflicts increase, the prospects for future peace dividends will erode as the desirability of further cuts in defense spending diminishes.

7. The bulk of U.S. economic participation in Central and Eastern Europe and in the Caribbean and Latin America will and should come from the private sector—in the form of capital, technology, and management. But U.S. government assistance—in easing the flow of each of these, and in providing direct development assistance to infrastructural and other projects not attractive to private capital—is also a compelling need. In addition, assistance should be provided in support of democratic processes and sound economic policies.

8. It is not our intention to determine what levels of funding are adequate to meet the pressing needs that have been identified. Nor do we recommend specific projects. The world does not lack for useful purposes to which a small fraction of our nation's wealth and talent might be put. Indeed, humanity's needs are far greater than our capacity to provide, especially at a time when our own society's needs are also considerable and significant.

In making the difficult choices that loom ahead, we will have to be guided by prudent judgments of timing, likely impact, and true self-interest—not to mention a healthy regard for our own limits. But it is an error unfounded in experience and unreflective of our traditions and character to assert that the problems of the world are beyond our capacity to ameliorate and, on occasion, even resolve. We know that foreign aid is not a popular cause. But neither was the Marshall Plan, even after a Democratic President had persuaded a Republican Congress to support it. Yet, few criticize that effort today.

The United States enjoys great prestige in Eastern Europe and in other parts of the world where its leadership helped bring freedom and democracy. Calls that this leadership be maintained now take the form of pleas for a renewed commitment to shoring up the foundations of international peace. These calls must be heard.

COVERT AID

Wars of Proxy Losing Favor As Cold War Tensions End

Continued assistance to rebel factions in Afghanistan, Angola and Cambodia in jeopardy

As the Bush administration confronts the first major international crisis of the post-Cold War era, Congress is still grappling with an issue that at one time seemed to embody the global competition between the superpowers.

When members of the House Intelligence Committee return from recess in September, they must decide whether to continue funding the large-scale covert assistance operations — in essence, wars by proxy — that the United States supports in Afghanistan, Angola and Cambodia.

With the easing of tensions between the United States and the Soviet Union during the past year, many in Congress have grown increasingly skeptical about the programs. In June, the Senate Intelligence Committee voted to eliminate funding for the Cambodian program and substantially reduce aid to the *Mujahedeen* in Afghanistan. Members also question the continuation of aid to the rebels in Angola.

The committee's actions were a sign that "the strong bipartisan support that once existed for the programs is now crumbling," said one source.

"There is no doubt that the level of dissatisfaction [over the programs] is rising," said Rep. Lee H. Hamilton, D-Ind., a former chairman of the Intelligence panel.

The administration has attempted to accommodate congressional concerns by stepping up negotiations to resolve the conflicts. As Secretary of State James A. Baker III noted, the recent decision to revise U.S. policy toward Cambodia was motivated in part by the vote in the Senate Intelligence Committee to terminate funding for the covert program.

Members of the House Intelligence Committee have acknowledged that the administration's attempts to highlight diplomacy could have an impact on the panel's deliberations. Said Stephen J. Solarz, D-N.Y.: "The debate will be over which action, a continuation of assistance or a cutback, will do most to contribute to a political settlement."

Matthew F. McHugh, D-N.Y., who sits on the House panel, added that because the administration previously has taken a pragmatic stance on a number of foreign policy questions, "it could tend to lead some House members to give Baker the benefit of the doubt in these areas."

The House panel was supposed to take up the covert assistance question in July as part of the fiscal 1991 intelligence authorization (HR 5422), but voted to defer consideration of the programs for two months. One factor was that members wanted to give the diplomatic process more time to work.

The committee decision gave the administration breathing space, but it also raised expectations for tangible progress on the diplomatic front. Said one congressional critic of assistance to the Angolan rebels, "Unless there is a real prospect for a peace settlement that could be achieved quickly, there is a real question over whether we should continue the aid."

Carryovers From the '80s

While the countries where the United States still covertly aids guerrilla forces could not be more different, the programs themselves have one thing in common — former President Ronald Reagan. The Reagan administration employed the CIA to assist those seeking to overthrow, or at least harassing, regimes backed by the Soviet Union or its surrogates.

The best publicized of these operations, of course, was in Nicaragua, where the administration fought Congress for years over aid for the contras. The Bush administration eventually hammered out an agreement with Congress to wind down the program.

While the administration has shown far more interest than its predecessor in pursuing negotiated settlements to regional conflicts, it has continued to request funding for the large-scale covert operations.

But with the Soviet Union less able and willing to fund client states throughout the world, it would seem to be only a matter of time before all such proxy wars become a thing of the past. "It is no longer the mission of the United States and the Soviet Union to confront

By Carroll J. Doherty

TOP SECRET

BOXSCORE

Bills: HR 5422, S 2834 — Fiscal 1991 Intelligence Authorization.

Latest action: The Senate passed S 2834 by voice vote Aug. 3. The House panel marked up parts of HR 5422 on July 19 but delayed some key decisions.

Next likely action: The House Committee will complete action on the bill in September.

Background: Congress has become skeptical of the need for covert aid programs in Afghanistan, Angola and Cambodia. The administration wants to continue the aid while diplomatic efforts proceed.

Reference: Senate action, Weekly Report, pp. 2431, 2232; House action, p 2332.

each other in every part of the globe," said former CIA chief William Colby.

However, intelligence analysts hasten to make the distinction between major proxy wars and small-scale covert actions. "There always will be a need for the CIA to have an operational role," Colby said.

That point was dramatically reinforced early this month when Iraq invaded Kuwait. Even before the huge U.S. military buildup in the Persian Gulf, reports in the media indicated that the CIA was developing a covert plan to destabilize the government of President Saddam Hussein.

Aside from the obvious difficulties associated with such a mission — Saddam reportedly has murdered or imprisoned most Iraqi dissidents — what is significant about the plan is that it has drawn no negative comment from Capitol Hill. Having pledged support for the administration's effort to contain Iraq, most lawmakers appear unconcerned about seeing the United States secretly work toward removing the country's leader.

"It is no longer the mission of the United States and the Soviet Union to confront each other in every part of the globe."

—William Colby, former CIA director

"There are still members who only reluctantly support covert action, but in Iraq there are vital interests at stake," said a member of the House Intelligence Committee.

Afghanistan: Close to a Deal

On Afghanistan, at least, the United States and the Soviet Union appear to be close to an agreement that would enable both superpowers to exit gracefully. Secretary of State Baker and Soviet Foreign Minister Eduard A. Shevardnadze discussed a proposal for Afghan elections, which also could lead to a phasing out of outside assistance, when the two men met in Irkutsk in Siberia on Aug. 1.

Both sides have indicated that a breakthrough on Afghanistan could occur at a summit meeting between President Bush and Soviet President Mikhail S. Gorbachev, scheduled to take place in Moscow later this year.

The Soviet Union withdrew the last of its 100,000-plus troops from Afghanistan last year, but it still provides the Kabul government with an estimated $300 million a month in assistance.

U.S. covert aid for the *Mujahedeen* totaled approximately $280 million last year, according to congressional sources. While marking up the fiscal 1991 intelligence authorization (S 2834), the Senate Intelligence Committee reduced that by $100 million, the sources said.

Given the momentum toward a settlement, the administration will be able to make a strong case for continuing the assistance, at least through the end of the year. As McHugh indicated, Congress will probably be hesitant to tie the hands of the administration in what could be productive negotiations.

But despite that, and even though the Afghan program has traditionally been quite popular on Capitol Hill, aid for the rebels has drawn widespread criticism during the past few months. Members of the Senate Intelligence Committee, including David L. Boren, D-Okla., the panel's chairman, and Sam Nunn, D-Ga., have called for a full-scale review of U.S. policy toward Afghanistan.

Hamilton and others have expressed concerns over the Islamic fundamentalist character of the rebels being backed by the United States. "We've been supplying enormous amounts of money to these groups, some of whom have little in common with the United States," said Hamilton.

Even Rep. Charles Wilson, D-Texas, perhaps the most passionate congressional advocate for the rebels, questioned the capability of the resistance to absorb more U.S. weapons, although he added that "the reality is that the Soviets provide 10 times what we send."

Angola: A 'Zero-Zero' Proposal

While the U.S. program in Afghanistan is the oldest and costliest of the three, it has never raised ideological hackles like the operation in support of the Jonas Savimbi-led National Union for the Total Independence of Angola (UNITA) forces. Even in the post-Cold War era, it still manages to evoke some familiar sentiments.

Rep. Ronald V. Dellums, D-Calif., has called military aid for UNITA "morally indefensible," while an analyst for the conservative Heritage Foundation said continued Soviet support for the government of President José Eduardo dos Santos is an indication "that Moscow has not yet abandoned the use of military force in pursuit of its global objectives."

The Bush administration currently provides approximately $50 million in military aid to the rebels. The administration recently reprogrammed an additional $10 million in assistance to UNITA from the CIA's contingency fund, according to congressional sources.

Although the Senate Intelligence Committee voted to continue the program in fiscal 1991, it attached unspecified conditions to the aid, the sources said.

"There is no doubt that the level of dissatisfaction [over the programs] is rising."

—Rep. Lee H. Hamilton, D-Ind.

Again, the administration is hoping to demonstrate that the covert aid program is helping to achieve diplomatic progress. The State Department indicated that it was somewhat encouraged by a recent agreement between UNITA and the Angolan government, under which both sides would allow U.N.-sponsored emergency food shipments to be delivered to the estimated 250,000 civilians at immediate risk from famine.

The Angolan government was initially suspicious of the so-called "corridors of peace" plan, but later agreed to grant safe passage for the food shipments. U.N. representatives have been working with both sides to establish the corridors.

A State Department official said the plan, if fully implemented, could "serve to build trust of both sides in each other" and possibly lead to an overall cease-fire.

But congressional opponents question whether the administration would be willing to wind down the covert program even if a cease-fire could be negotiated, given Bush's previous statements of support for Savimbi. In January 1989, Bush sent the UNITA leader a letter saying he would continue "all appropriate and effective assistance" until "national reconciliation" was achieved in the country.

"National reconciliation" is usually taken to mean a process leading to multiparty elections, which would include participation by members of UNITA. Thus far, the two sides have been unable to agree on a formula that would lead to elections, or a cease-fire.

While the administration wants to see democratization in Angola, many members of Congress apparently would be satisfied with the elimination of all outside military assistance — from the Soviet Union and the United States — to the country. Such a "zero-zero" proposal reportedly was discussed by Baker and Shevardnadze at their meeting in Irkutsk.

A termination of outside military aid would build on the 1988 tripartite peace settlement in southern Africa, under which Cuba agreed to withdraw its 40,000-troop contingent from Angola. The State Department has said the withdrawal, due to be completed in 1991, has been proceeding on schedule.

With a phaseout of Soviet aid, and minus the presence of the Cubans, "it becomes more of a civil war, rather than Soviet expansionism," said McHugh, a longtime critic of the Angola program. Given the fact that the administration seems to be willing to accept such an arrangement in Afghanistan, other Democrats are beginning to wonder why a similar deal, while obviously not perfect, would not work in Angola.

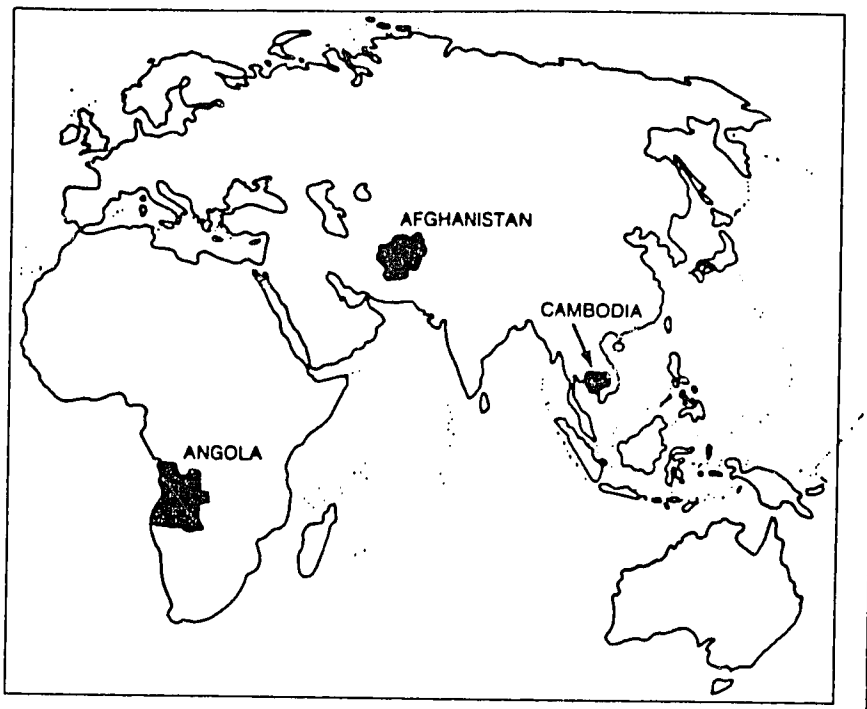
But the administration is concerned about the wide discrepancy in the military stockpiles held by each side. The State Department estimates that the Soviet Union will send the dos Santos government $800 million in military aid this year — more than 10 times what the U.S. will provide for Savimbi forces. "Even if a cutoff could be negotiated, the government would hold a major edge," said one official.

In addition, although the geopolitical situation has changed a great deal since he first burst upon the scene, Savimbi remains an extremely popular figure with American conservatives. His trips to the United States, arranged by the well-connected Alexandria, Va.-based lobbying firm of Black, Manafort, Stone & Kelly, normally include a visit to the White House.

For a president concerned about his right flank, it could prove politically risky to endorse any peace settlement for Angola that is perceived as containing less than favorable terms for Savimbi. The UNITA leader is planning a visit to the United States sometime this fall, said lobbyist Paul Manafort.

Meanwhile, the Angolan government also has upgraded its lobbying efforts, in preparation for the House Intelligence Committee's consideration of the UNITA aid package. The government, which has no ambassador to the United States, has hired the law firm of Washington, Perito & Dubuc as its Washington representative.

Covert Wars



Afghanistan: President Jimmy Carter came to the aid of the *Mujahedeen* shortly after the 1979 Soviet invasion. President Ronald Reagan significantly increased the aid and provided sophisticated anti-aircraft weapons. Under President Bush last year, the U.S. covert aid program came to about $280 million. But with the United States and the Soviet Union close to a deal on Afghanistan, the program might be wound down.

Angola: U.S. involvement in Angola began with the 1975 civil war and continued after the U.S.-backed UNITA lost that war. Reagan stepped up support for UNITA in 1986, and the Bush administration is now providing about $60 million annually in covert aid. The administration seems insistent on democratization, but Congress may not be willing to wait, preferring instead a deal that would end outside aid to both UNITA and the Soviet-backed Angolan government.

Cambodia: The United States has been trying to force Vietnam out of Cambodia since 1982. U.S. covert aid, now estimated to be as much as $24 million annually, goes to resistance groups led by former Cambodian leader Prince Norodom Sihanouk and former Prime Minister Sonn Sann. But they are loosely allied with the Khmer Rouge, which is blamed for killing 1 million Cambodians from 1975 to 1979. For that reason many in Congress oppose the aid. The Bush administration recently withdrew support for the coalition, but that may not be enough to save the program.

U.S. Love Affair With Covert Aid . . .

Covert action has been used in one form or another since the beginning of warfare, but for the United States, it took on unprecedented importance with the arrival of the Cold War. Successive administrations have embraced covert action as a useful tool in fighting Soviet expansionism and other threats to U.S. national security.

Between 1951 and 1975, according to a 1976 Senate Select Intelligence Committee investigation, the CIA was involved in about 900 major projects in foreign countries, including dozens in Vietnam. Although most of the operations were designed to affect foreign politics at the margin, several were intended to overturn governments.

Reagan

The number of covert operations increased dramatically when Ronald Reagan took office in 1981 and nominated William J. Casey as the director of central intelligence. Casey had served in the Office of Strategic Services (OSS), the forerunner of the CIA, during World War II.

According to Gregory F. Treverton, a former staff member on the Senate Select Intelligence Committee and author of a study of covert action in the postwar era, the number of actions roughly tripled in number during the Reagan years.

Three of Reagan's major covert operations were in Angola, Afghanistan and Cambodia. Although two had their beginnings before Reagan, they all increased significantly in size during his administration.

Angola

The CIA first became involved in Angola in 1975 when it provided money and arms to the pro-Western National Union for the Total Independence of Angola (UNITA) faction in the Angolan civil war. UNITA, headed by Jonas Savimbi, lost that battle to the leftist Popular Movement for the Liberation of Angola, which received aid from Cuba and the Soviet Union, but UNITA continued to use its base in southern Angola to fight the new Marxist government.

But because UNITA had relied for years on military and financial support from South Africa, members of Congress were reluctant to support it, and in 1976 approved an amendment to the defense appropriations bill (PL 94-212) by Sen. Dick Clark (D-Iowa, 1973-79) effectively barring CIA intervention in Angola.

In June 1980, in light of State Department estimates that about 20,000 Cuban troops remained in Angola at the time, Congress weakened the Clark amendment allowing military support of UNITA if the president openly requested it and Congress approved.

In July 1985, after receiving assurances that the Reagan administration had no immediate plans to aid UNITA, Congress repealed the Clark amendment.

Early in 1986, Savimbi visited Washington to appeal for U.S. assistance. Reagan enthusiastically backed Savimbi and in February ordered the CIA to provide up to $15 million worth of arms and ammunition to UNITA.

In spite of regional peace efforts, the United States continues to arm UNITA, providing by some estimates up to $60 million this fiscal year.

Afghanistan

Less than a month after the Soviet Union invaded Afghanistan in December 1979, President Jimmy Carter declared that the United States had a "moral obligation" to arm the Afghan resistance. Carter reportedly allocated

The lobbying group TransAfrica, which has taken a high-profile role on South Africa, has also been actively attempting to persuade Congress to defeat aid for UNITA. Since Congress is not considering any changes to the U.S. economic sanctions against South Africa, TransAfrica and its executive director, Randall Robinson, have concentrated heavily on the issue.

Cambodia: 'A Conundrum'

Of the three regional conflicts, all sides agree that the civil war in Cambodia will be the most difficult to resolve. "It's a conundrum," said Dave McCurdy, D-Okla., a member of the House Intelligence Committee.

Currently, the United States reportedly sends the non-communist resistance $10 million a year in covert assistance, although diplomatic sources in the region have cited a much higher figure — as much as $24 million annually.

The United States supports the groups led by former Cambodian leader Prince Norodom Sihanouk and Sonn Sann, a former prime minister. But the two forces are part of a loose coalition with the infamous Khmer Rouge — and therein lies the basis for congressional opposition to the program. The Khmer Rouge has been accused of killing more than 1 million people when it ruled the country from 1975 to 1979.

In response to congressional pressure, Secretary of State Baker on July 18 announced policy changes. Baker said the United States would withdraw diplomatic support for the coalition, initiate talks with Vietnam and ease restrictions on humanitarian aid.

Most members of Congress welcomed the revisions, but said that they would be insufficient to prevent the return to power of the Khmer Rouge. A congressional letter recommending further changes, circulated by Senate Majority Leader George J. Mitchell, D-Maine, attracted 66 signatures.

On the more narrow question of the covert program, the House Intelligence Committee might approve the assistance, forcing the issue to be resolved by a conference committee.

But in this case, the decision by the committee to defer consideration of the aid worked against the administration: Members who were undecided have been clearly influenced by reports indicating that the Khmer Rouge has made substantial gains on the battlefield.

Rep. Bill Richardson, D-N.M., who voted present when a package of overt assistance was considered by the full House in June, said he now is opposed to "all assistance" for the rebels.

. . . Has a Long but Controversial Past

$30 million for covert military assistance in a plan that included sending old Soviet weapons from Egypt.

By the winter of 1982, over 100,000 Soviet troops occupied Afghanistan, leaving the resistance comparatively underarmed, and in December, the Senate Foreign Relations Committee called on the administration to provide "effective material assistance."

That same month, Reagan directed the CIA to provide more sophisticated weapons, including mortars and grenade launchers. By September 1986 rebel forces were receiving Stinger anti-aircraft missiles, and total covert military aid to the Afghan resistance had climbed to roughly $300 million.

Although Soviet troops austensibly left Afghanistan in February 1989, leaving behind a cadre of advisers, the United States reportedly continues to aid rebel groups fighting the Soviet-backed government.

PATRICK TYLER

UNITA rebels in Angola continue to receive U.S. aid.

Cambodia

Vietnamese forces invaded Cambodia in 1979, and in 1982 the United States began trying to force them out, providing covert aid to two small non-communist guerrilla groups allied in a loose coalition with the Khmer Rouge against the Vietnamese-backed government.

Currently, the United States reportedly sends the non-communist resistance $10 million in covert assistance, although the Senate Intelligence Committee voted in June to terminate funding for the program.

Officials in the region have cited a much higher figure for the covert aid, estimating it to be as much as $24 million annually. Jeremy J. Stone, the president of the Federation of American of Scientists, recently conducted an investigation of the program and concluded that the United States sends $24 million a year to the resistance, in both covert and overt operations.

In June, the House approved $7 million in non-lethal aid to the guerrillas as part of the foreign aid appropriations bill (HR 5114). Like previous foreign aid legislation, the bill prohibits any assistance for the Khmer Rouge.

Although the money is only a tiny part of the foreign aid budget, the issue has been fraught with controversy because of the involvement of the Khmer Rouge. Human rights groups charge that the rebels, rulers of Cambodia from 1975 to 1979, killed more than 1 million Cambodians.

The overt-covert assistance program also represents the first active U.S. role in the region since the Vietnam War.

For years conc[illegible] about Vietnamese expansionism outweighed that [illegible]e Khmer Rouge returning to power. But recent reports that the Khmer Rouge is gaining in strength vis-à-vis the non-communist resistance, as well as reports that the Khmer Rouge has indirectly received American aid, have sparked congressional concern and led to an administration re-evaluation of its policy.

—Sheldon Yett

The administration, aware of the mood on Capitol Hill, has indicated that it might make further policy revisions — including possibly initiating direct talks with the Cambodian government. But the administration has said it is committed, in the short run at least, to continuing aid for the non-communist resistance.

In July, a senior administration official said that without the program, "there might be the very real likelihood that they [the resistance] would turn elsewhere for support, and that turn might be to the KR [Khmer Rouge]."

Covert-Overt Programs

Under the current, apparently contradictory, rules that govern discussions of such covert programs, the president is able to openly pledge continuing U.S. aid to UNITA in Angola — even though that assistance is technically covert.

By the same token, Secretary of State Baker can, as he did at a Paris news conference, discuss the vote by the Senate Intelligence Committee against the Cambodia program, even though that vote was supposed to have been secret.

According to Solarz, both of the above instances involve "overt-covert programs." Said Solarz, "If they are widely known enough to be written about in the newspapers, they are not really covert, are they?"

But members of both Intelligence panels are normally circumspect in discussing the programs, for fear that they will be accused of disclosing information that is technically classified.

Many members, including the current chairmen of both Intelligence panels, have advocated completely lifting the veil on such programs. "It is my view that they are foreign policy matters and should be considered as such," said Boren.

When he chaired the intelligence panel in 1986, Hamilton narrowly lost in an attempt to stipulate that aid for UNITA be publicly debated by Congress. Solarz said it is likely that, because of pressure from members, the question will arise again this year. *(1986 Almanac, p. 387)*

The chairmen are not suggesting an open-debate policy for anything but large-scale programs, like those in Afghanistan, Angola and Cambodia. As one Senate aide put it, "Most people think that the Intelligence committees consider little else but those programs. The fact is that the committees deal with many classified issues, and most of them stay that way." ■

TREASURY NEWS
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STATEMENT OF THE HONORABLE
DAVID C. MULFORD
UNDER SECRETARY OF THE TREASURY FOR INTERNATIONAL AFFAIRS
BEFORE THE SUBCOMMITTEE ON
FOREIGN OPERATIONS, EXPORT FINANCING AND RELATED PROGRAMS
COMMITTEE ON APPROPRIATIONS
U.S. HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I am pleased to have this chance to discuss with your Committee the President's recommendation to Congress that the United States Government forgive Egypt's Foreign Military Sales (FMS) debt. The President's decision to forgive Egypt's FMS debt was stimulated by Egypt's vital leadership in resisting Iraqi aggression in the Gulf. The President's decision is unique and does not extend to other FMS debtors. It was based fundamentally on geopolitical and military grounds.

The President made his recommendation in recognition of Egypt's unique, unparalleled strategic contributions to the pursuit of peace and security in the Middle East and the inability of measures short of forgiveness to safeguard our strategic relationship with this important Arab partner. Thus, forgiveness of Egypt's FMS debt is an integral part of the United States' on-going efforts to restore the rule of international law in the Gulf.

The President's recommendation for forgiveness covers approximately $6.7 billion in Egyptian FMS debt. This includes about $4.4 billion in principal outstanding on loans made by the Federal Financing Bank (FFB) with the full faith and credit guarantee of the Secretary of Defense through the Defense Security Assistance Agency (DSAA). The remaining $2.3 billion is owed to DSAA and represents arrears plus amounts that DSAA has already paid to the FFB under the terms of its guarantee when Egypt failed to make payments that were due to the FFB.

The legislative mechanism that the Administration is considering to accomplish the forgiveness involves three steps First, DSAA's Guarantee Reserve Fund would purchase the $4.4 billion still owed to the FFB, using funds borrowed from the

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Treasury Department under existing authority. This would consolidate all of Egypt's $6.7 billion FMS debt in DSAA's hands. Second, the legislation would authorize DSAA to forgive the entire consolidated stock of Egypt's FMS debt. Third, the legislation would permit the Secretary of the Treasury to forgive all of the Department of Defense's borrowings from the Treasury Department undertaken in connection with Egypt's FMS debt. Thus, the Department of Defense would have no further obligations relating to Egypt's FMS debt.

We favor this approach because it enables the Department of Defense to honor its guarantee to make the FFB "whole." This is important because the FFB is simply a financing mechanism, with no responsibility for administering programs. If the FFB were required to forego its guarantee rights and forgive Egypt's debt directly, a precedent would be set that could ultimately lead to forgiveness of a substantial portion of the Bank's remaining portfolio. As the FFB's portfolio totals some $162 billion, this could be an extremely costly precedent.

I understand, Mr. Chairman, that you and your Committee have a strong interest in other areas of official debt. First, I want to state that our general policy is not to forgive debt, except in very special circumstances. Secondly, I want to emphasize that our treatment of Egypt's FMS debt is distinct from the actions that the United States Government has taken or is prepared to take on the non-military official debt of other countries. Finally, we have found that there is no single, comprehensive program for dealing with other official debt that effectively meets the needs of all heavily-indebted countries. The only overriding theme has been our emphasis on encouraging significant and lasting economic reforms.

Our treatment of official debt has been highly differentiated and tailored to the specific circumstances of particular countries involved:

- The United States and other participants at the 1988 Toronto Summit agreed to extend exceptional <u>multilateral</u> debt relief to low-income debt distressed countries in sub-Saharan Africa that were undertaking economic adjustment programs. This has since been extended to Bolivia.

- We have also recognized the need to provide exceptional <u>bilateral</u> relief to sub-Saharan debtor countries which are undertaking significant macroeconomic and structural reforms. Section 572 of the FY 1989 Foreign Operations Appropriations Act allows the [illegible] States to extend bilateral relief by forgiving [illegible] Assistance and ESF loans for those sub- [illegible]ies that have in effect economic reform pro[illegible] the IMF and World Bank.

- o President Bush's "Enterprise for the Americas Initiative (EAI) is a cooperative effort to boost growth, trade and investment in the Western Hemisphere and includes some elements of bilateral debt reduction conditioned on economic and investment reforms.

These initiatives raise complex and far-reaching issues that bely a comprehensive solution. The debt situation and the type of debt vary significantly from country to country. I would be happy to discuss these issues in more detail. We look forward to working with you and your Committee.

American Enterprise Institute for Public Policy Research

In Search of Our National Interest

by Irving Kristol

In the years after World War II, the *New York Times* made a bold editorial decision. It decided that its opening pages, usually running to at least half the first news section, would be devoted to international news, rather than to national news, as had been the custom. It was a bold decision because it ran against the well-nigh editorial assumption that Americans were more interested in reading about their own country (or even their own locality) than about foreign affairs. The *Times's* editors thought that, with the United States now a world power, and one engaged moreover in defending the Free World against messianic communist movements, international affairs were more important than domestic developments. If Americans didn't realize that, they should be led to realize it, and the *Times* would play its part.

I have always admired the courage and idealism behind that decision—except of late. As a regular reader of the *Times* I now find myself skimming those pages, and even being irritated by what I now feel to be their obtrusiveness. With every passing month, the editorial emphasis seems more and more off-key. I dutifully read the headlines and opening paragraph or two, and then move on, remembering little and, I now realize, caring less. Somehow the world has changed with the collapse of Soviet (and Chinese) imperialism; many of the world's problem areas seem awfully distant from the United States—and no longer particularly interesting from the point of view of American foreign policy.

Liberian Rebellion

Take the following news stories, which, in any recent week, one could find reported on at some length in the *Times*:

• In Liberia, a dissident military faction is leading a rebellion—apparently successful—against the dictatorial and corrupt government of a tyrant called Doe. The rebels are led by a former associate of this Doe, named Taylor. No one has any idea what these rebels stand for, and it is possible that they don't stand for anything except for replacing a Mr. Doe with a Mr. Taylor.

I read the accounts of this situation with a sense of numbness. What am I supposed to feel and think? If the Soviets (or the Chinese or even the Cubans) were involved, I would know what to think, since we would then be confronting a challenge. But this is a purely internal Liberian matter, and while I am saddened by the sufferings of the Liberian people caught up in this conflict, I see no reason why Liberia today should even be within the purview

of American foreign policy—or why the *Times* should be devoting so much space to it.

• In Ethiopia, a brutal Marxist regime is being seriously threatened by a rebellion whose leaders seem to be equally barbaric Marxists. Again, the Ethiopian people are suffering horribly at the hands of both combatants. But the sad truth is that one's fund of compassion for suffering peoples all over the world is limited. In any case, absent Soviet involvement, Ethiopia has pretty much slipped off the spectrum of American foreign policy, so far as I can see. We have no national interest there, and my own interest in reading about events there is minimal.

• In Cambodia, a war is being fought by a Vietnamese puppet regime, the forces of the abominable Pol Pot (who is supported by the Chinese), and other groups whose sole virtue seems to be that they are not allied with the one or the other. We are very much involved at the diplomatic level, opposing the Vietnamese and Pol Pot, and we also send some military aid to the "third forces," though to no apparent effect.

Why are we so concerned, and so involved? Cambodia, to its misfortune, is of great interest to neighboring Communist Vietnam and Communist China, who at the moment are using it as a battleground. It is also of keen interest to neighboring Thailand, a nation friendly to us, understandably apprehensive about its neighbors, and therefore deserving of the military aid we sent it.

But the future of Cambodia is obviously of no serious interest to the United States. We have no power to shape the future of that land, and we seek no such power. Only the *Times* and State Department bureaucracy, on inertial guidance and still taking their bearings from a global cold war, remain interested.

• In Myanmar (a.k.a. Burma), the military rulers have allowed elections that, on paper at least, resulted in a victory for the opposition. Not only the *Times* but the American media as a whole have given this event much coverage—though, having read it all, I still don't know what the "democratic" opposition stands for, or whether one can take it seriously as a political force. Nevertheless, there is no doubt that Burma (as I still insist on calling it) has been terribly misgoverned in recent decades, and that a change is welcome. It is especially welcome if the change results from free elections.

But having said that, what else is there to say? We have never had any involvement with Burma, nor do we have any reason to be involved with it today. Yes, it would be nice if Burma evolved into a liberal democracy, Western-style. But that is a Burmese option, not an American responsibility, since we have no influence in that land. And if Burma evolves in some less attractive direction? Well, we have lived with such a Burma for some four decades now, and the American people seem not to have experienced any trauma as a consequence.

There are many other examples that can be given, but they all add up to one conclusion: With the end of the Cold War, an era of American foreign policy has come to a close. We won that war. "Global containment" of communism did work—far better, indeed, than we anticipated. Communist governments still exist, to be sure, but the era of communist expansionism has come to an end. So where, we have to ask, does that leave us? What is our foreign policy now about?

This question, alas, is not one that the State Department seems able to focus on. The State Department, very much at home in NATO, keeps desperately seeking new reasons for its continued existence. It even solemnly negotiates with the Soviets over whether a unified Germany will be a member of NATO, and whether (and how many) American and Soviet troops might be stationed there. But if one thing is certain it is that it is

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the Germans who will decide this issue, and one can reasonably expect that, eighteen months from now, the Germans will have asked both American and Soviet troops to leave—which they will do. Whatever else the Germans decide with regard to NATO will be up to them, and to them alone.

The only innovative trend in our foreign-policy thinking at the moment derives from a relatively small group, consisting of both liberals and conservatives, who believe there is an "American mission" actively to promote democracy all over the world. This is a superficially attractive idea, but it takes only a few moments of thought to realize how empty of substance (and how full of presumption!) it is.

The Old-Fashioned Way

In the entire history of the United States, we have successfully "exported" our democratic institutions to only two nations—Japan and Germany, after war and an occupation. We have failed to establish a viable democracy in the Philippines, or in Panama, or anywhere in Central America. Why should anyone think we can do so in Eastern Europe or Southeast Asia? If these countries are going to be functioning democracies, they will have to achieve that goal the old-fashioned way—by working at it. Free elections are only the beginning.

That leaves us with a policy vacuum. We are still a world power and have every intention of remaining so. This means that a traditional kind of isolationism is out of the question. But we are now a world power that is no longer compelled by an adversary to be interested in every part of the globe. We are now free to pick and choose and assemble a coherent agenda. In short, we are now free to define our national interest, instead of having it defined for us.

It has been so long since we have had this intellectual-political task that we have quite forgotten how to go about it. Reviving the idea of "national interest," and giving it national substance, ought to be at the top of our national agenda. It is far better that we do this job rather than permit bloody circumstance and ad hoc responses to do the job for us.

[from the *Wall Street Journal*, June 7, 1990]

Irving Kristol is the John M. Olin Distinguished Fellow at the American Enterprise Institute.

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SECTION NOTES

Senate and House Vote For Iraq Sanctions

Using the farm bill as a vehicle, both houses of Congress signaled their disapproval for the recent threatening actions by the Iraqi government, voting July 27 to impose tough new economic sanctions against Iraq.

The Senate voted 83-12 in favor of an amendment to the farm bill (S 2830), offered by Alfonse M. D'Amato, R-N.Y., that would cut off new financial credits for Iraq until the president certifies that it is in compliance with international agreements on human rights and weapons non-proliferation.

At the same time, the House passed an amendment to its farm bill (HR 3950), offered by Rep. Dan Glickman, D-Kan., that is also aimed at punishing Iraq. The legislation also would suspend export guarantees but would reallocate the credits to "emerging democracies." The amendment was adopted, 234-175.

Supporters of both amendments decried the poor human rights record of Iraqi President Saddam Hussein, and the threats made by Hussein against neighboring Kuwait. This week Iraq reportedly massed 30,000 troops on its border with Kuwait.

The State Department has opposed sanctions against Iraq but recently signaled that it is reviewing that policy. However, on July 27 a spokesman said the kinds of "measures now under consideration would not help us achieve U.S. goals with Iraq."

Opposition to both amendments came from farm state lawmakers, who said a lucrative market for U.S. agricultural products may be lost.

In 1989, the United States provided about $1 billion in credit guarantees for exports of agricultural commodities to Iraq. In the current fiscal year, $500 million in agricultural credits has been extended, but release of new credits has been suspended pending an investigation into alleged irregularities with the program.

Aid to Afghan Rebels Cut by Senate Panel

Congress and the administration appear to be in a race to reduce U.S. involvement in Afghanistan.

The administration is making progress toward an agreement with the Soviet Union that could lead to disengagement by both countries from the war in Afghanistan, according to a congressional source.

The Senate Intelligence Committee, meanwhile, has voted to cut covert aid to antigovernment rebels in Afghanistan. A source confirmed published reports that the committee trimmed $100 million from the estimated $280 million the United States annually provides for the Mujahedeen rebels.

World Bank May Create Fund To Offset Gulf Crisis Damage

By Hobart Rowen
Washington Post Staff Writer

Reflecting a growing sense of urgency over the Persian Gulf economic crisis, World Bank President Barber Conable said yesterday that a new pool of financial aid for Eastern European and other severely affected nations may have to be created by the bank for distribution next year.

Speaking at the conclusion of the joint World Bank and International Monetary Fund meeting, Conable said this new approach would be necessary "if the crisis continues for a protracted period of time—that is, if the price of oil stays up and there continues to be turmoil, uncertainty and impact on the global economy." He defined "protracted" as an extension of the crisis into 1991.

IMF Managing Director Michel Camdessus also indicated that his agency is exploring ways of assisting countries not usually eligible for IMF-subsidized loans. But the IMF does not plan a special fund. Both Conable and Camdessus indicated that financing would be sought from "windfall" countries benefiting from higher oil prices.

Additional assistance contemplated by the World Bank and IMF would be separate from the aid planned for the so-called "front-line" nations of Egypt, Jordan and Turkey, for which a coordinating committee under Treasury Secretary Nicholas F. Brady is attempting to collect up to $14 billion for this year and next.

The discussion of added ways of meeting the economic fallout from Iraq's invasion of Kuwait was symbolic of a growing concern among some at the annual meeting that the initial response to the crisis may have been too optimistic.

The sharply rising spot market price of oil this week induced second thoughts among officials.

Dramatic explanations by some Eastern European ministers of the new plight of their countries also appeared to have had an impact. For example, Czechoslovak Finance Minister Vaclav Klaus said: "My English does not offer me adjectives for describing the problem now."

Because the Soviet Union is charging the world market price for oil—when it can deliver it—Klaus pointed out that, in effect, "we are facing the three oil shocks of the last two decades all at the same moment. . . . It seems clear to me that some extra, additional financing will be necessary."

Similarly, Polish Deputy Prime Minister Leszek Balcerowitz told the meeting that just as the Polish economy was showing "the first faint signs of recovery," the loss of two-way trade with Iraq—a main source of its oil—had thrown things into reverse. He, too, appealed for extra help.

Conable said candidates for additional aid next year include Pakistan, Sudan, India, the Philippines, Bangladesh, Morocco and Sri Lanka, as well as the Eastern European nations. Many of these are "middle-income" developing countries not eligible for concessional aid through the World Bank's International Development Association (IDA).

In related developments:

- Camdessus and Conable said that after conferring with Soviet "special invitees" at the joint session, they were ready to begin immediate technical assistance to that country without waiting for it to complete a long process of membership application.

"It's going to be a tough job to reorganize the Soviet economy, and it will take some revision of their thinking," Conable said. "But that doesn't mean they're a basket case. The Soviet Union can be highly productive. It has lots of resources and a lot of educated people."

- Middle East members of the IMF dumped the highest-ranking—and only—Iraqi official at the agency as their alternate executive director. Abdul Moneim Otham of Iraq will be replaced by Azizali Mohammed, a Pakistani.

The ouster took place during the regular election of executive directors, results of which were announced yesterday. Mohamed Finaish of Libya continues as executive director for the Middle East group.

- Conable, whose five-year term expires next June, broadly hinted he would be receptive to reappointment, saying, "It's a very interesting job," and that he is "grateful for expressions of support." Recalling earlier criticisms of his stewardship, he said: "It's not like it was the first couple of years."

THE NEW YORK TIMES, August 13, 1990

As U.S. Warms to U.N., It Finds Unpaid Debts Embarrassing

By ELAINE SCIOLINO
Special to The New York Times

WASHINGTON, Sept. 12 — At a time when President Bush is using the United Nations as the anchor for international sanctions against Iraq, the United States finds itself in the somewhat embarrassing position of being in substantial debt to the organization.

The President, who on Tuesday night said, "We're now in sight of a United Nations that performs as envisioned by its founders" has asked Congress, however, to approve a major contribution to the United Nations, which would reduce by more than half the substantial American debt built up over the years.

But even though the White House request has passed the House, there still is doubt that it will be approved by the Congress as a whole.

According to United Nations figures, the United States currently owes about $750 million — about $320 million for the current regular budget and individual peace-keeping accounts and about $430 million in past debts.

The Bush Administration has asked Congress to approve a $700 million package that includes full payment of Washington's 1990 dues, plus installments to cover the old debt to be paid out over five years.

The United States does not recognize the validity of about $70 million of its United Nations debt. Over more than a decade, Washington has consistently withheld what are known as "legislative and policy withholdings" arising out of such disputes as the tax liabilities of American citizens working for the United Nations and support for activities related to the Palestine Liberation Organization.

As testimony to the rising status of the United Nations in Congress, the House has already passed a bill approving the first year of the White House plan. In an initial action by a Senate subcommittee today, the Senate went along with the House decision.

Senate Prospects Questioned

But passage of the bill is by no means a sure thing, according to some lawmakers. "Now there's a large question of whether it can survive on the floor of the Senate," said Senator Warren B. Rudman, Republican of New Hampshire. "That I can't answer."

If the Congress gives the President everything he asked for, the United States would turn over about $410 million to the United Nations this year, which will leave a debt of about $340 million, according to the United Nations.

That figure does not include debts to specialized United Nations agencies such as the World Health Organization or the Food and Agriculture Organization.

Some of Washington's closest allies find the American debt particularly annoying in light of the Administration's appeals for more sharing of the financial burden of the Persian Gulf crisis.

Mr. Bush and his aides have portrayed the White House as a responsible party committed to paying all its debts, and thrown the responsibility on Congress. Even the harshest critics of Washington's unwillingness to pay acknowledge that the President's plan represents the most generous proposal for the United Nations in years.

In remarks before the Senate Foreign Relations Committee last week, Secretary of State James A. Baker 3d said that as the world is faced with the first post-Cold War crisis, "We're the biggest deadbeats in paying paying our dues to the United Nations." He called the situation "outrageous" and urged Congress to approve the President's budget request, "regardless of what it takes."

Payment of the past debt is by no means automatic. The White House has stated that the payments depend on whether the Administation and the United Nations agree on how the money should be used.

"You can't just talk about paying dues," said Alan Gerson, counsel to Jeane J. Kirkpatrick and Vernon A. Walters, former American chief delegates to the United Nations, and author of a forthcoming book on Washington's relationship with the United Nations. "You have to understand the monies that have been withheld and why. One category strictly financial and fiscal under Gramm-Rudman, a second is linked to financial reform at the United Nations and a third is because we thought their expenses were illegitimate."

LOS ANGELES TIMES, August 12, 1990

U.S. Aid to a Troubled Philippines Refocuses Debate on Military Presence

□ Bases: With U.S. image high in the wake of recent natural disasters and an attempted coup, negotiations may take on a different tone.

By Michael Bociurkiw

MANILA

While U.S. and Philippine negotiators ready for another round of talks on America's military presence here, at no other time in recent memory have U.S. military personnel played such a visible role in restoring calm to the troubled nation.

In the past year, Americans based at the largest U.S. military installation outside the United States have helped put down a coup attempt that almost toppled the Aquino government, launched dramatic rescue missions in the aftermath of the July 16 earthquake and played a vital role in typhoon-relief efforts.

Although U.S. officials strenuously avoid playing up these events, the past year has brought strong reminders of how dependent the Philippines has become on about 40,000 U.S. military representatives stationed at permanent installations at Clark Air Base, Subic Naval Base and four smaller facilities.

Vivid television pictures of U.S. servicemen pulling survivors from under the rubble at Baguio are sure to be etched in the minds of people here when the two countries resume negotiations for a new bases agreement later this month or early September. The current agreement allowing the U.S. military installations in the Philippines expires in September, 1991.

To some, the U.S. bargaining position never looked better.

"The earthquake definitely improved the climate for the negotiations," said Philippine Rep. Jose de Venecia, a prominent member of the Joint Legislative-Executive Bases Committee. "This was a shining moment in America's role in the Philippines."

Media reports frequently speak of how the 400 U.S. servicemen from Clark were the first to arrive in the mountain resort city of Baguio with 55-bed mobile hospitals, supplies and equipment. In comparison, the Philippine military arrived late and appeared disorganized, Western diplomats said.

A surprising number of letters to the editor in local newspapers and columns have drawn a link between the U.S. participation in earthquake relief efforts and the bases debate. Coming on the eve of the most important phase of bases negotiations, in an eerie sort of way the disaster came at a time when Uncle Sam needed a way to prove his usefulness to ordinary Filipinos.

"The majority approved of our assistance in the coup attempt and they are glad we did what we did. The same holds true for the earthquake," said a U.S. official.

Whether or not the same feeling is echoed throughout typhoon-ravaged Manila—where spray-painted signs with such slogans as "No to U.S. Bases" compete for space with gaudy Filipino movie billboards—is uncertain. This is still a land where people see U.S. conspiracy theories behind most events, such as the recent withdrawal of the U.S. Peace Corps—seen as a ploy by Washington to exert pressure on Manila ahead of the negotiations.

Until now, the debate over retention of U.S. bases has been wrapped up in an emotional web of arguments ranging from the threat the bases pose to Philippine sovereignty to how much Americans should pay for using some of the most coveted pieces of real estate in the country.

But analysts predict that the highly visible U.S. involvement in putting down the December coup and the quick U.S. response to the earthquake could influence the undecided members of the Philippine negotiating team—lead by Foreign Secretary Raul Manglapus—to drop its hard-line posturing.

National pride will heavily influence thinking on the Philippine side of the negotiating table. In a recent interview, President Corazon Aquino, who has studiously avoided spelling out her position on the issue, said the presence of the bases has stalled her country's efforts to achieve full sovereignty. "It's a matter of our national sovereignty and territorial integrity," she said. "In any country where there are foreign bases on native soil it does create a problem."

Last week, Aquino raised hopes of U.S. officials, saying she wanted the talks finished within five months.

When the two sides sit down together to hammer out an agreement, the Philippine side is in no position to dictate terms. Filipinos may have already overplayed their hand in earlier negotiations by demanding exorbitant rent for base lands and placing unrealistic demands on negotiators. The Philippines wants at least $360 million for use of the two installations. (The Bush Administration has responded with a request to Congress of $220 million in 1990, but is not expected to come up with more than $160 million.)

What's more, before coming to the negotiating table earlier this year, Philippine officials failed to acknowledge the potential huge economic dislocation of removing the bases, which employ 78,000 Filipino workers. One aide to Aquino described the embarassing Philippine approach as "stick-em-up-guy diplomacy." In recent months, Aquino's government seems to be clinging to power and defending itself against charges of inaptitude. Rumors of coup attempts, frequent power outages, water shortages, charges of corruption and a frightening economic decline have combined to transform Malacañang Palace into a crisis-management center. Last week, troops in the Philippines were put on full alert following rumors of a fresh coup attempt.

Washington may not have to look hard for convincing arguments to bargain down the compensation fee for the bases. More than ever, Manila may not be willing to risk the loss of large amounts of critically needed American foreign aid.

"There is a feeling at the moment that the U.S. should not be given carte blanche for their own purposes in the Philippines," said De Venecia.

De Venecia is the author of a popular proposal that would transfer Philippine bases now situated on valuable land in Manila to either Clark or Subic, under a generous joint-uses agreement giving the United States until the year 2000 to withdraw.

The plan, approved by the Philippine Bases Council in February, also calls for Manila's congested Ninoy Aquino International Airport to be moved to Clark, about 60 miles north of Manila. Both moves could generate billions of dollars for the cash-strapped government and free up vast tracts of land for redevelopment.

"This is the best possible option for the Philippine government," De Venecia said. "It is designed to usher in a new era of friendly relations between the Philippines and the United States."

If the Philippines adopted such a strategy, it would shift the emphasis from the money factor to planning a withdrawal that would minimize disruption to the economy and prevent acute political embarrassment to the government. A phased-out withdrawal also means America would not be placed in the uncomfortable position of saying an abrupt goodby to a long-time ally.

Once the two sides reach an agreement, it could still be scuttled by lawmakers in the United States. A bizarre provision in the Philippine constitution stipulates that the bases agreement must be ratified not only by the Philippine Senate but by the U.S. Senate as well. U.S. officials say they much prefer an executive agreement, but the Philippine feeling is that the Senate's imprint would give it the full force of an international treaty.

But this should not cause undue worry to U.S. negotiators. Said one senior official close to Aquino, "The United States always gets what it wants around here. There is no doubt that there will continue to be some U.S. presence after 1991." □

Associated Press

U.S. Marines pull a survivor from wreckage of a school after earthquake.

Michael Bociurkiw is a Canadian journalist with the South China Sunday Morning Post.

DEMOCRACY IN EASTERN EUROPE: HOW MUCH WILL IT COST? WHAT WILL IT MEAN FOR THE THIRD WORLD?

by Mauricio Herman

With an overflow attendance of 230 members and guests, the SID-WC Annual Dinner was held at the International Club of Washington on June 20, 1990. The keynote speaker for the evening was Dr. Carol Adelman, assistant administrator for Europe, Asia and the Near East of the US Agency for International Development (AID). Three respondents, representing different geographic areas of the world, also presented comments. They were Leonard H. Robinson, Jr., president of the African Development Foundation; Felix Pena, special advisor to the president of the Inter-American Development Bank; and John H. Sullivan, vice president for international activities of Development Associates, Inc.

Dr. Adelman began her talk by recognizing that the world's spotlight is presently on Eastern Europe. She pointed out that AID has recently begun to support initiatives, such as funding the Democracy Institute of the Karl Marx University in Budapest, which just a few months ago would have been unthinkable. She identified four major categories of AID activity in Eastern Europe. The first, Transitional Economic Support, refers to such projects as the Polish-American Enterprise Fund and the Hungarian-American Fund. She emphasized that these countries are not seeking aid, but specific forms of technical assistance. The second category focuses on funding democratic activities which might lead toward more pluralistic societies. The third provides for technical training and scholarships via institutions like USIA and IESC. Finally, the fourth category addresses environmental issues, calling attention to the fact that Eastern Europe is the only part of the industrialized world where death rates are actually rising.

Eastern Europe provides an important lesson for LDCs by showing that state planning does not work.
— *Dr. Carol Adelman*

Dr. Adelman also mentioned that Eastern Europe provides an important lesson for LDCs by showing that state planning does not work. Economic and political liberalization, she stressed, go hand-in-hand and are mutually reinforcing.

Mr. Robinson initiated his comments by stating unequivocally, "Equity is my concern." He went on to point out a serious contradiction between the amount of aid currently provided to Africa and that being considered for Eastern Europe. "Africa is not getting a fair share", he warned. To demonstrate his point, he explained that the per capita aid to Egypt and Israel is $900 per annum, whereas for Black Africa, the per capita aid is less than one dollar. With a shrinking foreign aid pie, Robinson voiced fears of renewed attempts to divert the scarce funds presently allocated to Africa toward Eastern Europe.

Per capita aid to Egypt and Israel is $900 per annum, whereas for Black Africa, the per capita aid is less than one dollar.
— *Leonard H. Robinson*

Robinson also said that there was a "disconnect" between the US and Africa, and that the US focus on private investment was reflective of the lack of understanding between the US and Africa. Robinson pointed out that there are no incentives for the US to invest in Africa, and concluded with the following observation:

I don't know which side of the balance sheet your interests and concerns lie with respect to the Third World. I believe that Eastern Europe will be taken care of; I'm not so sure about Africa.

Dr. Pena, in turn, spoke of the ambivalence prevailing in Latin America. Most feel that the changes in Europe will bring about both trade and investment diversions, but some, particularly those in higher policy and academic positions, argue that Eastern Europe also presents Latin America with new opportunities. Not only will the OECD countries grow faster, but larger markets for food and other primary exports will open up. Pena pointed out that this presents a challenge to Latin America, a region which has both absolute and comparative advantages.

Dr. Pena referred to several parallels between Eastern Europe and Latin America, both old societies undergoing transformations into modern democracies. He specifically mentioned the need to nurture new-born democracies, contrasting the experience of the Weimar Republic in the 1920's to the more positive response of Western nations to recent events in Eastern Europe.

Finally, Dr. Sullivan captured the general feeling of the audience when he stated that these are "days of celebration and days of fear." He concurred with prior respondents that a financial and trade "crowding out" should be expected, but asserted that resiliency, not fear, is the operative word in Pacific

Asia's development model has proved successful, and should be emulated by Eastern Europe.
— *John H. Sullivan*

DEMOCRACY

Continued from page 2

Asia. He pointed out that since the South East Asian tigers (Singapore, Korea, Taiwan) no longer need extensive aid, Eastern Europe's effect on them will be relatively insignificant. Moreover, he asserted that Asia's development model has proved successful, and should be emulated by Eastern Europe.

Dr. Sullivan concluded by pointing out another irony beyond that of celebration and fear. He recalled his memories of the creation of Eastern European buffer zone by the Soviets and how many in the days and years following World War II never thought they would live to see the Soviets grip on Eastern Europe release. Sullivan claimed that many felt that if and when Eastern Europe became free "Uncle Sam would be there to shower big bucks on the captive states... But when it happened," Sullivan continued, "Uncle Sam was broke. And that may be the greatest irony of all."

A spirited discussion period followed under the direction of moderator, Dr. John Maxwell Hamilton of the World Bank. A member of the audience made the point that political rather than economic determinism seems to underlie aid and investment flows. The member continued that with developing countries still representing over half the population in the world, social Darwinism is a dangerous philosophy to follow. ❐

THE WASHINGTON POST, July 8, 1990

Richard N. Gardner

Aid the Soviets Can Really Use

The seven industrialized democracies have an opportunity at the Houston economic summit to help the reformers in the Soviet Union who want to make their country a free-market democracy. What is needed are two initiatives for coordinated Western aid—one economic, the other political.

The first element is an economic package that should not start with large-scale loans, which in the present disorganized state of the Soviet economy would bring no lasting benefits and could not be repaid. What the Soviet Union most urgently requires is a credible program to transform it into a market economy, coupled with the building of the necessary institutions to carry such a program out. These institutions must include laws that create and protect private property rights, a stock market, a private banking system, anti-monopoly legislation and an organized process of privatizing state enterprises.

A week of economic discussions in Moscow last month with senior Soviet officials and academics reinforced my conviction that the Soviet Union cannot devise and carry out such a program on its own. It lacks people with the necessary knowledge and experience in free-market economics, and it badly needs Western advice and technical assistance.

Nor can these needs be supplied by occasional brief visits of Soviet delegations to the International Monetary Fund and the World Bank in Washington, to the Organization for Economic Cooperation and Development in Paris or to the European Commission in Brussels. What the Houston economic summit should offer Mikhail Gorbachev is the establishment in Moscow as soon as possible of an international team of experts—selected by these organizations—who could work with Gorbachev's economic advisers and those of Boris Yeltsin at the Russian republic level.

The purpose should not be to impose a Western design upon the Soviet Union but rather to help it fashion a program that would provide the basis for a subsequent package of financial aid.

Since the IMF, the World bank, OECD and EC cannot finance such a joint mission for a country that is not a member, a modest technical assistance trust fund of, say, $5 million could be created in the United Nations Development Program on behalf of non-market economies in transition, for which these organizations could serve as executing agents. There is reason to believe that Gorbachev and Yeltsin would welcome such an initiative provided it were clear that it was intended as a consultative mission and not as an infringement on Soviet sovereignty.

But it is obvious that a program of economic liberalization in the Soviet Union cannot succeed without a parallel program of political liberalization. The latter process requires an alliance between Mikhail Gorbachev, Boris Yeltsin and those reformers on their left who want to transform the Soviet Union into a real free-market democracy. Such reformers include such men as Anatoly Sobchak, the mayor of Leningrad; Gavril Popov, mayor of Moscow; Sergei Stankevich, Moscow's deputy mayor; and Viktor Aksyuchits, leader of the new Christian Democratic Party.

Western governments cannot help such reformers directly without making the charge of interference in the U.S.S.R.'s internal affairs. But they could agree at Houston to encourage a coordinated program of aid on the part of their political parties, trade unions and civic groups. In the United States, a leading role could be taken by the National Institute for International Affairs of both the Democratic and Republican parties, which already have a successful track record of assisting democracy in such countries as Chile, Nicaragua and Czechoslovakia. Together with European groups, they could offer advice on the drafting of the U.S.S.R.'s new constitution, on the effective operation of the Soviet and republic parliaments, and on the creation of an independent judiciary.

A popular election for president of the Soviet Union is now scheduled for 1994, and Gorbachev will be under pressure to advance that date to 1991 or 1992. By providing the non-Communist forces with needed hardware (computers, fax machines, and publishing equipment) as well as advice on running political campaigns, the West can help them—and perhaps reform Communists as well—to compete in these elections on the basis of equality.

The skeptics will say that a liberalized Soviet Union is a chimera and that the country's future holds nothing better than chaos followed by repression. It is true that in the light of Russia's tragic history, an orderly transition to free-market democracy is a long shot. But the seven leaders at Houston should make a prudent investment in that long shot, given what their countries and all humanity have at stake.

The writer, a former U.S. ambassador to Italy, recently led a private delegation to Moscow for talks on U.S.-Soviet economic cooperation.

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DIALOGUE

The Houston Summit

Should the West Bail Out Gorbachev?

Yes, Targeted Aid Wouldn't Be Wasted

By Graham Allison

CAMBRIDGE, Mass.

When the heads of the leading industrial democracies meet in Houston next Monday, President Bush will face a question he has been trying to avoid: what can the West do to help Mikhail Gorbachev?

Frustrated by the Bush Administration's recalcitrance on aid, Bonn unilaterally extended $3 billion of credits at discount rates. The European Community is discussing a $15 billion aid package. Washington risks not just being left behind but left out.

Are there initiatives the West could take now that would raise the probability of perestroika's success? Credits are one thing and not to be scoffed at. But there is a more important agenda of actions to assist the Soviet Union's transformation to democracy and a market economy.

The strategy is this. By giving concrete assistance to specific steps toward free markets and democracy, the West can facilitate such actions, create incentives for further steps and offer hope for the longer run. Consider five particulars.

Demonstration projects. These might include model family farms, like the ones now being established in a Dutch-sponsored project to produce vegetables; McDonald's in Moscow, whose imported cattle and seeds for lettuce and tomatoes are several times as productive as Soviet equivalents and whose methods for delivering services mesmerize Muscovites, or American prefabricated housing.

Advanced communications. The Soviet Union is open to the transfer of the technological infrastructure of pluralism: printing presses, xeroxes, personal computers, dishes that receive satellite signals and a high-tech telephone system.

In Moscow, Leningrad, Sverdlovsk and 50 other cities, non-Communist Democratic Coalition candidates won majorities in recent elections. Helping these groups to communicate, learn from each other and publicize their views serves our values and interests. An initiative that would give one million such devices to democratic forces this year could be mounted today.

Managerial and technical training. The best argument in most Soviet policy circles today is "that's the way Americans do it." Flying carpets bearing wise men for a weekend is not the solution. Soviet leaders and policy makers need informed, sustained collaboration with their Western counterparts if they are to tackle issues like the transition to a market economy, privatization of state enterprises, reform of industrial ministries and decolonization.

Joint business ventures. High-visibility national joint ventures would provide substantial financial benefits and capture imaginations. Joint development of underdeveloped Soviet oil and gas reserves could earn an additional $5 billion annually for the Soviet Union within three years and $15 billion annually within a decade. In addition to profits for Western firms, this would also enhance Western energy security, since guaranteed long-term contracts would expand world energy supplies.

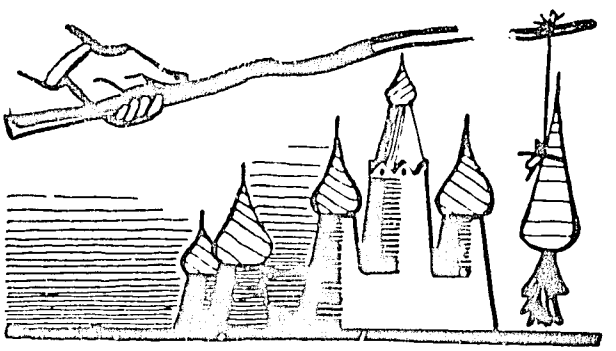
Joint environmental ventures. Radiation from Chernobyl fell on the East and West alike. The West can align itself with the march of history by leading a collaborative donation of Western technology to reduce the ongoing destruction of the Soviet — and our common — environment.

The essence of such an agenda is to demonstrate in deeds the West's commitment to helping Mr. Gorbachev transform the Soviet Union. Such initiatives could cost $10 billion to $15 billion a year. Split three ways, that would mean $5 billion each for the U.S., Europe and Japan. If that seems large, recall that U.S. taxpayers spent $150 billion *last year* to defend American security interests in Western Europe. Our Western European allies spent an equivalent amount.

Suppose that President Gorbachev had offered to free Eastern Europe, eliminate the Warsaw Pact military threat, pull Soviet troops back to the Soviet Union and permit German unification — all for a price. What would the West have been willing to pay?

The West has an historic opportunity to invest in developments that advance the slow but real transition of the Soviet Union to economic and political democracy. □

Graham Allison is professor of government at Harvard's John F. Kennedy School of Government.



Illustrations by David Suter

THE NEW YORK TIMES, July 5, 1990

No, It Will Put Moscow On Welfare

By Judy Shelton

MARSHALL, Va.

At the Group of Seven's Houston meeting, the biggest item on the agenda will be economic aid to the Soviet Union. Now that the cold war is over, the Soviet Union seems like just one of the boys.

The Soviets desperately need imports from the West — food and consumer goods in particular. President François Mitterrand of France wants to make aid to the Soviets a top priority at the summit meeting. Chancellor Helmut Kohl of West Germany has written to the leaders of the U.S., Japan, Canada and the European Community, asking them to come prepared to seriously consider the question of economic cooperation with the Soviet Union.

Judy Shelton, a research fellow at the Hoover Institution, is author of "The Coming Soviet Crash."

President Bush says he will consider aiding Moscow if it cuts defense spending. But it will be interesting to see what he does in Houston. Our allies are talking about a rescue plan costing $15 billion to $20 billion. Do we really want to participate in such a grand-scale welfare scheme? Can it possibly serve U.S. interests to help bail out Moscow?

If you look at the matter from a strictly humanitarian perspective, there is nothing to discuss. If we can prevent people from dying, we must do so — as we are now doing with aid to Iran — although why Soviets should rank higher than all other third world sufferers is not clear.

From a strategic viewpoint, one might argue that it is necessary to stabilize the situation in the Soviet Union while emerging political factions sort things out. The idea is to defuse the potential for explosive social upheaval by diverting the people's attention with Western goods.

Speaking politically, one might stress the need to preserve Mikhail Gorbachev as leader of the Soviet Union. Mr. Kohl wants to keep Mr. Gorbachev in power at least until he has secured agreement on German unification, and, for Mr. Mitterrand, it "is in the interest of everyone that Mikhail Gorbachev succeed." But has anyone asked Boris Yeltsin?

Look at the mechanics of the proposed deal: Assuming the sought-after financial credits are made available, what happens to the billions of dollars worth of Western food and consumer goods shipped to the Soviet Union? It gets eaten and otherwise used up. Gone. And next year?

Do we change our minds and decide to let the Soviet population starve? We don't want that to happen, but we also don't want 280 million permanent wards feeding off the West.

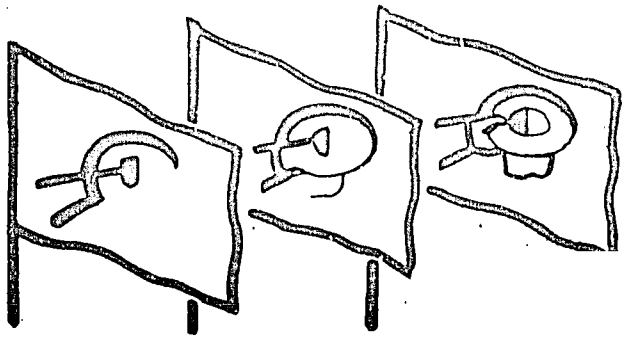
The Soviets, we all know, need to drastically reform their economic system so they can start taking care of themselves. Will a huge financial package from the West be a catalyst for reform or a substitute?

If the money goes to Moscow, it will serve as a direct subsidy to the Government and provide a windfall for the state budget. Western consumer goods sell at exorbitant prices: A computer costing $2,500 in New York, or 1,500 rubles at the official exchange rate, trades for 45,000 rubles — $72,000 — in Moscow. The Soviet Government denominates the transaction in rubles at both ends and rakes in the difference as revenues from foreign trade.

Unless the West plans to drop the consumer goods from helicopters, or unless we insist that the Soviets distribute the goods gratis, they will reap colossal paper profits as the exclusive agent on billions of dollars worth of Western imports. The Kremlin could plug the gaping hole in its budget without cutting a single ruble out of military expenditures.

If the West wants to foster economic reform in the direction of less military output and more civilian production, a plan to turn Mr. Gorbachev into a kind of Santa Claus, handing out Western consumer goods, is not the way to go. It will look as if we are siding with Mr. Gorbachev against the more progressive, democratic forces seeking private property rights, economic self-determination and political autonomy. Government-to-government bailout programs do not signal a commitment to free markets and small business.

So far, Soviet economic reforms have amounted to Government announcements of plans to raise fixed prices on basic consumer goods. The prices will still be fixed; they will just be fixed higher. The West's limited financial resources should not perpetuate the Soviet state apparatus. □



THE WASHINGTON POST, August 21, 1990

David S. Broder

Aid To the Right Soviets

You need not be an economics expert to know that President Bush has one piece of his Soviet policy exactly right. Even a first-time visitor to the Soviet Union, like this reporter, can see and hear enough in three weeks to know that Bush is correct to reject massive U.S. economic aid to Mikhail Gorbachev's government.

The scale of the country and the depth of its problems dwarf any conceivable package of American grants and loans. If West Germany's Helmut Kohl thinks he must offer such aid as the price for Gorbachev's acceptance of German reunification, so be it. But Bush is right to say that until Gorbachev gets serious about dismantling the structural barriers to rational market decision-making that decades of communism have erected, pouring money into the top of the Soviet Union would do little to relieve the privation of its people.

When aid is given, it should, as Bush says, be in the form of technical assistance. What Bush does not yet seem to grasp is that in most cases, that aid can be most usefully given, not to the slow-moving, rigidified, status quo ministries of Gorbachev's central government but to the local and regional officials now on the cutting edge of change in the Soviet Union. Doing that will require the Bush administration to shift from its narrow focus on dealing with Gorbachev to a more broadly conceived effort to establish links with the next generation of leaders in what is certain to be a more decentralized Soviet Union.

Just how laggard the United States is in making this shift in its perspective and policy I learned on a visit to Leningrad. The consulate there—our only diplomatic outpost outside Moscow—serves the Baltic states of Latvia, Lithuania and Estonia and the Leningrad area, all of which are historically and geographically linked to the West.

The independence forces in the Baltics and the non-Communist city government in Leningrad are pushing private enterprise as hard as they can, with burgeoning numbers of joint ventures and cooperatives. But the overworked U.S. consular staff includes no commercial attaché nor anyone with business or economic background.

The able U.S. consul general, Richard Miles, estimates that he has seen at least 1,000 visiting American businessmen in his office in the past two years, but fewer than a dozen of them have come back through a second time in pursuit of contracts or work. By contrast, he said, the Japanese are building contacts by placing Russian-language trainees in Leningrad and Baltic factories, and German bankers are ubiquitous return visitors.

Part of this is the familiar tale of American business' inability to see the usefulness of investing time, talent and resources in places where the payoff will be years away. But part of it is also the Bush administration's reluctance to encourage even private business to bypass Gorbachev's centralized bureaucracy. So worried is our government about Gorbachev's survival that we are neglecting opportunities to encourage those who are far more venturesome in the only kind of economic reform that can offer hope of ending the Soviet people's endemic poverty.

Bush is understandably preoccupied with doing as much diplomatic business with Gorbachev—on arms reduction and resolution of regional conflicts—as he can, while the crafty Soviet leader is still calling the shots. Only last week did Secretary of State James A. Baker III say for the first time that the United States is beginning to cultivate contacts with some of the independent political movements in the Soviet Union.

But the administration is running behind the curve of change. Even an official of the Communist Party Central Committee, Igor Malaschenko, told me, "The decline of the central government is inevitable. It is impossible to reform from the center. The new designs for confederation and for the economy will be drafted largely in the republics."

Yet the U.S. government persists in acting as if everything depended on Gorbachev's fate. The point was made best by 40-year-old Victor Acsyuchits, head of the fledgling Christian Democratic Party, when I went to see him in his shabby, 11th-floor apartment on the edge of Moscow.

"Where the West makes a mistake," he said, "is to declare Gorbachev the initiator and leader of the democratic forces. It is not so." Acsyuchits argued that the current U.S. policy does not even serve Gorbachev's long-term interests. "When the West bets only on Gorbachev, they do him no service; they dig his grave. They ratify his position as the head of the most reactionary force in this society, the Communist Party.

"The only way for the West to help Gorbachev is to help foster a civil society by aiding the non-party groups that Gorbachev could rely on to govern, instead of the Communist Party. In Poland, you were wise enough to see you should support Walesa, not Jaruzelski," the Communist general who outlawed Solidarity a decade ago and now serves as figurehead president. "Why do you not see that here?"

I asked Acsyuchits if he had made this argument to any American official. "No American official has ever talked to me," he said.

THE CHRISTIAN SCIENCE MONITOR, July 12, 1990

Bush's Latin American Initiative: a Reassuring Move

By Sylvia Saborio
Special to The Christian Science Monitor

WASHINGTON

THE United States invitation to Latin America to forge a new relationship based on economic self-interest rather than strategic concerns is a positive, reassuring move toward a much troubled region.

President Bush announced the Enterprise for the Americas Initiative June 27 as the cornerstone of a new, post-cold-war, economic partnership with Latin America. The proposal is noteworthy in several respects.

First, it gives a much needed boost to the morale of Latin Americans who feel that events in Eastern Europe have overshadowed the equally profound political and economic transformations under way in Latin America and who fear that the support the region needs to consolidate those reforms might be diverted elsewhere.

Second, it recognizes the complexity of the problems confronting Latin America and the fact that the cycle of recessive adjustment and inflationary growth can only be broken by supplementing domestic efforts with external support on a broad range of issues, including trade, debt, and finance.

Third, while it offers only limited tangible, short-term benefits, the initiative does set an agenda for future US-Latin American economic relations, with potentially larger mutual benefits down the road.

The initiative rests on three pillars: trade, debt, and investment.

In the area of trade, the proposal sets as a long-term objective the establishment of a hemispheric free-trade zone. The US would enter into free-trade agreements with countries ready to engage in reciprocal trade liberalization, and would negotiate more limited bilateral accords with other countries.

On debt, the key proposal is to reduce the region's $12 billion official debt to the US. A sizable share of the concessional debt (currently about $7 billion and spread among the smallest, poorest countries in the region) would be written off on a case-by-case basis. In addition, a portion of the outstanding official nonconcessional debt would be sold at a discount, to be used for debt-for-equity and debt-for-nature swaps. The remaining official debt would be rescheduled and future payments on it would be made in local currency and set aside to fund environmental projects.

GUEST COLUMN

In terms of investment, the main proposal is the creation of a new investment fund at the Inter-American Development Bank, to provide up to $300 million a year to support market-oriented investment reforms and privatization.

In the short term, the main impact of the initiative is likely to be felt on the official debt side. If half of the concessional and one-quarter of the nonconcessional official US claims were eliminated, the savings in debt-service payments for Latin America would be on the order of $1.6 billion over the next four years. This does not amount to much in the overall scheme of things, but for the smaller, poorer debtors in the region it would provide much needed relief. If other industrial governments did the same, the benefits would multiply.

But while the benefits of the initiative in terms of debt reduction may well be limited, its environmental implications are likely to be significant: Even if only a small fraction of the official debt were set aside to finance environmental projects, it would likely represent a considerable increase in such spending.

In the longer term, the removal of tariff and nontariff barriers to trade is potentially the most important element of the initiative. Whereas the notion of a hemispheric free-trade area has a certain intuitive appeal, it should not undermine ongoing efforts to strengthen and liberalize the multilateral trading system. An open, global system of commerce remains the best option for both the US and Latin America.

In sum, the initiative was superb diplomacy and may become significant economics, provided the US and Latin America work together to fully develop this embryonic proposal into a dynamic and mutually beneficial partnership over the years.

□ *Sylvia Saborio is senior fellow in charge of trade at the Overseas Development Council in Washington, D.C.*

THE CHRISTIAN SCIENCE MONITOR, July 12, 1990

US Rethinks Africa Aid

Bill now in Congress would cut foreign support to several nations

By Peter Grier
Staff writer of The Christian Science Monitor

WASHINGTON

KENYA is only the latest in a string of sub-Saharan African nations whose ties with the United States are being strained by their rough handling of domestic dissent.

Overall US aid to the sub-Saharan region will likely increase. But the 1991 foreign-aid appropriations bill now wending its way through Congress sets restrictions on money for Zaire, Somalia, and Sudan, among others whose actions have raised Congressional ire.

Though these restrictions haven't yet been passed into law, they have widespread support in both the House and Senate.

"What you are seeing is a greater sensitivity to human rights issues," says a congressional staffer involved in the African foreign aid process.

Ironically, this sensitivity may stem from a decline in Africa's importance to the US.

The fading of the cold war and democratization of Eastern Europe have made Africa "more marginal" to Western interests, notes Claude Ake, an Africa specialist at the Brookings Institution.

"While many people lament this," says Mr. Ake, "it brings the US and the West to act more on principle" in their dealings with the continent.

Kenya, for example, was long considered a model of political stability in an unstable continent. But President Daniel arap Moi's crackdown on pro-democracy demonstrators has already ineradicably changed how his rule is viewed in Washington.

President Moi's Kenyan African National Union party has governed Kenya since its independence in 1963. Opposition parties have been banned since 1982, the year Moi survived a coup attempt. Increasing political repression, allegations of corruption, and poverty have fueled unrest in Kenya in recent years. This tinder burst into flame July 7 in Nairobi. Pro-democracy riots then spread to towns north and west of the capital, with 15 dead as of this writing.

US-Kenyan relations have turned sour, with Moi accusing the US of interfering in his affairs. The State Department has lodged an official protest over Kenya's harsh criticism of US Ambassador Smith Hempstone, and a key US congressman – Rep. Howard Wolpe (D) of Michigan, chairman of the House Africa subcommittee – says he will press Congress to freeze or cut Kenyan aid. In addition, Congress will likely consider withholding any 1990 Kenya aid that has not yet been spent.

Behind the cuts in aid are the end of the cold war and increasing US interest in human rights.

Kenya isn't the only African nation to run afoul of Congress this year. Zaire's "widespread human rights abuses and systematic governmental corruption," in the words of a congressional report, will likely lead to aid restrictions.

Zaire's security forces have been accused of torturing and killing political opponents. Zaire's President Mobutu Sese Seko has reportedly amassed a personal fortune of $6 billion in a country whose per-capita income is $150, and lately has waffled on promises for democratic reform.

During House debate of the foreign-aid appropriations bill last month, Rep. David Obey (D) of Wisconsin, chairman of the Foreign Operations Appropriations subcommittee, called Zaire "one of the world's largest outrages."

The House-passed 1991 foreign aid appropriations bill would bar all US military assistance to Zaire, as well as US Economic Support Fund payments.

In addition, any US-funded development assistance would have to go through private organizations, not the Zaire government.

As currently constituted, the foreign-aid bill would also continue a ban on economic and military aid to the Sudan, Africa's largest country and for many years the largest sub-Saharan recipient of US funds. "Human rights violations are now rampant in Sudan," complains a congressional report that accompanies the bill. "Armed militia have slaughtered dissident tribespeople, refugees have been used as shields against rebel advances . . ."

A similar ban on money for Somalia would also continue under the foreign-aid legislation, although the State Department has called for Somalian aid to resume next year.

Hundreds of civilians suspected of sympathizing with the rebels in Somalia's civil war have been slaughtered by the government, according to the House report. "Somalia's record on human rights remains one of the worst," it judges.

Military and economic aid for Liberia has also been suspended this year due to abuses of the regime of President Samuel Doe. If President Doe is ousted by rebels, as now seems likely, Congress and the Bush administration will probably wait to see if the rebels live up to promises of democracy before the flow of money is resumed.

These restrictions don't mean the sub-Saharan region is a loser in the foreign-aid money bill, as currently constituted. Overall, the bill would allot $800 million for bilateral economic aid to sub-Saharan Africa, an increase of more than 40 percent from the Bush administration's request of $560.5 million.

THE WASHINGTON POST, Sept. 18, 1990

Makau wa Mutua

Zaire Doesn't Deserve That Aid

In mid-May, Zairian security forces stormed the campus of the University of Lubumbashi. According to several recent reports, these soldiers massacred at least 300 unarmed students. One member of the government's Garde Civile who was at the campus that night says that he counted 347 bodies as they were being evacuated from the university grounds by government agents. Some of the victims were reportedly buried in a mass grave near the local airport.

Several days later, Assistant Secretary of State for Africa Herman Cohen arrived in Zaire. Without even mentioning the violence at Lubumbashi, he told reporters that the United States would direct its future foreign aid toward "emerging democracies, such as Eastern Europe, Zaire and some other African countries."

Cohen's ill-timed and inappropriate support for the Mobutu government is sadly characteristic of U.S. policy toward Zaire for the past 25 years. Equating pronouncements of reforms in

"Thousands of Zairians have been tortured, subjected to cruel treatment and prolonged incommunicado detention . . ."

Zaire with the sweeping changes in Eastern Europe was particularly troubling, coming as it did in the immediate aftermath of the Lubumbashi killings. Regrettably, Cohen's noisy diplomacy is only the most recent example of the administration's failure to exert needed pressure on President Mobutu. In 1984, barely a year after Zairian security forces brutally attacked several opposition politicians following their meeting with visiting U.S. congressmen, Assistant Secretary of State Elliott Abrams told a congressional committee that "human rights conditions in Zaire had improved over the last 20 years." Dismissing these and other acts of violence by Zaire's security forces, Abrams implored Congress to provide more aid to the government of Zaire.

Several months later, Mobutu was treated as an honored guest by President Reagan. Reagan gave Mobutu a "warm welcome" and praised him as "a faithful friend for some 20 years." Responding to criticism of the administration's negative handling of the human rights issue in Zaire, Assistant Secretary of State Chester Crocker asserted that "it was wrong to characterize Zaire as a brutal police state." Rather he suggested that "abuses that do occur tend to be committed at the lowest level by individuals acting on their own, without sufficient training or material support." In 1986, Reagan renewed his unqualified praise for Mobutu, calling him "a voice of good sense and goodwill."

This misguided U.S. approach to Zaire has continued during the Bush administration's first 18 months in office. Mobutu was the first African leader received by President Bush at the White House in June 1989. The administration has requested that Congress provide Zaire with $56 million in military and economic aid for FY 1991, citing Zaire's support of various Western policies.

What this policy ignores is a prolonged and systematic pattern of institutionalized abuses of human rights in Zaire. Since Mobutu came to power in 1965, Zaire's security forces have continued to routinely harass, arrest, detain and abuse perceived political opponents. Thousands of Zairians have been tortured, subjected to cruel treatment and prolonged incommunicado detention, actions that have led to a total breakdown in the rule of law.

Official bodies created to protect the rights of Zairian citizens—specifically, the courts and a government human rights ministry called the Department of Citizens Rights and Liberties—have failed to carry out their mission. The judiciary has been plagued by interference from Zaire's sole political party, the Mouvement Populaire de la Revolution, and from the executive branch. Despite annual pronouncements of reforms for more than a decade, Zaire's judiciary has not punished the security forces for arbitrary arrests and illegal detentions.

The DCRL, which was formed in 1986 to promote and protect human rights, lacks the credibility, authority and political will to redress abuses. It has not resolved a single human rights case since its creation. Instead, it has been used cynically by the government to defend the government's human rights record before international tribunals such as the United Nations.

In April, Mobutu announced his intention to abolish the one-party state and to sanction a three-party political system. But Mobutu clearly asserted that he would remain as chief of state and as the "ultimate recourse" for future governments of Zaire. He also emphasized that he would remain above all state organs even if a multiparty government were allowed. Since the announcement, Mobutu has failed to take any steps to reform the security forces, which are the main perpetrators of human rights abuses.

Soon, the U.S. Senate will decide whether the administration's request of $56 million in aid to Zaire should be granted. The Senate vote provides an excellent opportunity for the U.S. government to make it clear that in the post-Cold War era, allies like Zaire must demonstrate concrete progress in human rights before further U.S. aid is forthcoming.

The writer is head of the Africa Project of the Lawyers Committee for Human Rights.

Improving US Food Aid

Changes in food program will feed more of the world's malnourished

By Lane Vanderslice

A DEBATE gone unnoticed in the press, yet one vitally important, deals with the future of the PL-480 program, the US food assistance program. The image of food assistance is feeding the hungry. But most of the program is far from doing that.

Most of the program is also far from promoting food security, which is the development aim of the program. This is especially for the most "food insecure" – the over 350 million malnourished people in the world including 150 million children.

To address the major problems, two of the three congressional committees with jurisdiction – the House Foreign Affairs Committee and the Senate Agriculture Committee – have proposed the greatest changes in the program since its inception. One key change is opposed by the administration, and has not been adopted by the third committee, the House Agriculture Committee. Thus the fate of the changes remains unclear as the House and Senate begin consideration of the farm bills, including PL-480.

The emergency feeding programs, about 16 percent of the program, are not in contention. What is principally in contention are the "Title 1" programs, which form over half of PL-480. Under Title 1, the US government provides food commodities to developing country governments by extending them long-term low interest loans.

The country government then sells food to those who can afford to pay (meaning malnourished people receive a small percentage of food) and uses the currency obtained for its own purposes, subject to certain conditions imposed by the US government. The conditions are supposed to promote food security.

There are at least three major criticisms of the program.

First, the developmental direction of the program has been usurped to a great extent by political concerns. In 1989, the top 10 countries receiving food assistance (in order) were Egypt, India, Bangladesh, Pakistan, Morocco, Afghanistan, El Salvador, Sudan, Jamaica, and Sri Lanka.

The food allocation levels of only three countries, India, Bangladesh, and Sri Lanka, did not seem to be strongly influenced by political considerations. Egypt and El Salvador, for example, receive far more aid per capita than Africa and Asia, where malnutrition is far more prevalent.

The second criticism is that the multiple objectives of the program, which include promoting economic development, US foreign policy objectives, and markets for US agricultural goods, have resulted in a slow and ineffectual bureaucratic process. Major and many minor decisions are made by a food aid committee comprised of the Agency for International Development, OMB, and the Departments of Agriculture, State, and Treasury.

The third and most fundamental criticism is that the PL-480 program, aside from the emergency feeding program and some other "Title 2" programs, could be doing much more to prevent malnutrition. In part this is a function of concerns already mentioned: Politics, not prevention, tends to govern much of the allocation. A cumbersome administration impedes the not very easy task of preventing malnutrition.

There are other problems. Developing country governments are mainly interested in obtaining much needed government revenue through the PL-480 program, and significantly less interested in finding ways to benefit malnourished people – typically less influential politically. Within the AID, PL-480 in general and the food security of malnourished people in particular, have suffered from what can charitably be described as "benign neglect." For example, the PL-480 program has only one nutritionist – who doesn't even work as a nutritionist but as an overall program evaluator. The average school district spends more on nutritionists than the $1.4 billion PL-480 program. Moreover, there is no substantive link between the AID nutrition staff and the principal nutrition resource of the US government, the PL-480 program.

We are entering a new era. PL-480, which once disposed of surplus crops, now has to buy food on the open market with real money. We have to decide: Are we getting our money's worth? And as cold-war concerns are reduced, it will be more possible than ever for the nations of the world to unite to resolve major world problems, which will be a great contribution to world peace. There is no more urgent problem than world hunger, and there is no program that can or should make a bigger difference in reducing world hunger than a redirected PL-480.

☐ *Lane Vanderslice is a public policy analyst with the National Council for International Health.*

LOS ANGELES TIMES, July 23, 1990

Population Growth Is the Great Enemy

■ Foreign Aid: So long as current trends continue, the money we spend to alleviate poverty in the Third World is wasted.

By ANTHONY C. BEILENSON

At this moment, more than 5 billion people share our planet. By this time tomorrow, another quarter of a million will be added to that number.

More than 90% of the newcomers will be born in the Third World. Many of them will die in childhood of malnutrition or disease and most of the rest will live out their lives in countries that cannot adequately feed and shelter the people they already have.

By the year 2025, the world's already strained and overexploited resources will have to sustain life for more than 8 billion people—an increase of 3 billion, most of them desperately poor, in just 35 years.

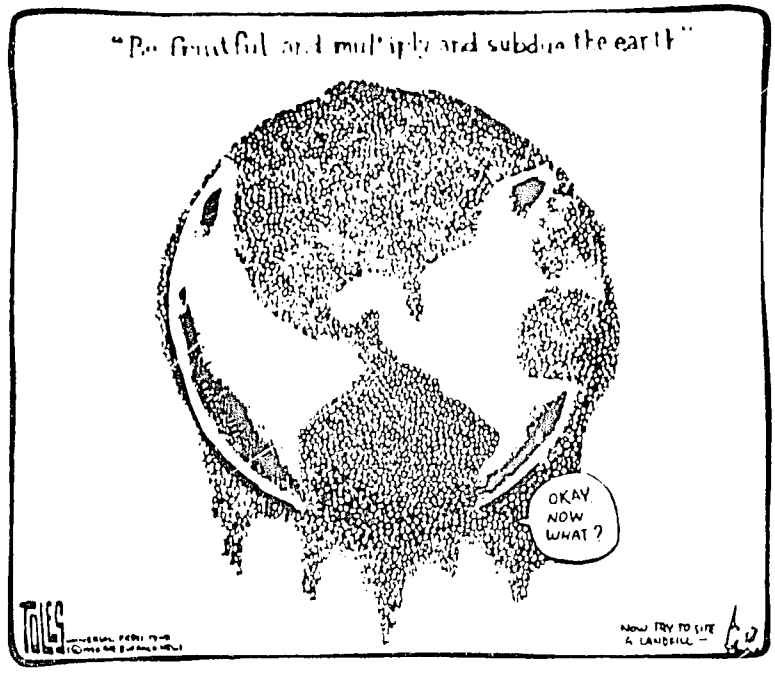
Besides condemning people to lives of starvation and poverty, this rapid growth in population is invariably taking a huge toll on the environment—stripping forests, eroding fragile soil and polluting and then exhausting water supplies. More and more land is becoming desert and tens of millions of people are moving every year to increasingly crowded urban slums, creating conditions that will inevitably lead to political instability and upheaval.

The harsh fact is that without a decrease in population growth rates, the outlook is bleak, both for developing countries and for our ability to provide them with any real, sustainable help. So long as current population trends continue, the billions of foreign-aid dollars we spend each year in an effort to alleviate poverty and stimulate economic growth in the Third World are simply being wasted; our generosity will always remain several steps behind the growing number of mouths to feed and hands to employ.

What can the United States do that will be of help? One good way to start would be to phase out all bilateral economic aid to developing nations (totaling in the proposed 1991 bill about $6.7 billion) and offer instead, to those countries that want it, substantial amounts of funding for family-planning programs.

In addition, we should take $1 billion a year from the money that would be saved and dedicate it to a crash project to develop inexpensive, effective and easily used methods of contraception. In many of those countries now, oral contraceptives, IUDs, diaphragms and condoms are either too expensive, rejected for cultural reasons or ineffective because they require health-care services that often are not available.

Ending economic assistance except for family-planning services is not nearly so hardhearted a proposal as it may at first seem. The truth of the matter is that our foreign-aid program does very little good in a world where a great amount needs to be done—our contribution to each country is relatively small and the effect upon the lives of its people is negligible. Our current aid projects help only a few thousand of the millions of people in a particular country; spending those same dollars on family planning would help that country provide more adequately for all its citizens.



More important, no matter how much aid is given by the United States and others, the truth of the matter is that developing countries cannot solve their economic problems without first solving their population problems. The reason is obvious: In most Third World countries today, populations are growing faster than the ability to provide food, shelter, health care, education and jobs.

'Ending economic assistance except for family planning is not nearly so hardhearted a proposal as it may seem.'

If these countries cannot adequately meet the basic needs of their own people now, they surely will be less able to do so in 20 years, when their populations will have doubled. By then they will be much worse off, even after the expenditure of billions of dollars in economic assistance by us and others in the meantime.

This inevitable reality of population growth is so simple and so inescapable that our failure to recognize it is striking. Yet we mindlessly go about our business, throwing away billions of well-intended foreign-aid dollars on development projects that are not doing the supposed beneficiaries any real good.

Hundreds of millions of people throughout the world would welcome greater family-planning assistance. Surveys indicate that half of the married women in developing countries do not want any more children; millions more would like to delay subsequent births.

Providing greater amounts of family planning aid and developing new contraceptive methods would be, without question, the most constructive, cost-effective and humanitarian contributions we could make to help developing countries achieve economic and political self-sufficiency, and to better the quality of life of people around the world.

We would be sending a needed message to the entire world that all of us—rich and poor nations alike—are careening toward immense and irreversible human and environmental tragedy that can be averted only if we immediately get serious about slowing our planet's burgeoning population growth.

Anthony C. Beilenson (D-Los Angeles) is chairman of the House Permanent Select Committee on Intelligence.

Los Angeles Times

FRIDAY, JULY 13, 1990

Together, No. 2 and No. 1 Can Help a Planet Blossom

Foreign Aid: America's program has lost its way. Linking development resources with Japan's is the way to go.

By JOHN W. SEWELL

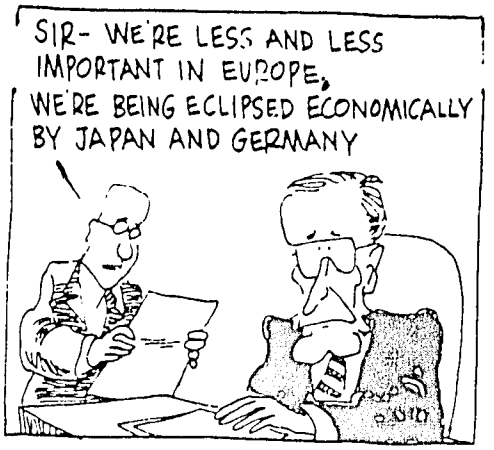
For the first time since World War II, the United States is not the dominant player in the foreign-aid field. According to statistics released in late June by the Organization for Economic Cooperation and Development, Japan provided $9 billion in development assistance in 1989; the U.S. contribution dropped to $7.7 billion.

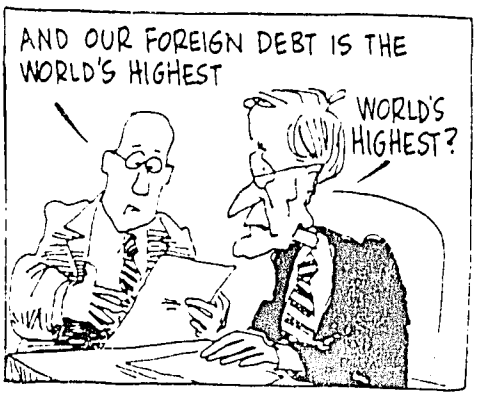
Some observers will greet this as long overdue news. After all, the United States has severe budgetary problems, and Japan should assume a larger share of the aid burden. Others may see it as evidence that the Japanese are now using the need to provide aid as a justification for maintaining a trade surplus. Whatever the case, it shouldn't stand in the way of the countries discussing how they can work together to meet new development challenges.

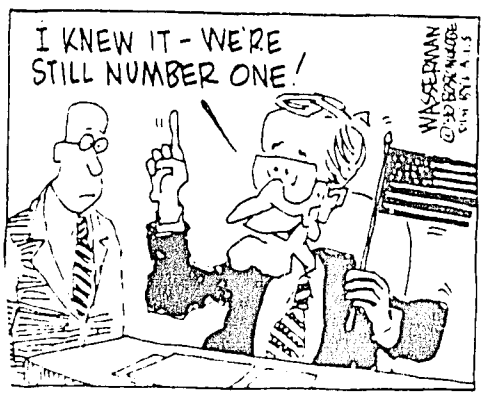
The United States is justly proud of its leadership in establishing a system of development cooperation that in only four decades has catalyzed remarkable progress in the developing world. Despite the continuation of unacceptable levels of poverty, income has grown in many parts of the developing world. Life expectancy and literacy in some countries are now approaching levels achieved by the industrial countries only in this century.

But America's development program has lost its way. In the early postwar years, aid levels reached well over 2% of gross national product. In 1989, when its economy was considerably richer, the United States spent only 15/100s of 1% GNP on development assistance. That is now the lowest percentage of any industrial country member of the OECD.

Even more important, the U.S. aid program is heavily weighted to short-term security and political concerns in the better-off developing countries. According to data from the Overseas Development Council, security aid claims nearly 60% of the Bush Administration's current aid request. It would allocate $258.88 per person to high-income countries receiving U.S. aid, and only 84 cents per person in the low-income countries.







Over the past decade, our deteriorating aid performance has been justified on the grounds that even if we spent a lower percentage of our GNP on aid, we were the world's largest donor and that we were bearing a disproportionate share of the cost of global defense.

Japan, on the other hand, has been taking on increasing responsibility for promoting development. Japanese aid increased by 87% between 1980 and 1987, and further increases are planned. Japan is now the largest bilateral aid donor in 2[illegible] countries and provides twice as high a percentage of its GNP for aid as the United States. Japan also has provided financing for debt relief through the World Bank and the International Monetary Fund and to meet emerging needs in Eastern Europe and reportedly in Panama and Nicaragua. The commercial emphasis that marked Japan's aid program in earlier years has diminished greatly. Now the program is increasingly marked by a concern with development in the recipient countries.

How will the United States respond to becoming No. 2 in the development field? A growing number of policy-makers agree that the current U.S. aid program has become an anachronism. Not only is it dominated by Cold War security concerns, it is also disproportionately concentrated in a few areas of traditional U.S. interest: Israel and Egypt, Southern Europe, Central America, Pakistan and the Philippines. The growing tension between emerging new needs to promote democracy and economic growth in Latin America and Eastern Europe, and to meet the critical challenges of African development, has led to a growing clamor, particularly in Congress, for an overhaul in U.S. aid strategy.

Policy-makers in the United States and Japan face an emerging global agenda of interrelated issues. Cooperation between the two countries should focus on policies designed to resume global economic growth, to sustain the environment upon which both industrial and developing countries depend, to eliminate the conditions that consign 1 billion people to live in absolute poverty in a world of plenty and, finally, to promote and sustain the remarkable flowering of political openness the world has witnessed in recent years.

The United States and Japan have abundant development resources—in policy-making and other skills, in innovation and human talent, as well as money—unique to each country. The need for their cooperation is too great to waste energy on stale debate about who is No. 1.

John W. Sewell is president of the Overseas Development Council.

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

STATEMENT OF
JOHN M. NIEHUSS
SENIOR DEPUTY ASSISTANT SECRETARY
FOR INTERNATIONAL ECONOMIC POLICY
U.S. DEPARTMENT OF THE TREASURY
AT THE AFTERNOON SESSION
OF THE DEVELOPMENT COMMITTEE
OF THE WORLD BANK AND THE INTERNATIONAL MONETARY FUND
WASHINGTON, D.C.
SEPTEMBER 24, 1990

Mr. Chairman. I welcome this opportunity to comment on the Bank and the Fund's poverty alleviation efforts and the Bank's integration of women in development issues into its operations. These are areas of great concern to the United States. We appreciate the extensive work -- in particular, the 1990 World Development Report on poverty -- done in preparation for this discussion.

Poverty

The United States concurs with the view of the Bank and the Fund that a sizeable reduction in poverty in the developing countries is of the highest priority. The World Development Report indicates that such a reduction is achievable if the commitment to appropriate policies is made.

Sound macroeconomic policies constitute the basis for a successful strategy to foster sustained economic growth -- the key element of any major poverty reduction effort. In countries which suffer from structural imbalances, economic reform is central to improvements in living standards for the poor and non-poor alike. For this reason, we support economic reforms which increase flexibility and opportunities in the economy, promote investment and growth, and assure the efficient use of scarce resources.

NB-961

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The World Development Report documents in case after case the necessity of economic growth for poverty reduction. We can dismiss the purported trade-off between growth and poverty reduction. Adjustment measures -- which are intended to correct imbalances and inefficiencies and promote growth -- are compatible with poverty alleviation efforts. The real trade-off is between assistance to the poor and assistance to the non-poor.

We understand, of course, that poor people must be able to take up the opportunities offered by a growing economy if they are to improve their living standards. This requires building their human capital by providing primary education and basic health services. We agree with the Bank that improving the provision of basic social services to the poor is the necessary complement of economic growth in a comprehensive poverty reduction strategy.

Improvements in social services are necessary to expand the number of people served, to increase the quality of the services, and to assure efficiency. Given the budgetary limitations of most developing countries, careful program design and implementation are needed to stretch the resources and attain the highest return. World Bank assistance can be very valuable. We welcome the Bank's intention to increase the proportion of lending to the social sector in the next three years.

On the issue of targeting particular groups for special interventions to alleviate poverty, I would like to sound a note of caution. The track record for targeted interventions is not strong; such interventions have frequently not reached the neediest groups and have usually proven to be unsustainable. Given the fiscal and administrative constraints faced by most of the developing countries, and a priority to improving social services, the scope for targeted interventions would appear to be small. They should be pursued on a limited, highly selective, basis.

The United States signaled its concern with poverty alleviation by giving this issue high priority in the negotiations for the ninth replenishment of IDA resources. Along with other donors, we stressed the need for increased commitment to poverty alleviation on the part of beneficiary countries. We applaud the move to give country commitment to poverty alleviation a greater weight in determining allocations of IDA resources.

Donors stressed the need to strengthen IDA's efforts in this area. This strengthening includes social sector projects focused on the poor, policy dialogue on poverty alleviation efforts, analytical work on poverty issues, and assistance to member countries in devising national poverty alleviation strategies. These strategies would seek to improve access by the poor to employment opportunities, productive resources such as land and credit, and social services. Such strategies are particularly useful for drawing together and taking into account the linkages between poverty, environmental management, population growth and the treatment of women.

I would like to emphasize an important issue here and that is the need to broaden participation in the development process. As President Conable said in his report to this Committee, "Poor people have not been sufficiently involved in the design of development projects." Given limited financial resources and information, and given the failed projects of the past, involvement of the beneficiaries in project design and implementation is a fundamental requirement. We strongly urge the Bank to expand the means by which its operations can profit from the knowledge and collaboration of beneficiary communities and non-governmental organizations.

In the World Development Report and in other documents provided to its members in recent months, the Bank has presented its basic strategy for an invigorated effort to reduce poverty. We support this strategy and look forward to seeing the Bank's proposals for implementing the strategies throughout its operations.

I would like to comment briefly on the International Monetary Fund's view of its role in poverty reduction efforts. The United States believes the work of the Fund in assisting countries to implement sound macroeconomic policies is crucial to poverty reduction. Given the serious imbalances in some of the countries receiving Fund assistance, adverse effects in the adjustment process may be unavoidable. Thus, it is important that the Fund continue to explore with its member countries the most appropriate mix and sequence of policy changes so as to strengthen the positive effects on the poor and minimize any adverse effects.

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Women in Development (WID)

We were pleased with the paper laying out the Bank's view of women's role in development and the Bank's approach to enhancing that role. It is appropriate that this paper is presented to the Committee at this meeting when we are also discussing the Bank's poverty reduction efforts. It is clear from the analytical work that the status of women and the economic opportunities available to them have close links to living standards in developing countries. There is a strong linkage between the economic status of women and the welfare of children, particularly young children who are most vulnerable to the effects of poverty. We believe that enhancing the role of women in the development process would contribute to reaching general development objectives and directly attack some of the causes of poverty.

We agree with the Bank's focus on the five priority areas: 1) female education; 2) family planning and maternal health care; 3) agricultural extension and other services; 4) credit and other services to women entrepreneurs; 5) access to labor markets. We support giving more explicit attention to women in development issues in policy dialogue. These issues should also be addressed in the national poverty strategies which the Bank is assisting its borrowers to prepare and separate, country-specific WID strategies should be prepared where appropriate. The integration of these issues into policy dialogue and country programming should help bring them into the mainstream of the Bank's operations. In addition, the Bank should intensify training for staff and establish a monitoring system to measure progress in this area.

As in the case of my observations on the Bank's poverty alleviation efforts, I do not think this paper gives sufficient emphasis to the importance of working with non-governmental organizations (NGOs), particularly women's groups in the borrowing countries. NGOs are important not only for their own small-scale projects which may serve as prototypes. They can also provide valuable field information and act as liaison with beneficiary communities. I urge the Bank to increase significantly its collaboration with NGOs in its women in development programs.

Conclusion

The two topics we have taken up this afternoon are closely linked and of high priority. The United States supports the general approaches outlined by the Bank and the Fund. We look forward to reviewing the programs and projects stimulated by these approaches.

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TONY P. HALL
CHAIRMAN

Select Committee on Hunger
U.S. House of Representatives
H2-505 House Office Building Annex 2
Washington, D.C. 20515

news release

For further information: Neal Flieger
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For Immediate Release
Wednesday, Sept. 12, 1990

HALL INTRODUCES LEGISLATION AIMED AT WORLD SUMMIT FOR CHILDREN

Rep. Tony P. Hall (D-OH), Chairman of the House Select Committee on Hunger, today introduced legislation to reduce the number of children who suffer and die needlessly every day in the developing world. According to the UN, 14 million children die every year.

"Nearly forty thousand children die every day", said Hall as he introduced the bill. "Most die of preventable causes when simple vaccines, vitamins and other low-cost, effective interventions could save them. If we are, as President Bush says, on the verge of a 'new world order', I believe that one of the priorities of that new order must be to end this shameful and unnecessary waste of human life."

Hall's legislation, the "Universal Childhood Security Act of 1990" provides for a five-year phased-in increase for funding of child survival activities conducted by the Agency for International Development. Child survival programs include basic nutrition, immunization, breastfeeding and other health programs. Under the legislation, spending for child survival programs increases from $225 million in FY 1991 to reach $600 million in FY 1996.

Hall's bill is targeted at the more than 75 world leaders, including President Bush, who will be delegates to the World Summit for Children, scheduled to take place later this month in New York. In calling for a Summit for Children in it's report "State of the World's Children - 1990, UNICEF stated that if world spending for child survival programs were to increase by two to three billion, the vast majority of child deaths could be avoided. The legislation calls on other donor nations, as well as the multilateral development banks and private organizations, to join by increasing funding for child survival programs.

"It's my hope that this bill will help stimulate the delegates to the World Summit," said Hall. "Saving the lives of the world's children isn't just America's responsibility, it's everyone's responsibility. I would hope President Bush would contact other world leaders, 'working the phones' on behalf of the world's children, as he did for the Iraqi sanctions."

The bill also provides for a phased-in increase in U.S. funding for basic education programs. Estimates are that about 100 million children, most of them young girls, lack access to basic primary education. At the recent "Conference on Education for All" in Bangkok, both the World Bank and United Nations committed to increasing their funding for education programs in order to address this crisis. The legislation notes that the United States is the largest bilateral donor supporting basic education, and therefore has a leadership role.

The bill also calls for caseload increases in the Special Supplemental Food Program for Women, Infants, and Children (WIC). WIC currently only serves about half of the eligible population. Hall noted that the United States has one of the highest infant mortality rates in the industrialized world, and spends more than $1.5 billion each year to treat low birthweight babies. "The WIC program is our first line of defense against infant mortality and low birthweight," he added.

Hall pointed out that the world climate is ripe for addressing the needs of children. "In a new world order, we should be able to re-order our priorities for the benefit of those who most need our help," he said. "Our effort to shape a new world order must go beyond a new world security order to embrace a new humanitarian order."

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SELECTED TOPICS

Successful Transition to Market Economy Requires Freeing of State Enterprises

In order for centrally planned economies to make a successful transition to market economies, state enterprises must be freed from direct controls. This was among the conclusions reached at a seminar on Economies in Transition, held in Washington on July 9–19. Thirty-three senior officials participated in the seminar, which was chaired by Willem Evers, Advisor in the IMF Institute. In a final session, Jacob Frenkel, Director of the Research Department and Economic Counsellor in the IMF; Massimo Russo, Director of the European Department of the IMF; Eugenio Lari, Department Head for Cyprus, Hungary, Poland, Portugal, Romania, and Yugoslavia at the World Bank; and Sir Alan Walters of the United Kingdom and Director of Putnam, Hayes & Bartlett responded to questions from participants. The following article highlights the major conclusions reached at the seminar.

The transition from a centrally planned to a market-oriented economy involves changing attitudes, institutions, and organizations. Organizations use routines conditioned by their environment and, although one might change the environment rapidly, it is not certain that routines can be changed as quickly. Institutions and organizations under stress of rapid change may also suffer a temporary decline in output or effectiveness, which—together with high initial unemployment—may delay the benefits of reform. This should not be used as an excuse to delay reform measures, adopt a piecemeal approach, or justify the introduction of a dual economic structure. However slow in responding, institutions and organizations should be exposed to the new environment as quickly as possible.

The overall objective of reform is to base the economy on a well-functioning market system. To this end, the reform should define property rights and establish conditions under which economic agents can respond to market forces. It is important that the transition take place with low inflation, because high or prolonged inflation would jeopardize the credibility of the reform. Specific reform measures should focus on:

- price liberalization;
- the promotion of competition and investment, especially foreign investment;
- the introduction of hard budget constraints and bankruptcy laws; and
- the establishment of a safety net, well-functioning financial and labor markets, and a proper degree of convertibility, particularly in current account transactions.

Also, a tax reform should be considered, and measures to deal with a possible monetary overhang should precede any other reform measures.

A monetary overhang may include enterprise deposits earmarked for special purposes, such as benefits or welfare payments, which would be relatively easily used by enterprises suddenly facing tight credit policies and the elimination of subsidies. Other components of a monetary overhang may consist of free deposits of enterprises, which may be excessive in relation to their transactions, and large accumulations of excessive household deposits and currency in circulation.

The existence of a monetary overhang will depend on the magnitude of banking liabilities relative to consumption and investment possibilities. The release of stocks after the introduction of price liberalization and tight credit policies would reduce the overhang, as would increased opportunities for investment in housing and an appropriate interest rate policy. An overhang can also be absorbed by the rise in the price level that might follow price liberalization, by a currency reform—a less desirable option—or by administrative means.

Another conclusion reached at the seminar was that the importance of sequencing is often overrated in the professional literature. In a macroeconomic sense, however, there is an obvious need for sequencing. For example, tight monetary and fiscal policies and price liberalization should precede the move toward convertibility. There could also be a need for sequencing at the micro level, but comprehensiveness and consistency would probably take care of any sequencing problem that might arise. Sequencing should not be used as an excuse for delaying measures.

A continuation of monopolies with free pricing could result in large profits for the enterprises concerned if some regulation were not introduced. Under these circumstances, the authorities would be justified in regulating prices briefly until the monopolies could be broken up and made subject to foreign competition.

Financial markets are essential, but in view of the length of time it would take to develop them, policies should focus on the early establishment of a competitive two-tier banking system in which commercial banks are capable of assessing risk. In addition,

- foreign banks and the use of foreign banking expertise should be encouraged;
- the government or some other central institution may have to assume responsibility for bank liabilities that can no longer be serviced and for nonperforming loans;
- central banks should be independent and will need to develop the skills necessary to apply indirect monetary control and to supervise commercial banks; and
- current banking statistics must be developed and maintained.

The introduction of price liberalization, hard budget constraints, and bankruptcy laws is likely to lead to spontaneous restructuring of many enterprises. Although some companies could well increase their labor force, spontaneous restructuring could, on balance, result in a rise in unemployment and a temporary decline in production. Productivity gains can be expected only over a somewhat longer term. Firms that cannot operate in the new environment will have to be radically restructured. Such restructuring (including closure) could exacerbate unemployment, and the loss of production, and force the government to assume considerable liabilities.

The existence of an efficient labor market is important, particularly if reform measures fail to elicit early gains in productivity. Falling productivity will inevitably have to be reflected in lower real wages. If un-

employment persists after restructuring, governments will have to consider relying to a greater extent on exchange rate policy.

Restructuring of enterprises must precede privatization. Although restructuring could be accomplished within a relatively short period, privatization will take longer, partly because of a lack of buyers and the need to work out administrative arrangements. For consistency of treatment and ease of administration, consideration should be given to the transfer of state property to a "state property agency" before privatization procedures are initiated.

The results of a nationwide accounting of assets and liabilities of state enterprises must be considered in any decision to distribute ownership shares of individual enterprises at discount prices. The quality of supervision of enterprises by the new owners will be enhanced if ownership is obtained at a reasonable price.

Massimo Russo (left) said the issue in Eastern Europe today is the misallocation of capital, not its destruction. At right is Eugenio Lari.

The transition will have repercussions for the government budget. Positive effects will consist of the termination of subsidies, increases in tax revenue resulting from productivity gains, receipts from privatization, improvements in tax administration, and greater discipline in expenditures. The introduction of customs duties may also have a positive effect, although such duties should not be introduced for revenue purposes and should be considered with caution if aimed at protection.

Developments that can be expected to have negative effects on the budget include reduced revenues resulting from temporary declines in output and higher expenditures associated with unemployment compensation, income maintenance, retraining, and the assumption of liabilities of state enterprises. Some countries may also experience the elimination of a net benefit to the budget when their trade with the U.S.S.R. is affected by the move from subsidized to world market prices.

Budgetary receipts from privatization and productivity gains may accrue after considerable delay, while budgetary outlays for unemployment benefits may be required soon after the restructuring of enterprises begins. There is therefore a risk of a budgetary imbalance early on in the transition.

Tax reform may also accompany the transition to market economies. Existing tax systems could be made more transparent, while the number of individual rates could be reduced. Eastern European countries should model their tax systems after those in Western European countries. A value-added tax is easy to collect and would tie in with the value-added tax systems of other European countries. In order to address equity concerns, the value-added tax should be supplemented by a company income tax and a politically acceptable personal income tax. Any new tax system should be coherent and transparent and should conform to the pattern of taxes in member countries of the Organization for Economic Cooperation and Development. It is not advisable to introduce separate taxes that would apply only during the transition, such as special tax rates for monopoly profits.

The safety net should aim at maintaining incentives to workers and should permit beneficiaries to make rational choices in their consumption. In this respect, it might not be wise to duplicate the social security systems that exist in some Western countries.

Fiscal decentralization may be an important part of the transition and should be based on the principle that each region pays for its own services. Poor regions could receive subsidies from the central government, but only if a matching formula is to be applied.

Because balance of payments financing is available, a payments union among Eastern European countries would not serve any purpose and could be counterproductive. From the beginning, governments should adopt a multilateral system of payments at realistic exchange rates so that the direction of imports and exports is unhindered by payments considerations. Direct foreign investment will improve competition in the economy and will also yield substantial benefits with regard to technical, marketing, and managerial expertise. It is therefore important, participants concluded, for governments to adopt liberal investment codes and to encourage foreign investment. Access to foreign markets will be essential; too many barriers could obstruct the transition or make it last longer than it otherwise would.

In the final session, Russo said that he saw important differences between the rebuilding of Western Europe following the Second World War and the developments now taking place in Eastern Europe. In the former case, the issue was to rebuild capital that had been destroyed, and the crucial need was financial. In Eastern European countries today, the issue is not capital that has been destroyed but, rather, capital that has been misallocated. Institutional aspects are therefore more important than financing. Sir Alan added that although the Second World War destroyed physical capital, "all institutional aspects were in place and all Western European countries had substantial market economies."

Sir Alan took exception to the view that "for a successful transition to a market economy it is essential to introduce democratic processes." Citing Hong Kong and Chile, he pointed out that some of the most successful economies are not political democracies. A.V. Bockastov, Assistant to the Chairman of the Commission for Economic Reform of the Council of Ministers of the U.S.S.R., disagreed, contending that the examples Sir Alan cited were exceptions to the rule and that those economies had thrived only because they were surrounded by democracies. He emphasized that, without democracy, countries such as the U.S.S.R. would not be successful in their transition to market economies.

Frenkel called for a distinction between transition and sustainability. Developments in Eastern Europe are generating a tremendous redistribution of power and wealth, he noted, and the question is whether the system can be sustained without a proper degree of democracy.

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INTERNATIONAL FOOD POLICY RESEARCH INSTITUTE

RESEARCH REPORT 80 APRIL 1990

HORTICULTURAL EXPORTS OF DEVELOPING COUNTRIES: PAST PERFORMANCES, FUTURE PROSPECTS, AND POLICY ISSUES

NURUL ISLAM

At a time when foreign exchange earnings are urgently needed to pay for rising imports and debt service, and the outlook for traditional agricultural exports is not bright, many developing countries are turning to exports of horticultural products—fruits and vegetables—in an effort to diversify their agricultural exports. But little research has been done on production, marketing, and exporting of these crops.

Horticultural Exports of Developing Countries: Past Performances, Future Prospects, and Policy Issues, Research Report 80, by Nurul Islam, looks at horticultural exports in the context of an evolving world market. It examines the size of the market, commodity composition, geographical distribution, and changing prospects. (It includes about 150 fruit and vegetable products and excludes cassava, cut flowers, foliage, potted plants, and nursery materials.)

The study finds the prospects for expanding exports of fruits and vegetables promising, especially for developing countries with abundant labor because they enjoy a comparative advantage in labor-intensive horticultural products. Given appropriate national policies and techniques, fruits and vegetables could add substantially to small farmers' income and provide employment. Conditions for expanding demand are also favorable. Demand is expected to grow in developed countries because of an increasing tendency to diversify the diet by consuming a wider variety of fruits and vegetables, and in developing countries because of rising incomes and population, on the one hand, and high income elasticity of demand, on the other.

Although developing countries' share of world agricultural exports declined from 41 percent to 33 percent between 1961-63 and 1983-85, their share of world horticultural exports increased from 38 percent for fruits and 24 percent for vegetables in 1961-63 to 42 percent for fruits and 28 percent for vegetables in 1983-85. In fact, the share of developing countries in world horticultural trade expanded even when its rate of growth slowed in 1975-85. By 1983-85, horticultural exports constituted 12-13 percent of agricultural exports of developing countries.

Thirty-one countries accounted for almost 90 percent of developing-country horticultural exports by 1983-85 (Figure 1). The highly specialized infrastructure required for export of individual crops, the difficulty of entering new export markets, and economies of scale all serve to limit the number of countries exporting each crop, as well as the number of crops exported by each developing country. Unless the volume of trade in a commodity is adequate, investment in development of specialized infrastructure for packing, transporting, and storing may not be economically feasible. The study finds that socioeconomic characteristics that contribute to success in world markets for manufactured exports are also relevant for success in horticultural exports. As countries expand their share of manufactured exports, reach higher education levels, develop good shipping facilities, and increase their access to world market information, they are more likely to succeed in promoting horticultural exports.

The developed countries accounted for 83 percent of world imports during 1983-85, largely among themselves. They obtained 72 percent of their imports from other developed countries and sent 80 percent of their exports to them. The United States and Japan were the fastest growing import markets during 1975-85, but Western Europe remained the largest market for imports of horticultural products from developing countries.

Most trade is undertaken with neighboring countries because the transportation and distribution costs are lower. But specialization in markets

may also be influenced by past economic and political relationships, which may lead to preferential trading schemes.

TRADE BARRIERS AND LIKELY EFFECTS OF LIBERALIZATION

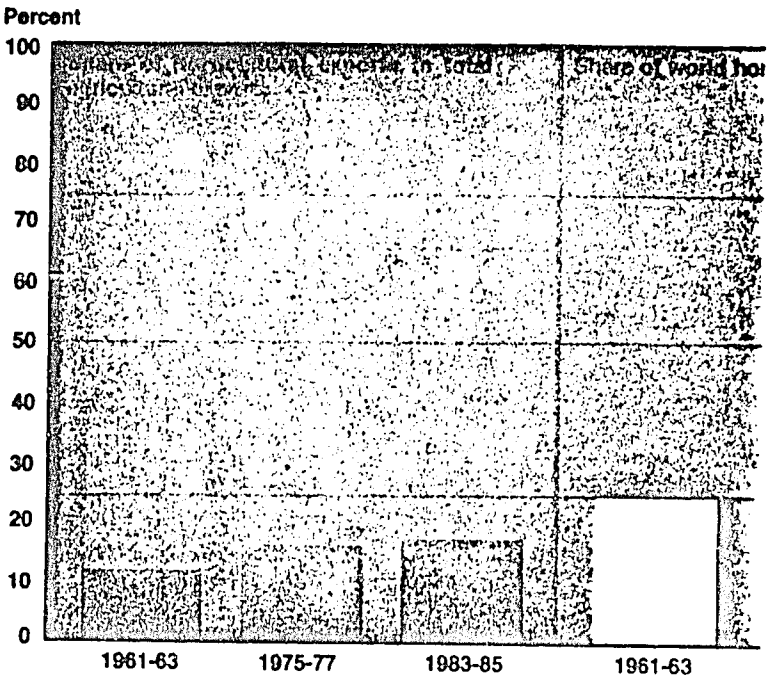
In industrial countries, both tariff and nontariff trade restrictions constrain the growth of exports. At 9 percent (average), duty rates on fresh vegetables were higher than those on fresh fruits (5 percent). Rates on processed fruits (15 percent) and on vegetables (12 percent) escalated with the degree of processing. Because the price elasticity of demand for processed products is much higher than that for raw products, the higher duties on imports of processed products are proportionally more damaging to the export interests of developing countries. In general, rates on tropical horticultural products are lower.

Nontariff trade barriers (NTBs) are, on the whole, higher for fruits than for vegetables, with the differences between import and domestic prices ranging from 22 to 180 percent for fruits and from 30 to 80 percent for vegetables. Except for processed fruits, trade restrictions, both tariff and nontariff, are higher in Japan and the European Community than in the United States,

The most important NTBs from the point of view of developing countries are sanitary and phytosanitary regulations—the health, safety, and quality standards set up by the importing countries for protection of plants and people against pests, diseases, and chemical residues. It is often difficult to distinguish regulations that address genuine health or safety concerns from those designed to act as trade barriers. Developing countries often do not have the trained manpower, research and testing laboratories, or inspection services to ensure that such standards are met. Furthermore, regulations vary widely among importing countries and change frequently, which creates uncertainty among exporters and discourages investment in the expensive, trade-related infrastructure that is needed to succeed.

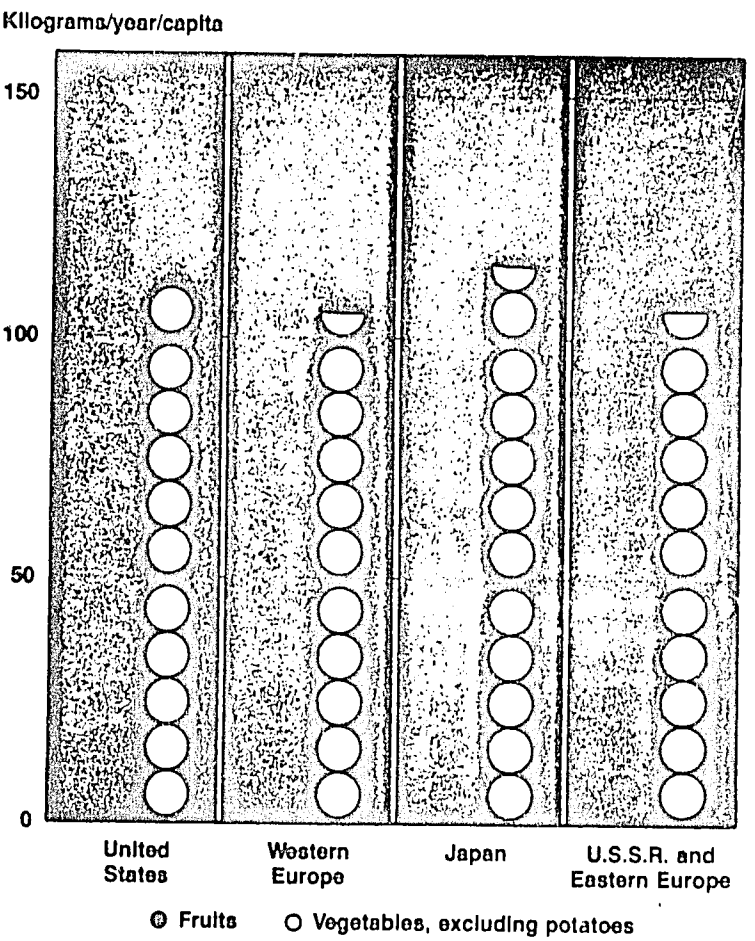
The study estimates that export earnings of developing countries would have been 6-9 percent higher in 1983-85 if tariff restrictions had been eliminated in the European Community, Japan, and the United States. Developing countries would have earned US$570-850 million more than they did. And eliminating NTBs would have led to increases of 24-36 percent, or US$2-3 billion over the base-year exports of US$9 billion in 1983-85, based on assumed elasticities of export supply and import demand. Considering the low ratio of imports to domestic production (no more than 10 percent for horticultural products in major developed regions), liberalization of trade is unlikely to have an appreciable impact on domestic production in developed countries.

Figure 1
Relative shares of top 31 developing-country exporters of f



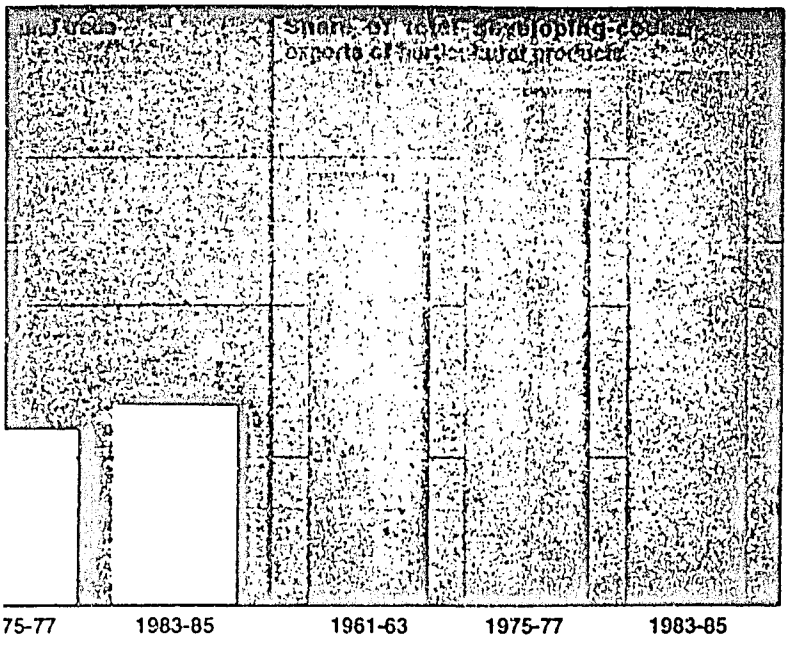
The combined market share in the world market of the 31 leading develop percent to 32 percent between 1961-63 and 1983-85. Almost 17 percent of

Figure 2
Per capita consumption of fruits and vegetables in developed countries, 1983-85



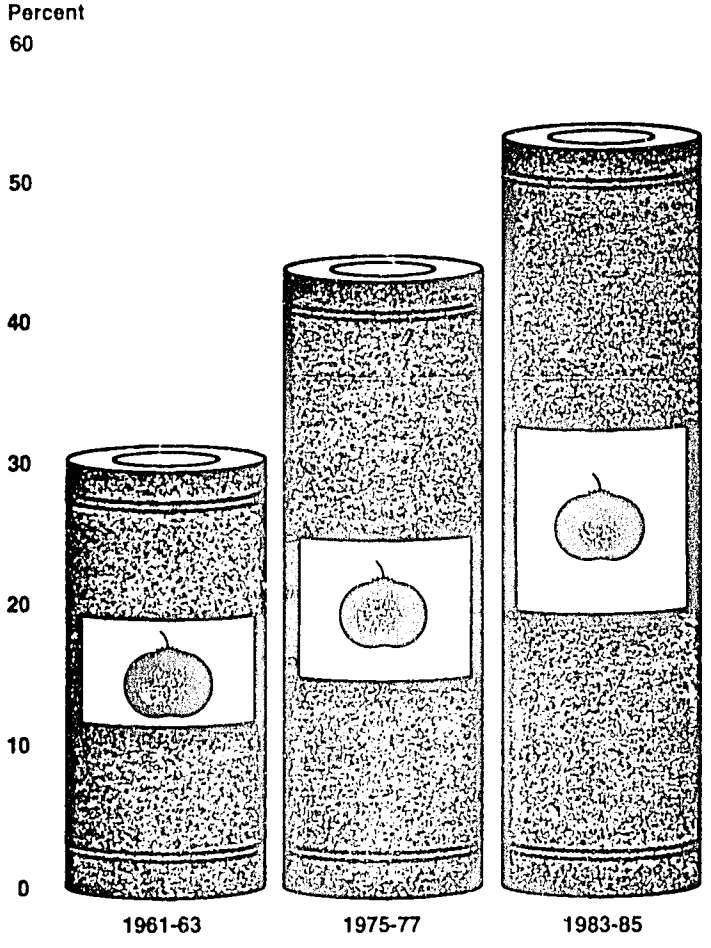
Even within Western Europe, consumption of fruit ranges from 56 kilograms per capita a year in the United Kingdom to 140 kilograms in Switzerland, indicating ample opportunity for increasing consumer demand.

:s and vegetables, 1961-83



country exporters of horticultural products increased from 25
r total agricultural exports were horticultural products.

Figure 3
Share of processed products in total horticultural exports of developing countries, 1961-85



Processed fruits and vegetables contribute to the growth of horticultural exports because processing reduces losses incurred in storage and shipping of highly perishable fresh products.

Successful multinational trade negotiations through the General Agreement on Tariffs and Trade (GATT) are essential for effective liberalization of trade in horticultural products. The high-income developing countries may be required to make some reciprocal concessions, which would open their markets to the rest of the developing countries, thus promoting intradeveloping-country trade. An international agreement on sanitary and phytosanitary standards and regulations is especially important. Standardization of regulations among importing countries, a system for international surveillance, and dispute settlement procedures under the GATT should preclude possible trade-distorting effects.

FUTURE PROSPECTS

Future prospects for horticultural trade will depend predominantly on the growth of import demand in the developed countries. Because consumption is already high in most developed countries and growth in incomes and population is expected to be slow, the annual rate of growth in their aggregate domestic demand is unlikely to exceed 1.3 percent for fruits and 1.1 percent for vegetables by the year 2000. Therefore, future growth of exports from developing countries will largely depend on the increase in the share of imports to fill aggregate domestic demand in developed countries. If past trends continue, this share is estimated to increase by 28 percent for fruits and 45 percent for vegetables, partly due to increasing demand in developed countries for horticultural products not available domestically.

It is worth noting, however, that the projected rates of increase in aggregate demand for fruits and vegetables are higher than those for cereals (including coarse grains), meat, and fats and oils. Considering that per capita consumption of fruits and vegetables varies widely among developed countries with similar levels of income and living standards, the potential for increasing consumption in the countries with relatively low per capita consumption is great (Figure 2).

The growth rate of aggregate demand in developing countries is expected to be about three times higher than that in developed countries partly because income and population growth is faster and partly because income elasticity of demand is higher. However, absolute growth in the volume of imports is expected to be small because it is starting from such a small base. As a result, the share of developing countries in total world import demand is estimated to increase from 17 percent during 1983-85 to no more than 20-23 percent by the year 2000.

One factor that could contribute substantially to the trade outlook for developing countries would be the opening up of markets in Eastern Europe and the U.S.S.R. These countries have had very

low per capita consumption of horticultural products and severe trade restrictions. For example, per capita consumption of oranges and bananas in the U.S.S.R. and Eastern Europe was less than 14 percent of that in the developed market economies during 1983-85. Increasing their consumption of just these two fruits by 2 kilograms per capita per year, could boost their annual horticultural imports 40 percent.

Total horticultural exports of developing countries are estimated to increase in the range of 1.6-3.4 percent per year, reaching US$12-15 billion in 1983-85 prices by the year 2000.

POLICY ISSUES

Except in tropical products, which constitute only a small share of world horticultural trade, developing countries need to strengthen their competitive position through cost-reducing innovations and improvements in quality. To this end, extension services and training at the farm level should be expanded.

Labor requirements vary from product to product and for the same product in different countries. Although countries where labor is abundant have lower labor costs, biological and mechanical advances and better infrastructure in developed countries may offset that advantage. This emphasizes the need for more technological research in developing countries to preserve and strengthen their labor-cost advantage. Because of the scarcity of available resources, the wide variety of products, and the need for a critical mass of research effort, countries must specialize in only a few products. Cooperation among developing easily be diversified from fresh horticultural products to more sophisticated processed products. Compared with other agroindustrial manufacturing processes, the techniques used for the processing of fruits and vegetables are relatively simple. The share of processed products in the exports of developing countries has steadily risen between 1961-63 and 1983-85 (Figure 3).

The organization of an effective system of packaging, processing, storage, transportation, and distribution is crucial to success in horticultural trade. Economies of scale are possible in all of these areas, which again argues for product specialization. Since about 70 percent of the final consumer price is accounted for by these costs, comparative advantage often depends more on how efficiently these services are organized than on the actual cost of cultivation.

More detailed studies of individual countries and projects are needed to determine how best to integrate small-scale farmers into a system of efficiently organized postharvest activities that yield economies of scale and how to promote the appropriate institutional arrangements. Alternative systems range from farmers' cooperatives to contract farming by small farmers for exporters, foreign importers, or processing firms. Multinational enterprises often combine their production and processing activities with marketing outlets in importing countries.

The scarcity of market intelligence and information on world trade, compared with other agricultural commodities, is a serious handicap. The amounts traded of individual horticultural commodities are so small that they do not attract the attention of statistical services. The need for co-

FOOD SECURITY CHALLENGES IN AFRICA UNDER STRUCTURAL CHANGE: AN OVERVIEW

JOACHIM VON BRAUN

STRUCTURAL CHANGE FOR FOOD SECURITY

There is widening recognition that a macro policy of rapid structural adjustment can contract demand, causing severe hardship for the poor. Fundamental difficulties arise when an attempt is made to cure this macro policy problem by adopting micro projects, such as targeted food and nutrition projects, especially where public institutions are weak and under severe fiscal restraint. The appropriate policy response may not necessarily be to undertake projects that parallel the macro policy reform process, but to review and possibly adjust macro policy in light of its food security effects (see the brief by Oyejide and the overview by Valdés).

While paying attention to the current painful consequences of structural adjustments for food security, policymakers must not lose sight of the fact that structural change is the desired outcome of a forward-looking development strategy. Elements of such a strategy are first, revitalized agricultural and rural growth, fostered by technological change, commercialization, and infrastructure buildup; and second, an improved human-capital base, for which education, health, and nutrition are key elements, which further support the rural growth strategy. Food security at the household level is both a desired *output* of successful development (with structural change) and a necessary *input* for development on a healthy human-capital basis, which permits accelerated technological change and specialization.

The concern for food security is a public policy concern that cuts across a range of issues. Central questions in this context are what role the public sector (versus the private) should play for food security, and at what scale. Food security is a basic element of social security. In the absence of formal systems for social security, and because of their prohibitive costs, public policy action for food security is called for in a number of places. These include the need to check food price levels and to stabilize prices, to respond appropriately to rapid growth of consumption of imported cereals, and to foster beneficial effects of rapid technological change and commercialization on food consumption.

TRENDS AND PROBLEMS

Africa's food security problem remains unsolved, and the 1980s have seen deterioration rather than improvement of food security in many parts of the continent. About one-fourth of the population does not obtain enough food to lead healthy and active lives. Rapid urbanization as well as a trend toward policy changes that cut preferential treatment of urban consumers have resulted in a rising urban food security problem. (The hunger problem in rural areas still predominates.)

IFPRI projections in the 1970s gave early warning of a rapidly **widening food gap** in Sub-Saharan Africa in the 1980s. A similar outlook for the year 2000 suggests that ever widening gaps will have to be filled by imports, including food aid. The gap is growing particularly rapidly in West Africa and in East and Southern Africa (Table 1). Extremely high population growth will remain a major challenge for food security policy in the long run. In view of high external debt and scarce foreign exchange, the rising food import bill will become increasingly difficult to pay.

Famines continue to be a recurrent problem in countries with poor resource bases, such as parts of Ethiopia and Sudan. They are aggravated by war, long-term effects of policy mistakes (such as the land tenure policy in Ethiopia and the mechanization policy in Sudan), neglect of the

Table 1
Long-term trends in Africa's staple food consumption and production

Region	1961-65 Quantity	1961-65 Rate of Growth	1979-83 Quantity	1979-83 Rate of Growth	Projection to 2000
	(million metric tons)	(percent)	(million metric tons)	(percent)	(million metric tons)
			Consumption		
Sub-Saharan Africa	53.9	2.5	83.5	3.5	161.3
West Africa	25.7	2.0	37.0	3.8	76.1
Central Africa	8.6	2.5	13.4	3.2	24.4
East/Southern Africa	19.6	2.9	33.1	3.2	60.8
			Production		
Sub-Saharan Africa	56.7	1.7	79.3	1.8	110.4
West Africa	28.1	1.1	36.0	1.0	42.0
Central Africa	8.8	2.0	13.2	2.0	19.2
East/Southern Africa	19.8	2.3	31.1	2.4	49.2

Source J von Braun, L. Paulino 1989.

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rural economy as evidenced by antiagricultural policies and failure to build infrastructure, and lack of preparedness and political will to respond to crises. Food production performance and hunger remain tightly tied in the famine-prone countries because public institutions are weak and international and interregional trade have been hampered. The instruments that have been effectively implemented for famine prevention in India—expansion of public works, rationing, and an effective public role in expanding food availability in times of crisis—are largely lacking in Africa, as explained in the brief by von Braun, Teklu, and Webb.

CRITICAL POLICY ISSUES

Policy responses to consumption change. While it is noteworthy that the share of noncereals, including roots, tubers, and plantains, in staple consumption remained at 42 percent between 1961-65 and 1979-83, the cereal composition of the African diet has been changing toward increased import dependence. The shares held by wheat and rice are increasing. In general terms, the policy response to the pressure for cereal consumption change can be addressed in three different ways (or a mix of them): first, by constraining consumption of the commodities through taxation or import restrictions (Nigeria's policy of banning wheat imports shows that this may involve high resource costs); second, by promoting use of traditional staples (by improving processing of coarse grains and cassava); and third, by promoting exports to pay for rising import bills. The latter two options have been underemphasized. Policies have centered on the first and disregarded the adverse effects on food security for the poor, whose demographic and work patterns, especially women's, make them more likely to be consumers of imported grain (see the briefs by Delgado and by Reardon and Delgado). Potential adverse effects for employment in the nonfood sector, resulting from drastic cereal price increases, need to be considered, too.

Price stabilization. The malnourished well as the urban poor in Africa are largely of food, at least during critical (high price) tin Seasonal and interannual price fluctuatior cause of nutritional deterioration. When foo in Sudan in 1984/85, the prevalence of mal children more than doubled to about 20 already high levels. Ad hoc project-base can do little to mitigate such shocks. Econo price stabilization policies, appropriately en holding and import options, have a key r household food security, as discussed i Pinckney.

Diversification of income and comm Food insecurity in Africa has complex pove and regional and intertemporal diversity. Di income sources can be an outcome of underlying forces. First, it is the outcome strategizing to cope with food security risks, the food and nonfood markets and in the market. This diversification of income so reduction is a symptom of poverty and con of forgone gains from specialization, wh captured in a situation where markets are m Second, it is the result of emerging rural g and thus a desired effect of an agricultu growth process with increased specializatior and farm levels. Nonagricultural income malnourished rural poor in Africa are alread 39 percent in four of the five cases in Tabl **Infrastructure** is the key to tapping the from specialization and to moving swiftly driven to growth-linkage-driven diversificatior by Reardon and Delgado).

A typical feature of structural change is a c of the agricultural sector in a growing e reverse also holds generally true: declining Africa show growing agricultural-sector sha

Table 2
Income sources of the mainourished rural poor (calorie-deficient households) at selected survey sites in Africa (early and mid-1980s)

Source	The Gambia (South Bank)	Rwanda (Northwest)	Kenya (Southwest)	Burkina Faso (Mossi Plateau)
			(percent)	
Agriculture	83.8	40.9	52.0	61.5
Subsistence food	54.9	28.1	38.1	29.2
Marketed crops	26.8	10.8	11.7	a
Other agriculture[b]	2.1	2.0	2.2	32.3
Nonagriculture	16.2	59.1	48.0	38.5
Nonagricultural wages	1.7	24.6	13.8	17.4
Other nonagriculture[c]	14.5	34.5	34.2	21.0

Source J. von Braun 1989
[a]Included under subsistence.
[b]Includes livestock, agricultural wages.
[c]Includes craftswork, services, transfers, and remittances.

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Table 3
Growth, position and change of share of the agricultural sector and food insecurity: selected African countries, 1965-87

Country	GDP per Capita, 1987	Economic Growth (GNP per capita), 1965-87	Agriculture's Share in GDP, 1987	Change in Agricultural Sector Share, 1965-87	Food-Insecure Population, 1980s[a]
	(US$)	(percent)	(percent)	(percentage points)	(percent)
Ethiopia	130	0.1	42	-16	62
Zaire	150	-2.4	32	+11	19
Malawi	160	1.4	37	-13	27
Tanzania	180	-0.4	61	+15	34
Burkina Faso	190	1.6	38	-15	21
Madagascar	210	-1.8	43	+12	13
Zambia	250	-2.1	12	-2	33
Rwanda	300	1.6	37	-38	14
Kenya	330	1.9	31	-4	28
Sudan	330	-0.5	37	-17	35
Nigeria	370	1.1	30	-24	13
Ghana	390	-1.6	51	+7	30
Senegal	520	-0.6	22	-3	18
Zimbabwe	580	0.9	11	-7	n.a.
Côte d'Ivoire	740	1.0	36	-11	6
Cameroon	970	3.8	24	-9	7

Sources World Bank
[a] Svedberg and calculations based on various World Bank and FAO statistics (share of population deficient in calories)

There are, however, some important "perverse" cases. These are countries whose overall economic stagnation or deterioration is combined with declining agricultural-sector shares. Accelerated deterioration of the agricultural sector coincided with and probably fostered economic decline in this group which includes Zambia, Sudan, Senegal, and Ethiopia—all of which are known to have particularly serious food security and nutrition problems. **Revitalized agricultural growth** is particularly urgent in these cases.

A key feature of structural change in rural Africa is commercialization of agriculture, that is, agriculture's increased market integration on the input and output side. There is much concern that potential gains from commercialization of agriculture would increase the food security risk of rural households. However, IFPRI research on the issue summarized in the von Braun and Kennedy brief, shows that in none of the study settings were negative effects of commercialization on nutrition noted. Positive income effects of commercialization were found to effectively reduce food deficiencies.

Health and sanitation. Rapid income growth from agriculture or elsewhere goes a long way toward solving the food security (hunger) problem. The same cannot be said for the problem of malnutrition, which is a complex interaction of lack of food and morbidity. The symptoms are arrested growth in children and high prevalence of illness. Health and sanitation have to be promoted in tandem with agricultural development to assure that growth is translated into nutritional welfare effects and a solid human-capital base for rural growth. The necessary income streams for sustainable promotion of health and sanitation, however, again largely depend on accelerated (rural) income growth.

CONCLUSIONS

Three sets of findings are emphasized here:

- Food security of the rural and urban poor in Africa cannot be protected in a situation of continued net-capital outflow, negative per capita income development, and unchecked price explosions. Targeted project measures may be successful at some locations, but wider coverage is frequently a problem. Adverse macro policy effects on food security can hardly be corrected by project measures alone.
- Agricultural growth (including food production growth), through direct and indirect employment and income generation, goes a long way toward improving food security in Africa. Technological change and an open trade regime, at least on a regional basis, are preconditions (see the briefs by Badiane and Badiane and Koester).
- In addition, the set of policy instruments for a household food security guarantee—tailored to specific country circumstances—needs to be deployed rapidly in the 1990s. This comprises public works (especially to build up rural infrastructure in the famine-prone countries); price stabilization (preventing explosive food price changes in the context of supply crises and exchange rate realignments); health and sanitation promotion (especially in rural areas providing access to respective services at low [time] costs for the poor); and institutional capacity to assess and respond to food insecurity (including institutions to monitor, design, and supervise implementation of food security policy modules). IFPRI and its partners in Africa have a key role to play in this respect.

Women in Agriculture: What Development Can Do

By Mayra Buvinic and Rekha Mehra
International Center for Research on Women
1990

An Agenda for the 1990s

Above all, rural women in the Third World need to increase their productivity and income in agriculture and related rural enterprises, to improve their own and their families' welfare. Because of the critical differences in the type of work men and women perform, and in the ways in which they utilize their income, interventions aimed at the family are not effective in alleviating rural women's poverty nor, in most cases, the welfare of children, for whom, almost universally, women are responsible. One of the most effective ways to attack rural poverty and increase rural women's incomes is to increase the productivity of smallholders, provided that such efforts benefit female as well as male farmers. Agricultural projects, therefore, must be oriented toward smallholders and should use a targeted approach within farming systems that takes into account women's roles as farmers and resource managers. This approach should focus on individual farmers (men and women) within farm households rather than on the household as a whole.

The initial step in a chain of events to increase the productivity of female farmers is research that goes beyond the farming system and examines the entire food system of the dominant staple foods in the area. This approach helps identify the constraints on both men and women in production, marketing, processing, and trade (Jiggins 1986).[2] Research is also needed on the nutritional effects of alternative production technologies (Pinstrup-Anderson et al, 1984). This research needs to be followed by policies that provide women farmers incentives to adopt agricultural innovations and by institutional changes that increase women's access to agricultural services. International donors can influence the nature of investments in agricultural research at international and national levels, the adoption of appropriate national agricultural policies, and the implementation of reforms in agricultural institutions so that women can have access to agricultural technologies, training, credit, and extension. Governments should be encouraged to implement land tenure reforms that will benefit all small farmers, men and women.

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Structural adjustment and other policy reform programs worldwide have produced a number of unforeseen problems because the role of women in various economic activities has not been taken into account. To be effective, such reforms must be structured to assist women, not only men, respond to price and other incentives. Agriculture, for instance, is typically targeted by short- and medium-term structural adjustment programs to increase production of exports or import substitutes to improve a country's balance of payments. For example, structural adjustment programs typically include measures to increase price incentives for export crops. But increasing the relative profitability of export crops may force women to work more hours, recruit the help of their children, or accept a decrease in their real incomes. Each of these options may have a negative impact on the family, on national food security, and on the long-term success of structural adjustment policies. Stepping up export-oriented production at the expense of locally grown food may cause a dysfunctional dependence on food imports.

There is a case, therefore, for balancing policy reform with effective sectoral strategies for raising the productivity of women's work in agriculture and microenterprises. Agricultural extension efforts should help women improve food production while allowing them to shift more of their labor to export production. Similarly, changes in legal, financial, and educational systems must be undertaken in order to enhance women's social and economic contributions to rural development in the long term. There is a need to examine carefully the implications of land tenure laws and regulations for women. Financial policies that encourage biases against, or reduce the profitability of, the types of borrowing that poor women seek must be revamped to increase the productivity of women's work. And educational policies and funding must be changed to reflect the very high social and economic returns to women's primary education and literacy.

The European Communities' Single Market: The Challenge of 1992 and Sub-Saharan Africa

By Alfred Tovias
World Bank Discussion Papers 100
1990

SUMMARY AND CONCLUSIONS

This report analyzes the impact of the completion of the European Community's (EC) Internal Market on Sub-Saharan African (SSA) countries. Not only economic size, but geographic propinquity and historical ties with EC members help to explain why more than half of SSA's trade is with the EC12. In fact the degree of SSA trade with the EC12 is larger than that of other regions geographically closer to the EC, Mediterranean countries or Eastern Europe. The same holds for bilateral and multilateral ODA originating in EC countries. In other words, SSA is closely linked economically to Western Europe, and particularly to the EC.

This being said, the completion of the EC's Single Market will have few irreversible or major effects on SSA, whether positive or negative. First, many of the issues covered by the EC-92 Program are of no direct concern to SSA exporters or consumers. Such is the case of deregulation of intra-EC banking and insurance services, a major item in the Program. Second, and more important, the actions of the African governments themselves will be crucial in determining their ability to take advantage of the positive elements of EC-92 and the extent of damage deriving from the negative effects on their economies.

A distinction must be made between the short-term and long-term impact (i.e., between static and dynamic effects). The first focuses mainly on the extent of external trade creation and of trade diversion against SSA exports; the second on the output and income generated by investments that respond to shorter-term changes. Quite a few aspects which should stimulate exports to the EC must be noted. In the case of EC-92 trade diversion effects derive not only from new arbitrary distinctions drawn between EC members and outsiders but also from the elimination of cost-increasing barriers (such as border formalities) on intra-EC trade. The latter leads to a more competitive environment and exploitation of economies of scale. Because of the limited export overlap between SSA and EC or EFTA exports, the trade diversion potential deriving from stiffer competition from European producers is limited to a few, key export sectors in many SSA countries, such as horticultural products from Kenya and Lesotho or air transport. The trade diversion potential may be amplified by the related investment diversion, e.g., in favor of new and safer ventures in Southern Spain. Domestic action by SSA governments could, however, counteract such trends by making the foreign investment climate in their countries more attractive.

Among the short-term effects, there are those concerning exclusively SSAs exports of goods, such as:

(1) The elimination of border controls and barriers

Cameroon, the Ivory Coast and Somalia will be affected by the removal of national quotas on banana imports from non-ACP countries directly competing

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with the former in the French and Italian markets. The Single Market may replace the special trade regimes for bananas of these two EC countries by a Community-based regime. The most liberal solution envisaged by the EC would be to apply the present rate of the Common Customs Tariff (20%) on non-ACP imports entering the Community. In such a case, exports of the three African countries could rise by more than 24%, while ACP Caribbean exporters, much less efficient, would likely lose exports. This is one case where ACP views do not coincide; Africa will be better off with a more "liberal" solution. In view of the importance of banana exports for Somalia, the creation of a real internal market for bananas is more likely to be a "plus" rather than a "minus". Given present supply conditions, Madagascar may also be able to develop banana exports to the Single Market.

The elimination of Member States Shares on most industrial products under the EC's GSP scheme since January 1, 1990 could lead to some trade diversion against Gabon's exports of plywood, particularly to France. But the new policy is not, strictly speaking, directly linked to the 1992 Program.

Individual EC countries, and France in particular, are less likely to be able to monitor petroleum supplies after 1992. Increasing EC imports of gas and petroleum products from Eastern Europe and the USSR are likely, given the reduction of tensions in Europe. In the absence of EC energy policies defining quotas, a change in import composition is therefore likely, possibly reducing the shares of SSA suppliers (Gabon, Angola, Nigeria, Guinea and Cameroon).

The elimination of Monetary Compensatory Amounts (MCAs) applied on sugar imports will reduce the actual price received by exporters in Mauritius and Swaziland, since in the past the principal UK importer used MCAs to benefit exporting countries.

Finally, Mauritius and some other SSA countries exporting sensitive products to the EC (such as clothing) may see their preferential status after 1992 somewhat eroded with the elimination of national QRs and national GSP tariff quotas on sensitive imports.

(2) <u>The harmonization of fiscal measures (e.g., the harmonization of VAT and excise rates)</u>

Two groups of SSA countries may be affected. First, SSA producers of coffee, such as Kenya, Uganda, Rwanda or Zaire would benefit from the elimination of Germany's excise tax on coffee. Assuming a price elasticity of demand of -0.3 (used in World Bank projections), German consumption would increase by at least 8%, representing an increase of 3% in EC consumption and implying US$200 million additional annual SSA exports to the EC.

Second, SSA exporters of jewelry, gold, silver and precious and semi-precious stones, such as Angola, Central African Republic, Congo, Guinea, Liberia, Sierra Leone, Zaire and Zambia should benefit from the reduction from present levels, ranging from 25 percent to 36 percent, to 20 percent of the VAT rate applied by France, Belgium, Italy, Spain, Greece and Portugal.

(3) The elimination of technical barriers (e.g., harmonization or mutual recognition of norms, standards and certification procedures)

Apart from the odd case of aircraft noise levels, which concerns air transport services (see below), SSA countries could be affected by new EC regimes for six categories of products exported to the EC: phosphates, tobacco, cocoa, palm oil, meat and fish.

The EC Commission intends to recommend new norms to reduce the use of cadmium-rich phosphates, such as those exported by Senegal and Togo. The new norm would also reduce the relative world price of such phosphates. Since the EC is aware of the effect which the new norms would have on Togo and Senegal, it is supporting research to find new methods to reduce the cadmium content of phosphates. In the event a strict norm should be enforced, the EC plans to provide a transition period to Togo and Senegal to adjust to it.

A proposal by the Commission to harmonize member states rules concerning maximum cigarette tar content by the end of 1995 should attract the attention of tobacco producers in Malawi and Zimbabwe, which have sufficient time to adjust to the new stricter norms.

The harmonization of the definition of chocolate, raising the level of vegetable oil allowed by French and Belgian producers will permit the latter to reduce the cocoa content of their chocolates. The extent they do this will depend on consumer reaction. On the other hand, the UK, a large producer of vegetable oil-rich chocolate, could expand exports of some brands of chocolate. These trends could adversely affect cocoa beans or butter exports of Ghana, Togo, Ivory Coast, Cameroon and Nigeria. But SSA exporters of palm oil, such as Ivory Coast, Nigeria and Cameroon would benefit from the same exercise as demand for their oil rose.

SSA producers of meat wishing to export to the EC must now have their slaughterhouses inspected by the EC. Because of their present lack of compliance with EC norms most of them are not allowed to export, forfeiting the advantages offered by the Lome meat protocol. With EC-92, the norms may be revised upwards. Madagascar, Kenya, Swaziland, Zimbabwe, Botswana and Namibia, all present or potential exporters, will probably need both assistance from the Commission to adjust to present and future norms as well as an improved response to such assistance.

The same applies to fresh or preserved fish products, exported mainly by Senegal, Ivory Coast, Madagascar, Mauritania, Mauritius and Seychelles. Whenever there are unified quality norms (e.g., for fresh fish or for can quality), the tendency is to raise the quality and environmental standards. But even when that is not the case, quality and health norms will be unified towards 1992 (e.g., for shrimps or canned tuna), with the tendency being to follow norms applied by the most strict EC country.

(4) Services

Among the issues related to SSA countries' exports of services the most important is air transport deregulation, which could lead to a 10% to 20% reduction in most intra-EC air fares. To prevent diversion of passenger trade or freight, European-African routes must also be deregulated, but for that to happen, SSA countries with air routes to the EC must adopt "open skies" policies. This would also counteract plans for intra-EC road transport deregulation slated to affect mostly SSA competitors (Mediterranean countries) in horticultural products (such as Kenya). In any event, once an Internal Market for air transport is created, it may be the EC, not its members, which will negotiate landing rights with SSA, altering the balance of power in favor of the EC.

SSA countries' civil aviation authorities should also take into account that the Community will apply from 1991 onward new and tight norms concerning aircraft noise levels.

Given the needs for "open sky policies" and the new EC noise standards, SSA airlines may need to concentrate only on those European routes where the standard of service that can be assured is the highest, so as to be able to compete with European carriers.

If such a strategy is pursued, SSA countries exporting tourism services to the EC (such as Kenya, Ivory Coast, Mauritius and Seychelles), should benefit from EC-92. They should become more attractive to tourists, both because alternative destinations in Southern Europe will become relatively more expensive as prices of labor and food rise as a result of single labor and food markets, and because intra-EC tax-free shopping will have disappeared.

(5) New procurement rules

There is one EC-92 issue relating to the prices applied on a substantial amount of SSA aid-financed imports of goods and services. The EC-wide bidding rules for procurement by EC-based public agencies may be extended as well to procurement linked to bilateral aid by EC countries. At present 46 percent and 87 percent of concessionary aid to SSA by France and Italy (60 percent of the EC's bilateral aid) is tied. Assuming that the price premium paid for this bilateral tieing is at least 25 percent, the savings that SSA would make would amount to at least US$600 million a year; at least US$700 million if all EC countries are considered. Given the difficulties of maintaining tied bilateral aid, the larger donor countries may resign themselves to progressively replace bilateral aid for ODA channelled through the EC, which is more transparent and can be used to procure goods and services more cheaply throughout the EC.

(6) Visas and other entry requirements

Some SSA visitors and migrants to the EC may expect more restrictive entry requirements into the Community as a result of the elimination of internal controls at EC borders. This may mean SSA residents will have to obtain visitor's visas to travel to the 12 countries in the EC, which is not the case nowadays for 19 SSA countries.

The short-term effects of EC-92, then, will depend on the specific goods and services each SSA country exports to the EC, and the speed with which its government and exporters adjust to the new changes. But what about the longer-term effects?

There is little doubt the Single European Act and the process of integrating the EC-12 has led to higher economic growth expectations in Europe. This more rapid growth will lead to a greater demand for imports. Unfortunately, the past delinking of most SSA countries from the global economy means it would be difficult to expect such a growth dividend to play any part in SSA exports unless the African countries themselves make a determined effort to make their economies more outward-oriented. This is one case where the actions of SSA nations are far more important than those of the European Community. Even then, the greater dependence of SSA countries on primary commodities, with their relatively lower income elasticities, means their share of the trade to this more buoyant market may not rise rapidly.

Over time, however, one would hope that some EC-92 measures might make a difference in SSA's development. Efforts to quantify them, however, only underline the marginal impact EC-92 may have on SSA as a whole. For example, the increased quality of EC aid would, if half were invested, produce a GDP growth rate of only one-twentieth of one percent. While the EC coffee and jewelry imports might increase significantly and banana imports be rearranged, the impact they would have on SSA as a whole may not be high; it would only be for the smaller countries highly dependent on these exports (e.g., a 2% increase in GDP for Rwanda from coffee, a 1.2% increase in Liberian GDP from precious stones) that EC-92 would have a significant effect on country-wide incomes.

THE WASHINGTON POST, August 1, 1990

Robert J. Samuelson

The Absurd Farm Bill

The best way to grasp the absurdity of our farm programs is to ask: Would we create these programs today if they didn't already exist? Would we force Americans to pay twice the world price for sugar? Would we decide to give dairy farmers $650 million a year to produce milk we don't need? Would we fatten the budget deficit by paying $5 billion a year in subsidies to wheat, feed grain, rice and cotton farmers? It would require enormous gall for anyone to propose these outlandish and costly ideas.

The absence of any compelling need for farm subsidies is obviously not important. Congress is now cheerfully extending the farm programs for another five years even though it could not conceivably justify the same programs if they were new. The legislation breezing through the House and Senate will cost taxpayers an estimated $50 billion to $60 billion between now and 1995. Retail food prices will be artificially raised by at least $10 billion annually. Yet, there's been barely a peep of public outcry.

You can partially explain this by the inertia of politics. Once in place, even the most worthless programs are hard to kill. They become encrusted in a cocoon of constituents, well-organized lobbies and powerful politicians. But farmers also tug at our emotions, and there are always a few celebrities (the Willie Nelsons and Jessica Langes) loudly mourning the vanishing of the family farm. All these plaintive wails obscure what's really going on: a mad scramble to squeeze private gain from the public.

Agricultural subsidies are little more than a costly exercise in nostalgia.

We have been at this for more than half a century—long enough to know that most of the reasons customarily advanced to justify these programs are wrong. Government subsidies clearly aren't needed to ensure the steady flow of food to market. Indeed, only about two-fifths of farm products receive substantial subsidies. These include the major feed grains, dairy products, peanuts, rice and sugar (sugar is protected mainly by tight import restrictions). Somehow, everything else—beef, chicken, eggs, pork and most fruits and vegetables—gets produced, processed and delivered without subsidies.

The idea that government policies preserve small family farms is an even bigger myth. Between 1935 and 1989, the number of farms dropped from 6.8 million to 2.2 million. Even continuous government subsidies couldn't neutralize basic changes in technology—more mechanization, better seeds and more fertilizer—that reduced the need for farm labor and made for bigger farms. By and large, this upheaval has been a boon to both consumers and farmers. Fewer farmers feed us better at a lower cost. In 1960, Americans spent 20 percent of their disposable income on food; today, that's 14 percent. Between 1955 and 1989, the number of dairy farms dropped from 2.8 million to 205,000, and the number of dairy cows from 21 million to 10 million. Yet, total milk production rose a fifth because each cow now gives 144 percent more milk than in 1955.

The loss of so many farms has involved much personal anguish but also has allowed people to live better. A half century ago, there was a vast gap in incomes and living standards between farms and cities. Now there isn't. Many vanished farms provided only a meager existence in exchange for grueling labor. The survivors are still mainly family farms, but they are *big* family farms. In 1989, half of all the farmland was owned by the 15 percent of farms that have sales exceeding $100,000. These are the farms that receive most subsidies. In 1989 nearly 60 percent of subsidies went to the wealthiest quarter of farms. The remaining farms are often run by part-timers who have other jobs (half of farm income comes from nonfarm sources).

Whenever Congress tackles farm legislation, farm groups are routinely described as being "on the defensive." What a joke! The public pays scant attention to the debates, and neither political party pushes for an outright end to subsidies. A few renegades (Republicans and Democrats) scream with little effect. In last week's debate, amendments were offered in both the House and Senate to trim the price support for sugar from 18 to 16 cents a pound, a trivial cutback. The proposals were rejected 271 to 150 in the House and 54 to 44 in the Senate.

The newest version of the "farmers on the defensive" story is this: the budget summit and a new global trade agreement will ultimately force reductions in subsidies. By this logic, Congress is simply going through the motions of extending the farm programs. Later, cuts in farm subsidies will be included in the larger packages to decrease the deficit and to approve new trade measures. So members of Congress can—by this reasoning—loudly flaunt their pro-farm sympathies now and then quietly renege later.

There may be a scintilla of truth in this, but mostly the argument is backward. By cutting farm subsidies now, Congress would improve the prospects for a major package to reduce the budget deficit. The same is true of trade. The more Congress subsidizes our farmers, the less seriously other countries (mainly the Europeans) take our demands to cut their own subsidies and import barriers. As a result, any trade liberalization is likely to be modest. Because U.S. farmers have more to gain than to lose from freer trade, their long-term interests are being sacrificed to their short-term addiction to subsidies.

Given the hardships of ending any addiction, there's a practical case for phasing out subsidies over, say, five years: farmers should have time to adjust to change. But there's no case for continuing the subsidies indefinitely. The economic health of American farmers has improved vastly since the early 1980s when they suffered the aftereffects of double-digit inflation and overborrowing. In 1989, farm profits (adjusted for inflation) were twice as high as they were in 1980.

Who cares? No one, really. The farm lobbies are effective because they operate in a climate of public indifference and, indeed, benevolent tolerance. Americans somehow consider farmers, as a class, more deserving than ordinary people. They do "real" work and evoke our past of rugged individualism. We want to be reconnected to our roots. Even in an era when government faces many pressing needs—and pressures for new taxes—we are willing to pay a high price for nostalgia.

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G-15: A Different Economic Summit

By Hazel Henderson

KUALA LUMPUR, Malaysia's elegant capital city, played host in early June to the first economic summit of the new "Group of Fifteen" countries: Algeria, Argentina, Brazil, Egypt, India, Indonesia, Jamaica, Malaysia, Mexico, Nigeria, Peru, Senegal, Venezuela, Yugoslavia, and Zimbabwe.

The inauguration of the G-15 economic summit launches a debate about how to judge and measure true "development." The combined populations of the G-15 total 29.6 percent of the world's people. By contrast, the Group of Seven industrial countries (the U.S., Britain, West Germany, France, Italy, Canada and Japan) meeting this week in Houston make up 12.7 percent of the globe's population.

Press coverage of global economics has been both traditional and conventional. Alternative, unofficial voices, such as those of non-governmental groups including the London-based The Other Economic Summit (TOES) have been barely audible. In an era of shuffling trade blocs such as Europe 1992, the North American Free Trade Zone, and the Eastern European countries, the new G-15 is a natural response.

The G-15 grew out of initiatives of the South Commission, a group of leaders from developing countries. Included were former president of Tanzania, Julius Nyerere, and Malaysia's Prime Minister, Dr. Mahatir Mohamed, who hosted the G-15 summit. President Suharto of Indonesia was in Kuala Lumpur as was India's prime minister, V. P. Singh, who felt G-15 would enhance cooperation between southern countries. The summit's final communique included references to a new post-cold war global economy, and a need for North-South sharing of responsibility.

The new G-15 country-group accepted responsibility for their own development and change, and cautioned the industrialized nations on "their formation of economic groupings ... that could lead to a fragmentation of world trade." Key issues included unresolved external debt problems and the ongoing transfers of resources from poor to rich countries. Many observers now see the 1980s as a wasted decade – when the economic development process reversed itself with tragic results widening gaps between rich and poor. These failures produced a crisis of confidence in the South about the viability of European industrial models.

The G-15 pledged to continue to meet and form common approaches to debt problems. It reaffirmed a commitment to "a balanced and successful conclusion to the Uruguay Round of GATT negotiations which takes into account the concerns and needs of developing nations." The Group called for new approaches to drug enforcement – crop substitution rather than eradication programs. A strategy on funding environmental protection will be presented at the 1992 U.N. Environment Conference in Brazil.

G-15 will likely continue the work of the South Commission whose report, "Toward a New Way to Measure Development," formed new economic models and measures of progress. The report concluded that more realistic "scorecards" of development were needed. New indicators would include such non-monetary indexes as literacy rates, life expectancy, unpaid productive work – along with indicators of energy-efficiency, military versus civilian budget ratios, and environmental depletion. The South Commission will release its final report in Caracas, Venezuela on August 3.

The South Commission's work may have triggered the new U.N. approach to measuring development, it used to rely exclusively on Gross National Product (GNP), as does the World Bank and the IMF. Recently, the U.N. released a new "Human Development Index" (HDI), which measures such factors as literacy rates and life expectancy. Comparing the GNP and the HDI measures of human progress changes the ranking of many countries. For example, Sri Lanka, whose GNP is only $400 per person, actually offers its citizens purchasing power equivalent to $2,000 per year, a life expectancy of 71 years (higher than the USSR). Its literacy rate of 87 percent outstrips the US (about 80 percent).

Costa Rica, with purchasing power of $3,760 per head, 93 percent literacy, and life expectancies of 75 years, streaks ahead of several European countries. The US drops from second (after Switzerland) in the GNP stakes to 19th on the HDI scorecard. The purchasing power of G-7 country members is about $14,000 per head per year, while this average among G-15 member countries is about $3,500. Thus, by some quality of life measures, many polluted industrial countries may fall behind more pristine, resource-rich ones in the South.

The G-15 will cause a re-thinking of "development." New definitions will emerge as differences between money and real wealth are clarified. Many southern nations may develop along their own cultural paths, rather than slavishly following World Bank and IMF formulas. The end of the cold war also signals the end of ideological, mutually exclusive capitalist or socialist paths to progress. The realities of the U.N.'s fourth development decade of the 1990s are likely to be more complex. The G-15 will enrich this debate as countries find their own innovative potential in an era of global interdependence.

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LOS ANGELES TIMES, July 31, 1990

Market Focus

Argentine Economy Not Dying on the Vine

■ A top winery becomes the model for a provincial government's efforts to modernize and diversify the marketplace.

By JAMES F. SMITH
TIMES STAFF WRITER

MENDOZA, Argentina—For decades, the Giol winery was an infamous monument to Latin American statism. Now it has become a model for the economic transformation that is fermenting in the region.

The government of Mendoza province bought the struggling winery in 1954, in an era when state domination of Latin American economies was accepted theory. The province took over the operation intending to help regulate the private market by giving small-time grape growers a guaranteed buyer.

Giol, founded by two Italian immigrants in the 1890s in South America's principal wine-producing valley, was to have been returned to the private sector in three years. It didn't work out that way.

As a government enterprise, Giol grew to become the world's largest winery, with 3,500 employees—although it only needed about 1,200 to produce its wines, both fine and table-quality. It added grape by-products and then a fruit-processing operation.

Bloated and inefficient, Giol began to leak. From 1983 to 1989, its losses averaged $500,000 a month. That $6 million a year was no small sum to a provincial government with an annual budget of just over $300 million.

Gov. Jose Antonio Bordon, who was elected in 1987, recalls: "We asked ourselves: 'Does Giol serve the people of the province? No.' So we decided to sell it."

Bordon, 44, is one of the young "renovators" of the Peronist party, whose founder, President Juan D. Peron, inspired the state takeover of the telephone system, the railroads and other businesses in the 1940s and '50s. Like Argentine President Carlos Saul Menem, another Peronist, Bordon is regarded by some diehards as a traitor to the Peronist cause.

But he pressed ahead with the Giol divestment plan. To ease the impact for the grape-growers, the government helped them form cooperatives to make them more competitive and give them some muscle in the market. So far, 25 cooperatives have been formed, most paid back their initial loans within six months, even though they had five years to pay.

The vast wine-producing complex, whose huge fermentation and storage tanks look more like an oil refinery than a winery, was sold to a combination of other wineries and the growers' cooperatives. The size of the state work force plummeted, with many accepting transfers to the police force or hospitals and others joining the newly private firm.

The privatization process was virtually completed in March. Only the regulatory branch of Giol, charged with improving the quality of Mendoza wines, remains in state hands, with 250 employees and a target of 100. The financial drain has stopped. The fruit-processing branch goes on the auction block in July.

The Giol winery is a case study in a broader initiative by Bordon's government to modernize and diversify the provincial economy. The production of fruits has multiplied five times since 1987, and exports have soared from $23 million to $203 million, including fruit-processing machinery sold to the Soviet Union.

Budget procedures have been revamped and computerized. Rodolfo Ingoyen, a Bordon adviser, said the government "discovered that we had 200 warehouses, and we didn't even know what was inside them. Now we know. We have identified 15% of the public work force. This is unknown in Argentina—we know what they earn and what they do."

The province had used 35 different systems of dividing itself into districts, depending on which public agency was involved. Now, police, schools and health and energy agencies have all adopted a uniform system, Ingoyen said.

Through such reforms the government discovered that the gas company was failing to bill nearly $1 million annually, a problem now being corrected.

The World Bank has cited Mendoza as a model for the rest of Argentina's 22 provinces to follow in reforming their moribund economies.

Mendoza, the fourth-largest province, with 1.5 million inhabitants, is arid but blessed with oil and other resources, making it traditionally one of Argentina's more prosperous regions. The capital city of 800,000, also called Mendoza, lies at the edge of the Andes Mountains foothills bordering Chile, near the tallest peaks in the Americas. The province offers some of the finest skiing in the Southern Hemisphere, a resource that Bordon wants to exploit more fully.

The governor said the fundamental problem in Mendoza was the over-reliance on a single crop—grapes—and the lack of market competitiveness of the smallest of the 20,000 grape producers, who simply had relied on Giol to buy up their product.

"Democratic governments had been subsidizing these producers. We had farmers producing 80 quintals (one quintal equals 220 pounds) on land that could produce 300 quintals with a bit of investment. Giol was a huge cost for so small an output," Bordon said in an interview.

"Now the resources we earned from Giol are going to credits, to capital investment, to reconverting the fruit industry."

But Bordon, often mentioned as a future presidential candidate, is adamant that the goal is not privatization for its own sake. "This is a pragmatic approach, so that we combine business efficiency with social justice," he said. "We don't want savage liberalism either."

Neither the United States nor Japan emerged from their crises of the 1830s and 1940s without allocating a key role to the state, Bordon noted, adding that Argentina's transformation also will require a combination of public and private initiatives.

"The Argentina problem is not going to be solved magically by shrinking and privatizing the state, but by being efficient and uniting behind a common project. We need to diversify products and markets. We have needed a change in mentality and technology. Democracy needs efficiency."

One key to Bordon's success is his economic team, led by 33-year-old Economy Minister Rodolfo Gabrielli. By balancing the budget and halting the Giol losses, the province has had more funds available to finance productive investment, particularly export-related businesses.

Processing of grape products such as juices and concentrates has increased, along with exports of tomato products (up 1,000% to $14 million last year), increases that begin to call to mind the economic boom across the Andes in Chile.

"This is proof that our people want to produce, when they are given the chance," Gabrielli said.

While serving as a congressman in Buenos Aires from 1983 to 1987, Bordon sponsored legislation tightening quality controls on Argentine wines, requiring that all fine wines in containers of one liter or less be bottled in the place of origin and under closer scrutiny.

Some Argentine wines, particularly red wines, have long been recognized as world-class, but cheaper wines, from Giol and other mass producers, had been criticized as inconsistent. Mendoza's wine people are confident that those complaints are being resolved and that Argentine wines will gain increasing prominence.

Raising exports is vital since wine consumption in Argentina fell by nearly half in the 1980s due to economic crisis and changing lifestyles.

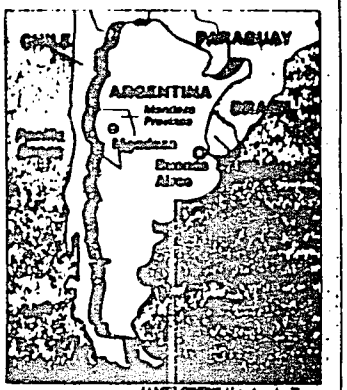
At the Giol complex in the town of Maipu, a few miles east of Mendoza, Jose Luis Sanchez said his cooperative, Lumai, has grown from an original 33 member growers to 80. "The difference is that before, the small guys sold at low prices," said Sanchez, a 19-year veteran of Giol. "Now the cooperatives can support them. The only solution was to group together, and not surrender to the big companies."

Argentine provinces have long been plagued by overreliance on Buenos Aires to bail them out of financial crises, while the provinces have complained that the national government neglects and underfinances them.

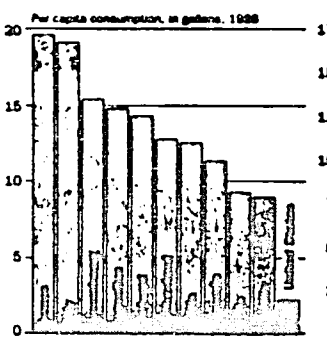
Bordon said Mendoza serves as a case study for successful federalism, and he pointed proudly to the World Bank's comments in May on his innovations: "They show that meaningful reforms in the provincial public sectors are possible in Argentina."

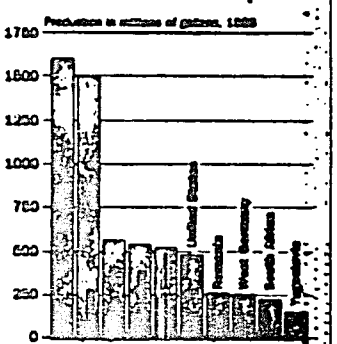
On the Grapevine

Argentina ranks fourth in the world in wine consumption, per capita, and fourth in the world in wine production according to 1988 figures provided by the Wine Institute. The Giol Winery, one of the oldest in the nation, has become a model for the economic transformation sweeping the nation.



MARCI CRUZAN / Los Angeles Times





SOURCE: Wine Institute, San Francisco

LOS ANGELES NEWSPAPER Via Associated Press

The facade of the Giol Winery remains as it looked when built in the 1890s.

The rules of foreign patronage in Africa are changing at a time of great instability there, writes **Michael Holman**

Between reform and more decline

Liberia's slide from dictatorship to anarchy is terrible, even by the standards of a continent used to upheaval. But far from being an aberration, Liberia could prove to be just the first of several states to collapse under the weight of economic mismanagement and ethnic tensions, compounded by policy failures on the part of the superpowers and aid donors.

Other wars in sub-Saharan Africa highlight the continent's fragility. Angola, Mozambique, Sudan, Somalia and Ethiopia are torn by conflict. Uganda has yet to recover from Idi Amin. Chad and Libya may again come to blows. Senegal and Mauritania keep an uneasy peace.

Almost wherever one looks, from Angola to Zambia, from Mali to Mozambique, the ossified political structures of post-independence Africa are cracking.

From across the continent come calls – endorsed by western governments, aid donors and lending institutions – for a multi-party system. Political adjustment is catching up with the economic adjustment programmes being introduced. But the cry for democracy is as much a moan of pain caused by the economic failures over three decades of independence and Africa is delicately poised between reform and further decline.

"Good governance" – the World Bank's term for better management and democracy – is essential to recovery from disaster. But it will not be the engine of growth for a debilitated continent.

The causes of the upheaval are complex. The most frequent explanation invariably couples the renewed search for freedom in Africa with the revolution in eastern Europe.

"The wind blowing from Europe has begun to sweep Africa. We should not moan over it, we should even rejoice over it," as President Mitterrand put it in a recent speech.

France, like Britain and the US, is encouraging the process by linking aid to democracy. "France will link its contributions to efforts designed to lead to greater ... democracy," Mr Mitterrand told African leaders at the francophone summit last June.

Even the Organisation of African Unity, that club of autocrats so tolerant of each others failings, last month conceded that it was necessary "to democratise further our societies and consolidate democratic institutions."

But there are more important influences than eastern Europe that are driving Africans to the barricades.

France is reappraising its relationship with francophone Africa. The superpower rapprochement has reverberations in southern Africa and the Horn of Africa in particular, as well as leaving several African leaders anxious about their dwindling foreign patronage.

Aid-dependent regimes have become uneasy as the World Bank and increasing numbers of western governments have moved towards demanding political reform as a condition of aid. South Africa's search for a constitution which accommodates the aspirations of the majority, while coping with the fears of minorities, is gripping the attention of the rest of Africa. Above all, a decade or more of sharp economic decline has made impoverished citizens throughout the continent angry with their rulers, and impatient to find leaders with alternatives.

Certainly, eastern Europe's revolution encouraged opposition movements. It further undermined belief in centrally controlled economic systems – though the examples of Tanzania and Zambia had already done that. And as regimes in East Germany and elsewhere collapsed, the governments in Angola, Mozambique and Ethiopia lost reliable allies.

(South Africa is *sui generis*. Government officials there acknowledge a two-fold impact which proved decisive in persuading President F W de Klerk to embark on radical change. The spectacle of mass demonstrations against elitist governments evoked the worst white South African nightmare. And the collapse of communism as an ideology encouraged Pretoria in the belief that it was safe to unban the South African Communist Party.)

But there are critical differences between the experience of eastern Europe and the process under way in Africa which limits the appropriateness of any comparison. The former has an industrial proletariat with considerably more muscle than that of the peasants in Africa's predominantly agricultural economies. Essential to the success of the eastern European revolution was the fact that the region's metropolitan power – the Soviet Union – was preoccupied by its own domestic crisis, and made clear it would not intervene.

For Africa, this process took place two to three decades ago, when Belgium, France, Britain and Portugal decided that the price of the colonial relationship was too high.

Post-independence Africa then enjoyed a brief period of democracy, before voters discovered that the district commissioner had been replaced by the party apparatchik and the parastatal bureaucrat. The latter are proving far more difficult to dislodge.

Alone among the colonising powers, France has kept up a willingness to intervene militarily and financially if a former colonial protégé is in trouble. This willingness may now be in doubt, a factor that will prove far more significant to political change in francophone Africa than anything that happened in eastern Europe.

Although France retains an extraordinary historical and cultural link with Africa, it is finding the financial responsibilities of underwriting the CFA franc increasingly onerous.

The CFA Franc, the common currency used by France's 13 former colonies, has been pegged to the French franc at a rate of 50 to one since 1948. It proved of mutual benefit for a while, but is now becoming a financial burden which is pushing France into a reassessment of its African ties.

France is also giving notice that its military involvement in Africa may be more limited than in the past. Mr Mitterrand again: "Our role ... is not to intervene in your internal conflicts. In that case France, in agreement with [African] leaders, will watch over the protection of its citizens, but it does not intend to arbitrate the conflicts." The prospect of losing the military umbrella – some 9,000 French troops are based in francophone Africa – is as disconcerting to current leaders as it is encouraging to their opponents.

The World Bank says Africa's economies must grow by at least 4 to 5 per cent a year for a 'modest' improvement in living standards

The impact of the superpower rapprochement is still being felt. The obvious benefit has been Namibia's independence, and the boost given to the peace process in South Africa.

As Namibia begins independence with a multi-party constitution, and the world demands the same from South Africa, opposition leaders in the region are asking: Why not us?

But détente has implications beyond southern Africa.

Aid and security has long been linked. As Africa ceases to provide cockpits for superpower conflicts by proxy, so aid to certain countries will decline. It has already in Somalia. Leaders of countries such as Zaire, who adroitly played on tensions between Washington and Moscow to bid up aid levels, are now getting less support, while their opponents receive a sympathetic hearing.

The rapprochment has also left a potentially dangerous power vacuum in the Horn, this could well be filled by Israel – which is almost certainly supplying arms to Ethiopia's president, Mengistu Haile Mariam – or one or more of the Arab states. This would exacerbate, rather than resolve the conflicts.

Last November, the World Bank added another element to the pressure on African governments. In the most searching examination of Africa's problems ever published by the Bank, the continent's largest donor called on leaders to become "more accountable to their peoples."

"Many governments are wracked by corruption and are increasingly unable to command the confidence of the population," said the Bank, warning that without democratic reforms, many countries structural adjustment programmes will fail and external aid will fail.

Most African governments are resigned to the prospect that in future, aid will have political as well as economic conditions attached. Neither the Bank nor governments such as the US and Britain which have endorsed this approach, have so far drawn up formal political criteria.

But on such a list would be issues ranging from the state of the local press to whether a recipient is a one or multi-party state.

One of the first countries to face such a test has been Kenya, where opposition leaders have been detained and President Daniel arap Moi has entrenched the authoritarian ruling party. During last month's unrest, Washington made clear that aid flows could be reduced if reforms did not take place. Britain issued a similar message, *sotto voce*.

Whatever the roots of the African unrest, one thing is clear. Despite World Bank supported economic reform programmes adopted in varying degree by about two-thirds of sub Saharan Africa, the continent remains in deep economic crisis.

The Bank's report on Africa pointed out that the region's economies must grow by at least 4 per cent to 5 per cent annually for a "modest" improvement in living standards. This target requires a 4 per cent a year increase in real terms of official development assistance, together with further external debt relief. It represents a gross Overseas Development Agency requirement of $22bn a year at 1990 prices by 2000, the Bank estimates.

Many economists believe this underestimates Africa's needs, but even this comparatively cautious goal may be hard to attain.

Donor fatigue has set in since the 1980s, when the high point of compassion was Band Aid in 1984. Nor are aid flows helped by the spectacle of the World Bank and the Economic Commission for Africa, the UN body that acts as the continent's think tank, quarrelling over the type of medicine the patient needs.

There are growing doubts that the Bank's "model patients" are, in fact, going to recover. After seven years of external assistance running at an annual rate of about $500m, Ghana, for example, is still a long way from passing the key test: can growth be sustained without substantial aid?

And even if the patient pulls through, will there be sufficient external support for the 40 or more sub-Saharan countries that need varying degrees of help? It seems unlikely. Private investment is negligible and the aid needs of eastern Europe overshadow Africa's. Meanwhile the voice of the Africa lobby carries less and less weight.

Africa now beckons neither high-flying diplomat nor thrusting businessman. Pretoria and perhaps Lagos rate highly. But the biggest career lure comes from Asia, Europe, and the US. Businessmen note that Africa's share of world trade has fallen in the past 30 years from 3 per cent to 2.5 per cent. They say that investing in south Asia costs roughly half as much as investing in Africa, and produces many times the return.

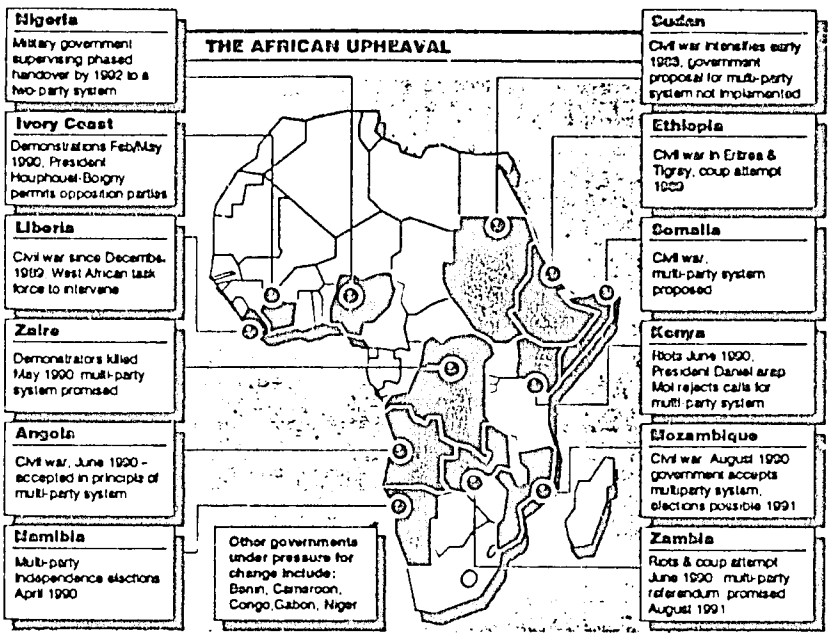
Africa, almost as impoverished today as it was 30 years ago, but now burdened by a $135bn external debt that equals the continent's GNP, will probably get poorer.

More will feel the pain as the years go by. Africa's population is expected to double to about 1bn over the next 20 years, unless fertility rates drop – or AIDS wreaks the havoc that some observers fear.

Africa's marginalisation is not just its own affair. In an interdependent world, all places are vulnerable to each other's misfortunes.

African deforestation may contribute to global warming; plants which could provide important genetic material for crop or medical research may be lost; diseases such as AIDS know no boundaries. Muslim extremism in Africa, a potentially destabilising issue in Nigeria could pose a new terrorist threat.

These may seem to be problems that can be addressed in the fullness of time. But the "multi-party" signals from Africa should be treated with caution: the continent may not be waving, but drowning, with more than Liberia soon to go under.



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Statements to the Congress

Statement by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, July 12, 1990.

I am pleased to appear before this committee to discuss reform of the deposit insurance system and expanded activities for banking organizations. Like each of you, my colleagues and I have spent considerable time discussing and debating the issues. We are reminded almost daily of the potential for public cost of the deposit insurance obligation, made so painfully apparent by the failures and difficulties of so many thrift institutions. Similarly, both the Congress and the Board are reminded repeatedly of the erosion of the competitiveness of our banking system both domestically and internationally. The time has come when these issues must be addressed.

The hearings you are conducting, Mr. Chairman, will establish a record preliminary to the publication early next year of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)-mandated Treasury study of the issues. The Board is participating in this study and has conveyed to the Treasury the views expressed in this statement. By holding hearings at this early date, I hope that the Congress will be able to focus on the needed legislation immediately after the release of the Treasury study. Basic reforms are required both of the safety net and of the range of activities permitted banking organizations.

The fundamental problems with deposit insurance that must be addressed are clearly understood and are, I believe, subject to little debate among those with drastically different prescriptions for reform. The safety net—deposit insurance, as well as the discount window—has so lowered the risks perceived by depositors as to make them relatively indifferent to the soundness of the depository recipients of their funds, except in unusual circumstances. With depositors exercising insufficient discipline through the cost of deposits, the incentive of some banks' owners to control risk-taking has been dulled. Profits associated with risk-taking accrue to owners, while losses in excess of bank capital that would otherwise fall on depositors are absorbed by the Federal Deposit Insurance Corporation (FDIC).

Weak depositor discipline and this moral hazard of deposit insurance have two important implications. First, the implicit deposit insurance subsidy has encouraged banks to enhance their profitability by increasing their reliance on deposits rather than capital to fund their assets. In effect, the deposit insurance funds have been increasingly substituted for private capital as the cushion between the asset portfolios of insured institutions and their liabilities to depositors. A hundred years ago, the average equity-capital-to-asset ratio of U.S. banks was almost 25 percent, approximately four times the current level. Much of the decline over the past century, no doubt, reflects the growing efficiency of our financial system. But it is difficult to believe that many of the banks operating over recent decades would have been able to expand their assets so much, with so little additional investment by their owners, were it not for the depositors' perception that, despite the relatively small capital buffer, their risks were minimal. Regulatory efforts over the past ten to fifteen years have stabilized and partially reversed the sharp decline in bank equity capital–asset ratios. This trend has occurred despite the sizable write-off of loans and the substantial build-up in loan-loss reserves in the past three years or so. But the capital ratios of many banks are still too low.

Second, government assurances of the liquidity and availability of deposits have enabled some banks with declining capital ratios to fund a riskier asset portfolio at a lower cost and on a much larger scale, with governmental regulations and supervision, rather than market processes, the major constraint on risk-taking. As a result,

more resources have been allocated to finance risky projects than would have been dictated by economic efficiency.

In brief, the subsidy implicit in our current deposit insurance system has stimulated the growth of banks and thrift institutions. In the process, the safety net has distorted market signals to depositors and bankers about the economics of the underlying transactions. This distortion has led depositors to be less cautious in choosing among institutions and has induced some owners and their managers to take excessive risk. In turn, the expanded lending to risky ventures has required increased effort and resources by supervisors and regulators to monitor and modify behavior.

But in reviewing the list of deficiencies of the deposit insurance system, we should not lose sight of the contribution that both deposit insurance and the discount window have made to macroeconomic stability. The existence and use of the safety net have shielded the broader financial system and the real economy from instabilities in banking markets. More specifically, they have protected the economy from the risk of deposit runs, especially the risk of such runs spreading from bank to bank, disrupting credit and payment flows and the level of trade and commerce. Confidence in the stability of the banking and payments system has been the major reason why the United States has not suffered a financial panic or systemic bank run in the last half century.

There are thus important reasons to take care as we modify our deposit insurance system. Reform is required. So is caution. The ideal is an institutional framework that, to the extent possible, induces banks both to hold more capital and to be managed as if there were no safety net, while at the same time shielding unsophisticated depositors and minimizing disruptions to credit and payment flows.

If we were starting from scratch, the Board believes it would be difficult to make the case that deposit insurance coverage should be as high as its current $100,000 level. However, whatever the merits of the 1980 increase in the deposit insurance level from $40,000 to $100,000, it is clear that the higher level of depositor protection has been in place long enough to be fully capitalized in the market value of depository institutions. The associated scale and cost of funding have been incorporated into a wide variety of bank and thrift decisions, including portfolio choices, staffing, branch structure, and marketing strategy. Consequently, a return to lower deposit insurance coverage—like any tightening of the safety net—would reduce insured depository market values and involve significant transition costs. It is one thing initially to offer and then maintain a smaller degree of insurance coverage and quite another to reimpose on the existing system a lower level of insurance, with its associated readjustment and unwinding costs. This is why the granting of subsidies by the Congress should be considered so carefully: They not only distort the allocation of resources but also are extremely difficult to eliminate, imposing substantial transition costs on the direct and indirect beneficiaries. For such reasons, the Board has concluded that, should the Congress decide to lower deposit insurance limits, a meaningful transition period would be needed.

A decision by the Congress to leave the $100,000 limit unchanged, however, should not preclude other reforms that would reduce current inequities in, and abuses of, the deposit insurance system. Serious study should be devoted to the cost and effectiveness of policing the $100,000 limit so that multiple accounts are not used to obtain more protection for individual depositors than the Congress intends. The same study could consider the desirability of limiting pass-through deposit insurance—under which up to $100,000 insurance protection is now explicitly extended to each of the multiple beneficiaries of some large and otherwise uninsured deposits. Both have been used at times to thwart or abuse the purpose of deposit insurance protection.

No matter what the Congress decides on deposit insurance limits, we must be cautious of our treatment of uninsured depositors. Such depositors should be expected to assess the quality of their bank deposits just as they are expected to evaluate any other financial asset they purchase. Earlier I noted that our goal should be for banks to operate as much as possible as if there were no safety net. In fact, runs of uninsured deposits from banks under stress have become commonplace.

So far, the pressure transmitted from such episodes to other banks whose strength may be in doubt has been minimal. Nevertheless, the clear response pattern of uninsured depositors to protect themselves by withdrawing their deposits from a bank under pressure raises the very real risk that in a stressful environment the flight to quality could precipitate wider financial market and payments distortions. These systemic effects could easily feed back to the real economy, no matter how open the discount window and how expansive open market operations. Thus, while deposits in excess of insurance limits should not be protected by the safety net at any bank, reforms designed to rely mainly on increased market discipline by uninsured depositors raise serious stability concerns. Public policy, therefore, should rely on other means as the primary mechanism to induce prudent bank policies.

A promising approach that seeks to simulate market discipline with minimal stability implications is the application of risk-based deposit insurance premiums. The idea is to make the price of insurance a function of the bank's risk, reducing the subsidy to risk-taking and spreading the cost of insurance more fairly across depository institutions. In principle, this approach has many attractive characteristics and could be designed to augment risk-based capital. For example, banks with high risk-based capital ratios might be charged lower insurance premiums. But the range of premiums necessary to induce genuine behavioral changes in portfolio management might well be many multiples of the existing premium, thereby raising practical concerns about its application. Risk-based premiums also would have to be designed with some degree of complexity if they are to be fair and if unintended incentives are to be avoided. In any event, the potential additional benefits on top of an internationally negotiated risk-based capital system, while positive, require further evaluation.

Another approach that has induced increasing interest is the insured narrow bank. Such an institution would invest only in high quality, short-maturity, liquid investments, recovering its costs for checking accounts and wire transfers from user fees. The narrow bank would thus require drastic institutional changes, especially for thousands of our smaller banks and for virtually all households using checking accounts. Movement from the present structure for delivery of many bank services would be difficult and costly, placing U.S. banks at a disadvantage internationally. In addition, this approach might shift and possibly focus systemic risk on larger banks. Banking organizations would have to locate their business and household credit operations in nonbank affiliates funded by uninsured deposits and borrowings raised in money and capital markets. Only larger organizations could fund in this way, and these units, unless financed longer term than banks today, would be subject to the same risks of creditor runs that face uninsured banks, with all of the associated systemic implications. If this were the case, we might end up with the same set of challenges we face today, refocused on a different set of institutions. We at the Board believe that while the notion of a narrow bank to insulate the insurance fund is intriguing, in our judgment further study of these systemic and operational implications is required.

If, in fact, proposals that rely on uninsured depositor discipline, risk-based premiums, and structural changes in the delivery of bank services raise significant difficulties, reform should then look to other ways to curb banks' risk appetites, and to limit the likelihood that the deposit insurance fund, and possibly the taxpayer, will be called on to protect depositors. The Board believes that the most promising approach is to reform both bank capital and supervisory policies. Both policies would be designed to reduce the value of the insurance subsidy. Neither policy would rule out either concurrent or subsequent additions to deposit insurance reform, such as the changes discussed previously, other proposals, such as increased reliance on subordinated debt, or new approaches that may emerge in the years ahead. In fact, higher capital, by reducing the need for, and thereby the value of, deposit insurance would make subsequent reform easier. There would be less at stake for the participants in the system.

At the end of this year, the phase-in to the International Capital Standards under the Basle Accord will begin. This risk-based capital approach provides a framework for incorporating portfolio and off-balance-sheet risk into capital

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calculations. Most U.S. banks have already made the adjustment required for the fully phased-in 1992 standard. However, the prospective increasingly competitive environment suggests that the minimum level of capital called for by the 1992 requirements may not be adequate, especially for institutions that want to take on additional activities. As a result of the safety net, too many banking organizations, in our judgment, have traveled too far down the road of operating with modest capital levels. It may well be necessary to retrace our steps and begin purposefully to move to capital requirements that would, over time, be more consistent with what the market would require if the safety net were more modest. The argument for more capital is strengthened by the necessity to provide banking organizations with a wider range of service options in an increasingly competitive world. Indeed, projections of the competitive pressures only intensify the view that if our financial institutions are to be among the strongest in the world, let alone avoid an extension of the taxpayers' obligation to even more institutions, we must increase capital requirements. Our international agreements under the Basle Accord permit us to do so.

There are three objectives of a higher capital requirement. First, higher capital would strengthen the incentives of bank owners and managers to evaluate more prudently the risks and benefits of portfolio choices because more of their money would be at risk. In effect, the moral hazard risk of deposit insurance would be reduced. Second, higher capital levels would create a larger buffer between the mistakes of bank owners and managers and the need to draw on the deposit insurance fund. For too many institutions, that buffer has been too low in recent years. The key to creating incentives to behave as the market would dictate, and at the same time creating these buffers or shock absorbers, is to require that those who would profit from an institution's success have the appropriate amount of their own capital at risk. Third, requiring higher capital imposes on bank managers an additional market test. They must convince investors that the expected returns justify the commitment of risk capital. Those banks unable to do so would not be able to expand.

We in the Federal Reserve System are in the process of developing more specific capital proposals, including appropriate transition arrangements designed to minimize disruptions. However, at the outset I would like to anticipate several criticisms. For many banks, raising significant new capital will be neither easy nor cheap. Maintaining return on equity will be more difficult, and those foreign banks that only adhere to the Basle minimums may be put in a somewhat better competitive position relative to some U.S. banks. Higher capital requirements also will tend to accelerate the move toward bank consolidation and slow bank asset growth. However, these concerns must be balanced against the increasing need for reform now, the difficulties with all the other options, and both the desire of, and necessity for, banking organizations to broaden their scope of activities to operate successfully.

More generally, many of the arguments about the competitive disadvantages of higher capital requirements are shortsighted. Well-capitalized banks are the ones best positioned to be successful in the establishment of long-term relationships, to be the most attractive counterparties for a large number of financial transactions and guarantees, and to expand their business activities to meet new opportunities and changing circumstances. Indeed, many successful U.S. and foreign institutions would today meet substantially increased risk-based capital standards. In addition, the evidence of recent years suggests that U.S. banks can raise sizable equity. The dollar volume of new stock issues by banking organizations has grown at a greater rate since the late 1970s than the total dollar volume of new issues by all domestic corporate firms.

Higher capital standards should go a long way toward inducing market-like behavior by banks. However, the Board believes that, so long as a significant safety net exists, additional inducements will be needed through an intensification of supervisory efforts to deter banks from maintaining return on equity by acquiring riskier assets. When it is not already the practice, full in-bank supervisory reviews—focusing on asset portfolios and off-balance-sheet commitments—should occur at least annually, and the results of such examinations should promptly be shared with the board of directors of the bank and used

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to evaluate the adequacy of the bank's capital. The examiner should be convinced, after a rigorous and deliberate review, that the loan-loss reserves are consistent with the quality of the portfolio. If they are not, the examiner should insist that additional reserves be created with an associated reduction in the earnings or equity capital of the bank. If the resultant capital is not consistent with minimum capital standards, the board of directors and the bank's regulators should begin the process of requiring the bank either to reduce those assets or to rebuild equity capital.

If credible commitments to raise capital are not forthcoming, and if those commitments are not promptly met, the authorities should explore such responses as lowered dividends, slower asset growth or perhaps even asset contraction, restrictions on the use of insured brokered deposits, if any, and divestiture of affiliates with the resources used to recapitalize the bank. What is important is that the supervisory responses occur promptly and firmly and that they be anticipated by the bank. This progressive discipline or prompt corrective action of a bank with inadequate capital builds on our current bank supervisory procedures and is designed to simulate market pressures from risk-taking—to link excessive risk-taking more closely with its costs—without creating market disruptions. Some flexibility is certainly required, but the Board has in mind a set of credible responses in principle and a presumption that these responses will be applied in the absence of compelling reasons not to do so.

Such an approach—higher capital and prompt corrective action—would increase the cost and reduce the availability of credit from insured institutions to riskier borrowers. In effect, our proposal would reduce the incentive some banks currently have to overinvest in risky credits at loan rates that do not fully reflect the risks involved. This reduction implies that the organizers of speculative and riskier ventures will have to restructure their borrowing plans, including possibly paying more for their credit, or seek financing from noninsured entities. Some borrowers may find their proposals no longer viable. However, it is just such financing by some insured institutions that has caused so many of the current difficulties, and it is one of the objectives of our proposals to cause depositories to reconsider the economics of such credits. As insured institutions reevaluate the risk-return tradeoff, they are likely to be more interested in credit extensions to less risky borrowers, increasing the economic efficiency of our resource allocation.

Despite their tendency to raise the average level of bank asset quality, higher capital requirements and prompt corrective action will not eliminate bank failures. An insurance fund will still be needed, but we believe that, with a fund of reasonable size, the risk to taxpayers should be reduced substantially. As I have noted, higher capital requirements and prompt corrective action imply greater caution in bank asset choices and a higher cushion to the FDIC to absorb bank losses. In addition, an enhanced supervisory approach will not permit deteriorating positions to accumulate. Moreover, the Board believes that forced mergers, divestitures, and, when necessary, conservatorships should occur while there is still positive (albeit low) capital in the bank to limit reorganization or liquidation costs. Existing stockholders should be given adequate time to correct deteriorating positions—including providing new capital—but the Congress should specifically provide the bank regulators with the clear authority, and, therefore, explicit support, to act well before technical insolvency to minimize the ultimate resolution costs.

These reforms should be equally applicable to banks of all sizes. No observer is comfortable with the inequities and adverse incentives of an explicit or implicit program that penalizes depositors, creditors, and owners of smaller banks more than those of larger ones. The Board believes no bank should assume that its scale insulates it from market discipline. Nevertheless, it is clear that there may be some banks at some particular times whose collapse and liquidation would be excessively disruptive to the financial system. But no bank is ever too large or too small to escape the application of the same prompt corrective action standards applied to other banks. Any bank can be required to rebuild its capital to adequate levels and, if it does not, be required to contract its assets, divest affiliates, cut its dividends, change its management, sell or close offices, and the resultant smaller entity can

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be merged or sold to another institution with the resources to recapitalize it. If this is not possible, the entity can be placed in conservatorship and liquidated.

I noted earlier that one response of some banks to the more intense competitive environment has been to draw down their capital buffer. These banks and other institutions cannot rebuild, strengthen, and maintain the appropriate level of capital unless they are able to adapt to the changing competitive and technological environment. The ability to adapt is crucially dependent on broadening the permissible range of activities for banking organizations. At the same time, we should be sensitive to the implications of the potential extension of the safety net—directly or indirectly—under those markets that banking organizations are authorized to enter.

The Board has for some time held the view that strong insulating fire walls would both protect banks (and taxpayers) from the risk of new activities and limit the extension of the safety net subsidy that would place independent competitors at a disadvantage. However, recent events, including the rapid spread of market pressures to separately regulated and well-capitalized units of Drexel when their holding company was unable to meet its maturing commercial paper obligations, have raised serious questions about the ability of fire walls to insulate one unit of a holding company from funding problems of another. Partially as a result, the Board is in the process of reevaluating both the efficacy and desirability of substantial fire walls between a bank and some of its affiliates. It is clear that high and thick fire walls reduce synergies and raise costs for financial institutions, a significant problem in increasingly competitive financial markets. If they raise costs and may not be effective, we must question why we are imposing these kinds of fire walls at all. Moreover, higher capital standards and prompt corrective action go a long way to limit the transference of the bank safety net subsidies to bank affiliates that fire walls are designed to constrain. And, as such, they should greatly limit the risk of distorted market signals and excessive risk-taking over an expanded range of markets, as well as the unfair competition, that might otherwise accompany wider bank activities.

Indeed, authorization to use their expertise over a wider range of markets might well be limited only to those banking organizations that meet a new higher capital standard. Consequently, the Congress might wish to authorize bank supervisors to grant certain of these activities only to those entities that exceed such a standard. Those institutions that consistently exceed the capital standard perhaps could receive more flexibility in supervisory treatment. For example, a notice requirement could be substituted for formal applications for activities permitted by law and regulation, provided that such acquisitions leave a banking organization's capital in excess of the higher standards. Other reductions in regulatory burden for highly capitalized banking organizations might also be appropriate. Such organizations would, however, still be subject to the same thorough annual examinations.

As you know, the Board has long supported repeal of the provisions of the Glass–Steagall Act that separate commercial and investment banking. We still strongly advocate such repeal because we believe that technology and globalization have continued to blur the distinctions among credit markets, and have eroded the franchise value of the classic bank intermediation process. Outdated constraints will only endanger the profitability of banking organizations and their contribution to the American economy. Beyond investment banking, the Board believes that highly capitalized banking firms should be authorized to engage in a wider range of financial activities as a part of the modernization of our financial structure and the maintenance of strong, profitable financial institutions that can compete in world markets. A banking system that cannot adapt to the changing competitive and technological environment will no longer be able to attract and maintain the higher capital level that some of our institutions need to operate without excessive reliance on the safety net.

Firms primarily engaged in the financial activities authorized to banking organizations should likewise be permitted to operate an insured bank. The Congress, of course, will have to give careful consideration to how to handle the activities some of these entities are already engaged in that would not be permitted to banking organizations.

More generally, as we expand the range of activities available to banking organizations, competitive equity suggests the desirability of functional regulation. Under such an approach, each area of activity should be subject to the same regulatory constraints as equivalent or very similar functions at nonbank firms. But independent of regulatory or organizational structure, all of us should understand that the market, the stockholders, and the management will think of the bank and any associated units—affiliates or subsidiaries—not as a confederation of businesses, but as an integrated organization. Recognition of this reality suggests that it is perhaps inefficient, at best, and under conditions of financial distress, ineffective, to try to make integrated businesses behave as if they were a collection of independent firms.

As a result, it may be more realistic, as I suggested earlier, to apply more limited fire walls to the new activities. I have in mind here restrictions such as sections 23A and 23B of the Federal Reserve Act, which already limit the financial transactions between a bank and its affiliates, requiring collateral, arms-length transactions, and—except when Treasury securities are used as collateral—quantitative limits based on the bank's capital. Moreover, recognition of the integrated nature of the operations of the insured unit with the rest of the organization raises the question of the implications of a piecemeal regulatory structure, with no means for ensuring that the activities of the organization as a whole do not impose undue risk on either the financial system or the safety net. We believe that some agency should be responsible for oversight of the entire organization, especially if expanded activities and less rigorous fire walls are adopted.

As the Congress considers modernization of our banking structure to meet the needs of the twenty-first century, it should not only widen the permissible activities of well-capitalized banking organizations, but also eliminate outdated statutes that only increase costs. The McFadden Act forces state member and national banks to deliver interstate services only through separately capitalized bank holding company subsidiaries (when permitted by state law) rather than through branches. Such a system reduces the ability of many smaller banks to diversify geographically and raises costs for all banking organizations that operate in more than one state, a curious requirement as we search for ways to make banks more competitive and profitable. The McFadden Act ought to be amended to permit interstate branching by banks.

In summary, events have made it clear that we ought not to permit banks, because of their access to the safety net, to take excessive risk with inadequate capital. Even if we were to ignore the potential taxpayer costs, we ought not to permit a system that is so inconsistent with efficient market behavior. In the process of reform, however, we should be certain that we consider carefully the implications for macroeconomic stability. The Board believes that higher capital and prompt corrective action by supervisors to resolve problems will go a long way to eliminate excessive risk-taking by insured institutions, and would not preclude additional deposit insurance reform, now or later. Moreover, we believe that with such an approach the Congress should feel comfortable with authorizing banking organizations to expand the scope of their financial activities. Indeed, we believe that permitting wider activities is necessary to ensure that such organizations can remain competitive both here and abroad. Increased activities are also required to sustain the profitability needed if banking firms are to attract capital. To limit the risks of safety net transference, some new activities might be made available by banking regulators only to banks with impressive capital positions. We believe that whatever the regulatory form and structure under which new activities are permitted, one agency should have oversight responsibility for the banking organization as a whole. It is also our view that, with these suggested reforms, reliance on stringent fire walls would not be necessary. And the McFadden Act should be amended to permit banks to deliver their services at the lowest possible costs and to more easily diversify their geographic risks. The Board has shared its views with the Treasury as part of our continuing consultations on these matters, especially in the context of their FIRREA-mandated study.

Finally, in considering all proposals, we should remind ourselves that our objective is a strong and stable financial system that can deliver the

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best services at the lowest cost and compete around the world without taxpayer support. This requires the modernization of our financial system and the weaning of some institutions from the unintended benefits that accompany the safety net. Higher capital requirements may well mean a relatively leaner and more efficient banking system, and they will certainly mean one with reduced inclinations toward risk. However, the Board believes our proposed reforms—including the authorization of wider activities by banking organizations—will go a long way toward ensuring a safer and more efficient financial system and lay the groundwork for other modifications in the safety net in the years ahead. ❑

VI Implementing Monetary Policy in the United States

Intermediate Targets and Instruments

Since the mid-1970s, monetary aggregates have been the intermediate targets of Federal Reserve policy. Targeting the growth in monetary aggregates implicitly assumes that the relationship between changes in growth in the monetary aggregates and economic activity is sufficiently reliable that the ultimate goals of monetary policy can be achieved by using monetary aggregates as intermediate targets. The Federal Reserve generally has established target ranges for the growth rates of M1, M2, and M3 during the calendar year.[59] With the Full Employment and Balanced Growth Act of 1978, Congress mandated that the Federal Reserve set annual target ranges for growth in monetary and credit aggregates and report these targets to Congress twice each year.

During the 1980s, however, the relationship between monetary aggregates and economic activity became less stable and less predictable, especially in the short run.[60] In light of the increased uncertainty surrounding the link between money and economic activity, the Federal Reserve has not set a target range for M1 since 1986, widened the ranges for both M2 and M3 for 1988, and maintained these wider ranges for M2 and M3 in 1989 and 1990. Furthermore, the Federal Reserve has broadened the scope of the variables that it monitors in formulating and evaluating policy to include a wide range of what it considers to be leading indicators of the course of the economy and inflation, such as commodity prices, exchange rates, the yield curve, and indicators of incipient pressures in the real economy.[61] That these indicators have played a relatively important role in the formulation of monetary policy can be inferred, for example, from the Federal Reserve's actions during the first five months of 1988. As noted in its July 1988 report to Congress, the Federal Reserve eased its monetary policy stance from late January to late March, and then became progressively less accommodative through late May.[62] As these changes in policy stance occurred while the targeted aggregates (M2 and M3) were within their target ranges, it seems reasonable to infer that these policy changes were in response to movements in variables other than M2 and M3. Moreover, the Federal Reserve eased its policy stance several times during the last several months of 1989 while the growth of M2 was at the midpoint of its target range.

In response to signals relating to the future course of output and prices, the Federal Reserve can choose among several instruments to influence monetary and credit conditions. The two instruments discussed below are those currently employed most frequently.[63] The primary instrument of monetary policy is open market operations in which the Federal Reserve buys or sells securities, thereby adding reserves to, or draining reserves from, the banking system. While the Federal Reserve is authorized to conduct open market operations in a variety of securities, it has chosen to conduct most transactions in U.S. Treasury securities because the treasury security market is extremely broad and deep, and therefore substantial purchases or sales of these securities will not have a significant impact on their yield. Most open market operations

[59] M1 consists of currency, travelers checks, demand deposits, and other checkable deposits. M2 is M1 plus savings accounts, money market deposit accounts, general purpose and broker/dealer money market mutual funds, small (less than $100,000) time deposits, overnight repurchase agreements, and overnight Eurodollars issued to U.S. residents by foreign branches of U.S. banks. M3 is M2 plus large time deposits, institution-only money market mutual funds, term repurchase agreements, and term Eurodollars issued to U.S. residents.

[60] See Axilrod (1985), Heller (1988), and Wenninger (1986). While this relationship has been called into question, it appears that the Federal Reserve continues to have confidence in the longer-term relationship between growth in the monetary aggregates and the rate of inflation. See, for example, Heller (1988), p. 422.

[61] These indicators are enumerated in Heller (1988) and in Johnson (1989).

[62] Board of Governors of the Federal Reserve System (1988), p. 526.

[63] Reserve requirements are also in principle an instrument of policy. While changes in reserve requirements do release or absorb reserves, and hence, could be used to affect the reserve positions of depository institutions, only limited use is now made of reserve requirements in the short-run implementation of monetary policy.

typically are not outright purchases or sales that permanently influence bank reserves, but rather take the form of repurchase or matched sale-purchase agreements that affect the level of reserves only temporarily.[64] The Federal Reserve typically makes only six to ten outright purchases or sales each year. It uses repurchase or matched sale agreements more frequently, because it considers most of its open market operations to be defensive, that is, to offset temporary fluctuations in reserves. These agreements typically last for only 1 day, rarely for more than 7 days, and never exceed 15 days.[65]

Of secondary importance is the use made by depository institutions of the discount window at each Federal Reserve bank in acquiring reserves at their own initiative. Discount window credit is available upon request by a depository institution, but is subject to approval by the Federal Reserve Bank within the district in which the borrower is located. Depository institutions are not entitled to a specific quota of discount window credit to be used at their complete discretion; rather, the discount window is regarded by the Federal Reserve as a marginal source of funds that is to be used sparingly when other sources are not readily available. The Federal Reserve generally sets its discount rate (the rate it charges depository institutions for short-term loans) below short-term market rates. Hence, borrowed reserves obtained through discount window credit are rationed by administrative guidelines, as well as by price. As future access to the discount window is reduced for those institutions that use this source of credit too frequently, such reduced availability constitutes an additional implicit cost of using the discount window. Nonetheless, institutions generally become more willing to incur this cost as the spread between market interest rates and the discount rate widens, so that the demand for borrowed reserves is a positive function of the spread between short-term market rates (particularly the federal funds rate)[66] and the discount rate.

There are three types of discount window credit. Adjustment credit consists of short-term loans extended by Federal Reserve banks to depository institutions to help them meet temporary reserve needs. Most institutions repay these loans within a few days; the largest banks are required to repay this credit the next business day. Seasonal credit consists of longer-term loans to smaller depository institutions that have relatively strong seasonal patterns in their deposits or loan demand. These two types of borrowing are affected by changes in the spread between the federal funds rate and the discount rate, rising when the spread widens and falling when the spread narrows. The third type of discount window credit is extended credit; it is longer-term credit extended to institutions experiencing such severe financial problems that they face prolonged difficulties in obtaining funds from other sources. Extended credit borrowing is considered to be relatively insensitive to interest rates and is normally *not* included in the measure of borrowing by depository institutions that is used by the Federal Reserve in implementing monetary policy.

Policy Formulation and Operating Procedures

The Federal Open Market Committee (FOMC) formulates monetary policy and issues directives for its implementation. The FOMC is composed of the seven Governors of the Federal Reserve Board, the President of the Federal Reserve Bank of New York, and four of the eleven presidents of the remaining Federal Reserve banks who serve on a rotating basis. The FOMC meets eight times a year (approximately every six weeks), evaluates current policy within the context of the state of the economy, and then decides on a short-run (that is, until the next meeting) course for policy that is broadly consistent with its longer-term intermediate targets and policy goals, but that also reflects the current state of the economy. At two meetings a year, longer-term monetary growth targets are determined. The period covered by the targets is from the fourth quarter of one calendar year to the fourth quarter of the next calendar year. In late June or early July the FOMC re-evaluates the current year's targets and proposes provisional targets for the next year. In late January or early February of the following year, these provisional targets are reconsidered and final targets agreed on for the current year.

The intermeeting policy stance decided by the FOMC is embodied in a directive—a relatively specific set of instructions governing the implementation of policy during the intermeeting period. The directive is issued to the Federal Reserve Bank of New York, which acts as the agent of the FOMC in conducting open market operations. The FOMC identifies a control variable that guides the day-to-day purchase and sale of securities, describes in general terms how the short-run path for the control variable is to be altered in light of unexpected economic developments, and defines the

[64] Matched sale-purchase transactions are conducted only in treasury bills, while repurchase agreements may be conducted in the entire range of treasury securities.

[65] See Kneeshaw and Van den Bergh (1989) and Madigan and Trepeta (1986).

[66] The federal funds rate is the interest rate in the overnight interbank market on deposits at the Federal Reserve that depository institutions with reserve deficiencies borrow from institutions with excess reserves.

scope within which the Federal Reserve Bank of New York may operate without consulting the entire FOMC. The general directive from each FOMC meeting is contained in the minutes of that meeting which are released to the public on the Friday following the succeeding FOMC meeting. More specific directives, released annually by the Federal Reserve Bank of New York, for 1988 are summarized in Table 6.

Since the advent of targeting monetary aggregates, the FOMC has identified three different control variables in its directive and in effect has employed three somewhat different operating procedures to implement monetary policy.[67] Prior to October 1979, the directive specified a relatively narrow range within which the federal funds rate was to be contained by open market operations. Whenever growth in the monetary aggregates was slower or faster than desired, the FOMC would adjust the acceptable range for the federal funds rate. As the control of inflation became increasingly more difficult with this approach for implementing monetary policy, the Federal Reserve adopted a new procedure in October 1979 designed to improve monetary control. This new procedure redirected attention away from controlling the federal funds rate to controlling the supply of nonborrowed reserves (that is, the reserves of the banking system not supplied through the discount window). Specifically, the intermeeting target path for growth in the monetary aggregates was translated into a target path for nonborrowed reserves; the Federal Reserve Bank of New York then aimed open market operations at achieving this target path for nonborrowed reserves. This reserves-oriented procedure played an important role in the disinflationary process of the early 1980s.[68]

The nonborrowed reserves procedure depended critically on the existence of a predictable, reliable relationship between the monetary aggregates and economic activity. In particular, the operation of this procedure did not involve any automatic accommodation of shifts that may have occurred in the demand for money. To the extent that such shifts did occur, they affected the real economy unless the short-run operating target for nonborrowed reserves was explicitly altered to accommodate the demand shifts. Without such an accommodation, shifts in money demand were transmitted directly to the real economy via interest rate changes. If money demand shifts were infrequent or relatively predictable, the nonborrowed reserves operating procedure would be appropriate.

[67] See Axilrod (1985), Gilbert (1985), Heller (1988), Madigan and Trepeta (1986), and Wallich (1984).

[68] See Axilrod (1985) and Heller (1988) for a more complete discussion of the evolution toward, and an evaluation of, nonborrowed reserves targeting.

Table 6. United States: Directives from the Federal Open Market Committee, December 1987–December 1988

Date of Meeting	Degree of Reserve Pressure	Borrowing Objective *(In millions of U.S. dollars)*	Discount Rate *(In percent)*
Dec. 15–16, 1987	Unchanged	300 (250 on 1/28)	6.0
Feb. 9–10, 1988	Maintain recently reduced pressure	250 (200 on 2/11)	6.0
Mar. 29, 1988	Increased	200 (300 on 3/30) (400 on 5/9)	6.0
May 17, 1988	Initially unchanged but anticipated need to increase pressure in weeks ahead	400 (500 on 5/25) (550 on 6/22)	6.0
June 29–30, 1988	Increased	550 (600 on 7/6)	6.0 (6.5 on 8/9)
Aug. 16, 1988	Unchanged	600	6.5
Sept. 20, 1988	Unchanged	600	6.5
Nov. 1, 1988	Unchanged	600 (400 on 11/22)[1]	6.5
Dec. 13–14, 1988	Increased	400 (500 on 12/15)	6.5

Source: "Monetary Policy and Open Market Operations during 1988," *Quarterly Review*, Federal Reserve Bank of New York (New York), Vol. 13, No. 4/Vol. 14, No. 1 (Winter–Spring 1989), pp. 83–102.

[1] A technical adjustment only due to a perceived shift in the relationship between borrowing and the spread between the federal funds and the discount rates.

Especially in the early 1980s, however, more frequent and less predictable money demand shifts were observed (at least ex post), due in large part to financial deregulation and innovation. Moreover, even after the adjustment to these changes had taken place, the demand for money (especially M1) was found to be significantly more interest sensitive than it had been before.[69] Partly on account of these developments, the Federal Reserve moved in late 1982 to a less automatic, more judgmental approach that has continued to the present and that places primary emphasis on borrowed reserves.[70] The increased use of discretion inherent in this procedure has enabled the Federal Reserve to be more responsive and accommodative to perceived changes in the demand for money. Reflecting the increased flexibility of the new procedure, the directive from the FOMC to the Federal Reserve Bank of New York is now less specific than the directive under either of the previous two operating procedures. Particularly under the federal funds rate targeting procedure, the directive specified a relatively narrow range for the federal funds rate. Similarly, under the nonborrowed reserves procedure, the directive stipulated a reserve path consistent with specific growth rates for the monetary aggregates. By contrast, under the current borrowed reserves procedure, the directive indicates only the FOMC's desired degree of pressure to be maintained on reserve positions of depository institutions during the intermeeting period. For example, the directive from the November 14, 1989 meeting of the FOMC states that "the Committee seeks to maintain the existing degree of pressure on reserve positions" (Board of Governors of the Federal Reserve System, 1990, p. 60).

The "pressure on reserve positions" generally refers to the level of adjustment plus seasonal borrowing from the discount window of the Federal Reserve. Specifically, the FOMC provides the Federal Reserve Bank of New York with a borrowed reserves objective that is considered to be consistent with the intermeeting path for monetary policy. This level of borrowed reserves is then subtracted from an estimate of the demand for total reserves[71] (computed by the staffs of the Board of Governors and the Federal Reserve Bank of New York) to derive a path for nonborrowed reserves. The operating desk at the Federal Reserve Bank of New York assesses the market factors affecting the availability of nonborrowed reserves and then decides on appropriate open market operations. While this procedure may appear to be quite similar to the nonborrowed reserves procedure which preceded it, it is actually quite different. In particular, under the nonborrowed reserves procedure, any change in the demand for total reserves did not affect the specified nonborrowed reserves path, whereas under the current procedure, any such change in the demand for total reserves is accommodated by adjusting the nonborrowed reserves path in order to achieve the borrowed reserves objective.[72]

The functioning of the current operating procedure is most easily understood by examining the relationship between borrowing and the spread between the federal funds rate and the discount rate. For a given discount rate, there is a level of borrowing that is consistent with the federal funds rate determined by the Federal Reserve as necessary to achieve the desired rate of growth for the targeted monetary aggregate or aggregates in particular, and its desired monetary policy stance in general. The task of the operating desk at the Federal Reserve Bank of New York is to conduct open market operations so as to achieve this level of borrowing, which in effect then determines the federal funds rate. The current procedure is therefore very similar to targeting the federal funds rate, but with an element of additional flexibility. Empirical analysis has indicated that an increase of about 25 basis points in the spread between the federal funds rate and the discount rate is associated with an additional $100 million of borrowing.[73]

Under this procedure, a greater degree of reserve restraint, that is, a tighter monetary policy stance, corresponds to a higher borrowing objective. For a given discount rate, this would be accomplished through open market operations that would reduce nonborrowed reserves, force additional borrowing at the discount window, and thereby exert upward pressure on the federal funds rate, widening the spread between the federal funds rate and the discount rate. The higher federal funds rate then leads to a higher level of interest rates that is intended to slow growth in the monetary aggregates and the overall economy, thereby exerting some restraint on actual and potential inflationary pressures.[74] Similarly, a lesser degree of reserve restraint, that is, a more accommodative policy stance, corre-

[69] See, for example, Wenninger (1986).

[70] This rationale for this shift in operating procedure is provided in Heller (1988), p. 426.

[71] Total reserves equal borrowed plus nonborrowed reserves, or equivalently, required plus excess reserves.

[72] See Gilbert (1985) and Thornton (1988) for a discussion of this point.

[73] See Thornton (1986), pp. 9–12. However, the relationship between borrowing and the federal funds rate is not completely stable and has exhibited permanent shifts. When these were perceived to have occurred, frequently formal adjustments to the targeted level of borrowed reserves have been made. Such adjustments have occurred since late 1988. See footnote 75.

[74] Johnson (1990) provides a Wicksellian interpretation, that is, that inflationary pressures will be moderated as market interest rates rise relative to the "natural" interest rate.

sponds to a lower borrowing objective, a lower federal funds rate, increased growth in the monetary aggregates, and stimulus to the real economy.

Identifying Changes in Policy

Given the features of the current operating procedure as described above, it is useful to ask under what conditions short-run (that is, daily or weekly) movements in variables that are integral elements of the procedure, that is, the federal funds rate, the discount rate, borrowed reserves, and nonborrowed reserves, indicate changes in the policy stance of the Federal Reserve. The interpretation of short-run changes in some of these variables depends on the stability of the relationship between borrowing and the spread between the federal funds rate and the discount rate. If this relationship is relatively stable, movements in some of these variables can indicate changes in the Federal Reserve's policy stance. If, however, this relationship is not very stable, it may be difficult to discern policy implications from movements in some of these variables.

The federal funds rate is clearly the key variable for discerning changes in the Federal Reserve's monetary policy stance. Changes in the federal funds rate could in theory represent adjustments taken by the Federal Reserve to achieve an unchanged borrowed reserves objective in the face of a shift in the relationship between borrowing and the spread between the federal funds rate and the discount rate. However, the Federal Reserve has typically adjusted the borrowing objective when such shifts have been identified (see footnote 75). Consequently, increases or decreases in the federal funds rate that deviate significantly from the range of recent movements can be identified and generally indicate changes in the Federal Reserve's policy stance. For example, on November 7, 1989, market participants noted that the Federal Reserve added reserves to the banking system even though the federal funds rate was trading below the widely perceived 8.75 percent Federal Reserve target. When the Federal Reserve repeated this action the following day under similar conditions, market participants generally concluded that the Federal Reserve had eased its policy stance slightly, a conclusion that was confirmed in the minutes of the FOMC meeting held on November 14, 1989, which were released on December 22, 1989.

Observed changes in borrowing over and above normal fluctuations could signal policy changes, but they could also reflect a change in the borrowing relationship that the Federal Reserve had identified and hence, would indicate a new borrowing objective.[75] Consequently, it is very difficult to discern policy changes from movements in borrowed reserves. Identifying policy changes from short-run movements in nonborrowed reserves under the current operating procedures is also quite difficult. As noted above, the Federal Reserve typically smooths short-term fluctuations in the federal funds rate by supplying or draining nonborrowed reserves as necessary. Consequently, short-term changes in nonborrowed reserves reflect these smoothing operations and hence usually do not contain information concerning changes in the current stance of policy.

Adjustments in the discount rate under the current operating procedure are typically transmitted to market interest rates and consequently are nearly always indicative of policy changes. In particular, for a given borrowing target an increase in the discount rate feeds through directly to the federal funds market as some depository institutions are "forced" away from the discount window by the higher discount rate and bid for an unchanged supply of nonborrowed reserves. As a result, the federal funds rate rises until the necessary spread is attained to achieve the unchanged borrowing objective. It is possible that a change in the discount rate could simply reflect an adjustment to a change in the borrowing relationship described above. Given the announcement effect associated with discount rate changes, however, it appears unlikely that the Federal Reserve would take such a visible action as a mechanical adjustment measure.[76] Instead, the Federal Reserve generally signals a change in its policy stance when it changes the discount rate.[77] It should be noted that

[75] In an addendum to the minutes of the FOMC meeting held on November 1, 1988 (released on December 16, 1988), it was noted that, subsequent to the FOMC meeting of November 1, depository institutions had reduced their demands on the discount window as adjustment plus seasonal borrowing had declined, falling significantly below the level anticipated at the November 1 meeting. The Federal Reserve Bank of New York, however, adjusted the reserve paths to incorporate a lower level of borrowing so that the federal funds rate would continue to trade in its previously established range. Minutes of the FOMC meeting during 1989 indicate several subsequent "technical" adjustments to the borrowed reserves objective. This increased propensity to alter the borrowed reserves objective may indicate that the Federal Reserve has begun to place less emphasis on the borrowed reserves objective and more on maintaining the federal funds rate at a particular level.

[76] Batten and Thornton (1984) and Thornton (1986) have found that discount rate changes, when they are announced, have a statistically significant impact on the federal funds rate, the three-month treasury bill rate, and the trade-weighted index of the foreign exchange value of the dollar. Both studies concluded that this "announcement effect" indicated that market participants interpreted a discount rate change as signaling a change in the stance of monetary policy.

[77] For example, in announcing the increase in the discount rate on February 24, 1989, the Federal Reserve stated that the action was taken to reduce inflationary pressures. Moreover, it is clear from the minutes of the FOMC meeting held on March 28, 1989, that the Committee intended the discount rate increase to signal a tightening of policy.

while a discount rate change typically signals a change in Federal Reserve policy, the discount rate is not changed frequently enough to be considered a timely indicator of the Federal Reserve's current policy stance. Consequently, the federal funds rate is currently the primary, and certainly the most timely, indicator of the Federal Reserve's policy stance.

Occasional Paper No. 70 . . .

Major Industrial Countries' Monetary Policies Focus on Short-Term Interest Rates

The central banks of the five major industrial countries focus primarily on short-term interest rates in implementing monetary policy. This is the main conclusion of a study by Dallas S. Batten, Michael P. Blackwell, In-Su Kim, Simon E. Nocera, and Yuzuru Ozeki of the IMF Treasurer's Department. Entitled *The Conduct of Monetary Policy in the Major Industrial Countries*, the study is No. 70 in the Occasional Paper series.

The study examines and compares the instruments and procedures for implementing short-run monetary policy that are currently used by the central banks of France, the Federal Republic of Germany, Japan, the United Kingdom, and the United States.

The implementation of monetary policy has "evolved considerably" during the last decade, according to the authors, most notably in France and Japan. Essentially, there has been a shift away from primary reliance on quantitative credit controls toward intervention in the financial markets to influence the availability and price of credit.

The Shift Away From Monetary Aggregates. From the mid-1970s to the early 1980s, a number of central banks used monetary aggregates as an intermediate target of policy (that is, as a means to achieve their ultimate growth and inflation objectives). The monetary aggregates targeted varied from the very narrow in the United Kingdom to the very broad in Germany. During the 1980s, however, monetary authorities—except those in the United Kingdom—tended to emphasize broad monetary aggregates rather than narrow ones, because the latter became less reliable as indicators of monetary conditions and less predictable. Also, the link between narrow aggregates and ultimate policy variables—growth and inflation—grew more tenuous. Moreover, since the 1980s, most central banks have become more eclectic in formulating monetary policy by expanding the range of variables they monitor.

Short-Term Rates. But regardless of which variables are important in formulating monetary policy, the authors note, "short-term interest rates play a major role in the operating procedure in each country" because they are a major influence on the demand for money and they directly affect economic activity.

While the five countries' monetary authorities tend to moderate excessive fluctuations in short-term interest rates, their approach to controlling rates is not inflexible, according to the authors. On the con-

Five Major Industrial Countries: Official and Key Money Market Interest Rates

Country	Rate	Description
France	*Taux des pensions sur appels d'offres*[1]	The interest rate established for official repurchase agreements, offered at the discretion of the Bank of France. This rate typically serves as the lower bound for short-term market rates.
	Rate on 5- to 10-day repurchase agreements	The interest rate set by the Bank of France for 5- to 10-day repurchase agreements available as emergency funding at the discretion of financial institutions. This rate is typically above short-term market rates and generally serves as an upper bound.
Germany, Federal Republic of	Discount rate	The interest rate charged by the Bundesbank for rediscounting eligible assets of financial institutions. This rate is typically the lower bound for short-term market rates.
	Lombard rate	The interest rate charged by the Bundesbank for collateralized short-term loans to financial institutions designed to bridge temporary reserve shortages. This rate is typically higher than short-term market interest rates and generally serves as an upper bound.
	Repurchase rate	The interest rate set by the Bundesbank on its periodic securities repurchase agreements.
Japan	Official discount rate	The interest rate charged by the Bank of Japan on its lending to financial institutions.
	Call money rates	Interest rates charged on short-term loans in the interbank market. Maturities range from overnight to one week on collateralized call loans and from overnight to six months on uncollateralized call loans.
	Bill discount rates	Interest rates charged in the interbank market for rediscounting private bills with maturities ranging from 7 to 180 days.
United Kingdom	Bank of England dealing rates	The interest rates at which the Bank of England either rediscounts bills of different maturities or lends to discount houses.
United States	Discount rate	The interest rate charged by the Federal Reserve on its short-term lending to depository institutions.
	Federal funds rate	The interest rate charged in the interbank market where depository institutions with reserve deficiencies borrow from institutions with excess reserves.

[1]Literally translated as "rate on tender for repurchase agreements."

Data. IMF, Occasional Paper No. 70

trary, the operating procedures in these countries allow short-term rates to be largely determined by the market; monetary authorities influence only the range within which these rates fluctuate. In general, the five monetary authorities try to accommodate changes in credit demand, at least initially, to prevent excessive movements in short-term interest rates. But over the medium term, they typically guide interest rates to levels consistent with their growth and inflation objectives.

The authors point out that, given the importance of short-term rates, it is not surprising that changes in these rates typically signal changes in monetary policy stance. But these signals are not equally easy to read in the five countries. The policy intentions of the monetary authorities in France, Germany, and the United Kingdom are "readily discernible"; key interest rates set by these countries' central banks (see box) establish a range within which the interbank rate (the rate at which banks lend to each other) fluctuates. But in Japan and the United States, monetary policy changes are not as transparent, because movements of key interest rates—the interbank rate in Japan and the federal funds rate in the United States—are driven by various influences, some of which are unrelated to policy changes. These influences need to be "filtered out" before the policy changes can be known, and market participants may take several days to do this.

Reserve Regulation. How do monetary authorities in the five major industrial countries influence short-term interest rates? One way, according to the authors, is by regulating the supply of reserves to the banking system. Each country's central bank uses either open market operations or interbank market operations as the major instrument of reserve management. The authorities in France, Germany, and the United States frequently rely on repurchase agreements—that is, agreements in which the central bank sells securities to, or buys them from, the banking system with an obligation to reverse the transaction at a specified, later date. These transactions enable central banks to fine-tune the adjustment of bank reserves and interest rates and give them the flexibility to respond quickly to unexpected developments affecting these variables.

The authors note that the duration and importance of repurchase agreements vary among countries. The U.S. Federal Reserve regards most of its open market operations as designed to offset temporary fluctuations in reserves. It therefore enters into repurchase agreements that generally last for just 1 day and never for more than 15 days. Repurchase agreements are also the main monetary policy instrument in France and Germany, but last longer (usually 10 to 20 days in France and 28 to 35 days in Germany). The essential difference is that, whereas, in the United States, the authorities use repurchase agreements both to smooth daily fluctuations and to achieve medium-term monetary policy objectives, the French and German authorities use them exclusively for the latter purpose. Repurchase agreements do not play a major role in policy implementation in Japan or the United Kingdom.

The Discount Window. The authors point out that the role of the discount window (a facility through which financial institutions can borrow directly from the central bank) in short-term reserve management declined during the 1980s, owing to the increased reliance on open or interbank market operations. "Discount window credit (or its equivalent) is now generally a marginal source of funds," except in Japan, where the authorities use "this extremely flexible facility" to smooth daily fluctuations in the banking system's reserve position. In Germany, the effective discount rate is a penalty rate. That is, it is kept above short-term market rates, thus penalizing institutions that borrow from the central bank. Consequently, discount window credit is typically used only as a last resort. In France and the United States, the discount rate is typically kept below short-term market rates, but "vigorous nonprice-rationing procedures" limit institutions' access to the discount window. In the United Kingdom, there is no official discount window, but the Bank of England occasionally lends to financial institutions at rates that differ from those prevailing in the markets.

The authors point out that the diminished role of the discount window "has not necessarily reduced the policy relevance of the discount rate. On the contrary, changes in the discount rate...are interpreted...as indicating a change in the stance of monetary policy."

Copies of *The Conduct of Monetary Policy in the Major Industrial Countries* are available for US$10.00 each (US$7.50 for university faculty and students) from Publication Services, Box S-299, International Monetary Fund, Washington D.C. 20431, U.S.A.

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THE PROGRESSIVE POLICY INSTITUTE DEBATE SERIES

Rapporteur's Report
By Delia Boylan

Robert L. Kuttner
Economics Correspondent, "The New Republic"
Author of The End of Laissez Faire (forthcoming)

Michael E. Porter
Professor, Harvard Business School
Author of The Competitive Advantage of Nations (1990)

on

"Do National Governments Matter in the Competitiveness of Nations?"

Thursday, September 6, 1990

Robert Kuttner

1. Relationship between U.S. Strategic International role/ domestic economic well being

a. Since World War II, the United States international economic policy has been one of bringing laissez faire to the world trading system. Such an attitude stems from our global hegemonic impulse--we thought that by being laissez faire ourselves, we would encourage others to "open up" and relax restrictions

b. It was also reinforced by the Cold War: as the leader of the Western Alliance, we tolerated mercantilism from our allies, even while foreswearing it elsewhere, as a tradeoff for their military allegiance

c. The problem with such an approach has been that with the exception of Great Britain, few other nations have had a corresponding geoeconomic goal--by failing to pay attention to such asymmetries in the international trading system, we have harmed ourselves while others have reaped the benefits accrued from economic nationalism

2. Economic Nationalism/Export Controls

a. At present, the peculiar way in which America's strategic goals interrupt our economic goals ("imperial overstretch") is largely ignored

b. For example, keeping a large military establishment is expensive, yet many of America's competitive advantages in high technology were incubated in the military; indeed, some of the best machinery tools in the world exist because of the defense industry

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c. Nonetheless, because of our blinding national security goals, we enact a series of stringent export control laws which prevent such technology from leaving the country and competing abroad because it is deemed to sensitive to release--some say aptly that we are more concerned with promoting laissez faire than with promoting our own industry

3. Need for Government Involvement

a. Kuttner says, Porter is right, much of a country's competitive advantage does occur in firms, not in nations--this explains much of why Japan, Korea, and Taiwan are successful. But public policy is also important--even in "Porter's law", there is alot of evidence of government involvement.

b. In Japan, there is a good cross-fertilization between the "sheltered" corporate culture (that which derives benefits from innovation, not price competition) and the "exposed" (that which is vulnerable to price competition)--In the US, we need to cultivate this as well.

Michael Porter

1.Differences among Nations

a. Productivity defines the competitiveness of nations

b. Globalization is the new base of success--nations and industry prosper not because of economies of scale, but because of their capacity to integrate and upgrade over periods of time;

c. Success will be achieved through pressure and challenge--national governments need to force companies to change and adapt and improve:

1. demand sophisticated customers at home
2. develop crucial home-based suppliers to foster innovation
3. enhance local rivalry and intense local competition to force companies to improve

2. Need for a Specialized Economy

a. What we increasingly need are specialized skills and technology, and a commitment to labor--the US government needs to send signals to US business to foster this blend

b. But the process of creating competitive advantage is localized--what is critical is the creation of highly specialized skills and labor in specific industries

c.Nations will still have an important role, even though the competition has globalized, but perhaps even more important are the state and local arenas

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3. Appropriate Role of Government

a. The role of government should change, depending on the relative state of advancement of an economy:

1.with less advanced economies, where there are scarcer resources and a more fragile industrial base, more intervention is needed to make the tough choices

2.in a more advanced economy, however, more indirect forms of government are needed to preserve the competitive rivalry--too much direct intervention can stunt growth by cutting off innovation

b. We need to recognize the similarities between US and Japan and encourage them--foster fierce local rivalry, develop preexisting industrial bases, and specialize skill-creating mechanisms

Rebuttal

a. Kuttner:

1. Whereas we restrain our exports, Japan tries to gain export markets--this is a primary example of the asymmetrical cost of hegemony that doesn't even enter the debate

2. Without access to global markets, specialized industry means little-- our system of export controls exemplifies a policy priority which influences what industry can and cannot do independently of productivity

3. By having industry and not industrial policy lead, we jeopardize our own competitive advantage--Kuttner feels Porter understates how much government and industry nexus in Japan. There is no guarantee on the law of convergence--since 1945 our policies have been overly dominated by moot trade policies, and unrealistic reliance on laissez faire which is now unconnected to the global environment.

b. Porter:

1.No argument on export controls. It is true we have traditionally put military/strategic objectives above economic ones, and this is bad.

2. Disagrees that even if we had the most productive firms in the world and yet other nations won't let us in, we are lost. Rather, we should be battering for access in those countries where it is presently denied, not managing trade through some multilateral "managed" system--this "cure" would be worse than the disease.

3. Cooperative research is not an evil, but nor is it the answer--many companies in the US have lost confidence but this doesn't mean they can't do it themselves. Changing competition is not a role for government.

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The American Enterprise

THE WASHINGTON ECONOMIST

July/August 1990

THE U.S. ECONOMY: A VISITORS' GUIDE

By Herbert Stein

THE MOST IMPORTANT THING for a visitor to know about the American economy is that it is very rich. The best measure of that is the gross national product: the U.S. GNP is now running at $5,500 billion a year. This is a staggering figure. In 1940 when the GNP was first estimated, the figure was about $100 billion. It had been about the same in 1929. Of course, most of this increase was due to inflation. But in real terms after allowing for inflation, the GNP now is six times as high as it was in 1929 and three times as high per capita. Consider that in 1929 the United States was already the richest country in the world, and Americans were congratulating themselves on how well off they were.

Comparisons with other countries are difficult and possibly not very revealing. But by the best estimates, the GNP of the United States is probably two and one-half times that of Japan and five times that of Germany. On a per capita basis, GNP in America is probably one-third higher than in either of those countries.

Interestingly, Americans do not seem to *feel* rich today, and economic policy is dominated to a degree by an acceptance of the feeling that the country is poor. The main reason for that is the "twin deficits": the deficit in the budget and the deficit in international trade and payments. People think that the country must be poor if it cannot afford to pay for its expenditures outright or if the country cannot produce as much as it consumes and has to import the rest from other countries.

But the deficits are not a sign of poverty. Any government, however rich the country, can have a deficit if it chooses to spend more than it chooses to collect in taxes. The United States has budget deficits because Americans prefer them. They prefer to have the deficit rather than do the things that would eliminate the deficit. These things are easy to list and would not be very painful. For example, the United States is not a very heavily taxed country. Americans pay a smaller proportion of their GNP in taxes than any other industrial country except Japan, but they prefer to have the deficit rather than pay another 2–3 percent of the GNP in taxes.

Similarly, the deficit in international trade or payments does not deny that the country is rich. In 1989, for example, Americans used about 1 percent more goods and services than they produced. That was the whole "deficit." Americans could have done without that extra 1 percent of goods and services easily. It was only about half of the increase in production over the previous year. They used the extra output because on the one hand they preferred to consume and invest a great deal, while on the other hand, savers in the rest of the world were willing and eager to invest in the United States rather than elsewhere, including their own countries.

Some people think that the United States is becoming poorer because Americans and their government borrow a good deal abroad. But actually, Americans are becoming richer; productive assets owned by Americans—at home and abroad—are increasing faster than liabilities to foreigners.

Another reason for the common feeling that America is not rich is the belief that the United States is falling behind other countries, notably Japan. But the fact of Japan's becoming richer—even if that were to happen—would not make the United States less rich in the relevant sense of its ability to meet the needs and desires of the American people. Anyway, the margin of the Japanese growth rate over the American rate is presently diminishing.

The rate of economic growth slowed worldwide after 1973. The U.S. rate recovered somewhat during the 1980s, but it is difficult to evaluate the magnitude because we cannot yet distinguish between cyclical and longer-run changes. We do not seem to be back to the growth rates of the best 15 or 20 years before

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Herbert Stein is a senior fellow at the American Enterprise Institute. Soviet visitors to the United States heard Dr. Stein give this lecture.

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1973 and may not yet be back to the lower longer-run rate.

There is an interesting stability in America's economic growth rate over very long periods. We now have estimates of per capita GNP for the 120 years from 1869 to 1989; for this whole period, the annual rate of growth was 1.78 percent. The year 1929 divides the 120 years in half and is also a historical year during which many things changed radically. But the average growth rate of per capita GNP was 1.80 before and 1.77 after 1929, which, given the difficulties of measurement, cannot be regarded as a significant difference. This neither indicates an iron law of growth for the American economy nor suggests that the growth is accelerating or decelerating.

Implications of Being Wealthy

So the American economy is very rich, and there is every reason to think not only that it will continue to be rich but also that it will get richer. The basic reason for our prosperity is that 120 million Americans get up in the morning and go to work to do the best they can for themselves and their families and previous millions did the same thing for more than two centuries. America has always had a legal system that assures its people that they will enjoy the fruits of their efforts—their labor, their saving, their education, and their initiatives. America's culture encourages people to benefit themselves economically and values their doing so. The country was populated by immigrants who wanted to live and work in such a legal system and culture. Moreover, the government has always been devoted to assisting and protecting people in these efforts. For example, the government has made available large amounts of capital in the form of land and education.

Events in America have to be understood in the perspective of the size of the economy. Almost everything we see happening turns out to be small relative to the size of the economy. Also, because of its size and diversity, the system seems to be stable and immovable in the aggregate while flexible in detail.

In earlier times, an event like the change of automobile models at the Ford Motor Company or a shortage of rain in Kansas could cause a national recession. The country is much more resistant to such things now. Even the loss of about $500 billion in the value of assets when the stock market crashed in 1987 was absorbed without much effect on the economy as a whole.

Actual or proposed policy changes also have to be seen in this perspective. For example, the Reagan defense buildup, which looked so huge at the time and was expected to be so disruptive economically, made hardly a ripple in the economy, and the same will be true of the cut in defense spending that is now under way. Similarly, a great deal of attention is now being paid to the proposed cut in the capital gains tax. But the most certain thing that can be said about it is that although the direction of its effects on the revenue and the economy is unclear, the effects will be relatively small.

For a country as rich as America is, getting richer faster is not a very important goal—or at least it is less important than it used to be and less important than it is in other countries. America's most important problems are not problems of the inadequacy of total national income but rather problems of inappropriate use of the national income the economy produces.

America's problems must also be seen in the perspective of American history. What appear to be the most critical problems now will be listed later, but first, it is useful to review some of the problems that have existed or have been alleged to exist in the past 60 years that no longer worry us. Looking back reminds us that the American society has the capacity to face its problems and deal with them.

The Stabilization Problem

The Great Depression gave rise to the fear that such catastrophes would recur or even that the economy would live in a state of permanent depression unless radical changes were made in the economic system. This fear is now gone, partly because that analysis was judged faulty; it underestimated the equilibrating features of the system. Changes in institutions and policies that stabilized the economy without weakening its free and efficient features dispelled those fears. Worry about the possibility of less severe, but still debilitating, recessions persisted, however. But the experience of the years since World War II has provided two lessons:

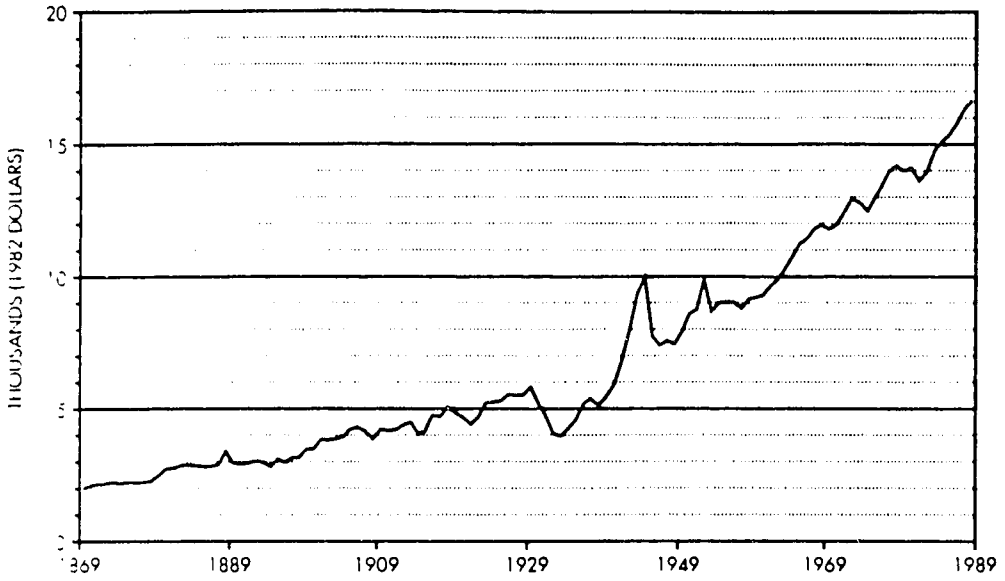
First, the only serious recessions, those of 1975 and 1982, in which unemployment rose to highs of 9 percent and 11 percent, respectively, came after fairly high inflation.

Second, even recessions of that depth turned out to be less painful than had been expected because they were short. This was because the average worker had substantial assets and was likely to be in a family with more than one worker, so that a period of unemployment was not disastrous.

What remains as the chief uncertainty about the stability of the economy is the possibility of inflation. This is seen as a political problem—whether the temptation of the short-term political advantages of inflationary policy can be resisted. The inflation rate in the United States is now about 4.5 percent. The economy is much better adapted to such a rate now than it was, for example, in 1971 when that rate caused the imposition of price controls. It is nevertheless a cause for concern.

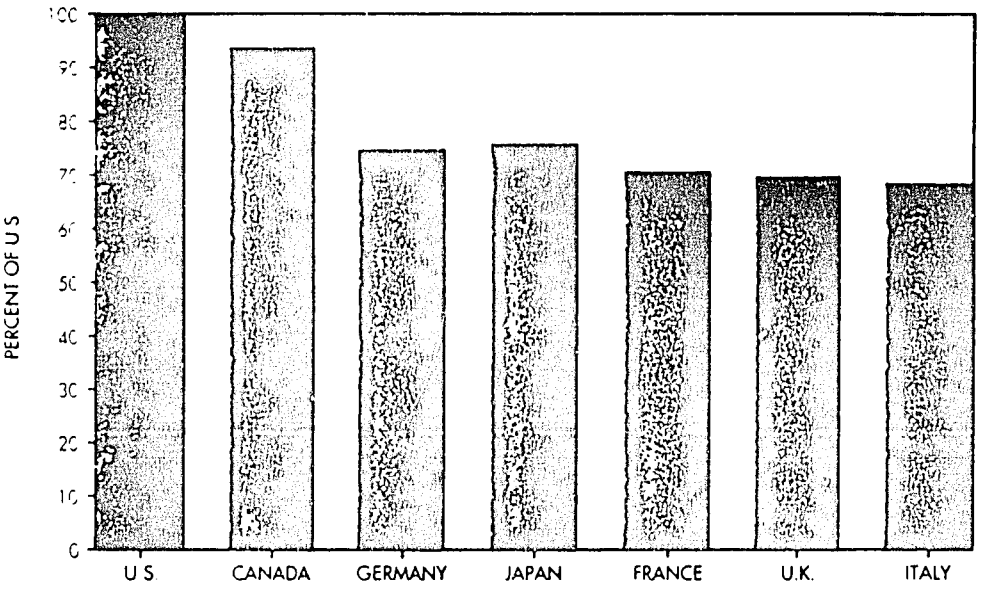
Unemployment has been running near 5.25 percent for about a year. That is somewhat higher than used to be considered full employment, but it is not a serious figure in the aggregate. Half of the unemployed are out of work for

U.S. REAL GNP PER CAPITA



INTERNATIONAL COMPARISON OF REAL GNP PER CAPITA, 1989

(U S = 100 PERCENT)



periods of five weeks or less, and the average duration of unemployment is about 12 weeks. The unemployment problem today is serious in that it most affects black youths, who are not being brought into the work force.

The Mythical Freedom Problem

Around the end of World War II, there was a great deal of worry in this country that although the threat of Nazism had been withstood, the threat to freedom remained serious. The threat—best described in Friedrich Hayek's book, *The Road to Serfdom*—was seen to lie in the expansion of the role of government that had been going on here under the New Deal and in England and elsewhere even longer. Although the argument was mainly about England, the author made it applicable to the United States, and the book was a best-seller here.

This worry has not since been as acute as it was in the first years after World War II, but it remains a standard part of political rhetoric and rises in pitch from time to time. There is some evidence of growing concern now. In a curious parallel to the post-Nazi era, the champions of freedom in the postcommunist era are finding the enemy at home—or are at least looking for him there.

The threat to American freedoms has never been real. Americans are more free now than they have ever been. Individual options have been increased enormously by the growth of incomes; the improvement of education, information, and mobility; the expansion of competition, including the increased exposure to the world market; and the reduction of legal and cultural discriminations of all kinds, based on race, religion, ethnicity, and gender.

The government sector in the United States has expanded in the past 60 years, but it is still small by international standards. Relative to GNP, government expenditures and receipts in the United States are at about the same level as they are in Japan and lower than in any other large industrial country.

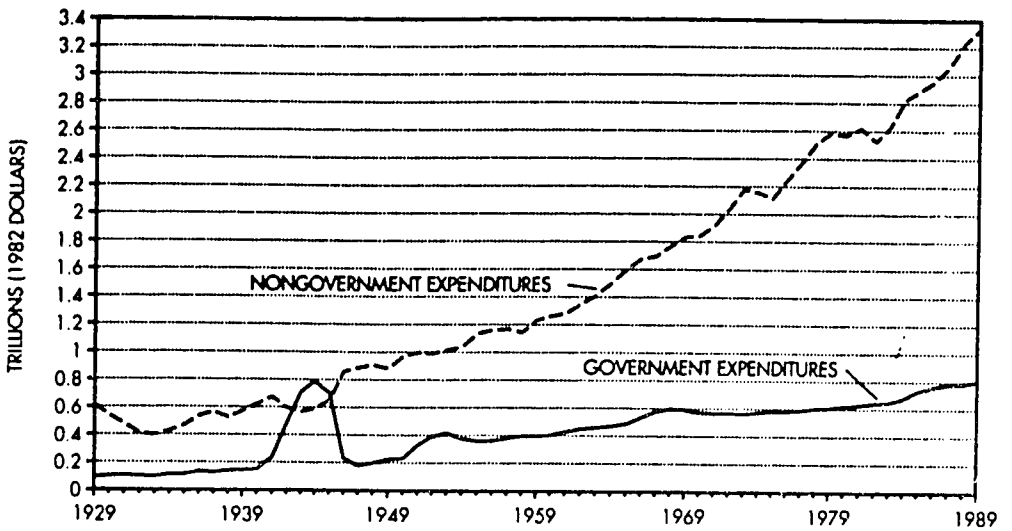
As a fraction of GNP, government expenditures in the United States rose from 10 percent in 1929 to 34 percent in 1989. By other measures the government share is smaller and has risen less. Receipts have risen from 10.9 percent to 32 percent, government purchases of goods and services from 8.6 percent to 19.8 percent, and government output, measured by payrolls, from 4.3 percent to 10.3 percent.

But the private sector has also expanded enormously. Even if the government share is estimated to have risen from one-tenth to one-third of GNP, the nongovernment GNP is four times as large today as it was in 1929 and twice as large per capita.

The total of government expenditures, however, is a poor measure of government's power to coerce individuals and limit their freedom, for several reasons. Forty percent of all government expenditures are for interest payments or transfers made according to objective formulas that do not enable the government to discriminate among individuals. The government is decentralized: the federal government makes only about 40 percent of government purchases of goods and services (less than 8 percent of GNP, three-fourths of which is for defense), the rest is made by states and localities. Moreover, the government's ability to exercise its influence in a coercive way is limited by the division of powers among the executive, legislative, and judicial branches, by the party system, and by public opinion.

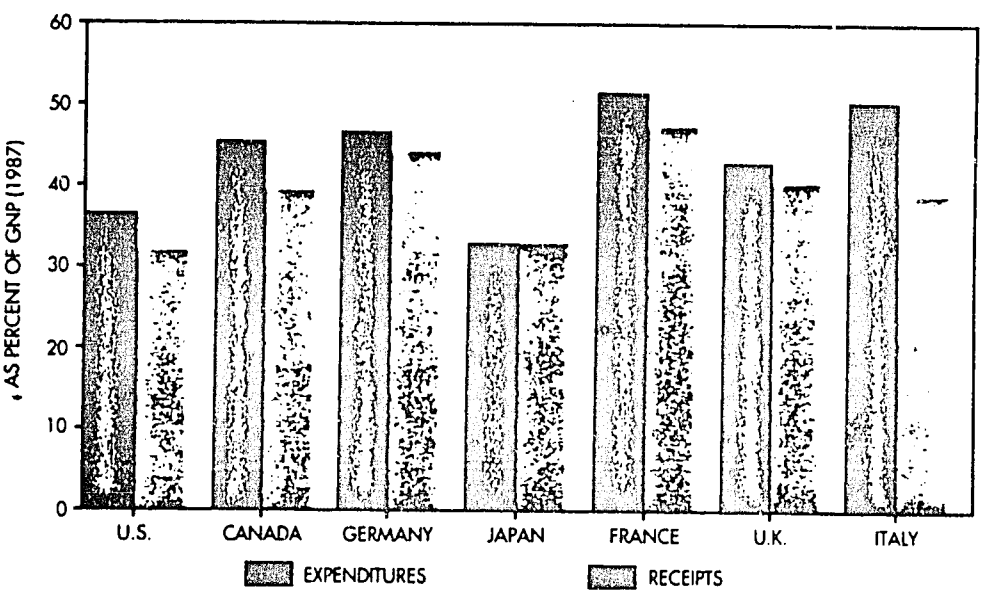
In one way or another, the government does regulate many U.S. industries—it regulates some of them quite a lot—but this is in fact a trivial impairment of freedom. There may be people who feel inhibited because they cannot practice brain surgery without a government license or because they cannot operate a commercial bank and an investment bank simultaneously. They are a minority. Many regulations are probably a source of economic inefficiency. It is difficult, probably impossible, to calculate the size of this effect. About ten years ago, one study concluded that the regulatory system reduced GNP by about 3 percent. That is about one year's normal growth of GNP.

U.S. GOVERNMENT AND NONGOVERNMENT GNP*



*NOTE. GOVERNMENT MEASURED BY TOTAL EXPENDITURES. EXPENDITURES ARE FOR PURCHASES OF GOODS AND SERVICES

INTERNATIONAL COMPARISON OF GOVERNMENT EXPENDITURES AND RECEIPTS



Other Worries

From time to time in American history, great concern has been expressed that the economy would be dominated by giant monopolies that would smother efficiency, prevent the achievement of full employment, and concentrate excessive power in a few private hands. Such concerns were heard in the 1930s and, to a lesser extent, in the 1950s. They are hardly heard any more. The American economy is seen to be highly competitive, more competitive than ever before. Government policy has helped avert a trend to monopoly. But the main lesson is that

unless government positively enforces monopoly, there are strong natural tendencies for competition to emerge. Moreover, reduced costs of transportation and communication and lowered governmental barriers to international trade have greatly widened the markets within which enterprises must compete.

Given the common notion of the United States as the country of big business, it is significant to note that most American workers are employed in fairly small enterprises. In 1985, 55 percent were employed in establishments of 99 or fewer workers and only 13 percent in establishments of over 1,000 workers. There seems to be no trend for the proportion in large establishments to increase.

Parallel to this worry about monopoly but on the other side of the political spectrum, there has been concern about the power of labor unions. This was especially notable just after World War II. Membership in unions was increasing, and so, apparently, was their economic and political power. Some thought stronger unions would stifle productivity and generate inflation. But this fear also passed. The proportion of nonfarm employees enrolled in unions peaked at about 30 percent in 1955 and has declined since to about 20 percent. Even where unions exist, they are less powerful than they were. Again, public policy, expressed in the Taft-Hartley Act of 1947, had something to do with limiting the trend to unionization. But the primary force was competition: unionized enterprises could not compete with the nonunionized—even in the benefits they provided their workers.

There was never any evidence that the spread of unionism, while it was going on, yielded benefits for workers as a whole. During the period of declining unionism, the labor share of the national income has increased from 67 percent to 74 percent. This suggests that unions were not essential to improving the condition of labor.

A third worry that has arisen from time to time is that the economy was chaotic and erratic and would stagnate because the United States had no "economic plan." This worry naturally arose when difficulties appeared, most notably in the 1930s. It recurred around the end of the 1950s, when the launching of Sputnik raised the fear that the Soviets might be outdoing the United States and when many Americans were fascinated by comprehensive British and French economic plans. There was another wave of talk in favor of planning in 1975 and 1976 after the oil shock.

But the idea that the United States should have a national economic plan never had much popular appeal. Any push to develop one has now disappeared entirely, and given recent events in Eastern Europe, none is likely to reemerge soon.

The Adaptive Society

The American system has performed well. And it continues to do so, not because it is finished, perfect, and free of problems, on a model laid down by Adam Smith, but because it adapts to its problems and solves or at least ameliorates them. The American economic system today is a long way from the capitalism of 1929. The government has assumed responsibility for maintaining economic stability. America has become a substantial welfare state, and about 15 percent of all personal income consists of transfers from the government. The government greatly affects national saving by its fiscal policy. It regulates almost every industry a little. But still, the free market remains at the heart of the economic system.

What makes the American society so adaptable is that we have an economic system interacting with a political system, each independent and each competitive within itself. Each system disciplines the other, limits its excesses, and acts to correct its deficiencies.

America's Problems Today

There is no consensus in America to about what our problems are. Three general viewpoints may be discerned

- There are those who, despite what been said above, give great weight tc traditional aggregate economic problems: the rate of growth, competitiver with other countries, the budget defi and the trade deficit.
- There are those who think that beca the threat of imperial communism ha diminished there are no national pro lems except deciding how to leave th American people alone, cut their tax and reduce government regulation.
- There are others who believe that United States tolerates conditions th might be bearable in a less-rich socie but that ought not to be acceptable ir the United States. These include the existence of a miserable underclass; t failure for over a decade to lower the percent of the population living in poverty, after earlier years of progres the sad state of American education; a the spread of dangerous drugs and violent crime. Moreover, the United States, as the richest, most capitalist, a most democratic country, has a role t play and obligations to assume in assi ing other countries to achieve democra free markets, and economic development.

These viewpoints are not being explicitly debated in the United State today, but they underlie many of the specific issues that are continually bei faced. Some decision about the relativ weight to be given to these views of tl American condition will emerge from the political process.

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FINANCIAL TIMES, JULY 6, 1990

The political debate in the US is being fuelled by a bestselling book, writes **Lionel Barber**

Rich pickings for a prophet of populism

Americans are taking a second look at the 1980s, and many do not like what they see. Once acclaimed as the decade when the country regained its strength and self-confidence, the 1980s are increasingly portrayed as a period of greed, self-indulgence, rising debt and false prosperity.

Now comes a new book* to stoke the debate. Mr Kevin Phillips, a prominent Republican political theorist, argues that the 1980s amounted to the triumph of Upper America. It was an era of "too many stretch limousines, too many enormous incomes and too much high fashion," when inequality intensified and the Republican Party lost touch with ordinary middle-income Americans.

The result, writes Mr Phillips, will be a populist backlash similar to those that followed other periods of unfettered capitalism. Just as progressivism followed the gilded age of robber barons in the late 19th century, and the New Deal followed the speculative binge of the 1920s, so too an anti-elitist economic populism will follow in the steps of Mr Michael Milken, Mr Donald Trump, Mrs Nancy Reagan and Mr George Bush.

Mr Phillips has stronger credentials than most political pundits. More than 20 years ago, as a precocious young Republican operative, he helped Mr Richard Nixon devise the "southern strategy" of wooing conservative white voters by painting the Democratic Party as liberal, elitist and remote from "Middle American values."

This cultural populism has helped the Republicans win five out of the last six presidential elections, including Mr Bush's crushing defeat of Mr Michael Dukakis in 1988. Mr Phillips's defection has infuriated Republicans, but it has given heart to the Democratic Party which – in terms of presidential as opposed to congressional elections – is about as weak as the British Labour Party after the defeat of Mr Neil Kinnock in 1987.

In the 1980s, Mr Phillips writes, money did not talk – it shrieked. It was an age in which economic inequality increased dramatically.

The income of the wealthiest 1 per cent of Americans now averages $550,000, and rose a mind-boggling 75 per cent in the 1980s, according to a recent study by the House Ways and Means Committee. The same 1 per cent's after-tax share of US income rose from 7 per cent in 1977 to a projected 11 per cent in 1990.

The 70 per cent of Americans who describe themselves as middle class also fared better in the 1980s, but far more modestly than the super rich. Mr Phillips exaggerates the disparities by including some of the late Carter years where the middle class was caught in the pincers of high taxation and high inflation.

For married couples, the median income rose 9 per cent between 1980 and 1988 to just over $36,000 – but was offset by cuts in social services, rising tuition, housing and health-care costs. Even more pronounced was the impact on the poor, whose median income fell in real terms by between 3 and 9 per cent. At the same time, under the 1986 tax reform law, top individual tax rates for millionaires fell from 70 per cent to 28 per cent.

The question is this: if economic populism was so potent, why did the Democrats fail to use it in 1988 against Mr Bush? After all, the evidence was widely available, and Mr Bush, the Yale-educated country club Republican who comes from the "watercress sandwich wing of the party" would seem to have offered an inviting target.

Mr Phillips contends that the Democrats were the Great Collaborators in the 1980s, supporting Mr Reagan in his legislative agenda which favoured the rich. In 1988, the Democrats merely flirted with populism. Only at the end of his campaign did Mr Dukakis finally start talking about income disparity, the "bi-coastal economy," and being on the right side of working men and women. But, after all, he was the "ethnic yuppie" who had made it.

Will the new populism sell in the 1990s? For tactical reasons, the Democrats certainly intend to pick up some of Mr Phillips's themes. The savings and loan debacle could create a populist backlash. The stigma of collaboration could also persuade the party to choose someone from outside Washington to run in 1992. More immediately, Mr Bush's acknowledgment last week that new tax revenues were needed to help reduce the budget deficit has already set off a debate on whether the top 1 per cent should pay more tax.

But as one top Democrat official points out: "We can't come across as the party that wants taxes, nor can we argue that we should tax the rich for the purposes of redistribution. We have to argue on the grounds of fairness."

By far the most important contribution that Mr Phillips has to make – and the reason his book has risen within two weeks to the Top Ten Bestseller list in the Washington Post – is the way he has exposed the current vacuum in American politics at the end of the Reagan era.

The search for a New Politics concerns Republicans as much as Democrats. Under the "kinder, gentler" leadership of Mr Bush, the Republicans have turned a little mushy. One measure of the party's desperation is its embrace of emotive but empty issues such as opposition to flag-burning and public funding of controversial art such as the homo-erotic exhibition of the photographer Robert Mapplethorpe.

But it would be foolish to write off the Grand Old Party in 1990, or the incumbent Mr Bush in 1992. The state of the economy will prove far more important in influencing voters than any vague backlash from Main Street.

The Democrats, too, should be careful about embracing Mr Phillips as the prophet who can lead them out of the wilderness. His book fails to identify a new role for government in correcting some of the excesses of the 1980s, whether at state or federal level. What is clear is that Mr Phillips, the man whom the conservative commentator Mr William F Buckley once described as a "Country and Western Marxist," has at least given the party an opening.

** The Politics of Rich and Poor, Kevin Phillips. Random House, $19.95.*

The pains of dependency

Anthony Harris looks for the underlying causes of the downturn in the US economy

The sharp Wall Street correction on Monday may well prove something of a diversion. Already, the usual suspects are being rounded up: the Chicago financial futures market, the program traders. The sterile debate about whether derivative trading makes the market more volatile, or simply achieves correction faster, is being rehearsed, both in New York and in Congress. This is familiar ground, and there is some complacency this time round: the circuit breakers installed after the Brady report of 1987 to slow down trading in a potentially panicky market worked beautifully. It is much more comforting to dwell on this than on the real reasons why sentiment is jittery.

The immediate triggers were the equally sharp overnight fall in Tokyo, and weekend nervousness about the Fed's regular report on the economy to the Senate banking committee last week, and especially the statement from the chairman, Mr Alan Greenspan, which backfired. Mr Greenspan meant to be reassuring. He said the Fed was aware of the disinflationary dangers of the wave of extreme caution which as swept through the US banking industry, and would offset it; and it would also offset the deflationary impact of any serious fiscal tightening that Washington might achieve. The markets were not reassured. The bond market concluded that lower short rates, whatever the justification, would mean a weak dollar; bonds fell sharply in anticipation of higher inflation, and of the higher returns overseas investors would require. (Prices eased again yesterday after Mr Greenspan said in the House that he is worried about inflation, correcting a possible impression from his Senate evidence that he is not. In a sullen market he cannot get it right.)

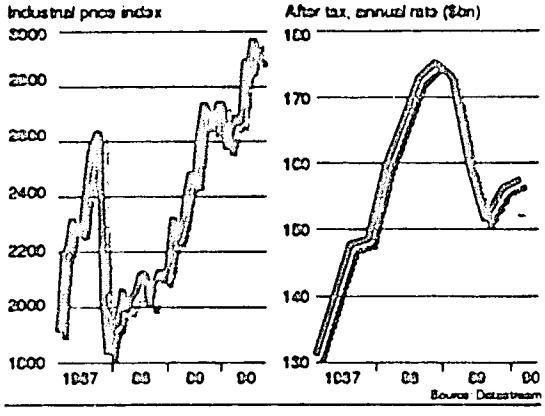
Then came a rise in Japanese interest rates, and the fall in the Tokyo market. Wall Street was sharply reminded that the US equity market, as well as the bond market, now relies partly on foreign inflows, and that the Fed might find it difficult to deliver on its policy, whether this is regarded as a promise or a threat. Any British reader with memories of a steep yield curve, a weak currency and the fear of the legendary gnomes of Zurich will know how demoralising this kind of dependency is; in the US, it is a novelty.

None of this would be unduly worrying if the US economy were regarded as robust, but while the economic forecasts – business forecasts as much as those from the Administration and the Fed – show very little cause for concern, they inspire only a hollow confidence.

This is partly subjective: most of the financial opinion-makers live in the north-east, which is currently suffering a sharp regional recession, accounting for about half of the 16 states now officially classified as in recession. Bullish forecasts contradict personal experience. But those trying to read the economy are also aware that models projecting past data may be bad guides at the moment.

The main threats to the eight-year-old expansion are the downturn in construction, defence cuts and a sharp scaling back in investment spending. All have one thing in common – a long production pipeline. In construction, for example, new housing starts and permits have fallen by a third in the last two years, and new commercial projects are at a virtual standstill. But construction activity and employment went on rising until only three months ago, and have scarcely begun to fall.

The story is much the same in defence and in capital goods: orders are sharply down, but it will take some time to work through existing order books. Equally, the attempts, especially at the state level, to cut public spending programmes is a threat mainly for the future. The momentum is all these fields continues, but there is no longer any push.



There have always been depressed regions and industries throughout the expansion, and there are still some quite strong positives. Farm incomes have risen strongly after the drought two years ago. The computer industry is recovering strongly with new products, the motor industry managed an unexpected sales revival in recent weeks, industrial output is still growing, and above all, as Mr Greenspan pointed out, inventories remain lean.

There are also positive regions. The south is emerging from its long nightmare, when the fall of oil prices led to financial collapse, and the industrial mid-west, laid flat during the dollar over-valuation of the mid-1980s, is still in a strong secondary phase of recovery, with housing and retail investment leading the way. The west coast worries about drought, overcrowding and the loss of its old dynamism, but is still a growth area by any standards but its own.

All the same, the core of any remaining optimistic forecasts, such as those from Morgan Stanley, which expects growth to rise to a 3 per cent annual rate in the second half of this year, rest on hopes for a recovery in consumer spending; but here the strongest doubts are beginning to appear.

They are inspired by the low confidence shown in recent surveys, with a large majority of the middle class wondering how it will make ends meet in the next decade, on the sharp fall in consumer borrowing, now barely keeping pace with nominal income, and most directly by the disappointing profit record, which speaks of a tight market in everything from cars to hamburgers.

There are also some reasons to fear that past real spending is being overstated. The share of consumer spending taken by services has been rising sharply. This is often contractual, and costs have been rising twice as fast as average retail prices. Rising local taxes are also inescapable (and reflected in the official shelter cost index), and so, to some extent, are rising air and public transports fares and sharply rising tobacco prices. All these trends are squeezing discretionary spending.

The bulls still argue that this reflects simply a temporary pause in income growth, which has now resumed, according to official figures. There are rumours, though, that the figures are faulty, and about to be revised sharply downwards. Given the huge recent revisions to other key figures – notably employment and housing – this scepticism is easy to understand. Congress has always demanded quick figures (and prescribes its wishes in law). Inevitably, it gets inaccurate ones. The real economy is visible only through a fog, so the mood about it can swing freely.

That mood is partly inspired by the grim state of the financial system. An immediate trigger for Monday's fall was a report that a little-known agency which guarantees student loans may be insolvent. There are similar fears about insurance for private-sector pensions. And the cost of the $500bn savings and loan catastrophe was officially estimates at a mere $50bn not long ago.

Mr Greenspan may argue that these costs are illusory, a transfer from one pocket to another; but they mean heavy official borrowing, higher long-term rates, a shell shocked banking system and soft property values. On the east coast, these are the most obvious realities. The economy may yet muddle through – for none of the figures suggests anything remotely like the depression of 1981-82, but confidence will be weak for a long time.

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THE WASHINGTON POST, August 5, 1990

Recession: This Time It Could Be the Real Thing

By George L. Perry

THE MOST overpredicted recession in modern memory may finally be on the horizon—and it could hardly come at a worse time.

Sagging consumer demand, weak business profits and investment and mounting inventories provide the classic conditions for an economic downturn. To these must be added the fragility of many parts of the financial system and now a surge in oil prices arising from Iraq's attack on Kuwait. These factors both add to the likelihood of a downturn and make it more urgent to avoid one.

But a full-blown recession is not inevitable: The Federal Reserve can reduce the risk of its occurring—and minimize the likely damage if it does occur—by actively pushing down interest rates now. The case for easing monetary policy is not just that the risk of recession is high enough to be worrisome. It is also that many parts of the economy have become financially shaky, so that a recession would be exceptionally damaging while lower interest rates would be exceptionally helpful. Moreover, reducing rates could even keep alive hopes for deficit reduction.

To be sure, the Mideast situation further clouds the economic outlook and complicates the Fed's conduct of monetary policy. Analysts will draw parallels with 1973-74, when the first big OPEC price increase contributed to a surge in overall inflation. But that episode occurred in a very different environment. In 1973, price and wage controls were being lifted and the consumer price index was already rising at double-digit rates. These price developments, together with the tight monetary policy used to fight them, brought on a massive recession. It is too early to know what the Iraqi invasion will ultimately mean for oil prices this time. But it adds to the likelihood of recession to the extent that the prospect of added inflationary pressure inhibits the Federal Reserve from reducing interest rates.

The economy is not yet in a recession by any accepted statistical indicators. Unemployment is still relatively low—despite last month's jump in the unemployment rate to 5.5 percent. And real GNP and industrial production both rose, albeit modestly, in the second quarter. But a close look at recent economic developments points to growing weakness in the expansion:

■ *Consumers have run out of steam.* Buying by consumers accounts for about two-thirds of total demand in the U.S. economy. Except for volatile automobile sales, consumer spending generally neither leads nor causes declines in total GNP. Yet by the second quarter of this year, real consumer spending on all major categories of both durable and nondurable goods was down, and only spending on services was still rising. When consumers get worried they tend to cut back discretionary spending—even if their own pocketbooks have not yet been affected. Although consumer surveys are inconclusive on this point, this unusually pervasive weakness in consumer buying may reflect worries both about national developments such as the thrift crisis and about developments closer to personal experience, such as weakening house prices. Nothing is likely to cure either worry soon.

■ *Business buying is sluggish.* Spending by business on new plants and equipment declined in the second

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Recession: For Real?

RECESSION, From D1

quarter. Capital appropriations, orders for capital goods, and construction contracts and declining profits all suggest weaker, not stronger, demand from this sector during the second half of the year. Commercial construction has gotten well ahead of need for office and retail space in most areas, to the point where its financing has become a serious problem for banks and other lenders. Residential construction declined in the second quarter and is heading down further. Some continued growth in exports is the only clear plus on the economic horizon.

■ *Inventories are growing while sales are weak.* The contrast between these weak final sales in most sectors and a considerable buildup of inventories in recent months is especially worrisome. Total final sales—the sum of sales in these sectors plus purchases by government—increased at an average annual rate of only 0.7 percent over the past three quarters, and actually declined at a 2.2 percent annual rate in the latest quarter. Since sales have been so disappointing businesses are not anxious to stock up. So the recent build-up of inventories has to be seen as largely unintended: Inventories rose because goods weren't selling, not because businesses wanted to be sure they'd be able to meet demand. Barring a renewed pickup in final sales, firms may soon cut production in order to keep inventories in line, and this in turn will reduce economy-wide employment, incomes and profits and weaken final sales still further.

So far I have described a classic business cycle in the making. At some previous times, the economy has marched up to the edge of such a downturn but not actually fallen over the cliff. When it has escaped it has generally been because the Federal Reserve aggressively reduced interest rates, as in 1985-86. Maybe this time final sales will strengthen spontaneously and interrupt the process even without lower rates. Maybe demands from abroad will expand our exports enough to overcome other weaknesses. But rather than relying on such hopes, a realistic appraisal should recognize that this time financial problems in the economy make a downturn both more likely and more damaging.

One major economic legacy of the 1980s is the high level of debt and leverage of many firms and the weak balance sheets of many financial institutions. The insolvencies that have overwhelmed the savings and loan industry are a well-documented disaster. The problems at major banks are emerging as the next bad surprise. And the bankruptcies of leveraged firms would be a feature of any future recession.

The problems of banks and related institutions are especially important now because they add to the chances of a recession. Major banks have gotten into trouble in several ways. Some of their loans were obviously very risky to begin with, others risky only after the fact. First it was Third World debt, then "oil patch" loans, then leveraged buyout paper and now construction loans in overbuilt markets. Aggressively marketed variable rate residential mortgages also added to risk by encouraging home buyers to take on escalating obligations they now find hard to meet. At present, banks in the Northeast part of the country are in the worst trouble, but California banks may be next.

These financial problems can spread to real activity in the rest of the economy through at least two channels: crumbling confidence and reduced credit availability. Although bank deposits are not at risk, insolvencies at major banks could only add to the caution of some consumers and business firms. But even without insolvencies and their effects on consumer and business confidence, some firms' ability to carry inventory and invest is almost surely being hurt by the newly found caution of bankers and bank regulators, anxious to avoid what happened to undersupervised thrifts. Other watchdog agencies may be having a similar effect in other ways. The Securities and Exchange Commission wants money market funds to hold only the top grade of commercial paper. That will add further to the cost and difficulties many firms face in borrowing for normal business purposes.

There is no simple cure for the financial excesses of the past. Soon Congress and the president must consider what systemic changes would reduce such problems in the future. But for now, lower interest rates would be a big help. They would provide some breathing space for financial firms to improve their balance sheets. They would ease the squeeze on borrowers, including new homeowners who now face sharp interest rates increases on their variable rate mortgages. They would offset some of the effects of credit rationing, and, by stimulating buying in the economy, would help avoid a recession.

Despite this picture of a growing recession risk and a pressing need for reduced interest rates, the Federal Reserve has been reluctant to lower rates. It did reduce the key federal funds rate by a tiny one-quarter percent. But Chairman Alan Greenspan emphasized that it did so only to offset some credit rationing by banks and not for the traditional reason of stabilizing a weak economy.

I can think of three reasons for the Fed's reluctance to ease. First, Greenspan and his Board may simply see the outlook differently than I do, with little risk of recession if present interest rates are maintained. Second, they may believe that cutting interest rates now would add unacceptably to inflation, or at least interfere with the eventual slowing of inflation that they regard as their main goal. Third, having all but promised lower interest rates in return for convincing reductions in the budget deficit, they may now feel they cannot lower rates without a budget compromise.

Inflation is a legitimate concern. The underlying inflation rate has been on a plateau of 4 to 5 percent for at least half a decade now, with actual inflation varying from this mainly as oil or food prices fluctuated. The sluggishness of the expansion in recent quarters was not accompanied by lower inflation and now, with oil prices rising sharply, actual inflation rates will almost surely be up for a few months. If the economy were stronger, this inflation outlook would justify keeping policy tight. But with present weak economic prospects, and presently fragile financial conditions, inflation fighting should not be the top priority.

Finally, lower interest rates should also contribute to the objective of encouraging deficit reduction. The budget negotiations are dragging and even an optimist has to believe that the earliest any measures could be debated and voted on is November, in a post-election session. If the economy is clearly turning down at that time, legislators, who are not anxious to cast unpopular votes to cut the deficit anyhow, will be susceptible to arguments that the economy is too weak to withstand tax hikes or spending cuts. Reducing interest rates so as to keep the economy as healthy as possible—and out of the budget debate—is now the best help that the Fed can give to the deficit reduction cause.

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THE WALL STREET JOURNAL MONDAY, AUGUST 13, 1990

The Fed Must Not Accommodate Iraq

By MARTIN FELDSTEIN

The rise in oil prices caused by the Iraqi invasion of Kuwait will raise the general level of prices in the United States and lower our real economic growth during the year ahead. But if the Federal Reserve does its job well, the oil price rise need not cause a recession or start an inflationary spiral like that of the 1970s.

Although there are already calls for the Fed to ease policy enough to prevent any economic slowdown, that would be a mistake. It would also be a mistake for the Fed to tighten monetary policy enough to prevent any oil-induced rise in next year's overall price index. The best strategy for the Fed would be to stick to its current implicit target of a rise in nominal GNP (i.e., total national output at current prices) of about 6% even though that will mean some slowdown in real activity and a somewhat faster rise in prices than would have been anticipated before the Iraqi invasion.

An unchanged nominal GNP target is more than just a compromise between a more expansionary monetary policy aimed at preventing any slowdown in real activity and a tighter monetary policy designed to prevent any rise in inflation. An explicit Fed promise to stick to a policy consistent with its original nominal GNP projections would reassure financial markets and the public that the current oil price rise would not trigger an inflationary spiral and ultimate recession.

No Accommodation

Market expectations that the Fed will not shift its nominal GNP goal are important. If companies believed instead that the Federal Reserve will respond to the oil price hike with an accommodating easy money strategy, as it did in the 1970s, they will try to get a jump on the upcoming inflation and the overall price level will rise by more than the direct effect of the oil price increase. But if companies believe that the Fed will not accommodate such a price rise, the overall price increase could be less than the direct effect.

Before the oil price jump, a nominal GNP rise of 6% during the next four quarters would probably have translated into an inflation rate of about 4% and a rise in real GNP of about 2%. Any faster rise in total spending would be inconsistent with bringing U.S. inflation down from its current unsatisfactory level.

And while the recent inflation rate of between 4% and 5% may seem moderate in comparison to the much higher inflation of the late 1970s and early 1980s, the current inflation rate is substantially above that in Japan and in major European countries and nearly twice as high as the U.S. sustained between the end of the Korean War and the acceleration of the Vietnam War. The Fed has been correct to insist on reducing the rate of inflation.

To lower the pace of inflation, the Fed has been gradually slowing the rate of increase of nominal GNP by slowing the expansion of monetary aggregates. In recent months, however, the execution of this strategy of gradualism has been frustrated by the reluctance of banks to lend in the current regulatory and economic climate. Despite the Federal Reserve's actions to lower the federal funds rate, the M2 and M3 monetary aggregates have not increased since April. The virtual standstill of the aggregates over the past six months is inconsistent with a nominal GNP rise of 6% and could contribute to a further slowdown this year.

Unless there is reason to expect a sharp rise in velocity in the future—and I can see no such reason—a more expansionary monetary policy during the coming months would have been appropriate in order to achieve 6% nominal GNP growth. Sticking with that same 6% nominal GNP target after the oil price rise may now require a slightly different path for money than it would have if the level of oil prices had remained unchanged. But the pace of monetary expansion should still be increased enough in the coming months to bring the aggregates back to the center of their target ranges, an expansion that would lower short-term interest rates.

What impact would such a 6% nominal GNP increase have on real economic activity during the coming year? If 6% nominal GNP growth would have implied a rather weak 2% rise in real GNP prior to the jump in oil prices, will the shift to higher inflation and lower real growth now mean a recession? I don't think so.

The extent of the increase in next year's inflation and the corresponding slowdown of real growth within the overall 6% nominal GNP rise depends of course on the extent of the jump in the oil price. Although no one can be certain about the future level of oil prices, as of today the spot price is $27 a barrel or about $7 a barrel above the $20 average around which oil prices have fluctuated for the past two years. Looking ahead, the prices of oil futures for the 12 months of 1991 now average about $24 a barrel. At the risk of overestimating the decline in real GNP growth, let's assume that the current $7 a barrel price rise will persist.

Board of Contributors

If companies believe that the Fed will not accommodate price rises, the overall price increase could be less than the direct effect of the jump in oil prices.

There are two channels through which the higher oil price will depress economic activity. First, an increase in the price of imported oil is like a tax levied by the OPEC producers on American consumers and businesses. Since the U.S. imports about two billion barrels of oil a year, a $7 a barrel price hike would reduce total real income by $14 billion.

Most of this would translate into reduced consumer spending. Although this would in principle be offset by increased demand for our exports as OPEC countries spend their added income, in practice much of that extra income would be saved by the OPEC countries. The increase in overall OPEC saving will lower world interest rates, but the resulting rise in U.S. investment won't happen soon enough to offset the fall in consumption in 1991. The net short-run impact would be likely to be equivalent to a decline in demand of $10 billion to $15 billion or between two-tenths and three-tenths of 1% of GNP.

The other short-run direct effect of an oil price rise is to raise the overall price level in the U.S. This rise in the price level would increase the public's demand for money. If the Federal Reserve does not fully accommodate this increased demand, short-term interest rates would rise and real activity would be depressed. This is what will happen if the Fed keeps the rise in nominal GNP unchanged. Over a two or three year period, such a policy will reverse the initial rise in the price level as the temporarily weaker economy slows the rise in the prices of non-oil products.

Interest rates would then subside and real economic activity return to normal. But in the short run, the higher overall price level would mean that the growth of nominal GNP would involve more inflation and less real economic growth. How much less? The impact of the higher oil price on the overall GNP price level depends on the total volume of oil produced in the U.S. (about 3 billion barrels a year) and not on oil imports. A $7 a barrel price rise would directly increase the dollar value of U.S. oil production by $21 billion a year or about four tenths of 1% of GNP. This translates directly into a 0.4% rise in the overall price level.

Since the combination of higher oil prices and depressed real activity would change other prices as well (the prices of coal and gas are already up while the prices of the wide range of goods for which demand will fall as overall activity slows will decline), it's not possible to say with precision how much the overall price level would change if the Fed holds constant the increase in nominal GNP. But even if the increases in coal and gas prices offset all of the other price slowdowns, the effect would be an overall price rise of only 0.4%. If total nominal GNP growth is unchanged, the effect of that higher price level would be to cut the growth of real GNP next year by four-tenths of 1%.

OPEC Tax

These estimates of each of the two effects taken by itself—the OPEC tax that reduces real consumer spending and the higher domestic price level that reduces the real GNP component of a given nominal GNP—are not additive. Because the two effects interact with each other, their combined impact is an average of the two effects calculated separately.

A precise estimate of the prospective change in real GNP is, however, not possible. But my own judgment is that if the Federal Reserve achieves a nominal GNP growth of 6% over the next four quarters, the oil price rise is likely to reduce real GNP growth in the coming year by only about one-half of 1%. Economic growth would drop to about 1.5% but a recession would be avoided and price inflation, while rising temporarily to 4.5%, would be kept under control.

Although such a slow growth of real GNP would be frustrating to everyone at a time when unemployment is rising and profits are falling, it would be the best response to the extra burden imposed on our economy by Iraq. Such a policy would avoid the risk of repeating the inflationary explosion of the 1970s.

Mr. Feldstein, former chairman of the president's Council of Economic Advisers, is a professor of economics at Harvard.

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THE WASHINGTON POST, September 2, 1990

Hobart Rowen

The Gulf Crisis: No Excuse . . .

If President Bush and Democratic leaders give up too easily on their earlier target of slicing $50 billion off next year's budget deficit and $500 billion over a five-year period, Saddam Hussein will have chalked up another hostage victory. The conventional wisdom in Washington, since the onset of the Persian Gulf crisis a month ago, is that the budget "summit" process that resumed this week will do well to find $25 billion in savings.

Political experts and commentators were too quick to bury the prospect of a peace dividend. It can't be denied that Saddam's invasion and annexation of Kuwait, followed by a huge American military commitment to defend Saudi Arabia, altered the economic landscape.

Sen. Sam Nunn (D-Ga.) estimates that a full year's cost of the troop buildup in Saudi Arabia, plus the economic aid to be given to friendly nations suffering because they've joined in the blockade of Iraq, will come to $50 billion. And that assumes no shooting: If war breaks out, the military costs alone will run to about $1 billion a day—four to five times the financial cost of Vietnam.

A "real world" deficit figure for next year, short of actual war, is $400 billion.

But facing this reality makes it all the more imperative that the budget-summit exercise be carried through, not dropped as "too hard." Of course, attention must be focused more intensively on cutting non-defense spending programs and on raising taxes.

It goes without saying that the Pentagon's needs for the Persian Gulf have to be met fully. But that shouldn't give Defense Secretary Dick Cheney carte blanche—as much as he'd like it—to continue wasteful, pseudo-sophisticated systems, mostly designed to level the Evil Empire.

The best guess at the moment is that the deficit for fiscal 1991 will run around $300 billion, including the true costs of paying off the savings and loan obligations to depositors. But that figure is understated by about $100 billion, because of the still-permitted use of Social Security and other trust-fund surpluses to pay ordinary bills.

So a "real world" deficit figure for next year—again, short of actual war with Saddam—is $400 billion. A deficit-cutting exercise should look at a $50 billion reduction for fiscal 1991 as a minimum. Uncle Sam is so short of cash that Secretary of State James A. Baker III and Treasury Secretary Nicholas Brady this week are going hat in hand to the Gulf, Europe and Asia to demand that our allies share the monetary burden of the confrontation with Saddam. In principle, this is wholly justified, and especially relevant to wealthy countries such as West Germany, Japan, Taiwan and Korea. They have no armed forces standing shoulder to shoulder with Americans on the front line in Saudi Arabia.

However, the real need for America to beg for financial support in this circumstance tells us dramatically that the excesses and failures of economic-policy making of the decade of the '80s have finally caught up with us: Uncle Sam is broke. We not only don't have the money with which to match our leadership in the necessary business of crushing Saddam, we don't have the money to rebuild our educational system and our roads and bridges and to pay other bills on the home front.

Worse, the nation appears to be heading into a real recession for part of this year and calendar 1991. This will boost expenditures for unemployment insurance and reduce normal tax revenues. Brady told reporters at the start of the Persian Gulf crisis early in August that inflation resulting from higher oil prices would cut the sputtering economic growth rate, then around one percent, about in half.

Many business economists are even more pessimistic. They think that government data lag behind actual results and that the economy already is in a recession, with many commercial banks and corporations facing a true crisis.

There is too much at stake, given what may be a long-term commitment in the Persian Gulf, to allow the budget to soar out of control. An extension of the deficit in these boxcar numbers means that we must continue to depend on imported capital—a dependency even more serious than that relating to oil, especially at a time when it appears that Japanese will have more difficulty in finding the multibillions they have been pumping into Treasury obligations.

To a major extent, we can and should reduce our dependency on petroleum. But when we borrow foreign capital to finance the deficit, we transfer our wealth abroad on a near-permanent basis, as interest costs multiply over the years.

Given the problems in the banking and financial community, a majority at the Federal Reserve Board knows they can't tolerate a deep or extended recession. In this situation, the economy desperately needs the lubrication of lower interest rates. Normally, the Fed is willing to accept slower growth than is really healthy for the economy—say, around the 2 percent level—so long as it keeps inflation under control.

But Brady's 0.5 percent real economic growth projection is too close to zero for comfort. To give the Fed the opportunity to move promptly and dramatically enough to cut interest rates, the budget summit must do its part.

Charles L. Schultze

. . . Not to Cut the Deficit

The fact that the nation's economy is soft at the moment—and is likely to get even softer because of the surge in oil prices—is no excuse for Congress and the president to back off from the task of cutting the federal budget deficit. To be sure, the tax increases and federal spending cuts needed for deficit reduction will put a damper on spending by consumers and government. But interest rates will then fall, and the Federal Reserve can push them even lower, thereby taking up the slack with other kinds of spending—on home building, business investment and exports.

The Federal Reserve does face a most difficult task in trying to minimize the economic damage from the sharp rise in oil prices, which simultaneously worsens both unemployment and inflation. But it faces no such difficulty in neutralizing the transition problems that come from deficit reduction. Ideally, perhaps, the budget negotiators could design a legislative package that cuts the deficit a little less this year and a little more in later years. But the urgency of enacting a deficit elimination package that covers a number of years remains as great as ever.

The country's political leaders—President Bush, Speaker Tom Foley, Senate Majority Leader George Mitchell and Minority Leader Bob Dole—agree that the federal budget deficit is sapping America's long-term economic strength and that it ought to be eliminated during the next three or four years. They also agree, deep down, that the deficit problem will not be solved without a combination of tax increases, cuts in middle class entitlement programs including Social Security, reduction in defense spending and some cuts elsewhere in the budget.

Despite this underlying agreement among the leaders, negotiations have stalled. Democrats will not put forward a plan that includes a tax increase because, with good cause, they know that apparatchiks and ideologues of the Republican Party will tar them with that position in the coming elections. And Republicans, with equally good reason, are afraid that if they propose the slightest cut in Social Security benefits, some rabble-rousing Democrats will try to repeat their electoral success of 1982 by accusing them of taking away the birthright of the nation's senior citizens.

Each side's more disreputable partisans are blackmailing the other side. And both sides are locked into frozen positions, even though the leaders in both parties know that the end result for the U.S. economy is creeping senility. (The United States, because of its budget deficit, now saves and invests far less than it did in the past and much less than other major industrial countries.) What's needed is a means of neutralizing the blackmailers. The president and the congressional leaders can do that while still preserving their parties' basic differences by issuing a brief statement of bipartisan agreement that would say something like this:

"We, the president, the majority and minority leaders of the Senate, the speaker and the minority leader of the House of Representatives believe that eliminating the federal budget deficit over the next three to four years is essential to the prosperity and long-term future of America.

1. "We all agree that a tax increase is necessary to balance the budget. We have different ideas about exactly how much and what kind of taxes should be raised. We will vigorously debate and then settle these differences through votes in Congress. But none of us, in either party, supports—indeed we condemn—attacks on candidates for Congress from the other party simply on grounds that the candidate proposed or voted for a tax increase.

2. "We all agree that some cuts in entitlement programs, including reductions in Social Security benefits (or increases in taxes on those benefits) must also be a part of any serious deficit-reduction program. We differ about exactly how to make the cuts, and we will debate and settle those differences in the normal way. But again, we condemn attacks against members of the other party merely on grounds that the member proposed or voted for Social Security or other entitlement cuts."

Leaders of both parties basically agree, but each side's more disreputable partisans are blackmailing the other side.

To avoid the possibility that political hatchet men will try to evade the intent of this statement, it should be issued by the principals themselves. In particular the president, not Messrs. Darman and Brady, should sign the pledge.

There are other necessary elements of deficit reduction—cuts in defense spending and in civilian programs outside of entitlements. But it is the politics of tax increases and cuts in Social Security benefits that are the nasty material for the political blackmail that has frightened both sides into stalemate. Getting rid of the fear of blackmail and the underlying agreement among the nation's leaders on what has to be done will begin to produce results. With the deficit impasse broken, the country's leaders can begin governing again.

The writer, director of the Economic Studies Program at the Brookings Institution, was chairman of the Council of Economic Advisers under President Carter.

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Yes, We Still Need Defense Cuts

The Gulf Crisis Is No Excuse for a Retreat on Spending Reductions

By Gordon Adams and Stephen Alexis Cain

BEFORE THE eruption of the Persian Gulf crisis, the need to cut the federal deficit to meet the Gramm-Rudman-Hollings target, combined with the evaporation of the Warsaw Pact and the decline in Soviet conventional military capabilities, made it almost certain that the defense budget would be cut significantly. Defense Secretary Dick Cheney sought $307 billion for defense in FY 1991; the Senate offered $289 billion and the House Armed Services Committee $283 billion just before Saddam Hussein's boot came down on Kuwait.

Now there is talk of a budgetary reversal. President Bush castigates those who would cut national defense. Assistant Defense Secretary Henry Cooper argues that the Iraq crisis indicates a need for strategic defense. Supporters of the stealth bomber argue that the crisis demands the B-2's capabilities.

We should not be playing such political games with our security needs. The first lesson of the current crisis is that the United States already possesses more than adequate troops and equipment to cope with the Iraqi situation. If we can't draw that lesson, we wasted the more than $2 trillion spent on defense over the past decade.

Even the costs of the Gulf operation do not support a case for restoring funding that the House and Senate have cut. In fact, the costs of the deployment are relatively small in terms of the overall defense budget. These divisions, carriers and air wings already exist; it is not a matter of raising and equipping new forces, even with the reserve call-up. Added costs involve principally those of transporting forces by air and sea, resupplying them once there, maintaining a higher pace of operations (flying hours, steaming days, combat vehicle miles) than they might have engaged in otherwise; and paying full salaries to reservists who have been called up.

The Defense Department has calculated this net cost at roughly $46 million per day, a figure which should decline once the forces are fully deployed. Let's assume that this means roughly $1 billion per month in additional costs spread over five to six months.

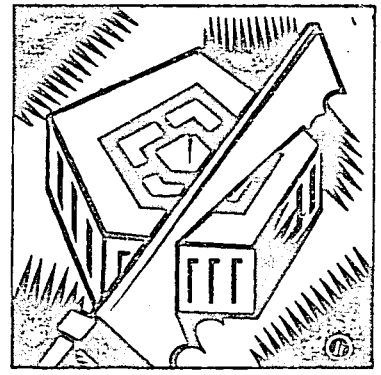
However, as the administration has already pointed out, the United States will not assume all these costs. The Saudis have agreed to provide funding for fuel, food and other supplies for U.S. forces, and the Kuwaitis and others have declared their willingness to assist. Even if the United States paid for the entire operation, the additional cost, over five to six months, is approximately the same as the difference between the House Armed Services and Senate defense numbers. Costs beyond six months, if any, could be covered by a supplemental appropriation or by reducing the level of operations for the 90 to 95 percent of U.S. forces not involved in the Persian Gulf.

Nor can the Iraqi threat justify restoration of individual weapons targeted for cuts. In the area of strategic weapons, for example, it is argued that funds for the B-2 bomber (cut by the House Armed Services Committee), the Strategic Defense Initiative (reduced by both the Senate and the House) and the Milstar communications satellite system (cut by the Senate) should all be restored, thanks to Saddam Hussein.

The B-2, its supporters suggest, would be useful for conventional bombing missions against Iraq. However, at $860 million per plane, the increase in bombing capability (assuming the B-2 performed as planned) has an unreasonably high price tag, especially since we have numerous other systems available for this mission (tactical aircraft, B-52s, B-1Bs and cruise missiles).

Advocates of SDI argue that it is needed in response to the risk that, one day, the Iraqis will possess long-range ballistic missiles capable of hitting U.S. territory. However, Iraq currently possesses only short-range missiles, against which an SDI system is not useful. Moreover, SDI technologies are far from ready for production. It would be imprudent to rush to deploy an ineffective system against a phantom threat, only to jeopardize strategic arms control talks with the Soviet Union, which could contribute much to the security and deficit reduction efforts of both countries.

Milstar could provide communications links between commanders and forces in the field—but it is excessive and redundant for this mission. In canceling Milstar, the Senate Armed Services Committee argued that we already possess substantial command, control and communications capabilities, having invested some $40 billion in



PETER HOEY—THE WASHINGTON POST

such systems during the 1980s. The additional expenditures for Milstar are meant primarily to maintain communications after an extended nuclear exchange, a problem thankfully unrelated to the current situation in the Middle East.

Furthermore, the Gulf operation provides no reason to reverse the troop reductions—between 100,000 and 129,000 active duty personnel—proposed by Congress. The forces deployed in Saudi Arabia and the Gulf are likely to total roughly 100,000, or five percent of total U.S. active duty personnel. Should the deployment double, it would still place only 10 percent of our forces in the region. Projected reductions tied to changes in the Warsaw Pact and the Soviet threat should be able to continue at the rate projected by Congress, leaving ample active forces for Third World contingencies.

Even the Defense Department projects a 25 percent reduction in active forces by 1996 (roughly 500,000 troops). After such reductions, the services would continue to have forces in and intended for Europe, deployments in the Pacific, and a rapid-reaction force of seven air wings, and five airborne and light infantry Army divisions, as well as Marine Corps forces and reserves to respond to Third World conflicts.

As for the reserves, a call-up of 50,000 reservists (to date, roughly 9,000 have been called up) would involve only 4 percent of selected reserve personnel. The reserve call-up does not indicate that active duty forces are inadequate. Reserves are being activated because, under the "Total Force" policy, the reserves supply the majority of medical, water supply, transport, refueling and other support services for active forces. In any case, reserve personnel were not reduced by either the House committee or Senate actions.

Advocates of conventional modernization programs are also trying to hitch a ride on the Iraqi threat. Now we truly need the C-17 cargo plane, its supporters argue, since airlift has become so important. But the Senate did not delay procurement funding for the C-17 in order to cancel it. Instead, the Senate argued that the program requires additional testing before production. This sound principle—"fly-before-buy"—should not be jettisoned simply because the Saudi operation demonstrates the importance of airlift. In reality, as former defense official Russell Murray recently pointed out, we could have purchased approximately 70 C-5 aircraft for the money we have already invested in just the R&D on the C-17.

Sealift is another requirement demonstrated by the Gulf operation. Since buying eight fast sealift ships in the early 1980s, the Navy has purchased no more. For 1990, Congress appropriated $600 million for fast sealift but Cheney sought to transfer all these funds. In the end, $225 million was reprogrammed, but the remaining funds have still not been spent. Sealift could be important to long-term military operations in the post-Cold War world; it has not had the priority it deserves.

The House committee and the Senate have also been criticized for reducing funding for—or deferring—other new hardware modernization programs: the Navy's A-12 attack bomber and SSN-21 submarine; the Air Force's Advanced Tactical Fighter, JSTARS aircraft and AMRAAM missile and the Army's LH helicopter. But none of these systems has any bearing on the current operation, since none will be operational anywhere close to the likely time frame of the Gulf deployment. Moreover, if war broke out, it would be more important to keep production lines for operational systems open than to rush new weapons into production. Thus the Middle East operation tends to support Congress's emphasis on improving current systems over starting new programs.

It might still be argued that these new programs are needed to stay ahead of potential adversaries. Nothing in the Gulf situation suggests, however, that staying ahead of the Iraqis technologically is part of our military problem. Their fighter aircraft and tank forces are more than a generation behind ours.

Aside from sealift, there is one other area where the Gulf operation may give budget-cutters pause. The House defense committee cut FY 1991 operations and maintenance (O&M) funding by $6.3 billion and the Senate cut it by $3.9 billion. Some of these funds may need to be restored to support the Persian Gulf operations. Particularly harmful would be the indiscriminate automatic cuts that would be imposed by Gramm-Rudman should Congress fail to develop a realistic budget alternative.

But even the O&M accounts are not sacrosanct. Saudi contributions and other potential allied support may limit the need for fund restoration. Moreover, as is frequently overlooked, not all of the O&M budget is essential for readiness, and much of it is wasted. And planned force cuts and reduced operations for Europe-oriented forces will free up operating funds.

In short, the Gulf deployment should not provide an excuse for reversing the course on which Congress has set defense funding and planning: slowing the rush into the untested and expensive next generation of military hardware; measuring each item against the new world realities to make sure we need it; making sure that it can perform as advertised; and moving toward the lighter, more mobile, more reserve-based forces that the new world requires. Nothing in the Gulf situation changes that sound strategy.

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THE NEW YORK TIMES, July 7, 1990

Raising Taxes Will Strengthen Bush

By C. Fred Bergsten

WASHINGTON

Democrats and many Republicans believe that President Bush's endorsement of higher taxes will hurt him politically. But they ignore the four major benefits that a successful resolution of the U.S. budget problem would provide.

First, interest rates would fall. The Fed chairman, Alan Greenspan, predicts that long-term rates, which drive investment and thus growth, could decline by two full percentage points. Key areas of the economy, such as housing, auto purchases and corporate spending on new equipment, should pick up quickly. The Fed must of course assure the needed monetary easing as soon as the budget package is sealed and delivered.

Second, the trade balance would improve. The dollar would weaken with lower interest rates and, along with the lower cost of capital itself, boost American competitiveness. This, in turn, would help American companies to capitalize on the continuing economic booms in Europe and Asia. Lower dollar interest rates would also ease the debt burden in Latin America and expand the region's capacity to buy abroad.

Lower interest rates and stronger trade should offset, or more than offset, the adverse effects of a tighter budget on the economy. The U.S. can enjoy export-led growth for the next several years, benefiting from strong foreign markets in the 1990's just as we benefited from heavy infusions of foreign capital in the 1980's.

To be sure, correcting the budget imbalance would have been safer several years ago, when the economy was stronger. But the risks will almost certainly grow if action is delayed further. Moreover, any recession now would probably be quite mild and short-lived, with growth resuming by 1992. For the longer run, strong private investment and trade improvement provide a much sounder basis for sustained growth than the consumption-led, Government-financed expansion of the 1980's.

Four ways to a better economy.

Third, fiscal policy can again become an active tool of economic policy. Today, with the deficit at current and prospective levels, the Government has virtually no way to respond if the economy falls into recession. Nor can we count on the Fed for monetary stimulation; not with a fiscal imbalance that would *rise* sharply in a recession and remain an inflationary threat. Budget action now would promote growth later as well as sooner.

Fourth, American foreign policy would strengthen substantially. Our credibility has been damaged by our unwillingness to provide even modest resources to support democratization in Eastern Europe and Latin America, international attacks on environmental degradation and initiatives in other areas. Budget correction would enable the U.S. to become a serious global player and leader again.

Notice that Japan responded immediately to the President's shift on taxes with new concessions last week, permitting a successful conclusion of the Structural Impediments Initiative. Mr. Bush's hand will be far stronger at the Houston summit meeting next week.

The magnitude of all these benefits will depend on the degree to which the President's willingness to raise taxes catalyzes both real spending cuts and a definitive resolution of the budget problem. The wisest course, economically and politically, is to agree promptly on specific measures to eliminate the deficit fully over the next four or five years.

The world of the 1990's and beyond will turn heavily on economic developments. The U.S. faces extremely tough competition from a uniting Europe, from Japan and from emerging powers in East Asia and elsewhere. Both our domestic prosperity and our global position depend on meeting that competition successfully. Budget correction is a central element in doing so.

Thus, President Bush's new stance on taxes marks his greatest contribution to the national interest to date. It may turn out to be his best political step as well. □

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THE WASHINGTON POST, Thursday, August 2, 1990

Michael Kinsley

Short-Term Capital Horizons

The oddest item on the Bush administration's now-you-see-it, now-you-don't list of possible new taxes is a securities transfer tax—a levy of perhaps half a percent on the sale of stocks, bonds, etc. This would raise several billion dollars. The impetus apparently comes from Treasury Secretary Nicholas Brady, who is obsessed with the idea that American finance is plagued by too much wasteful speculation and "short-term time horizons."

The Bush proposal for a capital gains tax cut is also intentionally biased against short-term investments, reserving its greatest blessings for those held for more than three years. Still, it is hard to reconcile the two tax ideas. On the one hand, the administration wants to cut the taxes on your net profits when you sell a stock. On the other hand, it wants to start taxing your gross revenues.

And not just that. One alleged benefit of the capital gains cut is that it will "unlock" old investments, encouraging investors to redirect their money in more efficient ways. Indeed the administration's rosy predictions that a capital gains cut would increase tax revenues in the early years are based entirely on people cashing in old investments, not on the incentive for new ones. Yet the transfer tax is designed to discourage exactly this type of "churning."

What sensible people want from a tax is to raise as much money as possible with the least disruption to the economy. (What good people want from a tax, as well, is to take more from those who can more easily afford it. But that is not our sermon today.) A securities transfer tax, deliberately designed to create friction in the wheels of commerce, is a strange bird to be hatched by a Republican administration. Does the government know better than the free market what "time horizons" the economy ought to have?

Lamentations over "short-termism" often confuse three different issues. One is whether U.S. corporations focus too much on this year's profits, slighting projects with distant payoffs such as research and development. Two is whether financial markets are too tumultuous, with traders preferring the quick in-and-out to a more extended investing relationship. Three is whether we as a society are consuming too much of our resources while saving too little for a more prosperous future.

Number three seems undeniably true to me, but that is a moral judgment, not an economic one. If Americans decide to live more for today and less for tomorrow, the result—through a chain of causation involving interest rates, money managers, etc.—will be that General Motors invests less in developing robots or whatever. That is financial markets working correctly, not incorrectly, and "throwing sand in the gears" (a phrase of Nobel economist James Tobin, who favors it) is no solution.

As for too much "churning" in financial markets, economists Lawrence and Victoria Summers of Harvard point out that the volume of financial transactions has exploded. In 1960, 766 million shares traded on the New York Stock Exchange all year. By 1987, the exchange was averaging 600 million shares a week. The Summerses estimate the total cost of operating the securities markets at $75 billion a year, or one-fourth of total corporate profits. And that includes the cost of using up some of America's best minds in the buying and selling of shares. The contribution of financial markets in efficiently allocating capital is worth something—but is it worth that much? The Summerses compare a lot of the effort invested by financial traders to people standing up to see better at a football game: it leaves them all, on average, no better off.

Lawrence Summers and Andrei Schleifer, an economist at Chicago, have developed a set of fancy theories to explain why financial markets have a built-in bias toward the quick payoff. It has to do with the interplay between the market professionals and the "noise traders"—meaning idiots like you and me. What they can't explain nearly as well is why this short-termism among the paper shufflers should have any impact on what really matters, which is the time horizons of corporate managers.

After all, even if I only plan to hold a stock for two weeks, I will be selling it to someone else who will be selling it to someone else and so on. How much I think these people will pay affects how much I will pay. The prospective value of a stock 10 years from now ought to have the same effect on its value today, irrespective of how often it changes hands in the interim. Even assuming that corporate managers care only about raising their stock price in the short run, there is no obvious reason why stock market churning should discourage them from projects with long-term payoffs if those projects otherwise make sense. Shleifer has concocted some non-obvious reasons, but he admits they are merely "plausible, but not necessarily true."

Apart from all the arcana, there is the question whether a securities transfer tax would drive the financial industry overseas. Most big industrial countries already have such a tax—Japan raises about $12 billion a year this way—but the trend is toward reducing or eliminating them, as finance goes global and markets have to compete for business.

The transaction tax, though, is more interesting for what it says about the Bush administration than for what would happen if it was enacted. It certainly wouldn't do much good, but it probably wouldn't do much harm, either. I would just like to hear an explanation from someone up there about what exactly they think the point of it is, and how it fits in to their general economic world view, if any.

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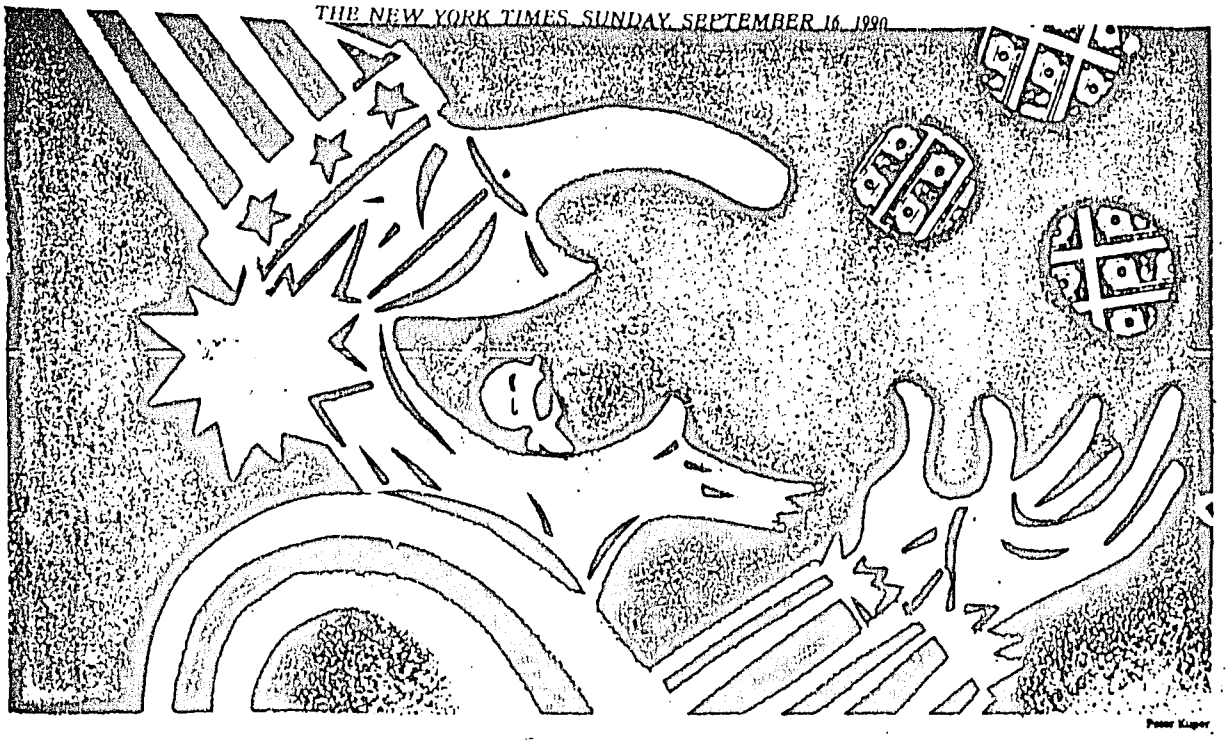

Peter Kuper

The Budget, From Comedy to Tragedy

By Peter G. Peterson

Our annual budget comedy is beginning to resemble a Greek tragedy, with well-meaning politicians terrified of doing the right thing and with our children as the hapless victims. Before the last act — which we hope is not yet written — it is time to rethink just why budget deficits matter and why we must do better than the "summit" package nearing completion in Washington.

Everyone agrees that America has a crying need for public and private investment, in both physical and human capital. Indeed, our rhetorical investment "imperatives" form a uniquely bipartisan consensus that extends from education of the work force to infrastructure to research and development. Everyone agrees except on one brute question: Where do we get the resources for this consensus investment agenda?

To invest, there must be savings — ours or those of more thrifty people elsewhere; our largely consumption-based deficits constitute negative savings. Counting the cost of the S.& L. bailout and discounting the illusory Social Security "surpluses," we now face deficits that will average $339 billion annually between now and 1995. From 1935 through 1989, with Federal borrowing wiping out over half of all private-sector savings, the net savings rate fell to 2.2 percent of gross national product, less than one-third the rate for the rest of the industrial world.

There were few visible effects of the 1980's "deficit decade," largely because savers from abroad "bailed us out" — even if that meant borrowing a trillion dollars from them. During the 1990's, however, the two biggest "surplus savers" among the industrial nations, Japan and Germany, will be less ready lenders. Japan's available savings will shrink as a rapidly aging population saves less, and as the Japanese invest more at home and spend more on consumer goods (both at U.S. urging). German savings are now flowing toward the reconstruction of Eastern Europe and the Soviet Union.

As we seek resources to cut deficits and fund investments, the supposed choice between "less spending" and "more taxes" is a false dichotomy when our third option is more borrowing. And borrow more we will, especially on "non-means-tested" entitlements — benefits passed out regardless of financial need. These have ballooned from $27 billion in 1965 to $472 billion in 1990. Add mandatory interest costs and we're up to $650 billion. Further — and putting our S.& L. "crisis" in perspective — our entitlement edifice has created unfunded liabilities that almost certainly exceed $10 trillion, or a hidden debt of $100,000 for every American worker.

Our national interest is served by programs that direct public resources toward investment and youth, not consumption and age. Perversely, while we squeeze the former, the latter are exempt from Gramm-Rudman cuts and protected with cost-of-living allowances (COLA's).

Thus, while Americans under age 18 have the highest poverty rate of any age bracket, they receive only $1 per capita in Federal benefits for every $11 going to each American over age 65 (who have the lowest povery rate, when all benefits are included as income). From subsidies to rich farmers to free medical care for old millionaires, we have massive "welfare for the well-off."

The structural elements of our entitlements have to be put on the table. We should move from age-based to need-based programs by progressive taxation of benefits, gradual reduction in COLA's for the non-poor, lower initial benefit levels for upper-income retirees, gradually rising retirement ages and increased cost-sharing for health benefits. For upper-income beneficiaries above some threshold, such as $50,000, an additional sliding-scale rate of up to 100 percent should be used to tax away the full value of benefits in excess of total contributions plus interest.

When the Japanese Government recognized that the cost of its public retirement system was quickly rising to unaffordable heights, it reduced average future benefit levels by roughly 20 percent. By contrast, our national plea seems to be captured by the American poet Peter Viereck: "suspend me in this choiceless now." We say it is "politically impossible" to change entitlements. Tomorrow, we may have to relearn — quickly and painfully — the true meaning of impossibility.

Some of these budget savings should go to the elderly poor. Raising average Supplementary Security Income benefits to 100 percent of the poverty line would require only about $5 billion, compared with the $15 to $20 billion that would be saved if all unearned Social Security benefits were taxed.

The current deficit deal doesn't begin to cut deeply enough.

Tax increases must play a role in eliminating the deficit, but not the major one. I favor a broad-based energy consumption tax such as a multi-year, phased-in gasoline tax of 25 to 50 cents a gallon. This could raise anywhere from $25 billion to about $40 to $50 billion yearly, shrink our oil-import deficit by perhaps $5 billion to $15 billion by 1995 and help pull down oil prices. Even an additional tax of 50 cents a gallon would bring our total gasoline taxes to only 81 cents — far less than the $2.01 a gallon that other industrial countries pay on average. Is cheap gasoline still another American "entitlement?"

Yet tax increases are an insufficient and short-term measure. Without reform, and with greater longevity, earlier retirement, low birthrates and medical hyperinflation, the cost of Federal entitlements could climb by a colossal 11.5 percentage points of G.N.P. between now and the year 2025, consuming 20 to 40 percent of worker payrolls. Even if the public consensus were suddenly to shift to allow such an unsustainable level of new taxes, these revenues would at best simply cover entitlement cost rises, leaving nothing to meet the needs of the new investment agenda.

Our predicament is a long-term, structural problem, not a short-term, cyclical one; thus the solution must also be long-term. Rather than pretending to hit a target this year of a $50 billion reduction, we should set a new 1995 Gramm-Rudman target of achieving a balanced budget, without counting Social Security trust funds and with enforceable expenditure limits.

We should then design a gradual, multi-year structural deficit reduction package that really gets us there. For economies no less than for individuals, episodic bulimia is not nearly as effective as a steady diet. A one-year freeze in COLA's, no matter how large, is a far less satisfactory spending reduction than a structural measure (such as COLA's for the non-poor limited to two-thirds of the inflation rate).

A phased-in, structural, long-term program would send a potent signal to financial markets to bring down poisonously high, long-term interest rates. Alan Greenspan has predicted that such a program would bring these interest rates down sharply, perhaps by 2 percent. Such a program would also be better politics, avoiding the needless costs of letting a budgetary meat-ax fall, according to an arbitrary one-year formula, in a soft economy.

Measured against these criteria, the most recent budget package falls far short. It is a good beginning — perhaps the best that could be done by politicians terrified of constituent reaction. Now it is up to the rest of us, in the economist Herbert Stein's words, "to make the world safe for the politicians to do the right thing."

It is said that our current deficit debacle is a tragic political deadlock between those who want high spending and those who want low taxes. In fact, both sides are getting just what they want: high spending and low taxes. Judged by our actions, what we really want is to protect ourselves — at the expense of our children.

The mystery for those of us past age 50 is why our parents never did the same thing. From 1940 to 1955, as a group much less affluent than we are today, they pulled America out of a depression, led a global war against Fascism, led another war against Communism in Korea, gave prodigious sums of foreign aid to Europe, supported massive outlays to young veterans on housing and education and still managed a level of net national savings more than double ours. Many opposed government spending. But when spending rose, few advocated borrowing instead of taxing.

Our parents' generation took the future seriously, and today we thank them for it. Someday our children will look back on us. When they weigh our material affluence against the challenges we faced, they will surely take a dim view of how few sacrifices we deemed worth taking for their benefit. That will be a final-act chorus few of us should want to contemplate. □

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Pleading Poverty

The budget deficit has nurtured a "myth of American bankruptcy," a notion that this country can no longer afford to address its problems at home or grasp opportunities abroad.

BY LAWRENCE J. HAAS

Last December, *The Miami Herald* took a rather unusual step to promote a long cover story in its Sunday magazine on the budget deficit. Apparently worried that nobody would read it, the newspaper illustrated the article not with charts and graphs, but with photographs of a sexy woman in lingerie.

Some might forgive the newspaper's appeal to prurient interest. The deficit can, indeed, be a boring subject, involving numbers too large to comprehend and concepts not easy to grasp. Nor have the nation's political leaders and journalists made the issue titillating. Since the deficit exploded in size in the 1980s, they have debated its effects almost solely in economic terms. Would the deficit, they ask, stunt economic growth or bring on a recession? Would it bring a new round of soaring inflation? Or higher interest rates?

To focus on economics, however, is to largely miss an important side of the story: the severe impact that big deficits have had on the federal government, on the policy-making process, on the customs and mores of America's leaders.

Most striking, the deficit has nurtured what might be called a "myth of American bankruptcy," a notion that the country can no longer afford to address its problems at home or grasp opportunities abroad. It has turned Washington into a city where penny-pinching and frivolous decision making is the norm, not the exception. Reluctant or unwilling to balance the nation's books—for that would require tough choices about which taxes to raise and which spending to cut—federal officials have opted to address huge needs with piddling sums of money.

When Polish Solidarity leader Lech Walesa asked the United States in early 1989 for $10 billion to rebuild his country's economy as Poland moved toward democracy, President Bush offered $115 million. When Bush proclaimed a "war" on drugs in September 1989, he asked Congress to increase spending by only $716 million—less than 0.1 per cent of the total budget—more than he had requested up to that point.

When Bush and Congress debated America's child care needs, they haggled over legislation that called for far less spending (in inflation-adjusted dollars) than the $2.1 billion in a bill that President Nixon vetoed in 1971—before people talked about a child care crisis. Time after time, the government concluded that it could not find adequate funds to address the problems at hand.

"Uncle Sam is running on empty," Sen. Ernest F. Hollings, D-S.C., wrote in *The Washington Post* in April 1989. "To serve in Washington today is to witness the federal government at its worst. We on Capitol Hill preen as we introduce empty 'sense of the Senate' resolutions, sham budgets and hollow bills and then expect to get a good government award for our efforts. . . . Meanwhile, under George Bush as under Ronald Reagan, the hollowing out of the federal government continues apace. Profound social problems—the pathologies of the underclass, a failing education system, declining competitiveness—are not addressed in any meaningful way whatsoever. Our government has charted a course of drift, disinvestment and decline."

It was a sweeping indictment, but perhaps not an overstated one. Since the deficit soared to mind-boggling heights in the early 1980s, it has warped the art of governing in Washington, constrained America's leaders and, in a sense, reduced the hopes and aspirations of those they serve. The government is locked in place, its leaders engulfed by this all-encompassing problem, unable to do much else because of it. Pressured by their constituents and by powerful interest groups to protect existing programs and not raise taxes, the nation's leaders lack the means to confront America's emerging challenges in a significant way.

"In my opinion, talk, thought and action about the budget in the government today is a scandal," Herbert Stein, chair-

This report is based on portions of National Journal staff correspondent Haas's new book, Running on Empty: Bush, Congress and the Politics of a Bankrupt Government (Business One Irwin).

man of Nixon's Council of Economic Advisers, told the House Budget Committee late last year. A few days earlier, drug czar William J. Bennett had reportedly explained why he would temper his request for antidrug funds by saying, "I live in the real world." Referring to Bennett, Stein said: "But the opposite is true. He and the rest of us are living in an unreal world, a world in which policy is determined by artificial, self-imposed constraints."

Unreal? Indeed. For America had not suddenly grown poor. It remained the world's richest nation in terms of the size of its economy, with its people enjoying the highest standard of living. But with its leaders unwilling to eliminate the deficit, the government pleaded poverty. "We have more will than wallet," Bush said in his inaugural address. But the President had it backwards, as columnist George F. Will pointed out.

America had more wallet than will—that is, more money in the economy than it was using wisely, more financial resources than it was willing to tap. What it did not have were political leaders willing to balance the budget so they could, in turn, make suitable federal investments in child care, in education, in housing, in antidrug efforts and in a slew of other areas.

RELUCTANT POLICY MAKERS

It is here that the economic and political sides of the deficit story mesh. Obviously, if the nation's leaders did not view the deficit as economically harmful, they would not feel compelled to control it. And in the absence of control, the deficit would grow to $250 billion or more (as it might anyway because of slow economic growth and higher defense spending related to the Persian Gulf crisis). Only because they worry that the nation will eventually pay the price for its fiscal profligacy do the political leaders pay attention.

But if they are unwilling to let the deficit grow much, they are almost as reluctant to reduce it. To impose tax hikes and spending cuts, elected officials need a reason behind which the public can rally, such as a sudden economic downturn. But the deficit is less a short-term problem than a long-term one. It is less likely to cause an economic collapse than it is to impair the living standards of future Americans.

Unwilling to ignore the deficit and unable to reduce it, federal policy makers are resigned to living with it. They are trapped in a cage of their own making. But rather than admit it, they hide behind the veil of national bankruptcy, a notion that America has run out of money, that its government cannot address today's problems.

"We find ourselves saying all kinds of absurd things," Stein, now a senior fellow at the American Enterprise Institute for Public Policy Research, told the Budget Committee. "For example, when President Bush announced his space exploration program, the pundits immediately got busy to say that although we could afford a big space program in the time of John Kennedy, we cannot afford it in the time of George Bush. But, in fact, real per capita consumption in the U.S. today is almost twice as high as when Kennedy was President, and we can afford much more than we could then.

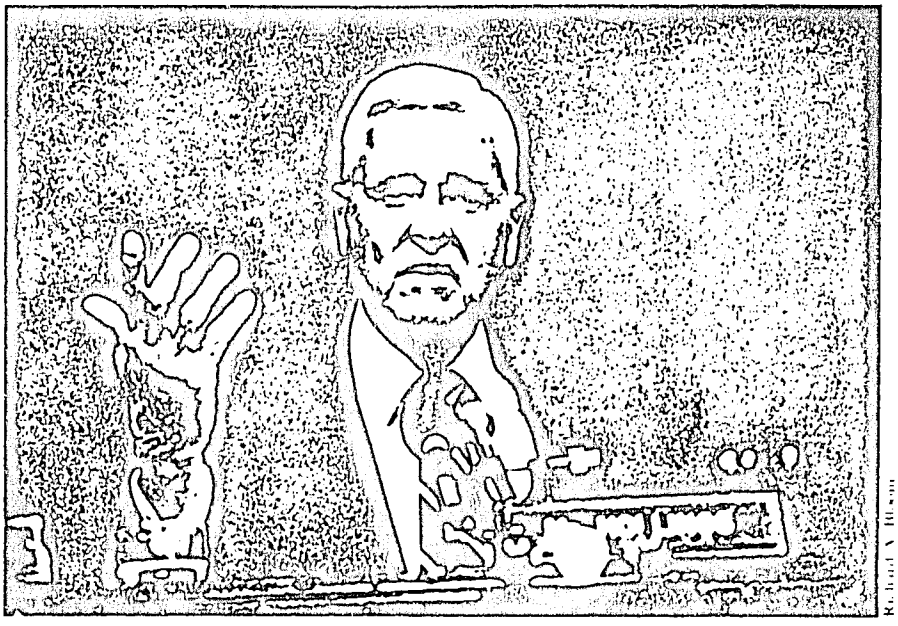
"The President evidently wants to extend some economic aid to Eastern Europe," Stein went on, "but there is a general consensus that we can only afford to provide aid in the low hundreds [of] millions of dollars, while the Japanese can afford to spend tens of billions of dollars. But the U.S. GNP [gross national product] is at least twice the Japanese."

Policy makers' attitudes may reflect the public's sense of national bankruptcy. Asked in 1988 about America's place in the world, only 22 per cent of respondents to an Americans Talk Security poll said the nation's economy was still the world's strongest; 41 per cent put it even with those of Japan and Western Europe; 34 per cent put it below.

Americans, meanwhile, were reading books that attempt to explain the nation's changing world role. It was perhaps no coincidence that Paul M. Kennedy's *The Rise and Fall of the Great Powers* (Random House), which suggests that American military commitments could bankrupt the economy, jumped aboard national best-seller lists after its publication in 1987.

But decline is a relative, not an absolute, concept. The United States is still the world's dominant economic power. Its lead had merely slipped as Japan and Western Europe rebuilt their economies from the devastation of World War II and became competitors.

Late last year, former Federal Reserve Board chairman Paul A. Volcker complained about the nation's willingness to use fiscal problems as an excuse to abandon world leadership. "It has somehow become fashionable to say that we can't 'afford' to do important things abroad, like providing substantial help to Eastern Europe, and that we can't afford to do even more obvious things at home, like rebuilding our cities and better educating our people," he wrote in *The Washington Post*.



Sen. Ernest F. Hollings, D-S.C.
"Our government has charted a course of drift, disinvestment and decline."

"Let's not confuse our political problems with lack of the resources required to support continued leadership," Volcker urged. "The margin of our economic advantage over other advanced countries has indeed narrowed, partly as a desired result of our own policies. But we are still the largest and richest economy the world has ever seen; by any measure, we are far better off materially than when we gave so generously to postwar Europe. So there are no inexorable economic or external forces—no new burdens—that demand we withdraw from leadership; if it happens, it will be of our own choosing."

Similarly, when asked in 1989 how America could afford his vision of a "war on drugs," Gov. Mario M. Cuomo, D-N.Y., attacked the assumptions behind

that question. "A radical government in Quebec invades New York," he told columnists Rowland Evans and Robert Novak. "The President declares this an outrage and demands it end. But will you send troops, Mr. President? Oh, no, we can't afford that. Let New York handle that. Let them use the militia. That's how we fight the drug war, and it is a war."

War or no war, Cuomo's point was well taken. Washington addressed the drug problem, which Americans said was the nation's most important, with only slightly less lethargy than it faced others. *Time* captured the mood with an article entitled "Is Government Dead?"

American Enterprise Institute's Herbert Stein Policy is set by "self-imposed constraints."

"Abroad and at home," it warned, with a teary-eyed George Washington on its cover, "challenges are going unmet. Under the shadow of a massive federal deficit that neither political party is willing to confront, a kind of neurosis of accepted limits has taken hold from one end of Pennsylvania Avenue to the other. Whatever the situation, . . . the typical response from Washington consists of encouraging words and token funds."

A FLAWED STATUTE?

Nothing symbolizes this "neurosis of accepted limits," this tendency to plead poverty when confronted by mounting social problems, better than the Balanced Budget Act that Washington thrust on itself. Enacted in 1985 and revised in 1987, it was supposed to guarantee a balanced budget by setting steadily lower annual deficit targets. If the White House and Congress could not meet them, the law would take over by imposing across-the-board cuts on many domestic and defense programs.

What Washington has learned since then is that probably no law can force America's leaders to do what they don't want to do. The budget act may have brought the budget a bit closer to balance. But the deficit, by most economic standards, remains far too high. And deficit cutting has come at great cost to the integrity of government.

As almost any officeholder would admit, the Balanced Budget Act has nourished a passion for blue smoke and mirrors, allowing policy makers to pretend that the deficit is falling rapidly when almost everyone knows otherwise. In a sense, the nation's leaders have been engaged in a conspiracy. They have all promised to cut the deficit. And when they have failed to do so in a meaningful way, they have boasted of their achievements as if they had turned the corner on the problem.

They congratulated one another, for instance, on their efforts to reduce the fiscal 1990 budget, although those efforts did little about the deficit. When Bush and congressional leaders gathered in the White House Rose Garden on an April afternoon in 1989 to unveil the budget agreement they had just negotiated, they told the nation something that they did not believe—that the pact would cut the deficit to just under $100 billion.

The negotiators and other top officials knew the agreement was a sham, a kind of paper tiger created by the Administration's optimistic economic assumptions and accounting gimmicks, not by serious deficit cutting. Even those happy about its existence were hard-put to defend it.

When Bush and Congress could not fully implement that modest pact, their rhetoric, nevertheless, reached loftier heights. "An excellent bill," White House spokesman Marlin Fitzwater said of the budget reconciliation bill that was supposed to enforce the agreement. Maybe "the best reconciliation bill in years," Office of Management and Budget (OMB) director Richard G. Darman said, citing an earlier assessment by House Budget Committee chairman Leon E. Panetta, D-Calif.

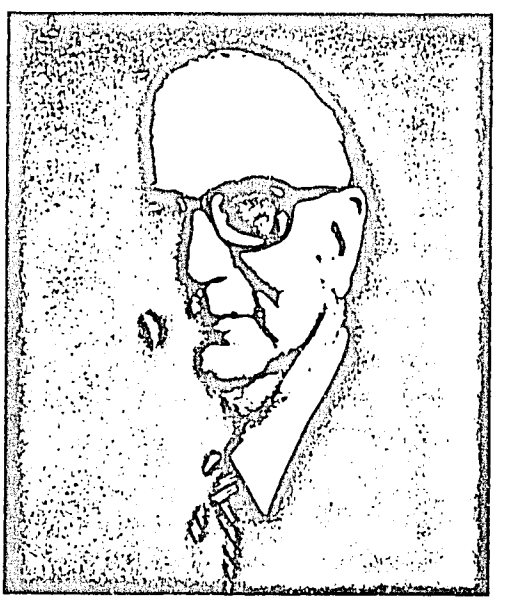
After Congress adjourned for 1989, its leaders talked up its performance on PBS's *MacNeil/Lehrer NewsHour*. Senate Minority Leader Robert Dole, R-Kan., quoted Darman's comments. House Speaker Thomas S. Foley, D-Wash., comparing the deficit cutting effort with those of earlier years, called it "one of the strongest, if not the strongest."

And yet when Reagan's first few deficits evoked deep concern, the government undertook some deficit cutting that makes 1989's effort seem laughable. In 1982, for instance, Congress passed a tax bill to raise $98 billion over three years and a reconciliation bill to cut spending by $13 billion.

By contrast, the tax and spending measures adopted last year were aimed at slicing an estimated $17.8 billion off the fiscal 1990 deficit. In January 1989, the Congressional Budget Office (CBO) had projected that the deficit would stay above $120 billion for at least five more years. A year later, with the tax and spending measures and new economic assumptions plugged in, the CBO's estimate had barely changed.

In their deficit cutting exercise, policy makers move government funds around like pieces on a board game. They enact policies intended to help meet the next annual deficit target, even if those policies might lead to higher deficits in later years. Because they focus on the next election, their aim is to get by for another year.

So they sell federal loans, generating quick dollars but costing the government in loan repayments in later years. They pass spending bills but prohibit some money from being used until a year or so



Former Fed chairman Paul A. Volcker We use fiscal problems to excuse inaction.

later. They delay the year's final pay date for government employees by a day or so, enough to push it into the next fiscal year. (In a variation on that theme, the Pentagon moved a pay date up from fiscal 1990 to 1989, helping to meet the 1990 deficit target but raising the 1989 deficit.)

If this is a game, the object is less to cut the deficit—although many would be pleased if that happened—than to let the White House and Congress boast that they have reached the required deficit target. But it is not just a game, for the stakes are high. Henry J. Aaron, a senior fellow at the Brookings Institution, told the House Budget Committee late last year, "I have the sense that as Congress and the Administration are forced to go through these exercises and resort to such devices, that we are all performing childish rituals rather than engaging in adult debate about constructive national policy."

So destructive are these "rituals" that Aaron and others insist the government would be better off scrapping the 1985 budget act. They have a point. In the early 1980s, before the Balanced Budget Act was adopted, the White House and Congress were forced to rely on their own sense of whether the deficit was so high that it would eventually hurt the U.S. economy. When they thought so, they cut it—and by much greater amounts than they have since the budget law was passed.

The deficit remains high. But fewer politicians seem to fear that it will cause economic harm. So they merely pretend to cut the deficit by exploiting loopholes in a law that hasn't met its designers' lofty expectations.

But don't expect the nation's leaders to take Aaron's advice. Though few politicians think much of the budget act, Democrats and Republicans alike do not want to be tagged fiscally irresponsible by repealing a law that's supposed to balance the budget. So they will hang on to the law—or a successor—and keep moving small sums of money around while not doing much about big problems.

IMPOTENCE

Not many policy makers like the situation, which conflicts with their normal predispositions. Most have come to Washington to do things—kick around ideas, debate policy, make laws. In attacking problems, most of them viewed government spending as their most potent weapon. Nor was this view confined to "tax and spend" liberals. In *The Triumph of Politics* (Avon Books, 1987), former Reagan OMB director Dave Stockman called it "the modern dirty little secret of the Republican Party: The conservative opposition helped build the American welfare state brick by brick during the three decades prior to 1980."

Only by fixing the deficit problem can policy makers return to the period of powerful government. But their short-term interests may not allow such a fix. For one thing, much of the budget is "off the table." Interest on the debt, representing 15 per cent of spending, has to be paid. Leaders on the Left and Right, reading the political tea leaves, have left alone other big chunks of spending, principally programs for the elderly. Social security, at 20 per cent of the budget, has been left untouched. Medicare, at 8 per cent, has been trimmed, but the cutbacks mostly affect providers, not recipients. Nor have government officials been more willing to cut other big federal and military retirement programs.

Policy makers have acted with similar discretion on the tax side. Having cut personal and corporate income rates in 1981 and 1986, few want to raise them. Scores of deductions have proven their popularity by surviving the tax code housecleaning that led to the 1986 Tax Reform Act. As with spending, much of the tax ledger is untouchable.

Washington, having created a deficit by commission, now seems ready to ensure its longevity by omission. Almost half of spending programs have been left untouched to consume an ever-larger share of the budget pie. Facing cuts each year, the remaining programs—defense and day-to-day domestic programs for housing, education and so on—have shrunk as a portion of the budget.

Liberals want more for social programs, and conservatives want to protect defense. But few in each camp have questioned the assumptions that have left so much of the budget untouched and have thus thwarted their efforts to find more money.

Such realities have helped to reduce the differences between Democrats and Republicans. In 1988, Bush effectively tarred Democrat Michael S. Dukakis as a "liberal," raising the specter of another round of "Big Government" that Bush opposed. But for all their supposed differences, Bush and Dukakis seemed to share the same assumptions about fiscal policy: leave social security alone and avoid raising taxes, particularly tax rates.

Bush, in his fiscal 1990 budget revisions, proposed the very thing that Dukakis had promised: a series of new programs with small down payments, but with a hint of more money for them in later years.

As for programs that are on the table—at least, for discussion—policy makers are not much more eager to cut them. More lawmakers than ever have a stake in existing programs because of the proliferation of committees and subcommittees. With more panels, each lawmaker serves on more. Members of the House Education and Labor Committee, for example, invariably grow to like programs that offer student loans, job training and other services. They study them, know their purpose, become attached to them, view them as less expendable than others and, accordingly, resist proposals to cut them. This is particularly true for subcommittee chairmen. The larger the programs within a subcommittee's jurisdiction, the more powerful is its chairman.

Henry J. Aaron of the Brookings Institution Who performs "childish rituals" on the budget.

Lawmakers also are spurred on by committee staffs, which have also grown. As lawmakers' workloads have increased and issues have become more complicated, the staffs have increased in power and have the same stake in programs that committee members have.

External pressures have also exerted an enormous influence on lawmakers. The number of national trade and professional associations headquartered in and around Washington reached about 2,200 by the

Richard A. Bloom

Child care has been losing out to lack of political will.

late 1980s—a third of all such groups in the country, according to the Greater Washington Society of Association Executives. More groups poured more money into campaigns through political action committees, whose numbers rose from 608 in 1974 to 4,268 in 1988 and whose contributions represented increasingly larger shares of total campaign funds.

When proposals are made for spending cuts, those groups leap into action. They send their Washington lobbyists to talk with lawmakers or staffs or with the relevant executive branch departments. They order their hundreds, thousands or millions of members across the nation to write to their Members of Congress. They contribute to an incumbent's reelection account.

Philosophically, Bush is not averse to using Washington to solve national problems. Indeed, with the public looking more favorably on an enhanced federal role in domestic policy than it did during the Reagan years, Bush seems well suited to the times. After vowing in his 1988 campaign that "I do not hate government," Bush offered a list of proposals for new spending that could have pleased any liberal Democrat.

But in 1989, when policy makers considered domestic needs, they slammed headfirst into the budget deficit. Rather than fix the problem, they hid behind the myth of national bankruptcy and offered relatively small sums for large needs. At the same time, they molded their actions to the often irrational rules of the 1985 budget law and, in the process, pushed for policies that seemed more counterproductive than helpful.

When the federal government, in its costliest rescue ever, developed a bailout plan for the thrift industry, many policy makers openly admitted that it was not the best scheme possible. Much of the cost of the bailout was put off to the future when the White House and Congress decided to borrow the money and repay it with interest over the next three decades. That raised the total cost by billions of dollars, but most policy makers took it in stride.

Bush and Congress boasted that they had stayed loyal to their schedule of annual deficit targets. Technically, they had. But in doing so, they resorted to fiscal gadgetry. Instead of accounting for all bailout costs directly, they set up a semi-private corporation to borrow most of the $50 billion. Healthy thrifts would repay the principal; taxpayers would pay at least $150 billion in interest.

Because the corporation would borrow most of the money, it would not show up in the budget. But for the same reason, interest costs would probably be higher. In essence, policy makers decided that proclaiming loyalty to their budget rules was more important than choosing the most cost-effective plan.

Some lawmakers, objecting to the idea of borrowing, wanted the government to pay the bill out of today's funds. When Rep. John J. LaFalce, D-N.Y., suggested that the government raise the $50 billion over three years through tax increases or spending cuts, few questioned his logic or his morality. But his idea raised too many politically troubling issues.

On the tax front, policy makers spent more time last year thinking about allocating new tax breaks than raising money to fix the deficit. A Bush-backed cut in capital gains taxes had a particularly seductive appeal. Not only would it let policy makers hand out a tax break to wealthy constituents, it also would bring a short-term burst in federal revenues, making it easier to meet the next deficit target.

In the long run, a capital gains cut could cost billions in lost revenue. Though some lawmakers talked about that problem last year, however, others ignored it. Only because the new Senate Majority Leader, George J. Mitchell, D-Maine, mounted an attack on Bush's proposal did Senate Democrats rally behind him to prevent the President from fulfilling a key campaign pledge.

Congress extended tax credits for nine months for business research and development, low-income housing construction and several other pursuits. But the extension was driven more by fiscal constraints than tax policy. Although the recipients would be likelier to take advantage of the credits if the breaks lasted longer, a nine-month extension was all that the government could afford.

On the issue of child care, the government's inaction was especially telling. This was perhaps the biggest domestic issue in the 1988 campaign, and the government was expected to respond with a new program and possibly with legislation on related family issues.

The political Left and Right had reached a consensus on major problems facing the U.S. economy, including the fifth of children living in poverty, the millions of youngsters lacking health care and learning little in school, the growing scarcity of adequately skilled workers and the increasing number of working-poor families.

But policy makers accomplished little. On child care, they could not overcome interparty and intra-party battles over how best to distribute scarce federal aid. Nor could they find a way to expand the earned-income tax credit (EITC)—the tool of choice for the working poor—and still proclaim that they had reached their next deficit target. Only because employers would absorb the cost did they raise the minimum wage.

Last year, it was child care and an EITC increase that lost out. Washington, apparently more willing to plead poverty than to solve the overriding deficit dilemma, could not respond to challenges posed by demographic changes at home and economic competition from abroad.

And unless Congress enacts, and Bush signs, legislation implementing the much-discussed "Big Deal" that would solve the deficit problem over the next few years, today's national needs will probably go unaddressed. ■

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Washington D.C., July 11, 1990

DEBT FOR NATURE SWAPS TO PROMOTE SUSTAINABILITY IN LATIN AMERICA

1. INTRODUCTION

Mr. Chairman, Members of the Subcommittees, I welcome the opportunity to state my views on debt for nature swaps and their role in environmental conservation efforts in tropical countries, which are disappearing at an alarming rate.

Within these forests live nearly two-thirds of all the plants and animals which share the planet with us. Nevertheless, each second that passes, the equivalent of an entire football field of tropical forest disappears, and with it, all the organisms that live in these ecosystems. We are extinguishing life on Earth at a rate thousands of times greater than in any previous period during the evolution of life. The fate of the tropical forests will not be decided in the 21st Century, but rather in the next decade, and with them may disappear a considerable component of the planet's biodiversity.

Economic pressures are forcing rural populations in tropical countries onto a path of destructive short term exploitation of precious timber species. Such exploitation is expanding ecological destruction, increasing pressures for climatic change, and limiting the development options of future generations. In most cases, however, there is still hope to redirect the development path toward a sustainable course, and we are presented with a unique opportunity to reverse the destructive trends of the past.

Appropriate economic incentives to tropical developing countries could significantly reduce deforestation and support a massive biomass buildup in a global scale. In addition to its positive influence on rural development and poverty in developing countries, such a program re-greening the planet is increasingly recognized as the most effective way to curtail the potential impact of global climatic change.

These economic incentives to tropical countries are critical to implement any strategy. H.R. 5088, as introduced by Congressman Kostmayer, would authorize the President of the United States to convert a portion of the bilateral debt of Latin American countries, and would therefore provide opportunities for the incentives required for environmental protection. The

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one initial debt-for-equity swap was approved by the Central Bank in January 1987. The Northwest Bank of Minnesota was allowed to swap $10 million of Costa Rican debt-titles that it held to take an equity position in Portico, a local door-manufacturing industry with considerable export potential. Local currency bonds provided by the Central Bank were used to purchase nearly 5,000 hectares of forest, which will be managed sustainably, with a cutting cycle of 35 years and speeding natural regeneration.

Since this was a private transaction and was directed to sustainable management and not absolute preservation, the deal did not attract much attention from the media, although it represented the first critical effort in Costa Rica. On February 2, 1987, the Ministry of Natural Resources proposed to the Central Bank a debt for nature program which was approved in August of that year for $5.4 million, as the first allocation of a longer-term program. During that year, in addition to Costa Rica, Bolivia and Ecuador also approved individual swaps or programs.

Since then, the mechanism of converting commercial debt into local currency instruments for conservation projects has gained widespread recognition and hundreds of articles have been written on the subject. Despite the publicity, only about ten countries have approved projects of this nature, and many developed as well as developing countries have expressed some reservations.

In the case of Costa Rica, in less than three years, over $90 million in debt-titles have been purchased for conservation and sustainable development projects. This is the equivalent of 6.5% of a total commercial debt of $1.5 billion. Although this entire commercial debt has recently been restructured, the debt for nature program carried out was the largest in the world and preceded the overall negotiations.

To understand how this process came about, it might be helpful to consider the evolution and characteristics of the program from its humble $5.4 million beginning.

Some of the most important features of the Costa Rican program were the fact that the idea was generated by the Ministry of Natural Resources and support from the Central Bank had grown slowly over time. The Bank eventually approved a program to be authorized by the Ministry and carried out through the National Park Foundation. The existence and respectability of this foundation were critical to the success of the program. Funds from a variety of donors, primarily U.S. environmental groups and foundations, would be channeled to the National Park Foundation, to be converted into local currency bonds for a variety of projects. Another unique feature of the program is that it included environmental education, ecological and scientific tourism, and sustainable forestry in addition to land purchase

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face value of the titles, interest rates near 15% and a maturation period of four years. Close to US $24.5 million have been purchased in this transaction, and with other additional grants may reach US $30 million.

A third quota of $5.6 million was approved by mid 1988, but the Central Bank had lowered the conversion to 30% of face value, partly due to the fact that some Costa Rican debt could be purchased for as low as 12 cents on the dollar. Some U.S. environmental groups claimed that Costa Rica was utilizing this as a strategy to lower the value of its debt, and others suggested that few takers would be interested under those conditions. However, this did not turn out to be the case, and by late 1988 donors had been lined up. With support from The Nature Conservancy, American Express Bank sold $5.7 million to this organization for 14 cents on the dollar. The Nature Conservancy, in turn, sold these titles to the National Parks Foundation at 11 cents on the dollar. The Central Bank provided bonds with interest rates at 15% and maturation periods of up to four years.

A final quota of US$ 10.8 million was approved in December of 1989 for additional Swedish funds. These have been the debt for nature transactions carried out thus far, and one may believe that the mechanism could be used indefinitely; however, limits exist in terms of inflationary impact.

Ultimately, debt for nature swaps are a mechanism through which developing country governments create value by multiplying the impact of donations for conservation by providing local currency bonds in amounts several times larger than the original grant. If we assess the overall Costa Rican program, nearly $14 million of grants and donations were used to purchase over $90 million of debt titles and to obtain close to $45 million in local currency bonds. The net result is that the Central Bank has provided three colones in bonds for each colon donated to Costa Rica. It is critical to bear this fact in mind in order to understand the alchemy of debt for nature swaps, because in the last count the colones injected into the economy by local currency bonds can have a significant inflationary effect.

Viewed from a different perspective, the overall result has been for the Central Bank to purchase $90 million worth of face-value titles for $45 million in local currency bonds, or less than 50% of face value. From this perspective, the Central Bank and the original donor have shared the discount obtained in the purchase of debt titles in secondary markets. If titles are purchased close to 15 cents on the dollar, the Central Bank can match the grant on a 3 to 1 basis and still pay less than 50% of the face value of the title, thereby reducing future interest payments on this amount.

One critical element in the Costa Rican program has been the effort to minimize the inflationary impact of the transactions by utilizing only interest payments from the local currency bonds. These instruments themselves are held in an escrow account and can not be sold.

Under the request of the Costa Rican Government, The Nature Conservancy commissioned a study to assess the potential inflationary impact of debt for nature swaps. This study concluded that if Costa Rica were to spend $50 million in local currency generated by swaps in one year, any inflationary impact would be less than one half of one percent. Although this figure is preliminary and might appear negligible, in ultimate instance we must face the fact that the limit to debt for nature swaps is their inflationary impact. The longer the term of the bonds, the smaller the problem becomes, and each economy must set limits based on its conditions. In the case of Costa Rica, the Central Bank has approved a target of $15 million per year starting in 1989 for conservation, education and micro-enterprises program.

The new program also provides the opportunity of dollar denominated, 20 year bonds with an interest rate of 3% and 80% of face value. The alternative in local currency is a 20 year bond, with 8% interest and 100% of face value. These options appear quite attractive and are likely to be implemented shortly.

Additional amounts could be approved only if the framework of debt-swaps could be expanded to include bilateral debt, since interest payments for this debt represent additional foreign exchange requirements besides the service of the commercial debt. This is why H.R. 5088 and the America's Initiative are both timely and appropriate.

6. BILATERAL DEBT OBLIGATIONS AND THE ROLE OF DEVELOPMENT BANKS

Bilateral debt obligations also provide an advantage in that no agreements with commercial banks are required and the two governments (lender and debtor) can enter into negotiations directly. These negotiations could include both partial condonation as well as partial conversion of payments to local currency bonds for financing sustainable development projects. Therefore, no intermediaries are required and the governments themselves can decide on the conditions of the swap and the contents of the program.

The essence of the proposed mechanism is that some bilateral loans, whose interest payments and amortization represent a tremendous burden to developing countries, be targeted for conversion into local currency funds that could be partially devoted to finance projects commonly agreed by lender and debtor countries. A concrete example could be a loan from country A to country B, whose interest payments could be devoted in local

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efforts being made by developing countries would be more effective if unequal exchange were reduced, protectionism decreased and debt renegotiated. Ultimately, new resources are required to deploy workable global strategies as outlined above. As concrete steps to initiate this process, several mechanisms should be established in the short term:

- Debt for nature swaps should be encouraged by both developed countries and multilateral development banks. These swaps should be expanded from commercial to bilateral obligations, so that old loans requiring foreign exchange could be earmarked in local currency for environmentally sound projects.

- An Environmental Rehabilitation and Development Fund should be created by the industrialized nations. Responsible directly and indirectly for considerable ecological destruction, they have the resources needed to help the developing world implement strategies for sustainable development. Such a fund would enable us to address environmental issues in a mutual, respectful, and constructive manner.

- Policies dealing with agricultural subsidies should be reconsidered, in light of the negative impact that they have on developing country farmers and consequently on the global environment.

- Efforts to negotiate urgent global treaties recognizing as common resources our shared elements -- such as the atmosphere, the oceans, and biodiversity -- should be encouraged and expedited."

On behalf of the Central American Management Institute (INCAE) I would also like to express our gratitude for the Committee's recent support to debt renegotiation to non-governmental organizations. Your continued efforts to support the processes of peace and development in Central America are greatly appreciated and will be critical in the future. Thank you.

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IMF Survey

JUNE 4, 1990

The Economy and the Environment: Revising the National Accounts

In light of the current concern about the environment, increasing attention is being directed to whether its interaction with the economy is adequately reflected in the national accounts—the bellwether guideposts for policymakers. The key issue is whether the national accounts neglect the consumption of environmental resources and thereby overstate the amount of income that can be consumed today without reducing the capacity to produce tomorrow.

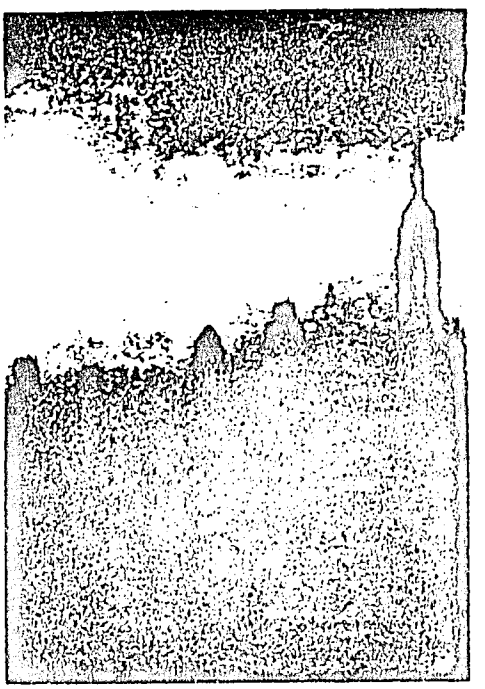
The strikingly different character of relations in the natural world and the economic world has, until now, kept study of the two realms largely separate. However, as part of the review now taking place of the United Nations System of National Accounts (SNA), last revised in 1968, a number of proposals have been made to revise the portrayal of the relationship between overall economic activity and the natural world within which it takes place.

Companies have found ways to account for their interactions with the environment, for example, in estimating the cost of preventing or correcting any environmental damage they may cause or of meeting the requirements of particular environmental legislation. At the macro level, however, it has proved difficult to measure the interaction of economic activity and the environment and to integrate these measurements into the national accounts.

What the National Accounts Cover

An understanding of these difficulties must begin with an appreciation of the nature of the national accounts, what they are designed to measure, and the conventions they have found it necessary to adhere to.

The national accounts, as set out in the SNA, do not attempt to cover all human activities. They do not, for example, cover most household work. Essentially, they measure only those economic activities that involve exchange in monetary terms. Because such exchange occurs when there is scarcity, activities that involve the consumption of seemingly infinite resources—breathing pure air, for example—are not covered and are not reflected in GDP. In addition, stringent criteria govern the recognition of capital assets in the national accounts. Specifically, tangible capital assets (other than nonreproducible assets such as land) are generally required to be the result of the production process, to be exchanged for money or produced for people's own use, and to be engaged in producing goods and services that are also exchanged for money.



New York's smoggy skyline: the impact on the economy of air pollution can't be measured precisely.

Recently there has been growing recognition that although many products of the environment are not exchanged for money, they are necessary to sustain economic activity. As a result, proposals have been made to adjust the national accounts to reflect this relationship. Of particular importance are proposals to acknowledge the capital nature of many environmental assets that interact (Please turn to page 168)

Camdessus Speaks On Eastern Europe, Global Cooperation

The hard road to economic reform in Eastern Europe and the need for "a new contract for international cooperation" were the focus of two recent speeches by M. Camdessus, the Fund's Managing Director. One was delivered at a conference in Budapest and the other before a special session of the UN General Assembly in New York. Excerpts from the speeches begin on page 170.

Correcting Flaws in the National Accounts

(continued from front page with the economy even though they are not exchanged for money, and to include in the consumption of capital assets the consumption of environmental assets.

Adjusting the national accounts for this purpose will be difficult; it will require measuring the interaction—sometimes likened to a balance of payments—of two altogether different worlds. Also, revisions of those sections of the national accounts that relate to the environment will have to be made in terms consistent with the rest of the national accounts.

Proposals for Change

Proposals by a number of economists, environmentalists, and statisticians for incorporating the interaction between the economy and the environment in the national accounts center on three issues:

- depletion of natural resources extracted for sale;
- "defensive" expenditures to prevent or correct environmental damage; and
- degradation of the quality of the environment as a result of economic activity.

The first two involve exchange for money and are therefore already covered in the national accounts, but would be treated differently. The third would introduce into the national accounts measurements to be drawn from the environment.

How is each of these three interactions between the environment and economic activity now treated in the national accounts and what suggestions have been made for change?

Depletion of Natural Resources. Under present national accounts practice, extracted natural resources such as oil are counted as part of production and, hence, GDP, when they are extracted and sold, and their proceeds are attributed to an operating surplus, which is distributed in the form of property income. Their use is not counted in depreciation. Under the proposed changes, such resources would instead be treated like capital assets that are consumed in the process of extraction and sale. But there are two views about the kind of capital asset they should be treated as.

One is to treat extracted natural resources like fixed capital assets that are gradually used up over time in helping to produce other goods—in much the same way as a piece of equipment. Under this approach, the extraction and sale of such resources would be included in GDP, but, because their supply would be consumed over time as with fixed capital assets, they would not be included in net domestic product (NDP) (see box).

The second view calls for extracted natural assets to be treated like inventory, that is, stocks of goods carried in from previous periods. This is justified on the grounds that such resources do not merely facilitate production in the way that fixed capital assets do; they are actually part of the products that are sold. Under this approach, extracted natural resources, other than their extraction costs and some profit margin, would be excluded from both GDP and NDP.

To accommodate either treatment, another category would need to be created in the national accounts in addition to the existing ones for fixed capital formation and changes in stocks. The new category would cover changes in nonreproducible assets used in economic activities.

Making the environment a sink for waste affects the sustainability of economic activities.

Defensive Expenditures. At present, expenditures to prevent or correct environmental damage resulting from economic activity, referred to as defensive expenditures, have a different effect on GDP depending on whether they are incurred by enterprises, governments, or households.

GDP is equal on the production side to total output and, on the uses side, to the total of final consumption, investment, and exports. Only governments and households are recognized as making final consumption expenditures in the national accounts, however. When enterprises incur defensive expenditures to prevent or correct environmental damage, these expenditures are counted as *intermediate* consumption necessary for enterprises' production. Thus, in sum, when defensive expenditures are made by governments or households, they are counted as final consumption and constitute a portion of GDP. But when such expenditures are made by enterprises, they are not counted as final consumption and

Capital Assets in the National Accounts

There are three broad categories of capital assets: financial, intangible, and tangible. Financial assets generally represent claims on others, while intangible assets, such as patents and copyrights, represent no claims on others. Tangible assets, which are generally above a minimum value, are used for productive purposes for a period of more than one year. They are of three kinds: fixed capital assets, such as buildings and equipment; inventories, or stocks of goods carried over from one year to another; and nonreproducible tangible assets, such as land and subsoil deposits.

Fixed capital assets are counted in GDP (the total monetary value of all goods and services produced within a country during a year) as fixed capital formation in the year in which they are produced. In subsequent years, their normal wear or depreciation is counted as a component cost of production and is included in GDP but subtracted to obtain net domestic product (NDP).

Inventories are counted in GDP only in the year in which they are produced. In subsequent years, as they are consumed, they are subtracted from total output and are not included in GDP.

Nonreproducible tangible assets are not included in GDP as being produced and are not depreciated or subtracted from total output as they are used. Their share in sales proceeds is counted as property income.

do not constitute a portion of GDP.

Two separate approaches are proposed to correct these disparate effects on GDP. The first would count the defensive expenditures of governments and households as intermediate costs necessary to prevent or correct the deterioration of the environment caused by economic activity. In addition, this approach would reduce GDP by any degradation of the environment that remains uncorrected. In other words, it would treat defensive expenditures incurred by governments and households in the same way as those incurred by enterprises.

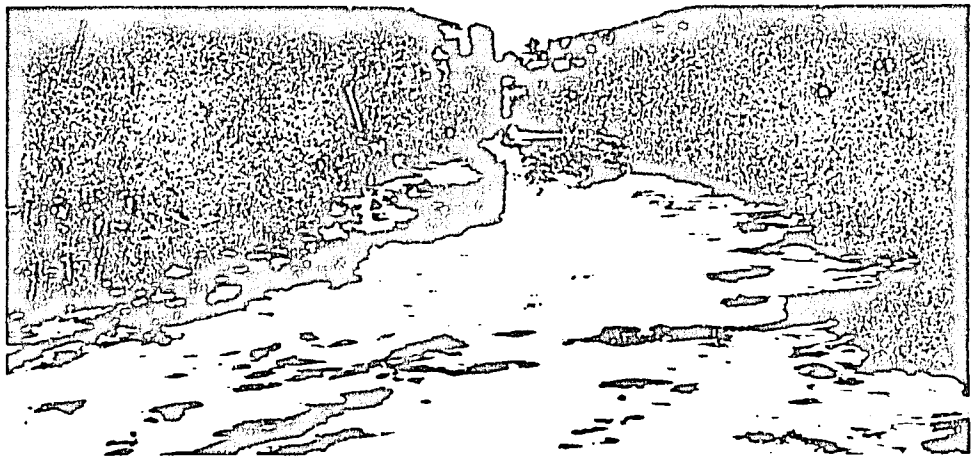
The second approach would include all defensive expenditures—whether by enterprises, governments, or households—in GDP but would subtract the degradation of the environment, in the same way as the depreciation of fixed capital assets is subtracted, in arriving at NDP. As a result, GDP would be enlarged to include the use of the environment—as the consumption of natural capital—and any environmental deterioration would be reflected only in NDP.

Environmental Degradation. Besides the extraction of nonrenewable resources, economic activity can also result in the degradation of renewable natural resources, such as forests and fishing grounds, and of the circulating resources of air, soil, and water. This can reduce the environment's productive capacity—for example, through overfishing, deforestation, and soil erosion—and its use as a sink for waste products, thereby affecting the sustainability of economic activities.

Some economic effects of environmental degradation are readily measurable. For example, crop losses caused by decreased soil fertility can be quantified, as can the reduced life of dam reservoirs as a result of increased siltation, following deforestation. Other effects, however, such as those caused by deteriorating air or water quality, cannot be measured precisely, although they may be evident in, for example, deteriorating human health.

Proposals for measuring the economic cost of environmental degradation generally focus on the cost of preventing deterioration or of restoring the quality of the environment to the level prevailing at the beginning of the accounting period, or to a level specified by official environmental standards. This could be estimated on the basis of air and water quality indexes, for example.

Another, more ambitious approach goes beyond measuring environmental degradation arising from economic activity alone. It also seeks to measure net degradation caused by *noneconomic* forces, including forces within nature itself, and to integrate these measurements into the national accounts. This approach would have to deal with difficult questions of the aggregation of negative as well as positive natural impacts, and of monetary quantification. Questions have also been raised about the appropriateness of integrating the entire environment, rather than just its interaction with the economy, in a measure of economic activity.



The national accounts don't measure the environmental degradation of Virginia's James River.

Integrating the economic effects of environmental degradation into the national accounts would involve approaches similar to those for environmental depletion and defensive expenditures. One approach would treat the value of environmental degradation as a decline in stocks and subtract it from total output to obtain GDP. The other would treat such degradation like depreciation of fixed capital and would subtract it to arrive at NDP. Either way, the economic effects of environmental degradation would be recognized as a decline in tangible assets and would be reflected in the calculation of income. The net change in the stock of environmental assets as a result of economic activity, therefore, would equal quantitative depletion and qualitative degradation reduced by the offsetting effects of defensive expenditures.

The economic effects of environmental degradation, unlike those of depletion and defensive expenditures, cannot be measured simply by reclassifying values already incorporated in statistics on economic activity. Rather, such effects would have to be derived by first measuring environmental damage and then estimating the cost of preventing or correcting this damage. Such measurements are necessary not only to adjust the national accounts, but also to establish "environmental accounting" as a first step toward sound environmental policies.

Integrating Environmental Impact Into the Accounts: Now or Later?

Beyond the question of how to reflect the environmental impact of economic activity in the national accounts, there is also the issue of whether this should be part of the core of the national accounts or compiled in a separate "satellite" account.

Those who propose a satellite account argue that the huge effort that would be required—in addition to the other changes in the national accounts that will now have to be introduced—calls for keeping the environmental account separate, at least until more experience is gained. In contrast, those who favor integrating environmental adjustments into the core of the accounts straightaway point out that the current review comes a quarter century after the last revision. They see this review as an opportunity to correct flaws in the accounts and to lay the basis for better national and international environmental policies.

Jonathan Levin,
IMF Fiscal Affairs Department

Issues relating to the measurement of the interaction between economic activity and the environment are comprehensively covered in a World Bank publication entitled *Environmental Accounting for Sustainable Development*, edited by Yusuf J. Ahmad, Salah El Serafy, and Ernest Lutz. The publication is available for US$10.95 (plus US$3.50 for shipping and handling within the United States, or US$6.00 outside the United States) from: World Bank Publications, Room J-2110, 701 18th St., N.W., Washington, D.C. 20433, U.S.A. Telephone (202) 473-2943.

Caring for the World: A Strategy for Sustainability

--IUCN/UNEP/WWF, June 1990

OVERVIEW

1. Caring for the World is a strategy for sustainability. It aims to overcome the problems of a deteriorating environment and diminishing natural resources. It outlines what people may do to satisfy their needs and improve their lives without lessening the earth's capacity to support them and their descendants. To change to ways of living and working that are sustainable calls for action on many fronts by many people. The strategy points out what individuals, governments, businesses and NGOs can do toward that end.

2. Like the World Conservation Strategy [1980], this Strategy emphasizes the interdependence of conservation and development; and the need to maintain earth's stock of natural capital, living only on income. It goes beyond its predecessor by taking full account of economic and social as well as ecological requirements of sustainability.

3. To achieve sustainability, three main obstacles must be overcome:

Lack of an ethical commitment to sustainability.

Inequitable distribution of power and of access to information and resources, within and among nations.

The notion that conservation and development can be managed separately.

4. Actions to care for the world are based on the following principles:

* Limit human impact on the biosphere to a level that is within carrying capacity.

* Maintain earth's stock of biological wealth.

* Use nonrenewable resources at rates that do not exceed the creation of renewable substitutes.

* Aim for an equitable distribution of the benefits and costs of resource use and environmental management among and within countries.

* Promote technologies that increase the benefits from a given stock of resources.

* Use economic policy to help maintain natural wealth.

* Adopt an anticipatory, cross-sectoral approach to decision-making.

* Promote cultural values that help achieve sustainability.

5. To overcome the obstacles to sustainability and conform to the foregoing principles, six strategic directions should be followed. Those directions and the most important of the cross cutting actions relating to each of them are:

Transforming attitudes and practices. A deeper and more widespread understanding is needed of how the biosphere works and what threatens it. We must develop a commitment to sustainability based on ethics and learn to behave as though tomorrow mattered.

ACTIONS: Form an international coalition to promote a world ethic of sustainability. Establish Amnesty for Earth to alert the world's people to offences against the biosphere. Incorporate environmental education in all education programmes and fund it sufficiently.

Building a global alliance. No less than a full partnership between countries is needed to arrange an equitable sharing of the costs and benefits of sustainability.

ACTIONS: Retire enough Third World debt to restore economic wellbeing. Make development assistance compatible with sustainability. Develop partnerships among NGOs of all countries. Adopt a global Convention on Sustainable Development.

Empowering communities. Individuals and community groups need to play their part in achieving sustainability and to share in the benefits.

ACTIONS: Promote Primary Environmental Care—a concept of self-help for individuals and communities to enhance their environments and develop sustainably, based on secure access to resources and information and full participation in decisions. Prepa[illegible]cal strategies for sustainability.

Integrating environment and development. Considering environmental management and development separately is the proven route to unsustainability; relevant planning and action must be integrated.

ACTIONS: Make sustainability a primary goal of economic and development policies, and reflect that goal in budgets and investment decisions. Establish the commitment to sustainability in law. Hold liable those who deplete biological wealth or damage the health of people or ecosystems. Include environmental and future user costs in the prices of energy, raw materials and manufactured goods. Use economic instruments to provide incentives for sustainable action. Plan land use on the basis of ecosystems. Strengthen governmental institutions for sustainability, building working partnerships with local governments and NGOs. Make free access to environmental information a fundamental right. Incorporate changes in stocks and flows of natural wealth in national accounting systems.

Stabilizing resource demand and numbers of people. Per capita resource use is too high in some countries; in others, per capita resource use does not meet basic needs and must be increased, but population growth must stop.

ACTIONS: Replace some taxes on income and sales with taxes on consumption of energy and other resources. Help lower-income countries adopt resource-efficient systems. Join and support "green consumer" movements. Triple the supply of family planning services in the 1990s. Improve the status of women and maternal and child health care. Direct development to increasing the security and incomes of the poorest families.

Conserving the variety of life. Biodiversity must be conserved for three reasons: all species have a right to exist; the variety of life helps to make the planet fit for life; and from the variety of life we get all our food, much of our raw materials, and many other goods and services.

ACTIONS: Join and uphold international agreements to conserve biodiversity. Provide communities with strong incentives to conserve biodiversity. Support management of biological resources by local communities and encourage the formation of grassroots organizations for that purpose. Ensure that conserving biodiversity is a priority of development policy and practices. Complete and maintain a comprehensive global system of protected areas. Estimate the contribution of biodiversity to the national economy.

6. Many of the actions that would move us in the strategic directions indicated are undertaken in a particular geographic or occupational context. These are:

Atmosphere, climate and energy. Climate change, ozone depletion and acid deposition are a consequence of the use of fossil fuels and CFCs as well as of deforestation and some agricultural practices.

ACTIONS: Priority actions fall into five groups: Reduce energy demand, increase energy efficiency and reduce use of fossil fuels. Halt deforestation and plant more trees. Phase out the use of substances that deplete atmospheric ozone. Prepare for the impacts of climate change. Reduce emissions of sulphur dioxide, oxides of nitrogen and carbon monoxide.

Industry. Being good to the environment is good for business. Industry and business can contribute to sustainability by taking care that their practices, processes and products conserve energy and resources and have a tolerable impact on ecosystems.

ACTIONS: Companies should make a formal, operational commitment to sustainability and environmental excellence. Develop and adopt performance and product standards. Control trade in and movement of hazardous wastes. Reach an international agreement on the sustainable use of biotechnologies. Adopt a policy for sustainable tourism.

Urban lands. Local governments need to be able to manage urban change to support more stable and productive economies while controlling environmental degradation and using resources sustainably.

ACTIONS: Develop stronger and more representative local governments. Integrate urban and related rural policies and actions. Empower and support citizen groups. Develop a transport policy that conserves energy and land.

Farm and range lands. Sustainable agriculture depends on the attitudes and practices of farmers. In lower-income countries, the needs are to increase self-reliance and security, minimize environmental damage and relieve pressure on marginal lands. In high-income countries, marginal lands should be retired from agriculture and conservation promoted.

ACTIONS: Promote understanding of and adherence to the principles of good land husbandry. Protect the best farmland for agriculture. Promote integrated pest management and control the use of fertilizers, pesticides and herbicides. Expand efforts to conserve genetic resources and ensure that they remain the common heritage of all people. Increase the productivity and sustainability of rainfed farming. Adjust macroeconomic, trade and pricing policies to support sustainable agriculture. Switch from price supports to conservation supports in high income countries.

Forest lands. Most countries should maintain 30-60% of their territory as modified and natural forest to secure the life support services and resources that only forests can provide. Community forest management can make a major contribution to that end. Global cooperation can help sustain forests and reduce unsustainable demand for their products.

ACTIONS: Maintain large areas of natural forest. Manage modified forests to produce many products. Evaluate all the goods and services provided by forests and establish cross sectoral forest policies. Ensure that the prices of forest products fully reflect their environmental and replacement costs.

Fresh waters. There is a need for greater awareness of how the water cycle works, of the importance of key aquatic ecosystems and how water and aquatic resources can be managed for sustainable use. International cooperation is essential for the management of shared water systems; communities should be helped to strengthen their capacity to use water wisely.

ACTIONS: Adopt an ecosystem approach to, and cross sectoral mechanisms for, water management. Manage water demand for efficient and equitable allocation among competing uses. Adopt policies and incentives that encourage wetland conservation and identify priority wetlands for protection.

The oceans. Seven out of ten people live within 80 kilometres of coastal waters. Due to intense and increasing pressure, the coastal zone is rapidly deteriorating and many fisheries have been depleted. More than three-quarters of marine pollution comes from land-based activities via rivers, direct discharges and the atmosphere. An integrated approach is needed to manage these activities.

ACTIONS: Give priority for regional land use planning to coastal zones and to drainage basins where pollution and land use have substantial impacts on marine resources. Pay more attention to controlling land-based sources of marine pollution, including provisions for such control in marine conventions. Protect major coastal wetlands, seagrass beds and coral reefs. Include a strong marine component in environmental education in all countries. Involve fishing communities and organizations in the management of fisheries. Develop an effective legal regime for managing uses of the open ocean. Develop a comprehensive and integrated legal regime for Antarctica and the Southern Ocean.

7. A strategy is useless if it is not implemented. While many of the actions required to put this global strategy into effect will be coordinated internationally, practically all of them will be what each country can do within its own jurisdiction. The best way for countries to determine how they can achieve sustainability is to prepare a national or a set of subnational and local strategies. These can—but need not—begin as conservation strategies, but they should ultimately be strategies for sustainability, prescribing the actions, suited to the country's own conditions, needed to conserve biological wealth and meet human needs.

8. National leaders, national and international agencies, NGOs and their members must try to make all people aware of the significance of sustainability; they must create a better understanding of how it can be achieved and they must develop a broad base of commitment to essential change: in attitudes and practices. Given that commitment, funds to invest in care for the earth can be raised. Among the sources of the needed funds are transfers from military budgets, taxes on emissions of carbon and other substances, and carefully designed levies on trade in certain commodities.

9. The value of this Strategy will be much enhanced if lessons can be learned from its implementation. IUCN, UNEP and WWF, the organizations that have formed a partnership to prepare the Strategy, will monitor, evaluate and report on Strategy-related actions and events.

--By Peter H. Sand, World Resources Institute
1990

Foreword

Several trends are acting together to push environmental concerns toward the front and center of the international stage. More and more, pollution is transboundary and even global in scope, threatening to damage the stratospheric ozone shield and alter climate and sea levels worldwide. Pressures on shared resources, such as river basins and coastal fisheries, are mounting. Massive deforestation by one region can alter another's hydrological cycle and the world's carbon cycle, even as it diminishes the global stock of biological resources. Resource deterioration in many nations is so severe that it registers in neighboring countries—when, for instance, ecological refugees flee across borders. And in the growing global marketplace, domestic environmental policies that affect business, industry, and agriculture need to be harmonized at the international level. Economic integration is also forcing environmental integration.

It is not just that there are more environmental problems so large that they can be intelligently dealt with only at the international level; it is also that the line between national and international environmental problems is fast disappearing. Nitrogen oxide emissions, for example, must be regulated locally because of ground-level ozone formation, regionally because of acid rain, and globally because ground-level ozone is a heat-trapping "greenhouse" gas.

In this instance, domestic and global environmental concerns push in the same direction, but in others they operate at cross purposes. Consider, for example, the case of alternative fuels. A car burning methanol made from coal emits perhaps twice as much carbon dioxide per mile as one burning gasoline does. So switching from gasoline to methanol might improve local and regional air quality—at the cost of increasing the global warming risk.

Environmental diplomacy is the logical outgrowth of the desire to protect one's own national environment, to minimize environment-related conflicts with other countries, and to realize mutual benefits, including economic progress and the protection of humankind's common natural heritage. As such, it is not entirely new. The register of international environmental conventions and protocols has grown steadily in this century; the main multilateral treaties today number more than 100, many of them aimed at protecting wildlife and the marine environment. What is new is the prospect that environmental issues will move from a secondary to a primary international concern and increasingly crowd the diplomatic agendas of nations. This diplomacy will increasingly affect domestic environmental policy.

No one knows exactly what the challenge of "internationalization" will ultimately require. Major policy and institutional innovations will clearly be needed, but the bottom line is that national environmental policy will more and more be set in concert with other nations.

And, outside of government, international business codes of conduct and other transnational norms will become far more common.

How can international environmental standard-setting and implementation practices be upgraded? What can be learned from our experience to date, which is more extensive than most imagine? How can we beat the lowest-common-denominator and slowest-boat syndromes that plague treaty-making? What alternatives to litigation can settle environmental disputes between nations? It is to these important questions that Peter H. Sand, a seasoned expert in international law and a pioneer in this new field, turns in this report.

Drawing on past environmental diplomacy to illuminate his points, Dr. Sand examines ways to tune up existing institutional machinery to deal with the tough decisions that lie ahead. He uses the 1973 Washington *Convention on International Trade in Endangered Species of Wild Flora and Fauna,* for instance, as an example of how "selective incentives" broaden the appeal of conservation agreements, in this case by offering economic benefits to otherwise reluctant parties. He points to the West German "blue angel" environmental label, introduced in 1978, to illustrate how models spread—in this case to Canada, Japan, and Scandinavia, all of which developed such labels in 1989. And he discusses how the 1987 *Montreal Protocol on Substances That Deplete the Ozone Layer* ensures the flexibility increasingly needed to keep international regimes attuned to the latest scientific evidence and to changing environmental and economic conditions.

Peter H. Sand is senior environmental affairs officer with the United Nations Economic Commission for Europe in Geneva. A German citizen and international lawyer, he has been involved in environmental management, diplomatic negotiations, and treaty-making for the past twenty years. Before taking the UN/ECE post, Dr. Sand served as chief of the environmental law unit at the United Nations Environment Programme, as assistant director general of the International Union for Conservation of Nature and Natural Resources (IUCN), and as senior legal officer with the United Nations Food and Agriculture Organization.

This study complements WRI's ongoing research on what roles global and regional institutions can play in tackling today's environmental agenda and how they advance and support the application of legal frameworks to deal with environmental problems.

WRI would like to express its great appreciation to the John D. and Catherine T. MacArthur Foundation, The John Merck Fund, and the Compton Foundation, Inc., which have provided financial support for WRI's efforts in this area.

James Gustave Speth
President
World Resources Institute

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LOS ANGELES TIMES, July 4, 1990

Reduce Global Warming at Lowest Economic Cost

Environment: The countries most willing to reduce carbon dioxide emissions should be compensated in cash and goods.

By MARTIN FELDSTEIN and KATHLEEN FELDSTEIN

The problem of global warming is sure to be on the agenda of the economic summit next week in Houston.

Although there are scientific doubts about the extent of the problem, there is no question that whatever is to be done must be accomplished on a global basis. The solution is not to ask individual countries to stabilize their emissions of carbon dioxide, as many environmentalists urge. What's really needed, contrary to recent statements by some Bush Administration officials, is a global fund to compensate those countries that do more than their fair share of cutting carbon dioxide emissions.

Carbon dioxide is a primary cause of global warming. Emissions accompany the burning of carbon fuels such as gasoline and home-heating oil, and through industrial processes that use coal, oil or gas.

The key scientific fact that makes international cooperation necessary is that while carbon dioxide can enter the atmosphere from any point, it is distributed equally around the globe within 12 months. There is nothing to ensure that those countries that heavily rely on the burning of carbon fuels will bear the burden of the global warming that may result.

Reducing emissions of carbon dioxide is a more appropriate subject for international negotiations and coordination than the problems of monetary and budget policy that have been the standard subject of economic summits in the past. Although a change in American monetary or budget policy does affect the other key industrial countries, the primary impact is on the United States. Foreign governments can rather easily offset the effects of policies that spill over from the United States to their economies. But when it comes to carbon dioxide pollution, emissions produced in the United States have the same impact abroad as they do at home.

The global nature of much of the environmental problem was clearly recognized in the 1987 Montreal Protocol, in which the industrial nations agreed to cut in half their emissions of the chemicals (chlorofluorocarbons, or CFCs) that are destroying the Earth's ozone layer. Many participants saw this as just the first step toward eliminating CFCs completely.

It would be a serious mistake, however, if the economic summit were to take the Montreal approach as the way to deal with the much larger problem of global warming and carbon dioxide emissions. The critical difference between CFCs and carbon dioxide is that it is feasible to eliminate CFCs altogether from the environment. In contrast, carbon dioxide can never be completely eliminated since emissions accompany not only virtually all industrial activity, but also are a biological byproduct of animal life itself.

Reducing carbon dioxide emissions involves economic costs. A country can reduce its emissions only by investing in more fuel-efficient technologies, by using more expensive fuels or by reducing its rate of economic growth. The economic cost of reducing carbon dioxide emissions differs among countries according to their current industrial technologies and agricultural practices.

Because global warming depends only on the total amount of carbon dioxide in the atmosphere and not on the country of origin, the goal of policy should be to reduce emissions in a way that has the lowest total economic cost, then distribute that cost among the countries of the world in a fair and acceptable way. Countries that can reduce emissions at lowest cost should take on a larger burden of reductions and receive compensation from the other countries in the form of cash and goods.

It would be wrong, therefore, if international negotiations to deal with global warming called for each country to stabilize carbon dioxide emissions at the current level or to reduce emissions by the same proportion. The United States is the largest contributor of carbon dioxide to the Earth's atmosphere. But it would be inappropriate for America to make any reduction in its emissions if the economic cost per ton were lower elsewhere. A better approach would be for the United States to achieve its fair share of total global reduction by contributing to a fund that compensates other countries with lower cost opportunities.

The less-developed countries have some of the lowest cost opportunities to reduce carbon dioxide emissions. Those countries would rightly complain if they were simply told to reduce their emissions in order to improve the global atmosphere. But sufficient cash compensation from the rest of the world could make the request very welcome.

The economic summit is obviously not the time to work out the difficult issues of just how much global carbon dioxide reduction is desirable, nor how the total world cost of achieving that reduction should be divided. Those are problems to be assigned to the economic and environment officials and their staffs. But President Bush and the other leaders of the industrial democracies can take a big step toward an appropriate policy on global warming by declaring the correct principal: carbon dioxide emissions should be reduced in those countries where the costs of doing so are least, and the countries that bear that burden should be compensated by the rest of the world.

Martin Feldstein served as chairman of the Council of Economic Advisers during the Reagan Administration. His wife, Kathleen Feldstein, is an economist.

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Introduce 'Green' Tax

Tax on pollution creates revenue, discourages waste

By Hazel Henderson

NOW that the "T-word" is out of the bag and President Bush has changed his mind on taxes, we should explore creative alternatives for bringing down the deficit. Such alternatives include: a new group of user-fees and "sin" taxes providing government with a major stream of new revenues, without hiking income taxes (in fact, *reducing* them) and helping to avoid a recession. It also includes levying fees on polluters.

Pollution levies, or "green taxes," as they are called in Europe, are approved by governments and most businesses. The Paris-based Organization for Economic Cooperation and Development (OECD) which represents the world's 24 major industrial nations, recently surveyed the 85 different kinds of "green" fees on polluting on the books in Europe. These taxes both speed cleanups *and* increase revenues.

These "green" fees can include deposits on returnables, car exhaust taxes, depletion taxes, and levies on such pollutants as carbon and sulfur dioxide. The Economist applauded all these measures as good economics and urged passage of them: "The environment could be a way to cut public spending and to generate a whole new source of revenue."

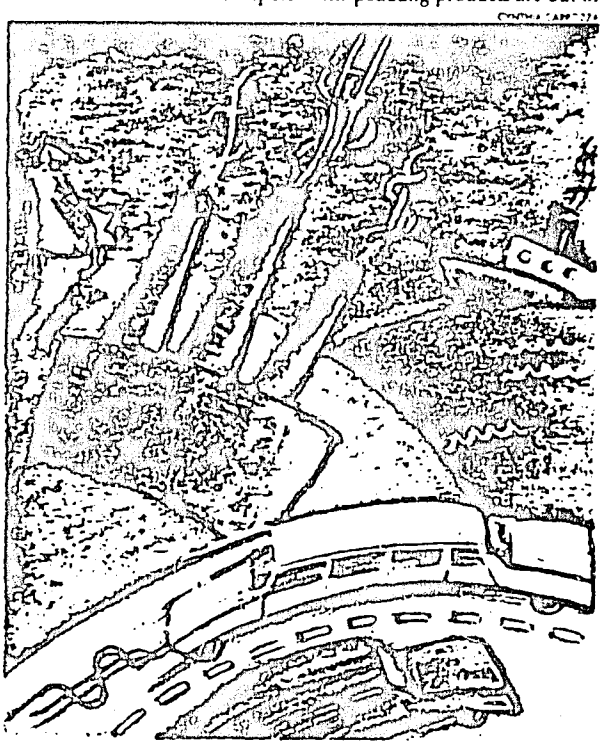
While governments in Europe are now seeing "green" fees as a major source of new revenue, business executives see them as much more palatable than bureaucracy and regulation. Most economists approve of "green" levies, since they provide correct price signals and improve markets' functioning. Some go so far as offering more dubious proposals to institutionalize the right to "trade" such pollution licenses in the marketplace, a decade-old practice now a feature of the Clear Air Act working its way through Congress. While markets cannot achieve the whole job, there are many cases when they can be effective – if fees for polluters are set high enough.

Economists like "green" charges because they help pay for the costs of pollution. Polluters are now "free riders" – passing on the costs of their activities to others. At last, after much resistance, this principle is being applied in many countries, including the US. Now is the time to fully extend it to our tax system.

Greening our tax code would also correct our national accounts: the Gross National Product, for example. GNP figures include the costs of cleaning up pollution and repairing damage and adds them into our accounts – instead of subtracting these costs to give a "net" GNP, as in Japan. For example, the cost of the cleanup of the Valdez oil spill was added to the GNP of Alaska, making 1989 look like a bumper year! Such costs should not only be subtracted from GNP, but the bills should go to the polluters. One doesn't have to be an economist to understand this. Polluting products would include costs of disposal and recycling. New markets for cleaner recyclable products would be able to compete more fairly. The "Green Market," says Business Week, will grow in the 1990s from $56 billion last year to $174 billion by 1995 – creating new jobs.

A "green" tax code, should include four environmentally-expensive activities: pollution, waste, depletion of non-renewable resources, and deliberately-planned obsolescence. (An example: disposables, like hosiery that runs on the first wearing.) The need to protect low incomes is addressed in Germany by *reducing* taxes on personal incomes proportionately as the "green" fees are raised. This shifts the burden from low-income individuals to those activities which pollute and deplete the earth – while remaining "revenue-neutral" overall. Americans already approve of the fairness of "sin" taxes (tobacco, alcohol) to pay for their effects.

Most companies that pollute see the writing on the wall. Consumers and employees of such companies are bringing law suits for damages, and companies are being found liable for a wide range of new claims. Another benefit of "green" charges involve the less-polluting, substitute products and services already available. Their prices would also fall, since most are offered by small, fast-growing companies that don't have the market power to "fix" prices. In many cases, such low-polluting alternatives are already cheaper: cloth diaper services, or non-polluting detergents. In addition, many of the *most*-polluting products are out of reach to consumers: stretch limousines, luxury campers, motor boats. "Green" levies should be highest on luxury items.



Workers can be redeployed and retrained as companies shift to less environmentally damaging operations. There is no substitute for spending new "green" revenues on retraining. Military contracting is a "sunset industry." The US economy is still too wasteful to compete. For example, we still use two and a half times as much energy to produce a unit of GNP as the Japanese. While they recycle over 50 percent of their "waste," we throw away 90 percent of ours. The sooner we get on with tightening up, the more competitive we will be in the world. Let's begin by "greening" our tax code.

Hazel Henderson is an independent futurist and consultant on alternative development. She is author of "The Politics of the Solar Age."

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Taking Stock: The Tropical Forestry Action Plan After Five Years

--Robert Winterbottom, World Resources Instit

1990

FOREWORD

In 1985, our reading of the state of the world's tropical forests and the pace of deforestation forced us to conclude that an ambitious global campaign involving more funds and people than any other environmental action plan ever launched was urgently needed. Our shared sense of the best way to get such an initiative off the ground was to scour and analyze all the data then available on tropical forests, to call on international agencies and forestry and agriculture experts from around the world to put these analyses into perspective, to search for successful projects that might be worth emulating, and to develop a budget for getting what we then called *Tropical Forests: A Call for Action* implemented at the national level in ways that suited each participating country's development needs and natural resource management challenges.

Five years later, the needs to control deforestation and to reclaim lost forestlands are greater than ever, and the need to take a close, hard look at the plan that has since evolved into *The Tropical Forestry Action Plan* (TFAP) is pressing. Because of WRI's role in launching the TFAP, we feel a particular responsibility to assess its successes and failures, its strengths and weaknesses, and to recommend how the process might be improved and better utilized in the future. *Taking Stock* is such an assessment.

As Robert Winterbottom's analysis indicates, the original plan was flawed in some respects. The rights and needs of forest dwelling peoples were not stressed in the original plan, for example, and it was assumed that increasing funding for the forestry sector would solve problems whose roots reach deep into economic and social policies made and observed outside the forestry sector.

Some parts of the original plan have also been misread or simply gone unread. Careful study of *A Call for Action* must assuage any skeptic's doubts that it is simply about trees. Over and again, the importance of sustainable agriculture to sustainable forestry is stressed, and increased attention to land use, forest management for industries, fuelwood and energy supplies, conservation of ecosystems, public participation, and institution building form the basis of the action plan.

More important, however, is the principal finding of WRI's analysis: the actual implementation of the TFAP has not lived up to original plans and expectations. As Winterbottom observes, the plan sprang from a widely shared belief that more effective programs in forest conservation and sustainable management, policy reform both within and outside the forestry sector, and improved land-use planning and inter-sectoral coordination could help make headway against uncontrolled deforestation and the waste of tropical forest resources; but, many of the institutions controlling the TFAP—FAO, donors, and national governments—seem to have become preoccupied with accelerating investment in the forestry sector at the expense of the quality control and direction needed to make the planning process and the plan itself succeed.

Taking Stock details a number of urgently needed steps for revitalizing the TFAP process so that the potential inherent in the effort can be realized. Looking to the future, the report stresses four goals in particular. First, the TFAP planning process must meet the needs and safeguard the livelihoods of people who live in or depend on the forest. Second, the plan should help ensure that the remaining areas of tropical forests are used in ways that contribute to national development, encourage multiple uses of forest lands, and protect biological diversity. Third, the TFAP should mobilize the resources needed to regenerate degraded tropical forest lands and promote sustainable land use around tropical forest areas. Stabilizing land degradation and promoting sustainable development patterns that relieve pressure on remaining natural forests are especially high priorities. Fourth, the TFAP should help stimulate needed policy reforms both in tropical countries and in development assistance institutions.

Taking Stock is a systematic attempt to call attention to flaws in the TFAP and lapses in its implementation and to weigh both against the plan's intended goals, its true potential, and the progress made so far in spite of set-backs and failings. Significantly, its conclusions were reached through a participatory process that was itself influenced by five years of experience with the TFAP. If the recommendations are taken with that same spirit, the odds are good that this tremendously important initiative can be put right in the 1990s—the decade in which the fate of tropical forests and their inhabitants could be sealed.

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James Gustave Speth
President
World Resources Institute

VI. CONCLUSIONS AND RECOMMENDATIONS

The most important conclusion of this assessment is that, despite some successes, the *TFAP as currently implemented is not achieving many of the plan's original objectives.* Moreover, it seems unlikely that the present TFAP planning process will ever be able to achieve some of them. Although the plan arose from a widely shared concern that more effective programs in forest conservation and sustainable management, increased attention to policy reform both within and outside the forestry sector, and improved land-use planning and coordination with agricultural and other development programs could help turn the tide against uncontrolled deforestation and wasteful depletion of tropical forest resources, many of the institutions controlling the TFAP—FAO, donors, and national governments—seem to have lost sight of these concerns as the plan has been carried out. At a minimum, these agencies have let their interest in accelerating investment in the forestry sector overshadow these concerns, and they have failed to provide the quality control and direction needed to make the planning process and the plan itself work well.

Today, a number of the organizations that initially supported the launching of the TFAP, including WRI, are deeply concerned about the internal contradictions and institutional problems that have prevented the plan from achieving its goals. These organizations share the belief that a failure to significantly reform and fully utilize the TFAP framework and planning process will soon make it impossible to muster further financial and political support for the plan—despite the continued strong interest in responding to the deepening crisis of tropical deforestation. The following recommendations speak to the urgent need for a recommitment to the TFAP goals and fundamental reform of the TFAP planning process and implementation structure.

1. Convene an International Forum on the TFAP.

Given the importance of evaluating the relative success of the TFAP and redirecting its future course, an international forum of representatives from international, national, and NGO institutions should be convened to give impetus to the required changes. On the agenda should be the clarification of the goals and objectives of the TFAP, guidelines for organizing the TFAP planning process, the establishment of a new management structure for the TFAP, criteria and procedures for the assessing and monitoring of the plan's success, and coordination of complementary actions.

Organized outside of the current TFAP structure, this forum could help achieve consensus on new approaches to combatting deforestation and implementation of the plan. It could also help to focus TFAP efforts. In the short and medium term, given the limited capacity of international aid agencies and other supporting institutions of the TFAP, priority attention for additional assistance within the TFAP framework should be focused on those countries where significant forest resources are most threatened, and where national governments demonstrate the greatest commitment to policy reform, participatory development planning, and adherence to the plan's goals and guidelines.

2. Clarify TFAP's Goals and Objectives.

Over the past five years, the TFAP has evolved to represent many things to many different organizations and people. Various incompatible expectations about the principal goals or anticipated end results of the TFAP have been raised, so it is now necessary to distinguish what the TFAP can and can't do at the national and international levels. In particular, it is critically important to underscore that the TFAP should not be used only as a means to increase investment in traditional forestry sector activities; rather, it should blaze a path toward the sustainable development of forest lands and help avoid the needless destruction of tropical forests.

Four goals implicit in the original TFAP and related to deforestation's root causes should be stressed in particular. First, the TFAP planning process must meet the needs and safeguard the livelihoods of people who live in or depend on the forest. Second, the plan should help ensure that the remaining areas of tropical forests are used sustainably—contributing to national development while encouraging multiple uses of forest lands and effective protection of biological diversity. This implies much more emphasis on the management of tropical forests for non-woody products (such as extractive reserves for natural rubber, oils, fruits and nuts) and non-consumptive uses (such as environmental ser-

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vices which may not be compatible with intensive timber management and hardwood extraction).

Third, the TFAP should mobilize resources to regenerate degraded tropical forest lands (using indigenous species to the greatest extent possible) and promote sustainable land use around tropical forest areas. Particular attention should be paid to avoiding land degradation and promoting sustainable development patterns that relieve pressure on remaining natural forests. Fourth, the TFAP should help stimulate needed policy reforms both in tropical countries and in development assistance institutions.

3. Make the TFAP Process More Open and Accountable.

The importance of "opening up" the TFAP process can't be overstated. For starters, documentation for the full secuence of TFAP-related activities must be accessible to all interested parties at each stage of the TFAP process, and appropriate fora should be provided for consultation, information transfer and dialogue. In particular, the private sector, NGOs, and representatives of local communities need to be associated in the earliest phase of TFAP planning, and involved in the preparation of "issues papers" and the planning of field studies and support missions. Special efforts are needed to address the concerns and to articulate the needs of groups that are frequently marginalized in development planning: women, landless, rural poor, indigenous forest dwellers, tribals, and other disenfranchised groups.[38] Quite simply, the TFAP can't succeed if it is held hostage to the rules of confidentiality often evoked as part of the development assistance process.

To respond to the increasingly forceful criticisms of the TFAP by forest dwellers and the NGOs who come to their defense, the TFAP process must be made dramatically more participatory, heavily involving both NGOs and those whose livelihoods depend directly on the resources of the forests. A survey of interested and relevant NGOs and forest peoples organizations should be completed at the outset of the national TFAP planning process to help facilitate full participation in and influence on the national TFAP planning process. Broad participation should be sought as a means to an end and *not* simply as a token effort with little impact on the actual outcome of the process.

Another way to open up the political process so that needed reforms and priorities come to light, is to shift away from sectoral technical planning and project identification and toward the development of equitable development strategies that adequately reflect the need to balance local interests with national ones, and ecosystem conservation with intensified management to expand resource produc Such trade-offs cannot be fully assessed nor ca political compromises be negotiated without t participation of all interested communities, be ning with the people most dependent on the f Priority should be given to the political planni process, in advance of the development of spe plans for institutional and policy reforms, and ciated investment.

Explicit criteria and standards for TFAP-re programs, activities, and proposals for investm and technical assistance should be followed so these actions are consistent with the basic goal the TFAP The same goes for guidelines for pa tory planning, impact assessment and evaluati tivities. Although individual countries will alw need to adapt "templates" for the TFAP plann process to their particular situation, a number sential principles and guidelines must be respe the TFAP is to succeed. Endorsement of TFAP grams and continued international cooperatio support of national and local TFAP activities s be conditional on the respect of these criteria, dards, and guidelines.

4. Give More Attention to Policy Reforms.

In many countries, government policies ar responsible for the indiscriminate destruction est resources. Tax incentives and credit subsidi guarantee large profits to private investors wh vert forest to pastures and farms. Governments low private concessionaires to log forests on te that induce uneconomic and environmentally ful practices. Massive public expenditures on h ways, dams, plantations, and agricultural settle ments, often supported by multilateral develop lending, are used to convert or destroy large ar forest for projects of questionable economic va In addition, industrial-country trade barriers t entry of forest products have helped prompt i propriate investments and patterns of exploita developing countries' forest industries.

Creating a better policy framework should come a cornerstone in sustainable resource ma ment. Unless policies that induce forest destru are changed, TFAP investments in reforestatio watershed management, wildlife conservation related initiatives will be overwhelmed. As int tional capital flows become increasingly linke broad macro-economic and sector policy agre ments, the international development agencies identify and analyze the effects on forest resou of tax, tariff, credit, and pricing policies and s the policy reform needed to root them out.

5. Insist Upon Improved Quality Control in TFAP Planning Exercises.

In the earliest stages of the TFAP planning process, more attention should be given to the collection and analysis of several kinds of information. Especially important are accurate demographic studies of forest dwelling and forest dependent people, socio-economic surveys related to the incentives and rationale for resource-use patterns and traditional management strategies, and analysis of tenure, customary rights, land use conflicts and legislation related to forest ownership and control over forest resources. Problems related to institutional weaknesses in the management of forest lands and the resulting *de facto* "open access" situations in some forest areas should also be analyzed, together with the prospects for a devolution of management authority, access control, and forest land ownership (via divestiture of public lands to local peoples).[39]

To help direct TFAP support, FAO and other cooperating institutions should also rapidly compile and disseminate updated information on the condition of tropical forests, highlighting areas where degradation and conversion have accelerated or where either poses an immediate, significant threat.

Also needed is increased support for field studies and analysis of the causes of forest degradation and destruction. A broad range of international, national and local institutions and organizations with capacities in these areas should be supported to promote independent analysis of the full spectrum of direct and indirect causes of deforestation, particularly from the perspective of those persons most directly affected by deforestation and over-exploitation of forest resources. Without such comprehensive and independent analysis, progress in policy reform and the control of deforestation will be slow at best.

More specifically, the TFAP planning process should provide for a more discriminating analysis of the types of forest land use, the effect of shifting cultivation, and the impacts of forest-dwelling peoples on forest resources. Unsustainable resource use patterns, including those driven by forces or pressures originating outside of the forest, should be identified and analyzed. The scope for improved management and utilization of non-woody forest goods and services of significance to forest-dwelling people and to extractive economies, and the need to maintain regionally or globally important environmental functions of forests should also be given more attention. Finally, the issue of "sustainability" in commercial logging and forest management operations needs to be more carefully scrutinized.

6. Develop a New Management Structure for the TFAP.

As long as the TFAP is housed within the FAO Forestry Department and supported primarily by forestry professionals representing bilateral and multilateral aid agencies, the plan is unlikely to be much more than a mechanism for coordinating development assistance in the forestry sector. Such a coordinating mechanism is very useful, though, and the Forestry Advisors Group and Coordinating Unit of FAO should be maintained and supported to serve this function better.

Despite recent strengthening, the current staff and resources of the TFAP Coordinating Unit in FAO are inadequate to coordinate such an undertaking in seventy countries. The FAO unit now needs additional resources to insure that information on TFAP planning and implementation is widely circulated, together with the guidelines for preparing national TFAPs.

Even with these important changes, FAO's Coordinating Unit can't be expected to adequately address all of the TFAP's wide-ranging goals and objectives, at the international, national, and local levels. Indeed, an independent management structure is needed to oversee and guide the implementation more impartially than forestry professionals and aid agency representatives can.

A broadly representative international steering committee is urgently needed to provide overall guidance to the TFAP's implementation. This committee would coordinate the support of FAO and donor agencies and ensure greater quality control in the action plans, more careful scrutiny of proposed investment programs, more effective responses to deforestation's root causes, and better monitoring of results. *(See Appendix 5.)* This committee would be backed up by a multi-disciplinary staff, independent of the current FAO structure and drawing upon expertise from governments, aid agencies, NGOs, and the private sector. The committee's secretariat would have primary responsibility for insuring compliance with the guidelines and procedures for preparing TFAPs and would take the lead in coordinating the TFAP with a wide range of complementary actions and programs (such as ITTO, national Environmental Action Plans, biodiversity conservation and global warming strategies, etc.).

At the national level, many steps can be taken to ensure that the implementing agencies are better equipped to lead the TFAP process. Most important, a national steering committee composed of representatives of government, NGOs, local communities, and the private sector is needed to guide and support

the preparation and implementation of the national TFAP.

TFAP steering committees and secretariats at the international and national (and sub-national) levels should be assured of adequate, sustained support and get the qualified staff needed to carry out their functions and mandate effectively. Supporting organizations of the TFAP should be encouraged to help fund the staff that these bodies need during the initial phases of their activities.

7. Increase Support for Training and Institutional Development.

As the results of many other "action plans" amply demonstrate, the impact of new guidelines, increased resource flows, and even political commitment will not register unless well trained and capable staff are available and given the institutional support and backing needed to make changes and implement programs. Indeed, a more systematic assessment of labor and institutional resources and requirements (in both the private and public sectors) must be built into the TFAP process so that the plan can be implemented in a timely and effective manner.

Unfortunately, many national TFAP exercises have failed to recognize, much less fully utilize, the full range of in-country public institutions and private organizations. In most cases, only the need to strengthen forestry agencies has been considered while other, more cost-effective and potentially significant opportunities in the private and independent sectors have been overlooked. This must change.

Within the donor agencies, a parallel change is desperately needed. These agencies have collectively doubled their funding over the past several years without increasing their own staffs enough to give national TFAP participants adequate technical support during national sector reviews and national TFAP preparation. Particularly important is adding staff in a full range of disciplines, including forestry and natural resource management, resource economics, land use planning, conservation biology, anthropology and sociology, law and public policy, and demography.

8. Insure Re-commitment of the Aid Agencies to TFAP Goals.

International development assistance agencies should re-assess their staffing, program development procedures, and funding priorities with TFAP's goals in mind. They must make sure that adequate staff are on board to respond to the requirements and opportunities of the TFAP, suspend counterproductive programs, and in a timely manner increase support for the broad range of actions needed to address deforestation and achieve the TFAP's goals. In particular, procedures for program design, evaluation, and monitoring need to be improved, and the procedures for the transfer of resources to both governments and NGOs should be simplified.

9. Coordinate the TFAP with Other Complementary Initiatives.

Carried out properly and expeditiously, the TFAP could be an ongoing source of new information about tropical forests and the people who manage and use them. Supported by policy reforms, it could help foster respect for the rights of indigenous peoples and other forest dwellers, encourage the participation of NGOs and the private sector, and even make some headway against such pressing problems as global climate change and the loss of biological diversity.

Still, the temptation to heap all manner of social, political, and economic goals on the TFAP has to be resisted or the plan will collapse under its own weight. What's important now is viewing the plan in the larger context of increased support for sustainable development, population stabilization, debt relief, agrarian reform, trade and macroeconomic policy reforms, biological diversity conservation, and global warming control strategies. The TFAP cannot be the primary vehicle for all of these changes, but it can contribute to and reinforce many of them to the extent that it is well coordinated with these other, complementary initiatives.

In particular, the TFAP process needs to establish closer ties to other initiatives developed in response to the threat of global warming and climate change, the debt crisis, and to the need to conserve biological diversity. Linkages with related, country-level natural resource and environmental assessments and strategic planning exercises, including National Conservation Strategies and national Environmental Action Plans, also need to be improved.

10. Build Support for an International Convention on Global Deforestation Issues.

Since the TFAP will never be a sufficient response to the urgent need to arrest deforestation and promote the sustainable use of forest resources, international cooperation in a number of areas needs to be strengthened by formal agreements. An international convention and protocols should be negotiated on a range of TFAP related and parallel actions that are needed to address global deforestation issues, in order to achieve net afforestation within a decade.

Such a convention should consider issuing a declaration recognizing the importance of forests in preserving biological diversity, protecting against global climate change, and providing opportunities for sustainable economic and social development for the peoples of forest-rich nations. This convention could also address such issues as the needs and rights of forest dwellers, the role of population growth, the importance of land reform, and other underlying factors bearing on the ultimate effectiveness and success of the TFAP and related initiatives.

Taking Stock underlines the urgent need to reform the TFAP. Redirection and a re-dedication to the plan's basic principles and goals are needed, including a deeper commitment to broad participation in the TFAP planning process and to the expanded role of local communities living in the tropical forests in the management and conservation of these forests. A new institutional framework and more systematic monitoring of the implementation of the TFAP are also needed, in order to insure that the TFAP leads the way in the sustainable development of tropical forest lands. Without these changes and a series of bold, new initiatives to deal with the threats to the world's forests, increased funding for TFAP-related development assistance is unlikely to significantly contribute to national development goals or to any improvement in the welfare of people dependent on tropical forests.

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World Wildlife Fund & Conservation Foundation letter

1990, No. 2

Population Growth and Conservation

IN THIS ISSUE: The rapid growth of the Earth's human population underlies diverse environmental threats, from deforestation and the loss of biological diversity to pervasive pollution and global warming. Yet many conservationists have only recently begun to wrestle with the question of population growth. This issue of the *World Wildlife Fund & Conservation Foundation Letter* seeks to further this process.

The *Letter* provides an overview of the scope of global population growth, theories on what causes it and some possible responses, and how rapid population growth will affect the earth's natural resources and environment. The *Letter* explores why family planning in the developing world is crucial, yet not enough by itself to stabilize population growth at a sustainable level, and also reminds us that the resource benefits of slowing population growth will in the short term be more than offset by consumption in industrialized nations, which use most of the world's resources.

From a conservation perspective, the global scope of population growth is less important than its effect on how local communities interact with their environment. It is at the grass roots that conservation organizations like World Wildlife Fund & The Conservation Foundation can bring about positive change by recognizing the dynamic relationship between population and the environment.

"Population Growth and Conservation" was written by Jonathan Adams, editor of the *World Wildlife Fund & Conservation Foundation Letter.*

Over the next 12 months, the Earth's human population will grow by over 93 million, roughly the equivalent of adding the population of another Mexico. In 10 years, more than 1 billion people will be added, the vast majority of whom will live in the developing world.

To feed this increased population, large areas of forest will be cleared to obtain land for crops and wood for fuel and housing. In the Amazon alone, ranchers, farmers, and loggers felled an area of virgin forest the size of Belgium in 1988. Traditional agricultural methods like shifting cultivation, which may be benign when population densities are low, contribute to erosion, destruction of topsoil, flooding, deterioration of the water supply, and the loss of biological diversity as population grows too large. By one estimate, two rain forest species are driven to extinction every hour—1,000 to 10,000 times faster than the extinction rate before human intervention.[1]

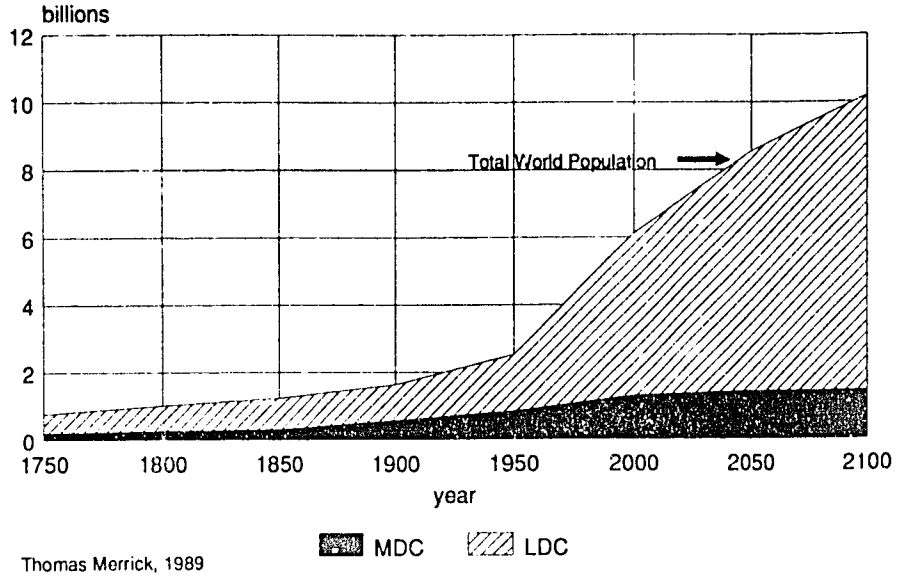
In India, where one-sixth of the world's population lives on just over 2 percent of its land, the Ganges annually carries 1.5 billion tons of soil into the Bay of Bengal, quadruple the load of the Amazon, which drains a basin five times as large. Destruction of forests, watersheds, and workable farmland is the indirect effect of population growth in India, Nepal, and Bangladesh.

The statistics for Africa are also grim. As a region, Africa has the highest population growth rate in the world; it also loses nine million acres of forest each year. Deforestation in Africa outstrips new tree planting by 29 to 1. It has been estimated that up to 90 percent of Africa's rangelands and 80 percent of its cropped land are affected by soil degradation.[2] The loss of both rangelands and forest habitats poses a severe threat to wildlife in Africa and across the globe.

The problem of rapid population growth and dwindling global resources might at first appear to have one relatively straightforward solution: simply increase the use of family planning, particularly in the developing world. As H.L. Mencken once said, however, "for

Recycled paper

Figure 1
Population Growth, 1750-2100



Thomas Merrick, 1989

every problem there is a solution that is simple, direct, and wrong." That dictum applies here.

WORLD POPULATION TRENDS

During the past 20 years, the annual rate of world population growth has begun to slow, after accelerating for more than two centuries. The growth rate—the difference between birth and death rates—now stands at 1.7 percent annually, down from a peak of just over 2 percent in the late 1960s. According to the United Nations, the growth rate could decline to between 1.4 and 1.5 percent by 2000, assuming large increases in the use of family planning, and could reach zero in the last decade of the 21st century.[3]

Despite generally falling growth rates, however, the absolute size of the world's population continues to expand rapidly (see figures 1-3).* Indeed, the largest increases in absolute numbers lie ahead. Though women in many parts of the world are having fewer children than their mothers, the extraordinarily high birth rates of the recent past mean there are more women of child-bearing age. This demographic momentum means, for example, that in the 10 years between 1975 and 1985 world population grew by 760 million—a number equal to the estimated total world population midway through the 18th century—but will grow by 830 million between 1990 and 2000.

Due to demographic momentum, world population growth will not slow for another 40 years. In fact, because family planning—the key element in bringing down birth rates to a level even with death rates—has not spread as fast as was hoped, the United Nations has revised upwards its estimate of what the Earth's population will be when it stabilizes. If current trends continue, population growth will not stop until the end of the next century when the Earth has some 11 billion people, more than double the current number.

Much of this growth is inevitable: the future parents have already been born. In most African countries, for example, at least 45 percent of the population is under age 15 (Gabon and South Africa are the only ones under 40 percent),[4] and in Kenya and Zambia a majority of the population is under 15. In Latin America, 38 percent of the population is under age 15, compared with 21 percent of the U.S. population.

While cause for concern, this fact should not imply that further family planning efforts are futile. A continued slowing of the growth rate (figure 4) will mean reaching a stable population more quickly and at a lower level. The next 50 years will be the most challenging for the global environment. Conserving wildlife and creating a sustainable society will have to take place in the face of continued population growth.

Two factors, mortality and fertility, determine how rapidly a population grows and by how much. Fertility refers to the capacity for producing offspring, which demographers usually measure in terms of the total fertility rate (TFR)—that is, the total number of children a woman can expect to have in her lifetime, given current rates. Worldwide, the TFR currently stands at 3.5.

Both the TFR and the natural increase (births minus deaths) are low in most developed countries. The TFR in these countries is now 2.0, half that of the developing world.* In West Ger-

* In the figures, "MDC" refers to More Developed Countries, as defined by the United Nations: all of Europe and North America, plus Australia, Japan, New Zealand, and the USSR. All others are classified as Less Developed Countries (LDCs).

World Wildlife Fund & Conservation Foundation Letter

World Wildlife Fund & The Conservation Foundation
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President: Kathryn S. Fuller

World Wildlife Fund & The Conservation Foundation is the leading U.S. organization working to save endangered wildlife and habitats around the world and to protect the biological resources on which human well-being depends. It is part of the international WWF network, which includes national organizations in 23 countries and an international office in Gland, Switzerland.

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many, deaths now outnumber births, while in the United States natural increase stands at 0.8 percent, or 1.82 million people, a year. Another 500,000 per year are added to the U.S. population through immigration.

Demographer Frank Notestein pointed out in 1945 that economic and social progress can lead to lower fertility. In any given culture, Notestein said, at first both birth and death rates will be high, and the population will not grow. As living conditions improve, death rates will fall but birth rates will remain high, leading to explosive growth. Eventually, according to Notestein's model, economic improvements will cause people to reduce their desire for large families, and the birth rate will fall to approximately that of the death rate.

Most developed countries have already made the "demographic transition" to this last stage, and some Asian countries seem to be moving in that direction. Figure 5 illustrates regional fertility trends. (Keep in mind that the data for Asia are skewed by China, home to over one-fifth of the world's population, where fertility is approaching replacement level.) Fertility—but not population growth—has fallen by over one-quarter in Brazil, Mexico, Indonesia, and Thailand. In Indonesia, for example, fertility has fallen from 5.6 to 3.4 children per woman since the mid-1960s.[5] Recent data suggest that fertility has also begun to fall in some African countries—for example, Kenya (where fertility has fallen from seven to six children per woman since 1984), Zimbabwe, and Botswana.[6]

Most of Africa, however, lags behind in the trend towards lower fertility. In 1960, Africa and Southeast Asia were growing at 2.5 percent per year, Latin America at 2.9 percent per year. Today, growth has slowed to 2.1 percent annually in both Southeast Asia and Latin America. The TFR in Latin America and Asia now stands at 3.6 (4.3 in Asian countries other than China). Meanwhile, growth in Africa has accelerated to nearly 3 percent per year, with a TFR of over 6, by far the highest in the world.

In Europe, economic and social changes were the engines behind the improved health conditions and eventually the balanced birth rates and mortality. However, fertility can decline markedly in countries where the economy is not highly industrialized, per capita income is low, and the population is largely rural, so long as family planning methods are made available—as for example, in Indonesia, Thailand, and Sri Lanka. Fertility declines in these countries have been associated less with per capita income than with improvements in access to family planning and health services, female education, life expectancy, and more equitable distribution of income.[7]

Rapid population growth places enormous pressures on the environment. As developing countries pursue higher living standards, they may follow some of the environmentally destructive courses already taken by the industrialized nations. If China, for example, exploits its vast coal reserves without taking suitable precautions, the impact on the global atmosphere could be staggering.

* A TFR of 2.1 is considered to be at the "replacement" level, because that is the number of children a couple must have to replace themselves, allowing for some mortality in childhood.

WHO USES GLOBAL RESOURCES?

Although slowing population growth is essential, its impact in the short term will be more than offset by the consumption patterns and lifestyles of industrialized nations, which use the vast majority of the Earth's available resources. These nations, with just one-quarter of the world's population, use 75 percent of the energy, 80 percent of all commercial fuels, and 85 percent of the timber. In one year, one person in the United States uses as much energy as 150 Bengalis or 300 Malians. Coupled with greater life expectancy in the United States, this means that each child in this country will represent as great a burden on the environment—as represented by energy use—as 500 Malians.

Developed countries are by far the major polluters of the earth's air and water. Demand for tropical hardwoods in developed countries is one of several factors driving deforestation, particularly in southeast Asia. As the World Commission on Environment and Development pointed out in its landmark 1987 report, "Sustainable global development requires those who are more affluent to adopt life-styles within the planet's ecological means."[8]

POPULATION GROWTH: BOMB OR BOON?

The ghost of Thomas Malthus haunts every discussion of the relationship between population growth and natural resources. Malthus, a churchman and economist, warned in 1798 that population, left unchecked, grows geometrically but subsistence increases only arithmetically. With the exception of postponing marriage, all the checks on population growth Malthus saw were negative—pestilence, war, famine. The Malthusian formula, or somewhat modernized versions, still underlies many discussions about population.

Malthus's gloomy prediction has not been borne out. Global human population has not grown geometrically, though it has shot up to new plateaus following technological advances in agriculture or health. The developed world has made a transition from high to low fertility, a process Malthus did not foresee. The second assumption Malthus made—he had little empirical data—also fails: food production has increased geometrically in parts of the world, largely as a result of improved crop varieties and Green Revolution technologies, and has outpaced population growth since at least 1950.

The Malthusian model, while failing to live up to the facts, has evolved into the more scientifically rigorous but

equally bleak view which today dominates popular debates about population growth. The best known proponents of this position are Garrett Hardin and Paul Ehrlich. In 1968, Hardin, an ecologist at Stanford, published an essay entitled "The Tragedy of the Commons." The central concept of this parable on human population is a grazing area open to all herdsmen and their cattle. If each cattle owner acts in rational self interest and constantly increases the size of his herd, eventually the grass will be gone and everyone's cattle will die. The solution, Hardin said, was government regulation; "freedom to breed will bring ruin to us all."[9]

Shortly before Hardin's essay appeared, Ehrlich, a population biologist at Stanford, published perhaps the most significant work on population since Malthus, *The Population Bomb*. The book opens ominously: "The battle to feed all humanity is over. In the 1970s the world will undergo famines—hundreds of millions of people are going to starve to death." Ehrlich's vision of a world about to be overrun has defined the parameters of the population debate for nearly a generation.

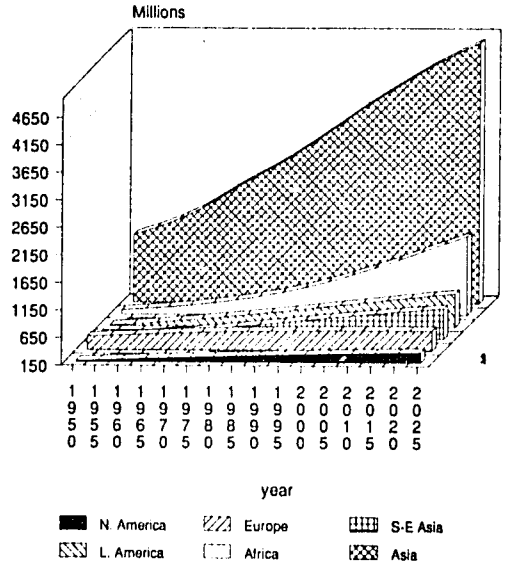
Both Hardin and Ehrlich advocate wide-ranging national and international efforts to curb population growth. Hardin believes that voluntary methods will fail, and in 1974 he proposed that the United States adopt a "lifeboat ethic" by refusing to give food aid, even in emergencies, to countries with fast growing populations. In a 1990 sequel to *The Population Bomb*, entitled *The Population Explosion*, Ehrlich and his wife and co-author, Anne, emphasize that they favor "population control": "The problem is that family planning focuses on the needs of individuals and couples: population control focuses on the needs of societies as well."

On the other side of the issue, economist Julian Simon claims that a growing population is to be welcomed. Not only have natural resources become less scarce—as indicated by falling prices—in the face of population growth, but more people means more of what Simon calls "knowledge creators" who will solve whatever problems may come along in the future.

Simon does not oppose disseminating family planning methods—he calls the effort to increase the availability of such methods "one of the great social works of our time." He takes aim instead at compulsory family planning programs and doomsday predictions of unceasing population growth. Simon's views are not highly regarded in the demographic and scientific communities, but the Reagan administration more or less adopted them at the 1984 World Conference on Population in Mexico City. To the dismay of many people both here and abroad, at the Mexico City conference the United States reversed its long-standing commitment to slowing global population growth through international family planning efforts.

Although it is fascinating to speculate about population growth in global terms—spaceship Earth, the global commons, etc.—such growth is the product of millions of decisions made by individual families. The key link between population and the environment stems from individual, not global, concerns and values: human rights, health, education, a better life.

Figure 2
Total Population By Region, 1950-2025



UN, World Population Prospects, 1988

POPULATION GROWTH AND THE STATUS OF WOMEN

Most environmentalists, demographers, and policy makers agree that achieving a sustainable society depends on slowing population growth. As Kenneth Boulding, a prominent economist, has put it: "Anyone who believes exponential growth can go on forever in a finite world is either a madman or an economist".[12]

How then to tackle the enormously complex task of containing a booming population? Ansley J. Coale, a leading demographer who is now Professor Emeritus at Princeton, argues that three factors must come together to reduce fertility: knowledge on the part of women that they can control their own fertility; motivation to reduce fertility; and access to the means of fertility control. This model provides a framework for understanding how family planning efforts fit into a broader social context.

The first of Coale's three factors is in place: most women in developing countries understand they can control their fertility, although knowledge and social acceptance of modern family planning methods—the pill, intrauterine device, condoms, diaphragms, sterilization—vary from country to country. The second factor, the motivation to control fertility, presents a much more complicated question. Children perform essential

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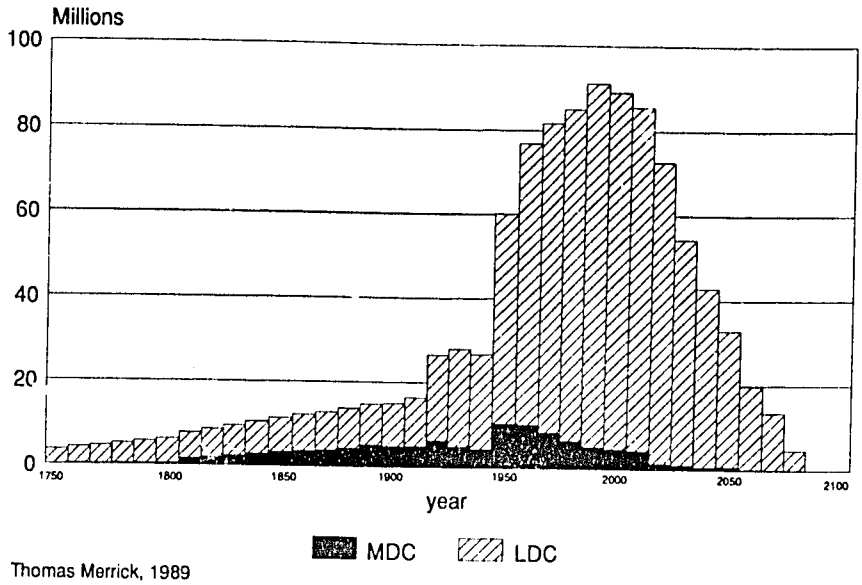
Figure 3
Average Annual Increase Per Decade



Thomas Merrick, 1989

family tasks in much of the developing world. They herd domestic animals, fetch wood and water, look after siblings and, later, parents.

As the rural frontier for fuelwood recedes and water and soil resources are depleted, the need for children to share the work load increases. Australian demographer John Caldwell argues that women in developing countries who decide to have more children are making rational decisions based on their economic conditions. Many Africans still see land as abundant and labor as scarce.

Women in many developing countries have a distinctly lower status than men. According to the United Nations Commission for Human Rights, one million girls die every year because their parents care less for them than for their brothers. Women typically cannot own the land they work, and have little or no access to information, technology, or credit. There is also a wide gender gap in education.

Children fill needs of labor and economic security necessitated by the low status of women. In Africa, the world's highest infant mortality compounds the problem: in 30 of 42 sub-Saharan countries, at least 100 of every 1,000 infants die in the first year of life. In the United States, Canada, and Europe, infant mortality ranges between 7 and 10 per 1000 live births. With such high mortality, having many children helps to ensure that some survive to adulthood.

Closing the "education gap" will be a particularly important factor in reducing both infant mortality and fertility. In Botswana, for example, a woman with no education will have over six children in her lifetime, while a women with at least a secondary education will have only four.[11] This relationship—the higher the education, the lower the fertility—holds true regardless of income, profession or trade, or religious beliefs. Infant mortality also falls among educated mothers, who are more likely to be familiar with immunization, oral rehydration therapy, breast feeding, and hygiene.

In many African societies, contributing to the immortality of the lineage by having large families is a fundamental religious responsibility, and bearing many children, along with good crop yields, is a sign of their gods' approval. A wife who tries to control her own fertility may fear the ire of her husband's ancestors—not to mention her husband and mother-in-law—and may undermine the sources of long-term economic support of her husband and his family.

In Africa, a woman's social status is directly related to her ability to bear children. It seems reasonable to expect that women will have a far greater motivation to reduce their fertility when they are able to acquire property and inheritance rights, education, the right to vote, freedom of choice in marriage, and the possibility of divorce. There must be an acknowledgment that women can have aims in life other than childbearing.

In addition to raising children and running the household, women in the developing world also often have the role of resource manager. Women in rural areas provide most of the food, fuel, and water for their families. They also carry out most environmental protection activities. Much of the soil conservation in East Africa—building terraces, using new cropping techniques, and so on—has been done without pay by small farmers, most of whom are women. In short, women in the developing world are a critical link between population and the environment.

Rapid population growth is increasingly seen as the major obstacle to achieving sustainable development. Promoting the sustainable use of natural resources cannot succeed, however, unless it is linked to efforts to integrate women into the process. As Barber Conable, president of the World Bank, has said, "Without the full participation of women, there can be no sustainable development. Without family planning, women cannot participate fully."

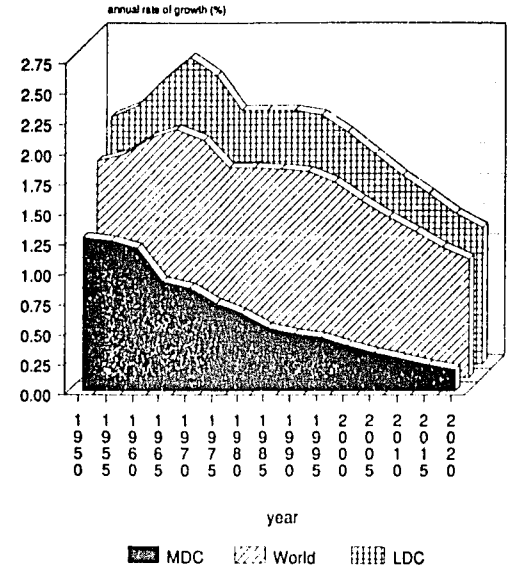
FAMILY PLANNING

The need for family planning programs is clear: more women die in India from causes related to pregnancy and childbirth in one day than in the developed countries in one month, over one-third of the 140 million women in the developing world who have become pregnant in the last 12 months did not want to have another baby; one out of five infant deaths in developing countries would be prevented if all births were separated by an interval of at least two years.[12] Looked at another way, a baby born within two years of its mother's previous delivery has a 90 percent greater chance of dying in its first

year than one born two years or more later. And as child survival increases, fertility decreases.

Many Latin American and Asian countries are developing effective systems for delivering health care and family planning services. The marked decline in fertility in countries such as China, Indonesia, Thailand, Colombia, and Costa Rica is primarily the result of government-sponsored family planning programs. Two notable exceptions to this pattern are Brazil, which has lowered fertility without the benefit of government intervention but with extensive family planning efforts by non-governmental organizations,[13] and India, where extensive government family planning efforts have thus far failed to slow population growth significantly.

Figure 4
Rate of Population Growth



UN, World Population Prospects, 1988

Instituting family planning programs in Africa—government-sponsored or private—remains a tremendous challenge. In a recent report on sub-Saharan Africa, the World Bank put the matter in perspective: "For a major region Africa's situation is unique. Its population growth is the highest seen anywhere, at any time, in human history."14

No region in the world has managed to develop in the face of population growth rates on the order of those now seen in Africa, according to the World Bank. Overall, Africa still has much open land, but development potential is not an issue simply of density but of potential as well, and much of Africa is arid. The transition from abundance to scarcity of land is already harming agriculture and the environment in some African countries. This transition took centuries in Europe and Asia, but is taking place over decades in Africa.[15]

Despite years of continued growth, most sub-Saharan countries had little enthusiasm for developing population policies and programs until quite recently. At the 1974 World Population Conference in Bucharest, all sub-Saharan countries, save Botswana, Ghana, and Kenya, were satisfied with their fertility and population growth rates and did not feel that population growth contributed to their economic problems. Much of the pressure to reduce population growth was suspect because it came from formerly colonial Western aid donors.

Most African countries also lacked adequate data on the extent of population growth until recently. Several large-scale demographic surveys have now been completed in the region, and these data reveal that national populations are larger than previously estimated, fertility rates are high, and that population growth rates are the highest in the world. They also suggest a large unmet need for contraception. By 1986, only Chad, Cote d'Ivoire, Gabon, Guinea-Bissau, and Mauritania encouraged women to have children or gave little support to family planning.

Access to safe, effective, modern contraceptives remains limited in Africa. Use of a modern contraceptive method exceeds 15 percent of married women in only 5 of the 20 countries for which data are available, and 3 of the 5 are in the relatively developed countries of southern Africa. Modern contraceptive use is higher in non-African countries: for example, 18 percent in Bangladesh, 45 percent in Mexico, 65 percent in Thailand.[16]

In general, for family planning programs to succeed, life expectancy at birth must be above age 50.[17] In mid-1989, as many as 23 sub-Saharan countries had not reached this level. In fact, between 1979 and 1983, life expectancy declined in 9 sub-Saharan African countries. Maternal mortality is also extraordinarily high in Africa; 150,000 women of reproductive age die each year, and an equal number are disabled due to complications from pregnancy. In 12 of 29 countries from which data are available, the mortality rate is over 500 maternal deaths per 100,000 births, compared to 44 in China and 90 in Sri Lanka.

Yet much of the limited demand for family planning is motivated not by health concerns or by a desire to limit family size but by a wish to avoid extramarital or premarital pregnancy and to substitute for sexual abstinence immediately following a birth.[18] Thus, fertility in Africa may remain high for a period even if contraceptive prevalence increases dramatically. Eventually, however, fertility will fall as contraceptive use continues to rise.

The cultural roots of high fertility in Africa remain firmly in place. These will change slowly, but family planning programs will not be the primary agents of this change. Rather, family planning will need to be made available as other factors lead people in Africa to want smaller families.

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WWF&CF AND POPULATION

Conservation organizations working at the grassroots can play an important role in fostering environmentally sound and sustainable life styles and thus slowing rapid population growth. This need not mean dispensing contraceptives, but rather focusing on such factors as the role and status of women, education, and public health. Population growth in any community or culture cannot be separated from its broad social context.

WWF has long sought to preserve endangered species and ecosystems. We are deeply concerned about the quality of human life as well. In many parts of the world the needs of the growing number of rural poor lead to the overexploitation of natural resources, and hence to the loss of habitat and biological diversity. As we learned long ago, if we are concerned with wildlife, then we also must be concerned with people.

Destruction of conservation reserves, the world's national parks, or still intact natural areas does not hold the solution to global poverty. Burning tropical forest or encroaching on national parks and preserves may fill short-term needs, but these activities can not be sustained. Once the resources held by these lands are used up, people will once again go hungry and the forests and the wildlife will be gone. The rapid expansion of human populations must slow and eventually stop to establish a balance between the needs of people and their environment.

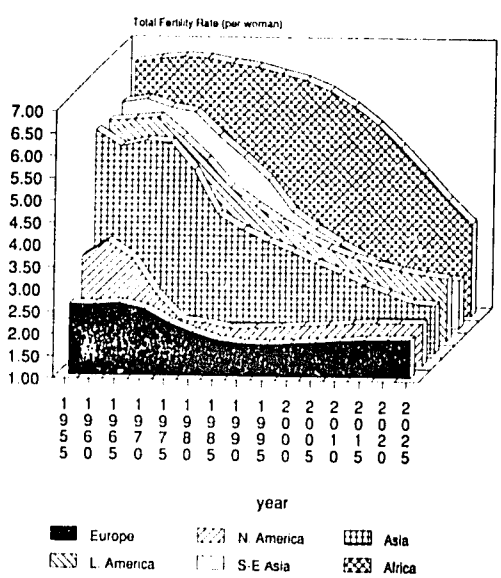
WWF&CF expects to play a growing role in helping people in the developing world to better manage their environments, whether that management takes the form of planting trees, conserving wildlife, or having fewer children. On the forested slopes of Mt. Kilum in Cameroon, for example, WWF&CF is working to upgrade a local honey cooperative. Harvesting honey from the forest provides an incentive for leaving the land intact, rather than clearing it for crops. With less land being cleared, the need for children to help work the fields diminishes. In the long term, money brought in from the sale of honey will improve the local standard of living, thus reducing child mortality and removing another cause of high fertility.

In the short-term, however, the population continues to grow. As we work to protect the environment by improving the lives of people in rural areas, we also support the efforts of organizations that are tackling the issue of population growth head on. In Nepal and Thailand, for example, WWF&CF is cooperating with local organizations in projects that address conservation, education, and population issues. Conservation and family planning are complementary, and bringing them together is a vital step towards a sustainable society.

Projects like these take advantage of WWF&CF's traditional strengths as a grass-roots organization, and they demonstrate WWF&CF's approach to population and the environment. Many international organizations have taken on the challenge of promoting family planning. WWF&CF's role—for both conservation and population—lies in the economic and gender issues that influence the decision to have children. WWF&CF will focus its efforts on the factors common to both population and natural resources, particularly through environmental and population education, community organization, and locally based projects that integrate environmental concerns with sustainable development.

Conservation organizations must not turn a blind eye to the needs of people. It is up to conservationists to ensure that in meeting these needs people do not destroy the environment. The next 10 years will be critical. Nafis Sadik, executive director of the United Nations Fund for Population Activities, joins prominent scientists and environmentalists in saying: "What we do over the next decade will determine the future of our planet."

Figure 5
Total Fertility Rate, 1950-2025



UN, World Population Prospects, 1988

Notes

1. E.O. Wilson, "The Current State of Biological Diversity," in E.O. Wilson, ed., *Biodiversity* (Washington, D.C.: National Academy Press, 1988), p. 13.

2. *Sub-Saharan Africa: From Crisis to Sustainable Growth* (Washington, D.C., The International Bank for Reconstruction and Development/The World Bank, 1989) p. 101.

3. Thomas W. Merrick, "World Population in Transition," *Population Bulletin* 41, no.2 (1989):3.

4. The statistics from sub-Saharan Africa cover 42 nations:Angola, Benin, Botswana, Burkina Faso, Burundi, Cameroon, Central African Republic, Chad, Congo, Cote d'Ivoire, Djibouti, Equatorial Guinea, Ethiopia, Gabon, The Gambia, Ghana, Guinea, Guinea Bissau, Kenya, Lesoto, Liberia, Madagascar, Malawi,

June 11, 1990

The Honorable Nicholas F. Brady
Secretary of the Treasury
Main Treasury Building
15th Street & Pennsylvania Ave., NW
Washington, D.C. 20220

Dear Secretary Brady:

On behalf of Natural Resources Defense Council (NRDC), National Audubon Society, and the Friends of the Earth-Oceanic Society, we are pleased to present you with the enclosed draft of "Policy Guidelines for Financing Projects Affecting Coastal Marine Ecosystems."

In a letter of March 17, 1989, Deputy Assistant Secretary for Developing Nations, David R. Malpass, asked that NRDC assist the Department of the Treasury in developing standards for U.S. evaluation of environmental aspects of multilateral development bank (MDB) loans affecting marine areas. Similar standards have already been established to assist in evaluating projects that may affect sub-Saharan savannas, tropical moist forests, and wetlands.

NRDC invited Dr. George M. Woodwell, Director of Woods Hole Research Center and Vice Chairman of the NRDC Board of Trustees, to oversee the drafting of the Guidelines. They were prepared by staff of NRDC, National Audubon Society, and Friends of the Earth, and reviewed and modified in a workshop in the Fall of 1989 attended by scientists, representatives of conservation organizations, and officials of assistance agencies. The Guidelines were circulated to an additional group of approximately twenty marine experts inside and outside of the United States.

Following your staff's suggestion, we have prepared a background paper setting out general principles to be followed in the planning and design of projects that might affect coastal marine ecosystems. Appendix B to the document is a set of draft standards that projects should meet to receive endorsement by the United States representatives to the World Bank, the Inter-American Development Bank, the African Development Bank, and the Asian Development Bank.

These Guidelines propose strict criteria for the approval of development projects that affect coastal marine areas. Coastal marine ecosystems need to be protected because coastal areas:

- Are home to one-half of the world's population and will absorb most of the increase by 2025 when the planet's population may approach 8.5 billion.
- Include the most productive fishing grounds, and commercially valuable nursery grounds.
- Contain a high proportion of the best alluvial soils for agriculture.
- Support water-dependent and water-enhanced industry and manufacturing.
- Are the major focus of tourism -- a major revenue source for developing countries.
- Include some of the world's most naturally productive ecosystems: estuaries and lagoons, brackish and salt water wetlands (salt marshes, mangroves), coral reefs, and seagrass beds.
- Contain a significant portion of the world's biological diversity.

Coastal marine systems, however, are coming under increasingly intensive economic development and population pressures, and are becoming the major recipient of human society's by-products. Yet, the greatest long-term threat to the world's coastal marine systems may be the result of separate phenomena -- global warming and ocean level rise.

In the past, the MDBs have often ignored effects on coastal marine ecosystems in the design and implementation of projects. We believe that there is a special need to review projects with a full understanding of their impacts on the environment and regional economies. These Guidelines emphasize the need for projects and loans to be designed in conjunction with comprehensive environmental assessments that will provide the underpinnings for informed MDB policy and activities. Also, these draft Guidelines recognize the need for monitoring of projects, which is critical to ensuring their ecological integrity and economic sustainability.

These draft Guidelines should have a lasting positive influence on the use of the world's coastal marine ecosystems and sustainable

development in the Third World. We have every reason to believe that the banks will observe and profit from these Guidelines, and their effect will be significant if they have strong United States support.

We would welcome any opportunity to discuss these draft Guidelines with you. We look forward to the adoption by the Department of the Treasury of the final standards for votes by the United States on development bank-financed projects that may have adverse impacts on coastal marine ecosystems.

Sincerely,

George M. Woodwell

George M. Woodwell
Vice Chairman, NRDC
Director, Woods Hole Research Center

Steven J. Parcells

Steven J. Parcells
Director, International Wetland Project
National Audubon society

Boyce Thorne-Miller

Boyce Thorne-Miller
Director, Marine Science Project
Friends of the Earth-Oceanic Society

Eric Christensen

Eric Christensen
Project Attorney
NRDC

cc: Charles H. Dellara
Assistant Secretary for International Affairs

John Niehuss
Senior Deputy Assistant Secretary

DRAFT POLICY GUIDELINES FOR FINANCING PROJECTS AFFECTING COASTAL MARINE ECOSYSTEMS

- Summary -

Coastal marine ecosystems are defined here as the natural communities between the high tide line and the edge of the continental shelf. They include beaches and fjords, estuaries and lagoons, seagrass meadows, tidal marshes, and mangroves, corals reefs, and subtidal benthic shelves. They are not only rich in biological diversity, but are vitally important as nurseries for commercial fish. Coastal marine ecosystems protect the land from severe storms, are used as harbors essential to commerce, and provide other economic benefits to people in developed and developing countries alike. Over fifty percent of humankind now lives within fifty miles of the marine coasts, and planners have good reason to believe that these coasts will absorb most of the estimated doubling of the earth's population, primarily in developing countries, that is projected to occur by 2025. Coastal marine ecosystems are and will become increasingly more vulnerable to human disturbances.

Conservation of marine natural resources and efficient economic assistance to developing countries are not mutually exclusive goals, but mutually reinforcing; both can be accomplished through comprehensive planning. Identifying the values and functions of marine natural resources and integrating them into development programs must take place as early in the planning process as possible.

In the past, the multilateral development banks (MDBs) have often ignored effects on marine ecosystems in the design of projects and loans. The MDBs, however, can use their influence with borrowing nations to work towards the use of coastal marine ecosystems as part of the sustainable economic development of the borrowing countries.

These draft Guidelines propose strict criteria for the approval of development projects that affect coastal marine ecosystems. They focus on the importance of the living resources of marine coastal ecosystems, and emphasize the need for the MDBs to understand the effects of all development projects, whether land- or water- based. The Guidelines stress the need for projects to be designed in conjunction with comprehensive environmental assessments that will provide the underpinnings for informed MDB policy. Once a project is completed, it should be monitored over a long period to ensure that the results are as intended and that the project fits into the overall goals of development that can be sustained.

Finally, it should be recognized that continued increases in emissions of carbon dioxide and other greenhouse gases may severely disrupt marine ecosystems through rapid climatic change and through rapid increases in sea level.

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THE WASHINGTON TIMES, August 30, 1990

B. J. CUTLER

Get the netters!

Conservationists call the fishing nets "walls of death" and their use like "strip-mining the oceans."

Those angry words are aimed at drift nets, a super-efficient method of commercial fishing that is done by factory ships mostly from Japan, South Korea and Taiwan.

The nets, an owner's dream and an environmentalist's nightmare, are nylon mesh 40 miles long and 30 feet deep. They drift at night and when they are pulled in, they kill indiscriminately — fish that are wanted and unwanted, porpoises and other marine mammals, seabirds and turtles.

The killer nets first stirred controversy in the South Pacific, where boats from the three Asian nations depleted stocks of albacore tuna, the livelihood of indigenous commercial and subsistence fishermen.

Led by Australia and New Zealand, the 13 nations of the Pacific Forum put such pressure on Tokyo, Seoul and Taipei that they withdrew their fleets.

The drift-net vessels redeployed to the North Pacific, where they are decimating marine life. U.S. observers on Japanese ships estimate that in a recent season those vessels alone destroyed 25,000 marine mammals and caught huge numbers of tuna.

As one result, ships using traditional fishing methods saw their catch of albacore tuna plunge from 20,000 metric tons annually in the late 1970s to 1,750 tons last year.

Such assaults on fish stocks led the U.N. General Assembly in December to demand unanimously a worldwide moratorium on drift-net fishing after June 30, 1992. In the meantime, the United Nations said, expansion of the practice must "cease immediately."

B.J. Cutler is foreign affairs columnist for Scripps Howard News Service.

Taiwan wasn't listening. In July and August, 15 of its large drift-net vessels appeared in Port of Spain, Trinidad, posing a threat to the marine resources of the Caribbean and the Atlantic.

Commercial fishermen in Trinidad said they had seen thousands of shark fins, a delicacy in Asia, aboard the Taiwanese boats, but no sharks. "They're dumping the sharks," said an expert. Since sharks are slow to reproduce, they could virtually disappear in another two or three years of drift-net slaughter.

The Caribbean and nearby areas off the coasts of the United States and northern South America are spawning grounds for albacore tuna, bluefin tuna, blue shark, swordfish, yellowfin tuna and white marlin.

A great danger exists that the drift-netters will catch the spawning fish, endangering several species. Swordfish and the giant bluefish tuna, one of the largest vertebrates alive, are said to be "on the verge of collapse."

Taiwan is not a member of the United Nations and, technically, does not have to obey the resolution against drift-net fishing. However, it runs a huge trade surplus with the United States, depends on Washington for last-ditch protection against China and is highly vulnerable to U.S. pressure.

The United States has similar trade and defense leverage with the other two marine predators, Japan and South Korea. It should not be shy about demanding that they stop searching for loc[illegible] in the U.N. resolution and stop drift-netting.

In addition, the United States should take the lead in organizing a hemispheric defense against the Asian threat to marine life. If nations of the Pacific Forum could push away the drift nets, a Caribbean-North American Forum can do so.

The point should be made bluntly to the three countries: After your strip-mining of the Pacific, you're not wanted in the Atlantic.

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Energy Demand in the Developing Countries: Prospects for the Future

--Mudassar Imran and Philip Barr

World Bank Staff Commodity Working Paper
Number 23
August, 1990

ABSTRACT

In recent years, energy consumption has increased rapidly in the developing countries. Their share in global energy consumption (outside of the USSR and Eastern Europe) has increased from 20% in 1970 to 33% in 1988. It is anticipated that these energy consumption trends will continue. Given their growing role in the global energy markets, the main motivation of this study was to highlight the key factors that have contributed to the historical increases in energy consumption in the developing countries as well as to project the changes likely to occur in the future. The scenarios for the future take into account the changing relationships between economic growth and energy consumption, structural changes, and the potential for fuel substitution. The evaluation of these elements has been based on sectoral analysis of demand for various fuels in the key sectors and the developing patterns in and limitations on fuel supply. The outlook for the future is reached by using analytical techniques as well as econometric model-based simulations. The study covers eight major developing countries representing about one-half of total energy consumption in the developing countries. Because of their diversity and size, the conclusions reached about these countries can reasonably be extrapolated to developing countries as a whole.

The results of the study indicate that increased levels of motor vehicle use and urbanization are the main factors contributing to increases in energy consumption in the developing countries. These factors, as well as rising incomes and shifts away from the use of traditional fuels, will continue to support increases in commercial energy use over the long term. As a result of fuel substitution, the pattern of fuel use will change during the 1990s. Gas is likely to become a more popular fuel, encouraged by changes in pricing and exploration policies and the development of major gas distribution projects. Aided later in the 1990s by environmental concerns, its share of commercial primary energy could triple by 2010. The share of coal in total primary energy is expected to fall significantly. However, in volumetric terms its use is projected to double, largely through increased use for electricity generation--particularly in China and India. Hydro use is also expected to more than double, with substantial growth taking place in China and India. Oil consumption seems likely to more than double by 2010, even under optimistic assumptions on conservation and substitution--largely due to increasing motorization and switching out of traditional fuels in the residential sector. Under the business-as-usual scenario, oil consumption of the five oil-importing countries will triple by 2010. The oil import requirements of this group could reach 65% and 88% of total oil needs in 2000 and 2010, respectively.

It is estimated that the total energy savings, due to improved efficiency and substitution, will be of the order of 23% of total energy use and 33% of oil use by the year 2010. The potential for savings is largest in the residential and commercial sectors in China and in the industrial sector in the other countries.

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--By Robert Walgate, The Panos Institute
1990

CHAPTER 13

CONCLUSIONS

The impact of biotechnology on development is a complex issue, on which there may be many opinions. But as a guide through complexity, here are some suggested conclusions which the reader may like to argue for, or against:

- **Biotechnology is neither demon nor angel.** It should not be attacked as entirely a scourge of the poor, or as an unmitigated environmental disaster. Neither should it be uncritically embraced as a panacea, an instant provider of food, medicine and wealth.
- **The initial impact of biotechnology on development has been overstated...** Several early promises and threats — such as a malaria vaccine, or the swamping of the vegetable oils market with cloned palm oil — are failing to materialise.
- **But the delays in implementation are temporary.** From small beginnings in research, great economic and social changes are unfolding.
- **The diversity of biotechnology means no one will escape its effects, for good or ill.** Biotechnology is not the introduction of "a tractor" or "a dam" or even a simplified "high-yielding variety", it is a growing set of techniques as potentially various as life itself, and it offers room for dealing appropriately with local constraints, crops and practices. Equally, it presents the danger that no one will be immune to the growth of biotechnology. Inappropriate, as well as appropriate, biotechnologies may impact every corner of developing economies.
- **One country's gain will often be another's loss.** And poor are at war with poor, as well as with rich nations. As this dossier reports, for example, China sold its hybrid rice technology to a Western buyer, excluding the rest of Asia from its success.
- **The key question is: biotechnology for whom?** Like any technology, biotechnologies are not neutral. They will be developed for the needs and purposes of the developer.
- **To be appropriate to a community, technological researc should be directed by that community.** So for developin country poor, the goal must be the direct or indirect control o the development of the technology that will affect them.
- **The ball is currently in the donors' court.** The poor ar hardly organised for controlling research. NGOs seen unprepared. The degree of enlightenment and concern, o otherwise, of researchers, donors, governments and priva industry, together with familiar political and economic forces will for the time being determine the equity or otherwise o biotechnologies that are developed.
- **At the same time, major efforts must be made to raise th level of effective awareness of affected communities.** Onl very well-informed communities will be able seriously t influence research directions in their favour.
- **Biotechnology is mostly in private hands.** In practice, mos of the tools of advanced biotechnology, particularly genetic engineering, are in the control of private multinationa companies.
- **Multinational biotechnology will seek profit.** Long-term potential profits in the South are seen to be large. Some technologies could bring profits to both South and North, bu companies will not invest in such technologies unless return are guaranteed.
- **Multinational profits demand markets and patents.** Profit will depend upon commercialising presently marginal rural areas. And with this, upon developing countries granting patent rights — a contentious issue, particularly where in many cases the patentable genetic material originated in developing country fields or forests.
- **Profit-seeking need not be entirely harmful to the poorest.** In this dossier, examples are given of multinational biotechnological activities in the South at both ends of the ethical scale.
- **Multinational research specifically in regard to the South is on a small scale** in relation to developments for Northern health and agricultural markets. The main danger may be the substitution of new Northern bio-industrial products for existing high-value Southern crops; the main benefit to the South may be some trickle-down technology transfer to groups working on more beneficial research programmes.
- **The multinationals are increasingly responsive to public**

pressure — which affects their market sales. Public information can again here influence events.

- **Public sector research is the real key to appropriate biotechnology.** In the context of private sector power, it is of paramount importance that public research on biotechnology for development is appropriate and well planned.

- **Researchers must "listen to the poor".** Short of adopting trickle-down theories of economic development, the only way to ensure the relief of poverty will be to listen to, respond to, and respect, the real needs of the poorest communities. Researchers must understand and learn from existing indigenous technologies, customs and constraints.

- **Such respectful interaction will be difficult.** The exercise of articulating real needs will not be easy. The extraordinary molecular sophistication of much biotechnology puts scientists at an enormous remove from the context of a rural village where the research might have an impact.

- **Field-to-laboratory communication is a matter for donors and NGOs.** Such long-range communication in biotechnology can hardly be managed by either end-user or scientist. It can only come about through effective, sensitive and imaginative field research, inquiry and communication. This should be managed by programme donors and governments in co-operation with those who know local problems — local groups and farmers, women and men, the poor as well as local elites.

- **The first solid benefits in agriculture** are likely to be the speeding-up of the breeding of improved crop varieties, and the early diagnosis of plant diseases for appropriate treatment and the control of epidemics. Later will come crops engineered for resistance to viral diseases, and to some insect pests.

- **The first solid benefits in health** are likely to be new tools of diagnosis, leading to faster, more appropriate treatment for individuals and better-informed health system planning. Later will come new and better drug treatments, and even later, vaccines against tropical diseases.

Biotechnology can be good for developing countries; but only if they and their friends make it so.

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Foreign Policy

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AIDING AFRICA

by R. Stephen Brent

Economic reform and liberalization is the order of the day—in Eastern Europe, the Soviet Union, and many less-developed countries. Lost in the news is the fact that many countries in the poorest area of the world, sub-Saharan Africa, are also pursuing economic reform, and have been doing so for several years.

African reform is different from that occurring in Eastern Europe in several ways. In the first place, it has not been preceded or accompanied by a change in regimes. In most cases reform in Africa is being carried out by the same governments that previously followed statist policies. African reform is also more limited in scope. Poland under a noncommunist government is trying to transform its economy to a market-based system in a single year. The countries in Africa most serious about reforms are proceeding much more gradually and have not committed themselves to a particular final destination. Finally, African reform has been influenced to an unparalleled degree by the World Bank and the International Monetary Fund (IMF). In fact, the impetus for reform came from the Bank and IMF, supported by the United States and other donor countries.

The World Bank and IMF have been able to push reform in Africa more aggressively than elsewhere because of African countries' high dependence on external aid, and because many had reached a crisis by the early 1980s. When the international institutions conditioned their loans on reform, most countries had little choice but to go along. The IMF took the lead in the early 1980s with short-run "stabilization" measures aimed at reducing budget and trade deficits, which had reached dangerous levels in

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many countries. In the mid-1980s the World Bank took center stage with "structural adjustment" programs intended to increase efficiency and growth over the mediam and long term through market-oriented changes.

The initiation of reform from outside has had pluses and minuses. On the one hand, it has set reform in motion in a majority of African countries, few if any of which would have undertaken liberalization on their own. On the other hand, the fact that reform started out as a "foreign product," and is still often perceived as such, has detracted from its support among Africans. Implementation of reform has lagged far behind rhetorical commitments and has been a process of two steps forward and one step back.

African reactions to reform have evolved over time. Initially, Africans strenuously denied that bad policies were major contributors to their economic problems, blaming terms-of-trade losses and other external factors. As more and more countries accepted World Bank and IMF reform programs, these attitudes moderated somewhat, but they did not disappear. Today most African governments recognize the need for change but also have strong reservations about the market approaches advocated by the donors, particularly about heavy reliance on the private sector.

In 1989 African criticisms of reform boiled over in a public dispute between the United Nations Economic Commission for Africa (ECA) and the World Bank. The subject was a report by the World Bank and the United Nations Development Program, which argued that reforming African countries were doing better than nonreformers in gross domestic product (GDP) growth, agricultural production, and exports. The ECA sharply criticized the Bank's analysis, claiming that reforming countries' performance was actually worse.

The technicalities of this debate (which supported the World Bank's position) were less important than the political differences it reflected. The ECA's views on the results of reform, as well as a later report laying out an ECA "alternative to structural adjustment," suggested that reform remains quite controversial in Africa, and that, at least in some

quarters, the basic principles of market-oriented reform have not been accepted.

Critics have developed a sophisticated critique of reform that has had considerable appeal—both in Africa and among sympathetic groups in the West. That critique involves three main arguments: that reform does not work, that it hurts poor people, and that it has been underfunded.

Critics of reform contend that reform has not produced the results promised, and will not be able to because it is unsuited to Africa's "special conditions." This view is influential even with African officials who are implementing reform. Many of them question the relevance of market methods to Africa and doubt that sacrifices now will lead to real growth later.

Part of this criticism is justified. The IMF and World Bank initially overestimated the growth payoffs of reform. They anticipated a more rapid supply response to "getting prices right" than has materialized, because of unexpected structural and political obstacles. Both agencies now recognize that adjustment is a complex process that will take time to produce results.

The growth payoffs of reform to date have been modest. Most reforming countries have barely stayed ahead of population growth. A few countries with strong reform programs, such as Ghana and Guinea, have achieved significant gains, with GDP growth averaging 5 per cent or better for 4 years. But for most, progress has been slow.

Nevertheless, reform has largely succeeded in halting Africa's rapid economic decline of the early 1980s. From 1978 to 1985 African living standards fell by 15 per cent—a steeper drop than in Latin America. This slide was catastrophic for countries so close to the margin. Since 1985 African countries with reform programs have either held steady or made small per capita gains in economic growth and agricultural production. Since 1985 food production for the continent as a whole has risen faster than population. That is the first time Africa has achieved this goal in 20 years, and much of the increase was in countries undertaking reforms. Better weather played a role in these gains, but reform clearly helped.

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Assessing Reform

While reform has not brought about the major growth hoped for, several questions must be answered before it is indicted. First, is reform not working, or is it just taking time to produce results? Experience elsewhere shows that higher growth does not necessarily follow immediately, or even directly, from liberalization. The Soviet Union has achieved little payoff from several years of attempted reform. Poland demonstrates that things can get worse before they get better. One of the lessons of the 1990s may be that liberalization of controlled economies is a much more difficult and drawn-out process than previously realized.

Second, what is the alternative to reform? This question is important because there is a tendency to forget the old system's bankruptcy. Africa's problem was not Soviet-style central planning, but distorted statism: bloated bureaucracies, inefficient state-owned enterprises, and counterproductive prices and policies. These resulted in economic stagnation, escalating government expenditures, and fiscal crises.

The continent's economic performance has been poor, not just in absolute terms, but also relative to other regions of the Third World. In productivity and growth Africa has consistently trailed other similarly disadvantaged regions, such as South Asia. Its internal rate of return on investment in the 1980s was an incredibly low 2.5 per cent (compared to 22.4 per cent in South Asia). Since 1970, it has lost almost half its share of world export markets to more competitive Third World producers. These differences cannot be explained by external factors. Africa's terms of trade have declined less than those of other Third World regions, and its per capita foreign aid has been higher. This suggests that bad policies are to blame. Returning to the old ways is not an option.

Third, have reform results been limited because market methods are unsuited to Africa's conditions, or because a true market approach has not yet been tried? While many African countries have made important changes since the early 1980s, all have a long way to go to

achieve truly liberalized economies, particularly private sector development. Some tough choices have been made on macroeconomic stabilization, but the process has not been completed in many countries. For example, exchange rates are still too high in a number of countries (including all members of the franc zone). Interest rates are too low in most.

The biggest problem, however, is failure to follow through with the many microlevel changes that viable market-based systems require. These include reduction and rationalization of the role of state-owned enterprises, deregulation of the private sector, encouragement of private investment, revision of investment codes, reform of the banking sector, and discovery of affordable ways to deliver social services. These reforms are essential if the essence of the system is to change and if production and growth are to increase significantly. Yet very few African countries have made much progress toward putting them into effect. The result has been reforms with the superstructure of liberalization but without the operational content. Without that content, many potential benefits are lost.

The most visible evidence of the limitations of current reform is the failure of any substantial amount of capital transferred to other countries by Africans (flight capital) to return home. As long as Africans themselves do not consider their countries safe places to invest, neither will foreigners. Yet increased private investment (domestic and foreign) is vital for growth.

Most African countries still have one foot in the old world of state control, government employment, and urban subsidies. They have not freed the private sector, curtailed state ownership of enterprises, tapped the entrepreneurship of farmers and small businesses of the "informal sector," or taken other steps required for higher growth. Long-standing suspicion of the private sector, fear that Asian businessmen will dominate it, and the political power of groups with a stake in the old order have combined to thwart such reforms. But one does not know whether real liberalization would produce significant growth because it has not yet been tried.

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Critics have also argued that reform hurts poor people. Structural adjustment is said to impose unacceptable social costs on vulnerable groups such as children and the poor. This criticism has struck a responsive chord not only in Africa, but also with some American private voluntary organizations and some members of the U.S. Congress. They have been receptive to allegations that structural adjustment represents a "trickle down" model that neglects or hurts the poor.

Responding to this criticism is difficult. One risks either appearing to condone Africa's terrible poverty, or asserting unconvincingly that things would be worse without reform. But the fact is that reform has not caused the suffering of poor people in Africa. Indeed, growth-oriented structural changes of the type that the World Bank has pressed for represent the best hope for poor people, especially farmers, to improve their lot.

To see why this is so, one has to distinguish between stabilization and growth-oriented structural adjustment. Most "social costs of adjustment" are actually associated with the demand-reduction phase of stabilization. This has required painful belt tightening. Government services have been cut back and many wage earners have suffered. However, one has to be clear about the cause of this pain. It was not stabilization itself, but the economic stagnation and imbalances that made reductions in government spending unavoidable. To hold stabilization responsible is to blame the medicine for the disease.

Structural adjustment, on the other hand, is not an austerity program. It seeks to increase growth and productivity by eliminating economic distortions and subsidies. This can be done with little harm to poor people's interests because these distortions have favored urban groups and those who are better-off. These include state and party officials, the military, civil servants, university students, and workers in state-owned enterprises, and they are the main losers under structural adjustment. The main winners are farmers and, to a lesser extent, the tradespeople and craftspeople of the informal sector. These are the main sources of dynamism in African economies. They also,

especially farmers, make up the majority of the poor. Thus structural adjustment does not boost growth in the hope that some of the resulting wealth will trickle down to the lower levels. Instead, it aims at both growth and greater equity. These goals do not conflict in Africa because the old policies were both inefficient and inequitable.

The Urban Bias

The story of how African policies reached this sad state is a true tragedy. The current political and social order did not result from malevolent intentions. Most African governments were sincerely pursuing national development goals when they adopted urban-biased and import-substituting strategies after independence. Donor agencies, influenced by development theories of the time, encouraged these policies. These development strategies combined with natural social forces (e.g., the desire of people to leave the farm and go to the city) to create politically influential urban groups that could demand benefits from the government.

The rural masses were not so lucky. Considered politically irrelevant by African governments, farmers were not only neglected but exploited. The main instruments of exploitation were price, tax, and exchange rate policies that penalized agriculture—the main source of employment for the poor—in order to subsidize urban consumers and industry. It is interesting to note the contrast with the treatment of farmers in developed countries. In Western Europe and the United States, where farmers account for a small fraction of the population, agriculture receives massive subsidies because of the political clout of farmers. But in Africa, where approximately 75 per cent of the people are farmers, agriculture has been exploited for the sake of the cities because farmers lack political influence.

Inequality has been compounded by the economic effects of African political systems. Government service and political connections have been the key to wealth, and ruling parties have relied heavily on patronage. Most African countries have been left with very inequitable societies, with the bulk of the population ig-

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nored, urban groups subsidized, and a layer of elites on top who enjoy a luxurious standard of living. Political power is inversely correlated with economic productivity: Urban elites are economically parasitic but politically dominant; farmers are the backbone of the economy but politically impotent.

Many critics of adjustment have not understood its impact on equity and politics. They have assumed that African governments are helping the poor, and that reform programs hurt the poor by disrupting these government efforts. Actually the opposite is true. The old African policies were regressive, while structural adjustment is progressive. Nor is it true, as African opponents of reform cleverly argue and critics in the West naively accept, that African governments resist reform for fear of its adverse effects on the poor. It is precisely the opposite: Reform is resisted because it harms the interests of politically powerful groups, while the groups it helps do not even show up on the political scope.

Two factors have contributed to Western misunderstanding of African realities. One is the tendency to view Africa through a lens of domestic Western experience. American critics see policy reform as supply-side economics and reject it as an attempt at trickle-down income distribution. Europeans look at adjustment in terms of social democratic ideals and lament the loss of government services. Both assume that governments serve the interest of civil society in Africa, as they do in the West.

But most African governments are not like Western governments. A large number are more like the pre-revolution governments of Eastern Europe—obstructing economic growth rather than supporting it, aggravating inequality by misguided policies and political favoritism, and repressing democratic freedoms. Changes in African government policies are not against the interest of Africa's people; they serve that interest.

The second factor is the tendency to identify policy reform with the austerity of stabilization. Stabilization is the first stage of reform, and it is painful. But stabilization is only a necessary corrective to past abuses, it is not the point of the reform process. The goal of reform

is to get a growth dynamic started. Unfortunately, that requires far-reaching economic changes that take time to accomplish, as well as more time to produce results. This growth-oriented phase of the process is very young in Africa. As a result, reform has been perceived as an austerity program rather than a growth program.

A third African criticism is that the donors have not extended sufficient financial support for reform, especially in terms of forgiving African debt. This criticism is partially justified. As a result of large borrowing from official creditors in the late 1970s and early 1980s, many African countries have very large debt burdens, even higher relative to gross national product than those of Latin American countries. Repayments on this debt are now limiting the growth that reform has produced by pulling money out as aid pushes it in. In addition, African debt has been heavily rescheduled without considering whether most countries will ever be able to repay. For all these reasons, there is a case for more debt forgiveness.

On the other hand, donors have increased aid to Africa steadily since the early 1970s. Today, with 12 per cent of the Third World's population, sub-Saharan Africa receives 34.5 per cent of total worldwide aid (up from 19.7 per cent in 1975). This is a major commitment of resources. The problem has not been donor stinginess, but a massive drop in Africa's foreign exchange earnings from private transactions. Private bank loans and investment fell sharply in the 1980s because of the depression of African economies, and export earnings declined drastically because of lower commodity prices and loss of market share. These losses have been so great that, even with increased aid, Africa has been left with lower foreign exchange and import levels than in 1980. Some, though not all, of these private losses have resulted from the policy problems of African countries.

Evaluating African reform is important because the continent's need for growth-oriented policies will be still greater in the 1990s. One reason for this need is increased population. African countries will have to achieve higher

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growth in the 1990s if they are to meet the mushrooming needs of their people.

Sub-Saharan Africa's population growth rate, at more than 3 per cent a year, is one of the highest that any region of the world has ever experienced. It reflects an average of almost seven births per woman. Although population growth has slowed dramatically in the rest of the Third World (except the Middle East), Africa's growth rate is still rising. The continent's population is projected to double in the next 22 years. By 2020 the population of Nigeria alone will equal that of the United States, and Africa's labor pool will be almost three times its current size.

The population problem makes the need for economic growth particularly urgent. Population growth sets the baseline of human needs that a society has to meet—education, food, jobs, and services. Africa already has tremendous youth unemployment because of the large number of new entrants to the labor pool and the sharply limited number of new jobs. In the 1990s this problem will get worse.

Nightmare Scenario

The food situation is particularly critical. Except for the last few years, agricultural production in most African countries has fallen ever further behind population growth since 1970. As a result, today Africa has a normal shortfall (not due to drought or other emergency) of about 10 million metric tons of food. If previous long-term trends continue, experts project that Africa will have an annual shortfall of 40–50 million metric tons by the year 2000. That is six times the amount of food that Africa received for emergency relief during the major famine of 1984–85. It is difficult to see how Africa could compensate for such a food shortage. The ECA has a name for this future prospect: the "nightmare scenario."

Addressing these problems will not be easy. The difficulty is indicated by the World Bank's estimates of what is needed to achieve modest per capita gains over the next 10 years: a sharp drop in African fertility levels, a doubling in the growth rate of agricultural production, a major increase in investment levels and the rate of return on investment, and real growth in

foreign aid of 4 per cent per year. All this will produce only 1–2 per cent annual increase in per capita income. At that rate it will take Africa 10 years just to recover the level of per capita income it had in 1980.

The other side of this prognosis is the risk of future decline. If everything goes right, Africa can make slow progress. But if key elements do not fall into place (many of which require decisive actions by both Africans and donors), the continent could suffer further decline.

As if its internal challenges were not enough, Africa also faces ever greater "marginalization" in the world economy. This will make it still harder for African countries to achieve the growth they need. Marginalization of private economic transactions involving Africa has been underway for some time. As previously noted, African countries have lost almost half their share of world export markets since 1970. They have also suffered a sharp drop in foreign bank lending and new investment since 1980. Recently even existing investment has fallen because of cutbacks by such traditional investors as the French and British.

Nor are future trends in international trade and investment likely to favor Africa. Prices for Africa's mineral and agricultural exports are expected to remain low. International banks are now extremely reluctant to lend to Africa because of the difficulty they have had getting past loans repaid. And foreign investors are likely to focus on new areas of opportunity: an economically unified Europe, liberalizing East European countries, and East and Southeast Asia.

Similarly, Africa's foreign aid is unlikely to grow dramatically during the 1990s. African leaders have expressed concern that the revolutions in Eastern Europe will cause aid to be diverted from Africa to Hungary, Poland, and other former East bloc countries. The World Bank and many bilateral donors have offered assurances that such fears are unfounded, noting that Africa and Eastern Europe receive different types of aid (concessional aid for Africa and market-rate loans for Eastern Europe). But it is hard not to suspect that eventually there will be some consequences, especially since many of Africa's heaviest aid

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donors (France, Germany, Italy, and Scandinavia) have a strong political and economic stake in Eastern Europe.

The problem may not be a fall in African aid, but a failure of aid to grow fast enough to keep up with Africa's rapidly growing needs. The main potential source of new funds is Japan. But Africa is unlikely to rank high on Japan's list of concerns.

Since 1970, Africa has lost almost half its share of world export markets to more competitive Third World producers.

Thus African countries face a dilemma. On the one hand, they must increase economic growth and food production in the 1990s to meet rapidly expanding human needs. On the other hand, the international environment is unlikely to offer easy commercial gains or significant increases in aid. Basically, Africa needs to do more with less. This will require that African governments and the donors—but especially African governments—take new initiative.

What should they do? The World Bank offered its recommendations for African development over the coming decade in a major study published in 1989, *Sub-Saharan Africa: From Crisis to Sustainable Growth*. It calls on African governments and the donors to work together to "fundamentally transform Africa's production structures." It advocates new actions to spur agriculture, improve education and social services, reduce birth rates, restore roads and other infrastructure, strengthen African institutions, and provide an "enabling environment" for growth.

The following recommendations draw on the Bank's analysis but focus on five areas where new political initiatives are required.

African Leadership. The most basic change needed is for African governments to take charge of restructuring their economies for higher growth. If Africa is to make the kind of changes needed, African leaders will have to truly take the initiative on reform. So far most

governments have acted as reluctant partners. The importance of African governments "internalizing" reform and actively leading it can hardly be overstated. Even with such leadership, most countries will have a hard time achieving sufficient growth in the 1990s. Without it, there is a risk that the whole process will grind to a halt.

This risk is real because of the changing agenda of reform. In the 1990s the emphasis must shift from macroeconomic adjustments to the multitude of microlevel changes required to get growth and investment moving. The Bank and IMF were able to lead macroeconomic adjustment fairly successfully through conditionality (though even then it was a second-best approach). But the pervasive changes needed to "put flesh on the bones" of reform cannot be accomplished the same way. These changes require political leadership from within because of the many actions they will demand of government ministries and their more direct impact on interest groups.

The need for Africans to take the lead in reform has been recognized by the World Bank and the bilateral donors. They are looking for ways to shift more initiative to African governments, train more African managers and economists, and reduce the use of conditionality. But giving more responsibility to African governments will only work if the governments are willing to pursue fundamental changes that respect economic incentives.

This does not mean that African governments should simply accept donor prescriptions. The donors have the most to say about issues of effectiveness and efficiency—how to do things. They have less right to comment on the proper ends of society, which must reflect African political and social values. An ideal synthesis would combine the best advice the donors have to offer regarding efficient mechanisms with the best of African social values and ideals.

Assertions to the contrary notwithstanding, traditional African values do not conflict with reform. The original political ideals of African leaders like Zambia's Kenneth Kaunda and Tanzania's Julius Nyerere emphasized lifting up the common man and helping the poor and

the weak. In practice, this is not the way Africa's economic policies have evolved. But the original ideals were quite consistent with reform's emphasis on rural development, curtailment of elite privileges, and reduction of centralized power.

The ECA has begun to address this issue, calling for greater equity, political participation, and democratization in Africa. It has also recognized that Africa needs far-reaching "socioeconomic and structural transformation." These are two important elements of a new development program. Unfortunately, the third important element of a future program—respect for economic incentives and market forces—is not part of the ECA model. In fact, the ECA explicitly rejects reliance on market forces as "not adapted to the African situation." Nevertheless, many of the ECA's views can be incorporated into a new synthesis approach.

Population. Today most African governments rhetorically support the goal of limiting fertility, in contrast to the situation 15 years ago, when they refused even to consider the problem. Programs and political commitment, however, are weak in most countries. The main requirement for progress in reducing population growth is political leadership. Donors can and should provide necessary financing. But only leadership by African governments and private institutions can produce the changes in public attitudes that are needed for real progress.

A few countries have made progress over the last five years (Botswana, Kenya, Senegal, Swaziland, and Zimbabwe). These examples show that determined government policies can lower fertility. Moreover, recent survey data indicate many African women would like to limit their family size but cannot obtain contraceptives. Thus there is hope for more progress. Nevertheless, the task ahead is great. Fewer than 5 per cent of African women use modern contraceptives compared to 50 per cent in much of Asia. Population growth rates only begin to fall when contraceptive use reaches about 20 per cent. Even in Zimbabwe, a country with one of the best family planning programs in Africa, the average number of births per woman is still 5.3.

Agriculture. Another area where new initiatives are required is agriculture. If Africa is to attack rural poverty and increase its food supply, it has to make major gains in agriculture, particularly in production by small farmers.

Since 1980, African governments have said that agriculture is their top priority. These sentiments, however, have not been matched by action. Most African governments have not seriously promoted rural development because of political pressures favoring the urban areas. What efforts they have made have been hamstrung by government bureaucracies' inefficiency and skilled Africans' reluctance to live and work in rural areas.

Reductions in the role of government and reliance on the private sector for services in marketing, input supply, and training can help cut through bureaucratic red tape. This has worked well where it has been tried, for example in Ghana. Overcoming attitudes and political pressures is likely to prove more difficult. There is a fundamental conflict between the economic imperative of empowering the countryside and the antirural bias of African governments and skilled workers. This conflict is one of the major challenges facing African leaders.

Agricultural development will also require new assistance from the donors, particularly for repair and improvement of rural roads and infrastructure. These items have been neglected for years. To raise them to a minimum standard will cost billions of dollars, which for the most part will have to come from outside.

The potential payoffs of a serious effort to develop agriculture are many. A growing agricultural sector would absorb unskilled labor. Farmers' higher incomes would result in demand for labor-intensive goods and services, creating further jobs, many in rural areas. And growth would be equitable, because most of the production would be done by small farmers, many of whom are women. Such gains have already been experienced by countries that have favored agriculture in the past, such as Kenya and Zimbabwe.

The decision of most African countries to neglect agriculture (lamented in the 1966 book *False Start in Africa*) was a major mistake, and

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the source of many of the continent's problems. Rectifying this would do much to improve Africa's productive potential. It would also bring Africa more in line with the agriculture-led development paths followed by many of the successful countries, such as South Korea and Taiwan, in their early stages of development.

Trade and Investment. Africa today depends heavily on foreign aid because of its losses in export earnings and private investment. Future aid, however, is not likely to grow as fast as Africa's needs. To achieve adequate economic growth in the 1990s, African countries will have to increase their export earnings and attract more private investment.

Until now most African governments have done little to promote exports. They have feared that higher production of export commodities would result in falling prices because of fixed world demand, and they have said that they would like to reduce their dependence on overseas markets through more trade within Africa. These arguments do not hold up. Africa's share of export markets has declined. The first challenge will be simply to make up for past losses. There are few commodities in which African producers are so dominant that they have to worry about price effects. Increased trade within Africa is a worthwhile goal, but it cannot replace trade with the outside world to any significant degree.

That Africa's exports must become more competitive if the continent is to grow is clear. The question is how. African governments and the World Bank favor more vertical integration and export diversification—namely processing of African raw materials in Africa and expansion beyond traditional commodities. But neither will work as long as African exchange rates are overvalued, labor markets are rigid and overpriced, and the private sector is suppressed. Moreover, African trade policies must shift from a "damage limitation" mentality (favoring withdrawal from the global marketplace) to active pursuit of export niches.

Changes are also needed in African policies on foreign investment. Such investment encourages domestic growth and plays an important role in expanding exports because foreign firms have the knowledge of global markets.

Yet many African governments, including such reform-oriented states as Ghana, remain ambivalent toward it. Rhetorical openness to foreign investment is not enough; tangible changes must be made in investment codes, bureaucratic regulations, and arrangements for repatriation of earnings. In these areas, too, Africa should learn from the successful Asian countries, which relied heavily on private capital, foreign investment, and export promotion.

Governance. African governments need to make major improvements in governance—the quality and effectiveness of governmental practices. Four specific changes are needed. First, African governments must broaden political participation. The monopoly of political power by urban groups and elites has directly contributed to Africa's current plight. It will be difficult to make development more equitable until ways are found to bring the excluded masses into the political process. Ghana's leader, Flight Lieutenant Jerry Rawlings, has recognized this in his country, where he is trying to increase the power and political voice of farmers. The ECA is also stressing participation and decentralization.

Second, African governments need to narrow the range of their interventions and become more effective in priority areas. They should abandon their futile attempts to manage everything. And they should perform their legitimate public functions more effectively, such as providing primary education, preventive health care, infrastructure, power, water, and judicial protection.

Third, African governments must try to curb pervasive corruption and favoritism, which in too many cases reach to the top. Corruption sabotages development by wasting scarce resources and undercutting people's sense of social obligation and shared burden.

Fourth, African governments should concentrate their resources more on development. In the past many African countries have spent excessive sums on their military establishments. In the 1990s it will become increasingly difficult to justify this spending, which diverts money and talent from the central task of development. Most governments also need to reduce the disproportionate share of resources

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going to urban elites, and shift that money to the public functions mentioned above, especially basic education and health.

The most basic change needed is for African governments to take charge of restructuring their economies for higher growth.

All these changes—in basic reform, population, agriculture, trade and investment, and governance—are politically difficult for African governments. A year ago an observer might have concluded that there was little chance of real progress being made, at least in time to turn around the continent's fortunes. That prognosis may still turn out to be true.

However, in recent months a new dynamic has begun to unfold in Africa that puts the old assumptions in doubt. A wave of political unrest and challenges to one-party rule has hit a number of African countries, including the Ivory Coast, Kenya, Somalia, Zaire, and Zambia. In addition, several other African governments have stated their intent, with varying degrees of commitment, to move toward multiparty systems. These countries include Nigeria, Benin, Gabon, and even war-torn Angola.

Taken together, these cases suggest a new political trend in Africa. Its future course is hard to predict. But one cannot rule out the possibility of an African version of Eastern Europe's political transformation, though political change seems more likely to be violent and protracted in Africa. Some of the signs are similar. Prolonged economic stagnation has caused people to lose faith in their governments. Long-standing resentments at the inequity and corruption of one-party autocratic rule are coming to a head. And the example of Eastern Europe has raised political consciousness. Africa's urban riots are not directed against the IMF (as in some recent Latin American cases) but against one-party rule. These factors bear a strong resemblance to the East European phenomenon of economic failure leading to political change.

Although the driving force behind the current unrest appears to be economic frustration, it cannot be taken for granted that political change, if it comes, will result in more rational economic policies in the short run. Alienation and militancy are greatest in the urban areas. If these forces dictate the shape of change, the result could be a return to earlier policies of subsidies, government controls, and make-work jobs for urban groups. In Nigeria the government believes multiparty competition would threaten to produce such an outcome and has put controls on the democratization process to protect the country's adjustment program. But in the longer run market-oriented reform has a certain inevitability, because nothing else will work. Conceivably, that political change in Africa could lead to a long-term adjustment process even more far-reaching in its consequences than current donor-led programs—because the reforms come from within. In any event, that is the hopeful view.

If a number of African governments do make significant economic improvements, either as a result of political change or new efforts by existing regimes, how should the donors respond? A credible donor response would include three elements: increased aid, expanded debt forgiveness, and favorable trade arrangements. Increased aid would be needed to support new programs in agriculture, infrastructure, and other areas. Debt forgiveness would be a necessary complement. The case today for more debt forgiveness will be even stronger if countries undertake an expanded development effort. The donors can then help free reformers from the burden of past mistakes by providing additional resources. Finally, it would be important to increase Africa's export opportunities. The developed countries should consider special trade arrangements to give reforming African countries favorable access to Western markets. On a continentwide basis, African agricultural exports could also be helped by a broader Western policy of reduced agricultural subsidies (as the United States is advocating in the General Agreement on Tariffs and Trade). This initiative would reduce competition from subsidized producers in developed countries

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and give African and other Third World producers a fairer chance to compete.

The development challenge facing Africa is tremendous. The continent needs fundamental social and economic transformation, which may not be possible without political change. Current reforms are only a start. To quote Winston Churchill's famous words of World War II: "This is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning." Africa's reforms to date do not represent the end of needed changes, or even the beginning of the end. They may represent the end of the beginning, in the sense that they have halted 25 years of movement in the wrong direction. But most of the positive steps that Africa needs for long-term growth still lie ahead.

Nor are the current adjustment recommendations of the donors an adequate guide for Africa's long-term development. They are more a corrective for past mistakes than a blueprint for the future. A vision of Africa's future will have to be worked out by Africans themselves, possibly under different political structures. The measure of Africa's success will be economic, but the determinants of that success will be political.

Executive Summary

SOUTH AFRICA: Relationship with Western Financial Institutions

Purpose

In 1986, in an effort to change South Africa's policy of racial segregation, the Congress passed the Comprehensive Anti-Apartheid Act that prohibited certain transactions and trade in selected items with that country.

At the request of Senator Paul Simon, Chairman, Subcommittee on African Affairs, Senate Committee on Foreign Relations, and Senator Edward M. Kennedy, GAO analyzed South Africa's financial situation, trade credits being provided to that country and the economic impact on South Africa of denying such credits, and the implications of excluding South Africa from the American Depositary Receipt system.

Background

The Comprehensive Anti-Apartheid Act of 1986 bans new investment that includes new loans; however, the ban excludes short-term credits associated with trade, which allow importers to pay for goods over a period of time. Before recent steps toward negotiation in South Africa, some advocates of sanctions had proposed imposing additional measures. Among these were banning all credits associated with trade and excluding South Africa from the American Depositary Receipt system. An American Depositary Receipt is a negotiable certificate issued by an American bank, representing ownership of the stock of a foreign company, that simplifies and aids the purchase of such stock by U.S. citizens.

South Africa faced a financial crisis beginning in 1985, when American banks refused to extend existing short-term credit lines because of political pressure, and other international banks followed suit. Because short-term credit then became unavailable, South Africa did not have the resources to pay off its debt when it came due. As a result, South Africa continued to pay interest on this debt but unilaterally froze repayment of much of the principal. Since 1985, South Africa has announced, after limited negotiation with its creditors, a series of three loan rescheduling arrangements to gradually pay off part of the frozen loans.

Results in Brief

Although South Africa has managed to significantly reduce its large debt repayments that fall due in 1990, its most critical barrier to sustained long-term economic growth is still a shortage of capital. This shortage is due to capital outflow and the unwillingness of international banks to make new, long-term loans. South Africa is able to get credits associated with trade to partially compensate for the lack of new bank

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lending, but the inflow of credits is small compared to the large outflows of total debt repayment and capital flight by cautious investors.

If the Western nations decide that additional economic sanctions are needed, a multilateral ban on credits associated with trade would probably have a significant economic effect by compelling the cash-short South African economy to pay cash for imports or resort to barter trading. South Africa would likely have to further restrict imports and increase exports in order to generate hard currency to make up for the reduced credits. However, a unilateral U.S. ban would have a limited effect, because many U.S. banks have already voluntarily stopped giving credits associated with trade.

Excluding South Africa from the American Depositary Receipt system would have a small impact on South Africa's economy because under the Comprehensive Anti-Apartheid Act, the receipts cannot be used to make new U.S. investments in South Africa. Furthermore, U.S. investors could still purchase underlying shares of South African companies issued before the statute's enactment and might take advantage of new offshore markets that would give them the same advantages as the American Depositary Receipt. But forcing U.S. investors to divest themselves of South African American Depositary Receipts might have some negative effect on South Africa's business climate and make it slightly more difficult to raise capital.

GAO's Analysis

South Africa's Financial Situation

South Africa has the resources to pay the interest costs on its international debt, but because it is virtually frozen out of world capital markets, it is unable to get new medium- and long-term loans to repay the principal on existing loans as it comes due. The problem is exacerbated by capital flight linked to its unstable political climate.

South Africa faced particularly large payments due in 1990 but has managed to reduce these by "smoothing" its payments and pushing them into the future. This smoothing was achieved through a new, favorable debt rescheduling arrangement for the largely short-term credit frozen in 1985 and by extending repayment periods for the largely longer-term loans and bonds not affected by or removed from

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the arrangement. Yet, even with the improved climate for p tiations, most international creditors are still unwilling to m medium- and long-term loans because of the uncertain politi and because South Africa is a problem debtor. This situatio with the debt repayment and capital flight problem, results tial capital outflow for the South African economy. Such an slows economic growth and remains South Africa's most cri nomic problem.

Credits Associated With Trade

South Africa is able to get some medium- and long-term cre ated with trade to partially make up for international bank to offer new, conventional loans. Thus, a South African con closed off from international lending for general purposes o cific development project may buy capital equipment for th receive credits associated with the purchase. South Africa's to foreign banks declined $2.8 billion from June 1986 to Jur while its medium- and long-term credit associated with trad by a maximum of $1.1 billion. However, such inflows are sn pared to South Africa's overall capital outflow of at least $ during that same period.

A multilateral ban on credit associated with trade to South significantly impede South Africa's trade by compelling tha pay cash for its imports. To make up for the reduced credit. Africa would be required to decrease imports and increase alternative to paying cash would be to barter its exports fo

In contrast to the significant effect of a multilateral ban, a U.S. ban on such credit to South Africa would have a limite indeed, many U.S. banks already are voluntarily refraining viding credits to South Africa because of the economic and of doing so. The ban would mainly affect American compan still selling to South Africa and extending credit of up to 1 y sales. Such companies might then be at a competitive disad tive to international competitors who could continue to pro credits.

Excluding South Africa From the American Depositary Receipt System

Most financial analysts GAO interviewed stated that South A panies were more or less indifferent to participation in the Depositary Receipt system and would feel minimal effect if South Africa were excluded from the American Depositary

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system, there would be little effect on South Africa's economy; Americans cannot currently use the receipts to buy new South African shares. American Depositary Receipts can only be used as surrogates for shares issued prior to passage of the Comprehensive Anti-Apartheid Act. Thus, Americans who hold the receipts cannot provide new capital to South Africa. Requiring Americans to divest their South African receipts would only result in a transfer of ownership between investors. As American investors divest, they may have to sell at reduced prices; thus, the price of the underlying shares may fall in the short-term. Divestiture also could cause a marginal downturn in the business climate in South Africa, thus slightly impairing South Africa's ability to raise capital in the future.

Recommendations

GAO is making no recommendations.

Agency Comments

As requested, GAO did not obtain agency comments on the report.

Overseas Development
Council/ IM&D Inc.

EXECUTIVE SUMMARY

The purpose of this report is to examine the constraints and prospects for U.S. private investment in sub-Saharan Africa (excluding South Africa). The report is not encyclopedic but is intended to serve as a resource to raise the level of awareness of U.S. businesses and modify perceptions of Africa as an unprofitable region for private investments.

The study acknowledges that development in Africa currently trails most of the rest of the world. However the research shows that the overall climate for private sector participation in economic development has gradually improved over the past five years. This is due in great part to massive economic reforms through structural adjustment programs and liberalization of political and marketing systems, all of which improve the prospects for carefully planned and targeted U.S. investments.

The important policy modifications which many governments have made since the mid-1980s contributed to Africa's average annual GDP growth rate of 2.1 percent during that time. This period also saw 17 countries increase output faster than population growth, improved terms of trade for non-oil exporting countries and growth in agricultural export production. These improvements are indicative of the realization by African governments of the need to create more stable economic environments which encourage foreign investors.

The current major foreign investors in Africa are from those nations with the strongest pre-independence ties, i.e. France and the United Kingdom. Other major investors include Germany, Italy, the Netherlands and the U.S. The primary focus of European investment activities are in the areas of mining, agricultural production (including forestry), construction, and management. The Japanese, who initially invested in energy, are increasing their general trade activities.

Current U.S. private investments fall into three general categories where they have a comparative advantage: oil and mineral exploration and production, light manufacturing, and services. Light manufacturing interests are, for the most part, focused on consumer products for domestic consumption and export. Banking, financial, accounting, and insurance services are being offered by major U.S. firms. U.S.-based international management consulting firms are providing assistance to African governments and businesses in areas related to economic planning, human resources and institution building projects, many of which stem from international aid efforts aimed at improving economic performance and business climates.

The areas and opportunities for future U.S. investments in Africa are varied but not vast. Primary commodities from mining and agriculture represent the traditional sectors with the most substantial potential for growth. The wood veneer and furniture industries in Europe, North America, and Asia have a special and continuing need for the high quality hardwoods found in Africa. While several countries are expanding their tourist facilities

and infrastructure, African tourism has yet to be fully developed and thus provides opportunities in management services, facilities development and other related services.

The modern sector offers non-traditional opportunities. For example, U.S. technology for tidal seafood farming and freshwater fish cultivation provides opportunities for sales in African markets as well as for exports. Several countries have large numbers of persons highly trained in data processing which offers the prospects of using satellite information batching for off shore data processing. Market surveys, commissioned by the State of Michigan, identified specific areas of investment opportunities in Nigeria, Zimbabwe, Ghana and several other countries. Smaller country markets should not be overlooked. Of particular note are Botswana, Togo, and Namibia which represent opportunities in the livestock, minerals, and tourism industries.

Further, the large volume of Official Development Assistance (ODA) provides U.S. firms with many opportunities to participate in African development programs. The World Bank and the African Development Bank encourage members, such as the U.S., who hold equity positions to bid on consulting, engineering, construction, technical assistance and procurement contracts. More than half of the twelve billion dollars in ODA currently going to Africa annually is available for U.S. corporate participation.

The study identifies current constraints to U.S. investments, both perceived and real. Responses from personal interviews and a questionnaire sent to 100 U.S. corporations, provided substantial information. The most critical constraints identified by our survey are the low level of infrastructure and general development, the quality and quantity of education, the lack of well managed government organizations with consistent and predictable regulations and foreign exchange conversion problems.

Another set of constraints are U.S.-related and range from difficulties in making contact with the African private sector, lack of specific knowledge about Africa, overly negative perceptions regarding the small size of the African markets and information gaps about the U.S. government agencies designated to assist potential investors. These agencies were also found to be underfunded and inadequately staffed.

Over the past ten years, the U.S. government policies for encouraging private sector growth in developing countries and promoting U.S. investments in this effort have fallen short in sub-Saharan Africa. An overview of the government agencies and programs designed to facilitate the policies revealed a system that is inadequate, resulting in insufficient outreach by the agencies to inform the U.S. private sector of available opportunities.

In response to questions regarding competing prospects for U.S. investments, most companies ranked Africa well below the Pacific Rim countries, citing the availability of better trained work forces, greater infrastructure, reasonable size markets and a lower cost per unit of investment for equivalent returns. Other companies will not proceed with new investments or expand current operations in Africa until there is clarification of the potential for investing in Eastern European markets.

International agencies are more active in dealing with investment constraints in Africa, particularly in the area of private sector development. The International Finance Corporation, from 1978 to 1988, increased the number of its projects in Africa from 73 to 229, providing financial aid plus legal and technical advice.

A review of the objectives and activities of non-governmental agencies and organizations indicate substantial special expertise in certain areas which can be used to mutual advantage by foreign investors and local employers, especially in agricultural production, labor force training, and social outreach.

A new U.S./Africa Business Council has been in the development stage for the past year with very limited progress. Our analysis suggests the Council could provide the missing link in the U.S. private institutional network, capable of focusing specifically on African and American business interests. Of special note however are the well-targeted efforts of several U.S. states to encourage both exports and specific investments by companies resident in those states.

The recommendations for action are organized into two categories:

The first recommends strategies for engaging the U.S. private sector by providing better information and support from strengthened U.S. government agencies and involving business associations and business educational institutions in the overall communication process.

The second category of recommendations discusses methods of providing encouragement for African business growth as well as new and stronger linkages to U.S. investors. They include support for organized groups of African industrialists and entrepreneurs, Chambers of Commerce, related organizations and private voluntary groups. It is also recommended that multilateral agencies re-examine their programs aimed at private sector and foreign investment development in Africa with the view of strengthening their roles.

While economic progress achieved in Africa since the mid-1980s still is at the early stage, we believe that the changing economic and political climate will continue to create improving opportunities -- albeit modest -- for U.S. private investments in Africa. The key factors affecting successful ventures will vary for each potential investor, but will certainly include: a careful analysis of specific markets and in-country visits; making full use of the technical, financial and informational services available to potential investors; seeking out information from companies with successful ventures in Africa; and establishing close linkages between U.S. companies, African governments, community-based groups and African entrepreneurs.

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REFORM OR ELSE?

To prod sub-Saharan nations to democratize, should donor countries and institutions tie their aid to political as well as economic reforms? While improvements in governance are crucial to achieving sustained economic growth, the role of donors needs to be carefully thought out so as not to hinder Africa's budding efforts toward political pluralism.

Betty Press

By CAROL LANCASTER

Should rich countries and international institutions providing concessional assistance and debt relief to sub-Saharan Africa link their aid to political, as well as to economic, reforms? This is the question of the day, raised and debated in the media, in policy discussions within the U.S. government, in public documents by international economic institutions, by African intellectuals, and by development experts.

This question emerges from two rather separate trends in world politics: efforts at structural adjustment in Africa, begun in the 1980s as a result of the deepening economic crisis, the desperate need of African governments for foreign financing, and the increasing tendency of governments, the IMF, and World Bank to condition their assistance on economic stabilization and structural adjustment. Over 30 African countries now have stabilization and/or structural adjustment programs with the IMF and World Bank.

But structural adjustment has yet to produce a clear-cut success in sub-Saharan Africa. Sustained economic reform programs in Ghana and elsewhere have contributed to healthy

Carol Lancaster is [illegible] in the School of Foreign Service at Georgetown University.

growth rates (of 5 percent or above in Ghana) over several years. However, an examination of the components of this growth suggests that it is based on an expansion in capacity utilization in agriculture and industry, large aid inflows, some investments in mining—likely to produce quick and profitable gains—and in the informal sector. Significant new investment in manufacturing and agriculture have not yet materialized. Indeed, in Ghana, domestic savings and investment remain among the lowest in the world and disinvestment in industry continues as inefficient firms collapse in the face of import competition. An increase in private, productive investment is a critical element in the success of structural adjustment; without it, there will be no sustained economic growth. The question is why the investment has not occurred and what can be done to encourage it. This is where the problem of governance arises.

Investors, African or foreign, put their resources at risk to make profits. In many lines of investment, particularly in manufacturing, investors will gain profits only over a period of years and so will invest where they have reasonable confidence that business conditions will not alter dramatically. In many of these aspects, Africa remains uncompetitive with other parts of the world. The logistics of doing business in Africa are still difficult, with transport and communications facilities poor and unreliable in many countries. Physical infrastructure is still inferior to that in other parts of the world. African labor is becoming cheaper, but in many places is still uncompetitive with the disciplined, literate, and often skilled labor in much of Asia or, more recently, Eastern Europe.

But above all, investors lack confidence in African governments which say they want private investment, but then act, at times unintentionally, to discourage it or which are riddled with corruption. Perhaps the most important obstacle to private investment and growth in Africa is that everything is open to negotiation. Rules and regulations are frequently implemented by government officials in an arbitrary and capricious fashion. Above all, investors require predictability on the part of their host governments. This is not present for them in much of Africa and so they go elsewhere.

Without an improvement in governance, sustained growth will not occur, for behind problems of economic mismanagement and corruption are problems of leadership, interest group pressures, patronage politics, a lack of transparency and probity in government decision-making, and an absence of public accountability. The Economic Commission for Africa acknowledged the problem of governance in its recent report, *An African Alternative Framework to Structural Adjustment Programmes*, as did the World Bank in its recent long-term study, *Sub-Saharan Africa: From Crisis to Sustainable Growth*. Thus, the problems with structural adjustment and renewed economic growth in Africa raise the question: Should aid be linked to political reform?

Is the pluralism so often thought to be necessary for a successfully functioning democracy sufficiently developed in Africa to support democracy?

The question is also raised as a result of the recent changes in Eastern Europe and the West's response to them. Eastern Europeans have combined their dramatic moves toward economic and political liberalization with appeals to the West for economic help (less concessional assistance than commercial loans, debt restructuring, technical assistance, and private investment). The Western Europeans and the U.S. have responded with some money and some promises, and the conditioning of their help on continuing political liberalization. The fact that democracy could break out in Eastern Europe, where it was least expected, suggests that it could happen elsewhere. Why not encourage it in Africa by conditioning aid on political liberalization there?

In answering this question, there are several important issues to consider. First of all, what is the *objective* of tying aid to political reform? Is it to promote more open, democratic societies as an end, for the good inherent in them? Or is it to promote economic development?

A corollary to this question is *which reforms* are necessary for meaningful political liberalization? What, in the words of Robert Dahl, would it take to ensure that African governments are "responsive to the preferences of their citizens"? To ensure citizens basic political rights, the following conditions are usually regarded as necessary: freedom of expression (implying media, universities, and public fora free to raise and debate political issues and to criticize government) and freedom of assembly; an independent judiciary enforcing the rule of law; and an opportunity on the part of the public to change the political leadership through periodic, free and fair elections. Much of the experience of independent Africa suggests that it may be difficult to fulfill these conditions within the framework of a one-party state. A multi-party state may be unavoidable.

As attractive as the idea of political liberalization is for Africa, there are some potential problems. First, open political competition may center on ethnic, regional, or religious cleavages dangerous to national unity. At independence, the fear of ethnically based politics (far from groundless) was the justification for the one-party state. Is there reason to believe that the dangers of ethnic politics have by now declined in importance or that ethnic politics would be less disruptive of national unity today than at independence? Does the answer to this question differ from country to country? If so, why? The tensions

resurfacing in Eastern Europe and the USSR suggest that even when they have been suppressed for decades, ethnic politics do not disappear as potent and often destructive political forces.

Second, is the pluralism so often thought to be necessary for a successfully functioning democracy sufficiently developed in Africa to support democracy? Third, are powerful political groups prepared to abide by democratic rules rather than resort to the use of force to gain or retain political power? Where societies lack powerful, organized groups with diverse and sometimes competing interests, a dominant group or coalition can function as an autocracy, even in democratic camouflage, promoting the interests of its own supporters and depriving others of economic opportunities as well as political rights.

Are Zaire, Liberia, Sudan, or Somalia sufficiently pluralist societies in which powerful groups are willing to play by democratic rules? The answer is clear in these cases. It is less so regarding Kenya, Nigeria, Senegal, or Côte d'Ivoire—although in each of these cases, ethnic or religious-based politics remain a possibility and a threat.

Fourth, it is possible that democratization in African societies can harm rather than hurt the success of structural adjustment programs, generally regarded as critical for restoring economic growth in the region. Open political debate would inevitably include the major issue with which so much of the continent is now struggling—structural adjustment. Structural adjustment programs are controversial (not the least because of the foreign involvement in them), painful (particularly for vocal and influential groups), and often emotive and ill-understood by the general public. The largest group benefitting from them—rural farmers—are typically the least articulate, the least well-organized, and among the least politically influential group nationally. Would they organize, articulate, and vote their economic interests in an election where structural adjustment is an issue?

It is very possible that where structural adjustment programs become the subject of open political debate or a major issue in political campaigns, where articulate, powerful groups and individuals are predominant (whose interests are threatened by structural adjustment), these programs will be discarded along with those politicians supporting them. President Babangida of Nigeria has acknowledged this threat by attempting to exclude it from the upcoming national election campaign. It very nearly defeated President Diouf of Senegal. There may well be a trade-off between political liberalization and economic liberalization in sub-Saharan Africa.

A second major issue is *how aid should be linked* to political liberalization. Conditioning foreign aid on political liberalization would add an additional degree of coercion to relationships between African governments and foreign powers, which is already there in conditioning aid on economic reforms. Perhaps, a degree of coercion on economic reform in exchange for additional resources is warranted, but there are limits beyond which such conditioning becomes counter-productive, both in terms of short-run relationships between aid donors and recipients, and in terms of the long-run interests of Africans who, in the last analysis, must be responsible for making their own decisions affecting their destinies.

More important, conditioning aid on political reform puts the initiative of deciding which reforms are appropriate and workable in the hands of foreigners, particularly government officials and international civil servants. There are few who are well enough informed to make such decisions about what will work politically in Africa's complex and changing societies.

An alternative to conditioning foreign aid on political liberalization would be for aid donors to deploy a portion of their aid in support of the many changes useful to promote democracy in Africa: training for judges, legislators, journalists, trade unionists; support for non-governmental groups which would be important in a pluralist political system, for example, professional, youth, and women's groups; support for independent public policy research institutions which could develop the alternatives to government policies necessary for open and informed debate.

These would not be new activities for the U.S. government, which has funded similar programs for four decades in Asia and the Far East through the Asia Foundation. It has not financed these sorts of activities in Africa (except in a small way in South Africa). This alternative would not be coercive and would leave decision-making in the hands of the Africans, but it would probably not bring about major political reforms quickly.

A further alternative for supporting democracy in Africa would be for aid donors to provide African govern-

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ments with additional aid after moves toward democratization had been implemented. This approach would contain a degree of coercion, but would leave decision-making and initiative in the hands of the Africans.

If the objective of linking aid to political reform is to promote the success of structural adjustment, more limited reforms may be sufficient and appropriate. These reforms could be targeted at *economic governance* and would include: transparent government budgeting (no more hidden accounts for the discretionary use of a Mobutu, Doe, or Ahidjo); well-planned investments appropriate to national economic needs and priorities (no white elephants dedicated to the everlasting memory of a particular leader or foreign aid donor); open and competitive bidding for large public investment projects (no more Turkwell dams in Kenya, Inga-Shabas in Zaire or Ivorian sugar projects); and the consistent and fair implementation of regulations governing investment.

Extending the conditions of foreign aid to economic governance implies that foreigners would assume the role of ensuring public accountability by African governments on issues of economic governance through close coordination of their aid and export policies, through monitoring recipient government economic decision-making and policy implementation, and through reducing or raising their aid levels based on the performance of African governments in this area. In theory, this is what is happening now with IMF stabilization and World Bank structural adjustment programs. The conditions of these programs could be formally extended to include economic governance.

An approach linking additional foreign aid to economic governance is not without problems. The most difficult problem may be getting foreign governments to cooperate in their policies vis-à-vis the Africans. There is a considerable degree of informal cooperation now, but many of the failures of implementation of economic reform programs in Africa can be traced to the support of developed countries of their African clients' desires to avoid reforms. President Mobutu of Zaire has demonstrated the most skill in manipulating his three patrons to avoid serious reforms. But he is not alone. Presidents Houphouët-Boigny of Côte d'Ivoire and Traoré of Mali have sought (and obtained) French intervention to avoid painful policy reforms.

Developed countries have their economic and political interests in Africa and are still often willing to put them ahead of their interests in economic reforms.

Developed countries have their economic and political interests in Africa and are still often willing to put them ahead of their interests in economic reforms. It remains to be seen whether the economic decline in the region and the decrease in East-West tensions will so erode foreign economic and political interests there that they will be willing to center their economic support for African governments largely on progress toward reforms.

Another problem with adding economic governance to the list of aid reforms required by foreign governments and international institutions is operationalizing the concept. What are the policies that should be reformed? How can we tell when they are changed? Should aid be conditioned on a sliding scale of reforms or on attaining an absolute level of reform? These are difficult, but not impossible questions to answer.

The final and most critical question is whether reforms in economic governance would be effective in promoting investment and growth in Africa. There are obstacles to increased investment in Africa, other than problems of economic governance. The question of whether extending structural adjustment lending to include economic governance would be effective in stimulating investment can only be answered in practice. Where other factors (infrastructure, labor costs and productivity, potential profitability of an investment) are favorable, improved economic governance could be helpful and perhaps decisive in encouraging investors. And it may only take one or two large and profitable investments in Africa to re-ignite investor confidence in the region.

In any case, improved economic governance is unlikely to worsen economic conditions in Africa or hurt broader prospects for investment and growth. At a very minimum, it would ensure a more efficient use of existing resources. And something needs urgently to be done to make structural adjustment successful—if initially only in one place. The alternative is further decline.

The linking of concessional resources to economic reforms has been with us for most of the decade of the 1980s. It now appears that governments are beginning to think about linking any additional aid resources to political reforms. This is an attractive notion to Western governments and to many Africans and one strongly suggested by the experience of Eastern Europe. There may be some useful and workable reforms to be achieved through this approach, particularly in the area of economic governance.

But linking economic support to broader political liberalization can be a dangerous and destructive approach to forcing desirable changes in African societies because, thus far, it is so poorly thought out on both sides; because foreign officials are not well-positioned to advise Africans on effective political changes; and because Africans, in their desperation to obtain additional concessional resources, may agree to changes which in reality they cannot or will not implement or which implemented, will prove unsustainable and generate further political and economic instability.

PARTNERSHIP

If "Afropessimism" is not to take hold, African nations still mired in autocracy, bureaucracy, and corruption must begin to democratize their political systems. Democracy alone, however, is not the answer—it must be accompanied by greater openness and accountability in the economic arena. Then, the continent will be in a stronger position to seek support from the West.

By RICHARD JOSEPH

The numerous challenges confronting African countries have now become cumulative, while the capacity of governments and societies to cope with them is increasingly strained. A widening fear that matters will become significantly worse rather than better in coming years has been given the label "Afropessimism." However, while realistically confronting the dilemmas of the continent, we must resist defeatist attitudes.

Using any set of available statistics—Africa's declining share of world trade, the comparatively small size of its economies, or the increasing proportion of debt to GDP—it is evident that the continent's economic contraction is likely to worsen during the coming decade unless current trends are reversed. Few statistics are more telling than the fact that Africa, which now holds an estimated 16 percent of the world's poor, can expect to see that proportion doubled by the end of the century. The warning by General Olusegun Obasanjo that Africa is becoming "the Third World's Third World" cannot be dismissed as merely alarmist. If there is an alarm, it should be one that arouses us to action.

Richard Joseph is a professor of political science at Emory University and fellow for African studies of the Carter Center.

The economic decline that sub-Saharan Africa experienced during the 1980s provoked a sometimes rancorous debate about what should be done. Most of the arguments advanced in that debate are now well-known and have been fully aired in publications of the World Bank and the Economic Commission for Africa. However, before real evidence of economic recovery could be identified in countries undergoing stabilization and adjustment reforms, the continent was swept by a wave of demands for more pluralistic political systems. Single-party rule in particular has come under sustained attack in the streets of many African cities and in the boardrooms of the major bilateral and multilateral donors.

Will democratization help, hinder, or confuse the process of economic transformation and development in Africa? It can be stated quite categorically that democracy, in and of itself, is not a panacea for Africa. There are, of course, African countries in which vigorous democratic systems are associated with dynamic economies, such as Botswana and Mauritius. Yet, there are also others in which democratic openings were accompanied by an acceleration of economic decline: Ghana (1979-81), Nigeria (1979-83), and Sudan (1985-89). A more nuanced analysis is therefore needed if we are to arrive at a satisfactory understanding of the relevant issues and considerations.

As a general principle, drawing on world-wide experiences, it is clear that the absence of democracy does not mean that economic growth will be stymied. There are nations like South Korea and Taiwan that experienced decades of sustained economic expansion under highly authoritarian systems, and even Japan's "liberal democracy" still retains oligarchic features. Another country now regularly cited in this vein is Indonesia, which has enjoyed a prolonged economic upswing under an autocratic military regime.

However, this pattern of reasoning is not fully satisfactory. Some scholars, like Claude Aké, distinguish economic growth from development, the latter which he feels necessitates human-centered qualities that are suppressed in "developmental dictatorships." Equally important is the fact that this issue does not have to be considered abstractly since we now have a good understanding of the dynamics of post-colonial Africa on which any analysis and prognosis should be based.

Virtually all countries in Africa today are hurting economically, including those that adopted socialist strategies of an authoritarian nature, such as Benin, as well as those that used more conciliar approaches, such as Tanzania. They also include countries that have been capitalist in orientation, such as Cameroon, Côte d'Ivoire, and Kenya; those that are led by military as well as by single-party regimes; and even those that are quasi-democratic like Senegal. In brief, a global crisis afflicts most of sub-Saharan Africa and its elements include the weakening of commodity prices, pronounced difficulties in

NOT PATRONSHIP

achieving export diversification, the absence of adequate domestic markets and limited access to external ones, and recourse to increasing indebtedness followed by a failure to generate earnings sufficient to service that debt.

A general cycle of impoverishment has therefore taken shape into which the majority of African countries have been gradually drawn. With an average of nearly 50 percent of external earnings being consumed by debt-servicing, and with commercial investments drying up, African countries have been rendered increasingly dependent on concessional aid and loans. In the short term, one of the major effects of structural adjustment programs is to compel African governments to acknowledge their countries' impoverished status by making sharp reductions in social spending—public employment, education, health, transport, and welfare services.

To adequately address the question of democracy and development in Africa, it is necessary to consider an additional dimension, namely governance. Those countries on the Pacific Rim cited earlier may be undemocratic, or partially democratic, but they have also developed appropriate systems of governance, especially concerning the use of available resources in both the public and private sectors.

Carol Lancaster has advanced the term "economic governance" to refer to practices of decision-making and implementation in the economic realm (*Africa Report*, July-August 1990). Concerned as this perspective is with matters that directly affect public investments and expenditures, her categorization is meant to exclude issues of a more strictly political nature such as the number of political parties, the nature of the electoral system, the structure of the government, and general constitutional provisions.

While there is some overlap between Lancaster's analysis and the one advanced here, one important difference is that I do not believe it is possible in contemporary Africa to achieve the separation she postulates between the economic and the more political dimensions of governance.

In the case of the newly industrialized countries, they succeeded for a few decades in making this separation until their people rejected the suppression of civil liberties and the artificial compression of incomes and living standards. One important reason for the success of these countries in expanding their economies under authoritarian political systems is because an investment climate was fostered characterized by predictability, stability, and productivity. This climate contrasts with the typical African one where, according to Lancaster, "everything is open to negotiation."

The reason why an African economy such as Kenya's began losing its attractiveness to investors, according to human rights lawyer Gibson Kamau Kuria, is because everything became open to negotiation or, put more bluntly, to bribery and political influence: Debts were no longer speedily repaid, official decisions were not based on the relevant legislation and regulations, and judgments of the courts did not reflect a transparent application of the laws.

Consultations that have been conducted by the African Governance Program of the Carter Center of Emory University have identified the ways in which the increasingly undemocratic nature of African governments was part of a more general failure to generate appropriate modes of governance. In this regard, the African crisis shares many similarities with that of the Soviet bloc.

Most African countries have become characterized by increasing centralization of government operations, by the entrenchment of political monopolies by single parties or military regimes, by the consolidation of what Thomas Callaghy in his writings on Zaire has called political aristocracies, by the relentless increase in presidential and military expenditures, by the bureaucratization and declining efficiency of the state sector, and by the closing-off of democratic routes to the procurement of state-controlled resources and the encouragement of nepotistic networks.

The pervasiveness of what we have termed prebendalism, as state offices are privatized and used to generate income for office-holders and their sectionally defined clients, has often culminated in extensive corruption at the summit of the political order and its replication in subordinate echelons. Students of Africa who many years ago decried Stanislav Andreski's characterization of African urban societies as "kleptocratic" are now forced to acknowledge the contemporary popular adage that "to eat *magendo* you have to earn *magendo*" (*magendo* referring to illicitly obtained goods and income).

In short, the general crisis in governance and the increasingly undemocratic nature of most African political systems have become intertwined. It is no longer possible to tackle one without the other, whether in the USSR and Poland, as is now generally accepted, or in Gabon and Zaire.

Nevertheless, we must avoid the seductive notion that democracy or "multipartyism" will rescue Africa from its distress. Democracy, while a prerequisite for Africa's economic revival, will not by itself guarantee such an outcome. Nor is the authoritarian route to economic recovery a viable option any longer because there is a need in Africa not just for an economically enabling environment, as is frequently asserted, but a politically enabling one.

Most African countries no longer have the luxury of trying to restructure their economies in isolation from the unfavorable political dynamics outlined above. This observation applies as much to Benin and Zambia, whose economies have hit rock-bottom, as to Cameroon and Kenya, which still possess some resilience. It is no longer possible to separate, on the one hand, disregard for the rule of law, the weakening of institutional checks on governmental power, and the monopolization of power by ruling cliques and autocrats, from the stifling of economic initiatives, the difficulty of sustaining economic reforms, and the prevalence of dishonest practices in business operations on the other.

Efforts to pursue a series of circumscribed reforms in economic and financial management, as was attempted in Zaire under IMF auspices, and in Liberia under U.S. AID, must now be recognized as impractical. President Gorbachev has learned with difficulty that the Soviet economy and political system must be simultaneously transformed. The Chinese gerontocracy pulled back sharply at the point when its version of perestroika without glasnost was firmly challenged. African countries, with their fragile economies and plural composition, cannot afford either a prolonged re-learning period for their leaders or violent, Ceausescu-like defenses of the decaying order.

It is evident that virtually all African countries must devise appropriate ways of facilitating greater openness, transparency, and accountability in their economic and political life. Attempts to create an economic marketplace without a corresponding political one are no longer credible. It must also be recognized, however, that Africa's predicament does not stop at its shoreline: Increased economic and political pluralism, even if appropriately combined, will not in themselves guarantee economic recovery. What is undertaken domestically will not automatically change the ways in which Africa is marginalized by the operations of the world economy.

In exploring new pathways to Africa's resumed development, the political dimension looms large wherever we look. Within African nation-states, unrepresentative and unaccountable governments must give way to ones that enjoy democratic legitimacy. At the regional level, long-frustrated attempts to promote integration and the gradual dissolution of national boundaries must be revived and accelerated in order to create larger markets and the freer flow of capital, labor, and entrepreneurial capacity.

Internationally, a peace dividend must be procured for Africa. A continent which has given so much to the world in the physical force of its enslaved and colonized peoples, in its cultural productivity, and in the material exports that largely served external needs, could rightly demand that new and determined efforts be matched by generous external assistance and special instruments to reconnect its economies to the growth points of the world economy.

The issue of externally imposed conditionalities is a secondary one. More important is the reverse consideration, namely, whether African countries will once again be in a position to demand supportive actions from the world community and especially from the richer nations and major development agencies. That was the premise of the 1986 Special Session of the UN General Assembly on the African crisis. Many promises made during that session by the industrialized nations have not been kept. However, it must also be acknowledged that much of Africa, in light of the internal shortcomings discussed earlier, may not have deserved the keeping of some of those promises.

A new Africa, with governments truly of, by, and for the people, could rightfully demand a "New Deal" for the continent. The promotion of progress in democracy and development in Africa requires the formulation in a coordinated manner of new domestic and external initiatives. It is only if these combined initiatives can be implemented in a spirit of partnership rather than patronship that hope will revive that Africa might elude the grim future being forecast by economists. ○

Africa Report, Sept./Oct. 1990

DEVELOPMENT

CHALLENGING CONDITIONALITY

Western donors' attention on Eastern Europe's aid needs and their introduction of democratization as a condition for further support are troubling to Africa's leaders, who fear a disengagement from the continent just when nations are adopting politically risky policy reforms.

By SALIM LONE

It is getting harder and harder for Western donors to convince African leaders that the flow of international resources toward Eastern Europe will not be at the expense of assistance for the world's neediest and most crisis-ridden region. Doubts about this assurance were hardened further in July when the Western economic summit's aid deliberations focused not on Africa, but on the Soviet Union.

Since 1986, when the United Nations recognized the imperiled state of African economies, each of these summits had regularly adopted special measures to foster economic recovery on the continent. Before last year's summit in Paris, President Bush had announced the first-ever U.S. debt write-off for a group of sub-Saharan countries.

But in recent months, Africans have been startled by a sudden shift in this support. Senior aid officials as well as the media have been regularly focusing on African policies and a lack of democratization as the exclusive causes of the continent's crisis, without acknowledging its severely disadvantaged position in the global economy. International policy-makers have therefore been meeting at the United Nations and at other specially convened international gatherings, most recently in London and in Maastricht, the Netherlands, to devise strategies to ensure that Africa does not become completely marginalized.

International marginalization is not the only challenge Eastern Europe is posing for African governments, who were already under severe pressure from restive populations bridling at years of unfulfilling austerity. The popular repudiation of single-party rule in the Eastern-bloc countries has also set off a wave of demands for similar pluralism across the continent, even in countries formerly thought stable. Adding to the pressure in this area is the newly articulated demand by senior U.S. and Western officials that the level of democratization within Africa will soon condition the amount of assistance allocated to it.

Everywhere on the continent, there is intense concern about these developments, and widespread skepticism about the motivation behind the sudden introduction of the conditionality of democratization. Africans note that donors are not saying that political pluralism will lead to more aid, only that those not democratizing will receive less.

Most Africans also know that the continent cannot possibly compete with Eastern Europe as a magnet for Western investment—indeed, this had trickled to a virtual halt even in once-favored countries such as Nigeria, Côte d'Ivoire, and Kenya well before new opportunities opened up in Eastern Euope.

Africans also recognize that the broad public support that existed in-

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ternationally for a continent in distress in the mid-1980s has been largely dissipated by the persistent nature of its crisis and its repeated appeals for increased international assistance.

So they suspect on the whole that the toughened donor attitudes herald a cutback on aid and a disengagement from a region whose problematic economies and poor future prospects seem less and less relevant to the growth of the richer countries.

Naturally, there is bitterness in many quarters about these new attitudes, as there is about the speed and volume of assistance being organized for developed Eastern European economies when compared to the slow pace of desperately needed debt relief and resource inflows for the world's most impoverished continent. There is particular bitterness over the fact that the seeming disengagement from the continent comes while the vast majority of African countries are pursuing politically risky economic policy reforms which had been urged on them by the donors as prerequisites for increased assistance and investment.

Socialist Tanzania, for example, has adopted foreign exchange regulations which are infinitely more liberal than neighboring market-oriented Kenya's, and has just passed into law a state-of-the-art national investment code to attract foreign capital. Togo is rushing to establish an export processing zone which gives foreign investors a virtually free hand. But are these countries really going to see an influx of foreign capital when the economic and political returns are infinitely greater in Eastern Europe?

Donors have a right to play a role in determining how their aid is used, and to encourage greater political pluralism and respect for human rights where it is needed.

But crude conditionality—which bases assistance on how strictly a country follows policies chosen by the donors—is at best counter-productive. It might elicit compliance from resource-starved states, but it also breeds deep resentment. In any event, no reforms will work unless they are, and are seen to be, nationally inspired. Nor can the diversity of African situations be addressed through the application of standard formulas that many donors advocate for *all* African countries.

Donors need to look carefully at how each country is proceeding in its own context. Most African countries have broken radically with their past orientations, and have initiated actions which call for enormous sacrifices from their people and which carry real risks for incumbent governments. Politically, many are moving to adjust to new domestic pressures for pluralism.

To succeed, such countries need less, not more, conditionality, and much more assistance. Their economic reforms will never succeed without such support, nor can the democratization donors are pushing for take place in a climate of extreme deprivation. The one bright spot in this long and uphill struggle is that Africa's needs for external assistance are minuscule when compared to the resources required for Eastern Europe.

Sudan Needs a Donors' Cartel

By John Prendergast

IT was an ominous day for the people of Sudan in June of 1989 when Hassan al-Turabi, leader of the fundamentalist National Islamic Front (NIF), proclaimed a *jihad* ("holy war") to Islamicize the country. The NIF-sponsored coup a few weeks later drew the battle lines for a violent dialectic that will continue until the roles of non-Muslims, and non-fundamentalist Muslims are determined.

Sudan was to be the bridge between Africa and the Middle East; the breadbasket of its Arab neighbors to the North, the caretaker of the Nile; and a moderate force on the southern coast of the Red Sea. All this potential has been consumed by war.

The human cost of the conflict is escalating. Former President Jimmy Carter recently pointed out that "more people perished as a result of the conflict in Sudan than all other wars in the world combined (over the last year and a half)," nearly 500,000. Almost 400,000 southern Sudanese refugees are in Ethiopia, Kenya, and Uganda. Possibly 3 million are internally displaced and rely on emergency food and medicine.

Economic activity is also being disrupted, infrastructure is destroyed, farmers are driven off their land, development projects are halted, budget deficits skyrocket from defense expenditures; family ties and cultural traditions are deteriorating in squalid refugee camps, the slave trade is flourishing, and a generation of children has largely been lost educationally.

The Sudan is rich in natural resources, and those controlling its exploitation have always been able to increase their personal fortunes. The recent ascendance of the NIF has heightened the role of religion in the power play, and allows political rivals to be seen as defenders of religious freedom and democracy.

The tragedy demands constant outpourings of emergency aid from the rest of the world. Though not always in sufficient quantities, that kind of aid will continue, albeit usually in response to pictures of starving children.

A fresh, pro-active approach by donors is needed. Aid, trade, and diplomacy must be seen with a longer-term focus. The international donor community can *protect* people from the repercussions of war, *liberate* people from oppressive leaders, and *transform* economic and political systems to be more responsive to the needs of Sudan's population.

Protection

The victims in southern Sudan have mainly been civilians killed by hunger. During the fighting, food has been systematically denied, and nearly 3 million internally displaced civilians have been held hostage to the military strategies of the SPLA and the government.

Opportunities abound for agricultural self-sufficiency in many non-contested areas of the south. The cornerstone of Operation Lifeline II (OLS II) the UN-sponsored relief effort in Sudan, should be programs that help Sudanese save themselves.

These strategies might be pursued:

1. Many areas are firmly controlled by the SPLA which the government cannot contest. Donor agencies should deliver seeds, tools, and other materials directly to these areas, as is being done now under OLS II.

2. UNICEF was successful in 1989 in opening up "safe passage corridors" for the movement of relief supplies in war zones. In 1990 and 1991, donors should press for "safe planting zones," areas to which people could move freely and farm.

3. In many areas, agriculture is further inhibited by droughts and floods. Providing small water pumps, in conjunction with food-for-work programs for digging irrigation canals and constructing maintainable dams, would help minimize the damage.

4. Although many children have already lost up to six years of schooling as a result of the war, an educationally lost generation of boys and girls is still avoidable. International donor organizations must work with indigenous local organizations such as the Sudan Relief and Rehabilitation Association (SRRA), Sudanaid, Sudan Red Crescent, and the Sudan Council of Churches to help develop a literacy campaign for displaced peoples.

Establishing closer ties with indigenous nongovernmental organizations in carrying out development programs must be a top priority of private voluntary organizations. Creative partnerships between international and local organizations can expand opportunities for primary health care, credit, education, and often meeting even more basic needs in a time of shrinking government services.

Congressional colleagues of the late Rep. Mickey Leland (D) of Texas, who died in a plane crash on his way to visit Sudanese refugees, should honor his memory by increasing the resources of the US Office of Foreign Disaster Assistance. This office needs to respond flexibly and with a longer-term commitment to civilians in rebel-held territory such as southern Sudan and neighboring Eritrea and Ethiopia.

Liberation

An International Donors Cartel for Peace in Sudan must be formed by the US, Egypt, Saudi Arabia, the European Economic Community, and other benefactors.

The US has provided the most military and economic aid to Sudan over the last decade. Consequently, the US bears a responsibility for the discriminatory policies of successive Sudanese governments which perpetuate war. But the Bush administration must not compound past policy errors by releasing further assistance to the Islamic military regime. As Bona Malwal, editor of the banned Sudan Times paper, said, "It is dead wrong to think that new money will influence this government for positive policy change."

Donors must end all trade and non-emergency aid until peace agreements are implemented. The present power structure guarantees the continuation of conflict, so our resources and trade facilities should be withheld until substantial changes are made.

This step includes voting against all World Bank and International Monetary Fund loan agreements with Sudan, and urging our European and Middle Eastern allies to do the same.

The principles which offer the quickest path to peace are those that are being pursued by the National Democratic Alliance inside the Sudan. Their platform would create a broad-based government and convene a constitutional conference represented by all segments of Sudanese society. The SPLA agrees in principle with this approach, leaving the National Islamic Front as the only faction opposed.

Transformation

A pact must be developed between international donors and a future Sudanese government willing to function on behalf of, rather than at the expense of, its people.

This entails a mixed bag of re-oriented assistance and economic aid conditions:

A. Development Aid. A Reconstruction Fund should be created to disburse seed grants for food security at the local level,

Continued on pg. 13

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environmental protection and restoration, and increased access to services by previously marginalized segments of the population. This would go exclusively to non-governmental organizations, neighborhood associations, church networks, and displaced camps.

B. Deconcentration of Power. Local-level leadership in development planning and implementation should be institutionalized, and the decision-making apparatus at the national level should be much more reflective of the ethnic, religious, and class diversity in the country. People's rights of access to resources to determine their own development would then be protected, and the previously unrestricted activities of speculating merchants would be regulated in their dealings in essential goods.

C. Democratization. This aid condition implies a radical restructuring of the ability of people to participate fully in and shape the political and economic future of the Sudanese state. Village associations and NGOs ought to be able to mobilize for social change without fear of reprisal and with confidence that they are truly a part of the process of nation-building.

D. Debt Reduction. Unless a substantial proportion of the $15 billion debt burden is written off, all future Sudanese governments will be handcuffed by extraordinary debt-service commitments. Instability and economic deterioration would be inevitable.

The international community can help bring peace to Sudan by cutting off the National Islamic Front from all external support, and supporting the popular movements and grassroots development efforts that will lead to the restructuring of society.

According to an old Northern Sudanese proverb, "When Allah created the Sudan, Allah laughed."

Allah didn't cry. There is hope.

☐ *John Prendergast is research associate, Center of Concern and co-coordinator, Coalition for Peace in the Horn of Africa.*

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NEW YORK TIMES, July 17, 1990

ABROAD AT HOME | Anthony Lewis

L'Etat, C'Est Moi

During the cold war the United States often supported undemocratic governments in the third world on the ground that they were pro-Western. Now that the cold war is over, and won, what should this country do when a third-world government we have favored turns nasty?

The question is raised in intriguing form by what is happening these days in Kenya. President Daniel arap Moi is cracking down hard on all who criticize his one-party state. Lawyers, journalists and politicians have been detained for speaking in favor of multiparty democracy — or defending the rights of those who do.

Kenya has for decades been a, perhaps the, Washington favorite among African countries. While others tried various forms of Socialism, Kenya had a capitalist economy. It was also seen as a Western bulwark when the Soviet Union interested itself nearby in the Horn of Africa.

Kenya is the largest recipient of U.S. aid in sub-Saharan Africa. The Bush Administration has it down for $53 million in the next fiscal year.

President Moi has always been an authoritarian figure, but he has become increasingly intolerant of opposition. He reacted angrily this winter to public criticism over the unexplained death of the Foreign Minister, Robert Ouko, whose charred body was found in the countryside.

Early this month prominent Government critics were taken into indefinite detention without charge. Among them were two former Cabinet ministers, Kenneth Matiba and Charles Rubia, who have called for multiparty democracy. Mr. Matiba's home was attacked last month by 15 men armed with clubs and machetes; his wife's skull was fractured.

Another detainee is the editor of The Nairobi Law Monthly, Gitobu Imanyara. Mr. Imanyara visited the United States not long ago and spoke with human rights groups about the situation in Kenya. In the three years of his magazine's existence, it has become the leading voice for free speech and due process of law. But it has now been effectively silenced, because anyone selling it is arrested.

The police have also cracked down on what they call "subversive music." They have arrested dozens of people for selling or listening to audio tapes with messages in favor of democracy. One of the tapes, referring to the murdered Foreign Minister, was called "Who Killed Dr. Ouko?"

Few Americans will know the people detained or brutalized in Kenya. But the pattern of tyranny is familiar. As in so many other places, a leader has begun to lose public confidence because of economic and other failures — symbolized by the massive shantytowns near rich neighborhoods of Nairobi. He has met grievances by brutal measures to hold onto power.

What should the United States do in those circumstances? The U.S. Ambassador to Kenya, Smith Hempstone, has given an uncommonly forthright answer to the question. He has spoken out against one-party rule and said the United States will favor African countries that move toward multiparty democracy. For that, Mr. Hempstone was denounced by a newspaper in an editorial headed, "Shut Up, Mr. Ambassador."

Last week a prominent Kenyan human rights lawyer, Gibson Kamau Kuria, sought refuge from the police in the U.S. Embassy. Mr. Hempstone took him in and succeeded in arranging for him to go to London.

The Kenya crackdown and U.S. aid.

What remains to be seen is whether Washington will support its Ambassador. On July 5, the day after the political arrests in Kenya, the Defense Department signed an aid agreement for $5 million in arms to Kenya. If the Bush Administration is serious about backing up Mr. Hempstone, it will surely stop that agreement.

The developments in Kenya show that there should be no ideological division in this country now on issues of human rights. Ambassador Hempstone, a former newspaper columnist, is a conservative. I think liberals will agree with him that America's voice should be heard when governments we have supported act tyrannically.

The Kenya case also makes a point about the universality of human rights standards. Americans who have been engaged in the effort to bring democracy to South Africa should take the same view in Kenya. The campaign against apartheid is also a campaign for a free political system, justice, no detention without trial.

U.S. aid now goes to many brutal regimes, from Guatemala to Zaire. Why should it, when the cold war reasons are gone? Human rights must play a larger part in our decisions on whom to help, and Kenya is a good place to start defining the terms. □

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Africa's Tottering Despots

A look at Liberia's Doe, Kenya's Moi, and Zambia's Kaunda

By Robert I. Rotberg

DESPOTIC, or merely authoritarian, regimes lose their legitimacy almost overnight. The pillage of Liberia and the rising voices of protest in Kenya and Zambia illustrate that lesson. Increasingly, especially in the wake of cataclysmic changes in Eastern Europe, Africans demand a say.

President Samuel K. Doe, an unlettered sergeant when he overthrew Americo-Liberian oligarchic rule in 1980, has governed capriciously and without attention to the views of most of his country's 2.5 million people. His personal and family enrichment became glaringly obvious as ordinary Liberians began to experience shortages, the failure of government services, ethnic favoritism, and officially condoned brutality.

When Charles Taylor invaded northeastern Nimba province in February with 150 men, Doe's coterie hardly took the prospect of civil war seriously. But the people had long wanted their complaints and views to be heard.

The potent cry of Mr. Taylor and other rebels has been "Why die for Doe?" And the army promptly melted away. There was some desultory fighting in Nimba, and nearer the coast, but undermotivated foot soldiers saw no compelling reason to go all out for a despot that had delivered little to them and, if they thought about it, for their country.

Mr. Taylor is on the verge of triumph. Neither Liberians, except for President Doe's ethnic compatriots, nor Western backers and donors, could see any point in trying to save the Doe government. The United States could have intervened, but wisely chose to abstain.

President Daniel arap Moi's regime in Kenya has provided much more materially for its people than could President Doe in Liberia. But ever since Mr. Moi acceded to the leadership of his country upon the death of Jomo Kenyatta in 1978, he has grown steadily more authoritarian and corrupt.

The present crisis, leading possibly to an army-led coup, has been coming for some time. Moi has never tolerated the democratic strivings of his Western-oriented, well-educated, and highly urban country of 19 million people. Nor has he moderated the stranglehold on economic and political power of minority tribespeople from his own Kalenjin group. Kenya is about 40 percent Kikuyu and 25 percent Luo; Mr. Kenyatta was the Kikuyu standard-bearer.

Now Kenyans in three-piece suits are being arrested for trying to hold protest meetings. Moi has promised to hunt down political pluralists "like rats."

President Moi refuses to permit discussion in parliament, in the press, or in the streets about the virtues of single-party versus multiparty rule in Kenya or Africa. The recent jailings of a dozen prominent opponents, and the pleadings of their wives that the men not be tortured or killed (as outspoken Kenyans have been in the past), plus the taking to the streets of university students, are but public indications that President's Moi's national legitimacy is over. When the soldiers turn their backs on him, as they did on President Doe in Liberia, Kenyans and the West will search for a more open-minded successor.

President Kenneth D. Kaunda is personally much more open-minded. He has ruled Zambia, a country of 8 million, since independence in 1964. Originally a tolerant democrat, he copied Tanzania and turned Zambia into a crypto-Afro-socialist state in the 1970s. His pro-urban commodity pricing policies destroyed the country's agricultural productivity and swelled the sizes of his cities. Then the net returns on copper, Zambia's only important export, fell dramatically and the country became saddled with major and continuing debt obligations, now totaling about $8 billion.

In the 1980s and this year, Zambia has asked for financial help from the International Monetary Fund (IMF) and many national donors. But the IMF has long demanded conditions, particularly the elimination of subsidies to urban consumers and the privatization of bloated state-run enterprises.

Recently, President Kaunda drastically reduced subsidies on maize meal and cooking oil, basic staples. Consumers naturally reacted with hostility, with serious rioting in the capital, and with renewed agitation for political change. There was an abortive coup, too.

But Zambia's crisis also mirrors that in Kenya. As President Kaunda's legitimacy as the founding father of his country has faded, the clamor for multiparty rather than single party rule has grown. The leading trade union wants more democracy. So do most Western-educated Zambians and university students. President Kaunda has hesitated to authorize a referendum in October on whether other parties will be permitted. His vacillations have further fueled discontent.

By letting the people decide whether or not the rule of one party is right for Zambia, President Kaunda may reign for a while longer. But if he continues to fear the kinds of democratic excesses that several parties might engender, and limits debate or curtails the referendum, a people ready for changes of all kinds might decide to oust its founder.

LIBERIAN PRESIDENT SAMUEL K. DOE

Robert I. Rotberg, president of Lafayette College in Easton, Pa., writes frequently on African politics.

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THE WASHINGTON TIMES, September 28, 1990

CHRISTOPHER MATTHEWS

At last, dealing with reality

The time is here for American liberals to revise strategy toward South Africa. Five years ago, I toured a country burned up with anger at a white government that would not change.

Now it has. Just as Soviet President Mikhail Gorbachev has changed the direction of the Soviet Union, another middle-aged lawyer named Frederik de Klerk has changed the direction of South Africa.

South Africa, though, is not yet either a democracy or a free society. Just like the Soviet Union, the outsider can condemn what remains of the old order and question the steps taken to date. What cannot be denied is the course of the changes. Incredible as it may have seemed five or 10 years ago, the Afrikaner is at last dealing with the demographic reality of a country of which the entire white community comprises only a sixth of the 28 million population.

The first big break came four years ago, when the ruling Nationalist Party of South Africa abdicated its right to white domination, dropping its national doctrine of "separate development" and accepting that of "power-sharing."

This February, the speed of change accelerated. With one stroke, Mr. de Klerk released Nelson Mandela from prison, legalized the African National Congress and agreed to talks on a new, democratic constitution.

In Washington this week, Mr. de Klerk admitted the deep-felt concession that underlies these political steps.

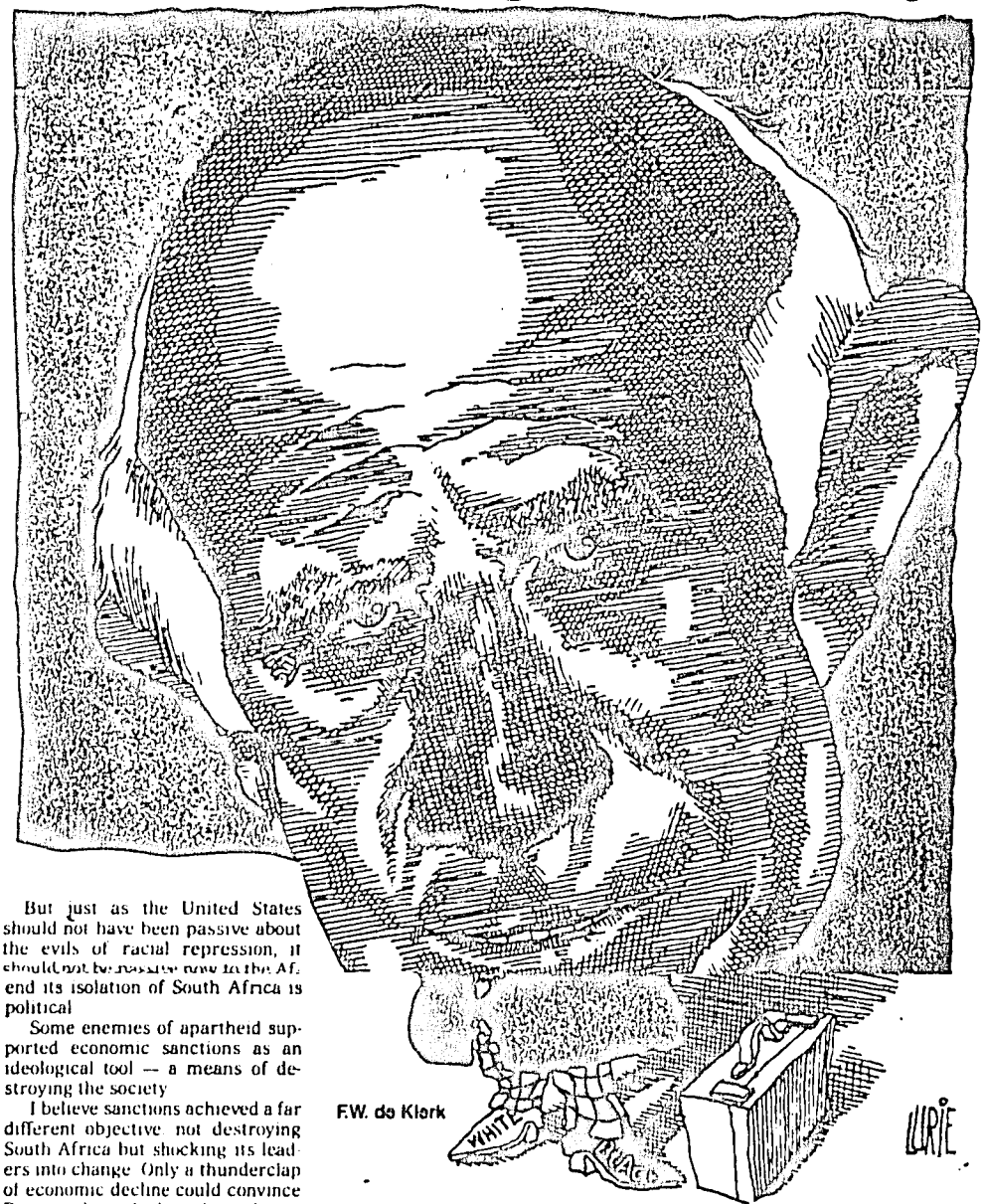
"We've come to accept that ours is not the privilege of the French or the Germans or the Dutch to numerically outweigh all the others sharing the same soil with us. That is not the privilege of the Afrikaner nation.

people are but a small, vulnerable minority.

We Americans can respond in two ways: reject them as "too little, too late," as some have done, or accept Mr. de Klerk's heroic changes as the basis of a new and positive relationship between our two countries.

I support the latter for the same reasons I supported a tough policy of economic sanctions prior to Mr. de Klerk's dramatic changes.

The first is moral. The United States should and could not have participated economically, socially or politically in a system that repressed six out of seven South Africans on the basis of race.



F.W. de Klerk

But just as the United States should not have been passive about the evils of racial repression, it should not be passive now to the Afr end its isolation of South Africa is political.

Some enemies of apartheid supported economic sanctions as an ideological tool — a means of destroying the society.

I believe sanctions achieved a far different objective: not destroying South Africa but shocking its leaders into change. Only a thunderclap of economic decline could convince Pretoria that it had no choice but to trade a sick political-economic system for a healthy one. The release of Mr. Mandela and other positive steps this year produced exactly the results many of us had hoped for. The sanctions did their job, morally as well as economically.

By raising the economic cost of apartheid, countries such as the United States made even conservative white South Africans see the economic dead end ahead. In this way, the West accelerated the political change that is the only hope for South Africa's future.

The United States needs to maintain the pace of change. We need to end sanctions on the same timetable President Bush has announced: The minute South Africa meets the two remaining conditions of the Comprehensive Anti-Apartheid Act of 1986 — freeing political prisoners and lifting the state of emergency.

However, rather than stand on the sidelines waiting for events to take their course in South Africa, Mr. Bush should put pressure on all parties, including Mr. de Klerk, to end the violence and get to the table.

The United States cannot afford to let the hands-off "constructive engagement" policy of the early 1980s be replaced by a 1990s policy of benign neglect. Our president needs to display in South Africa a bit of the world-class, hands-on diplomacy he's shown in the Persian Gulf.

Christopher Matthews, Washington bureau chief for the San Francisco Examiner, is a nationally syndicated columnist.

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THE WASHINGTON POST, September 27, 1990

William Raspberry

A Matter Of Time In South Africa

While South African President F. W. de Klerk was inside the White House, hoping to persuade President Bush that major change is underway in his country, 150 protesters were outside, hoping to make the point that, for South African blacks, very little has changed.

Both were right.

In terms of the prospects for racial peace and political justice, South Africa has made a quantum leap. As recently as a year ago, only die-hard optimists thought there was any chance of avoiding full-scale racial war. Today, everyone believes that, with a few timely concessions and a little luck, South Africa can finally dispose of apartheid and move to some negotiated arrangement for political power sharing.

The difference in outlook is largely attributable to two men: Nelson Mandela, who spent more than a quarter of a century as the world's most celebrated political prisoner, and de Klerk, who released him early this year.

Mandela has shown both the charisma and (surprisingly) the stamina necessary to unite the foes of apartheid, with the major exception of Zulu Chief Gatsha Buthelezi, with whom he has scheduled a meeting. De Klerk, in defiance of his country's powerful right wing, has made essentially all the concessions demanded by blacks as a necessary condition to negotiations.

Mandela and other major political prisoners have been released, the African National Congress and 32 other outlawed organizations have been unbanned. The official "state of emergency" remains an obstacle, but not an insurmountable one. Racial accommodation really does seem a reasonable prospect.

But for ordinary blacks in South Africa, little has changed. They remain powerless, largely propertyless and voteless. Their schooling and health care remain abominable, and their oppression by the white-run security forces continues unabated. They alone, among South Africa's racial groups, remain without representation in the government.

In addition, serious problems remain, including the recent kidnapping and assault charges against Mrs. Mandela, political opposition by right-wing whites and inter-tribal killings by blacks, particularly in Natal. Some of the killing is the result of long-standing animosity between Buthelezi's Inkatha and non-Zulus in the region, and some has been attributed to what has come to be called a "sinister third force"—presumably a malign conspiracy between racist elements of the security forces and their black stooges.

Still, it's hard not to believe de Klerk when he insists that the changes underway are "irreversible."

De Klerk, whose visit here is the first by a South African president since the 1946 visit of Jan Smuts, told a breakfast meeting of journalists that there is "a growing commitment by a growing number of leading figures in all spheres to a negotiation process from which must flow peaceful solutions, a broad consensus with regard to a new constitution and full participation within that new constitution."

For the first time, he implied his willingness to accept a one-man, one-vote arrangement, at least for the lower house of a bicameral legislature, though he naturally insists on political protections for the white minority.

He listed as the major remaining problems (aside from the country's shattered economy) the need for major investment in black education ("We need to build one new average-size school per school day"), the continuing internecine fighting between blacks in Natal and the debate over the form of the government and the shape of the economic system.

He indicated that he has no doubt that these problems can be resolved.

If they are, it will be because of the extraordinary character of de Klerk and Mandela, and the extraordinary bond between them.

Even while recently criticizing de Klerk for being less than candid with him regarding his internal opposition and the treachery of the defense forces, Mandela said he still regards de Klerk "as a man of integrity—and I think he feels the same way about me." "We have developed enormous respect for each other," he said, "and we talk very frankly. I can call him at any time. I can get him out of bed or pull him out of cabinet meetings. We have that kind of personal relationship."

That personal relationship, which de Klerk also described to journalists this week, may be the key to South Africa's racial dilemma.

The unanswerable question, about which de Klerk is known to worry, is whether this odd couple has the time to work things out.

As de Klerk recently told a European visitor, he has only three years before he has to face his party (and little likelihood that he would be reelected), and Mandela, 72 years old and ailing, may not have much longer than that to live.

His poignant conclusion: there's no time for the temporizing and game-playing that has marked previous regimes if South Africa is to save itself.

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De Klerk Is No Hero to Me

By Randall Robinson

WASHINGTON

As President Bush welcomed South Africa's President F. W. de Klerk, to the White House yesterday, I hope I wasn't the only one asking "What's wrong with this picture?"

In extending a friendly handshake to Mr. de Klerk, Mr. Bush set an important precedent: He became the first U.S. President to meet the highest representative of a society organized on the principles of segregation and brutal racial exploitation.

Mr. de Klerk's public relations team has worked hard to portray him as a crusader for reasonable and moderate change, a patient and well-intentioned man. And the Bush Administration has at times appeared eager to accept exaggerated claims of progress and reform.

The reality is that little has changed under the de Klerk Government. In some respects, things have gotten much worse.

While Mr. de Klerk tours Washington, his nation is gripped in a spasm of violence. Over the last six weeks, more than 800 black South Africans have been killed in what the U.S. press usually describes as "factional" or "tribal" violence.

In fact, this violence is directly rooted in the apartheid system Mr. de Klerk's Government still maintains. There is also convincing and disturbing evidence that security forces under Mr. de Klerk's control have permitted, and even participated in, most of this "factional" strife.

Some of the fighting is an outgrowth of a political rivalry between elements of the African National Congress and supporters of Inkatha, the Zulu organization headed by Chief Mangosuthu Gatsha Buthelezi. But Chief Buthelezi and Inkatha have themselves been permitted to amass power, often by intimidation, with the direct collusion of Mr. de Klerk's Government. Indeed, the last six weeks of escalating violence coincide almost to the day with Chief Buthelezi's announced intention to expand his power beyond his Natal base.

Eyewitness accounts of police participation or acquiescence in Inkatha violence are far too numerous to discredit. In Natal, the police openly side with Inkatha, usually intervening well after Chief Buthelezi's thugs have attacked and retreated.

A recent report by the Geneva-based International Commission of Jurists concluded that "the police are seen as both player and referee, and in some cases their conduct has been violent and cruel." Another report, issued in Pretoria in August by the Government-appointed Goldstone Commission, has lent further credence to reports of police collusion with Inkatha. The commission found that police sometimes failed to stop attacks that they had advance knowledge of, and that they often failed to disarm Inkatha members.

The latest revelations of a "hidden hand" or "third force" implicate security forces as well. Numerous affidavits from journalists and South African citizens detail attacks in which white men wearing hoods, or with faces blackened with soot, have participated in the fighting. Whites have been seen shooting from minibuses and directly participating in the hacking deaths of innocent bystanders. Whites have been spotted assisting Inkatha vigilantes in attacks on townships, in brutal massacres on a moving train and in the razing of a squatter settlement.

> He has done little for blacks, and he tolerates the violence.

In response, Mr. de Klerk has initiated "Operation Iron Fist," a response that calls to mind those of his predecessors: blacks' civil liberties are suspended, troops are sent to black residential areas, townships are enveloped in razor wire.

These sad and bloody scenes are the proper backdrop for the image of F. W. de Klerk in the White House. We hope that President Bush clearly expresses to Mr. de Klerk our nation's disgust at apartheid, and our insistence on its dismantlement.

Americans believe in Nelson Mandela's message of "sanctions until democracy" and in the fundamental sense of justice and fair play so manifestly offended by the de Klerk Government. These beliefs should not be swayed by the South African's much-coveted photo opportunity with President Bush.

Mr. de Klerk must seek an end to the violence sweeping his country. He must make genuine and irreversible progress toward dismantling apartheid. And he must pursue these objectives through concrete steps at home, not through smiles and handshakes in foreign capitals. □

Randall Robinson is executive director of TransAfrica, a foreign-policy lobbying group.

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Support for Microenterprises: Lessons for Sub-Saharan Africa

By Maryke Dessing

ABSTRACT

World Bank Technical Paper #122
Africa Technical Department Series

Microenterprises play an important role in Sub-Saharan Africa; they account for a sizeable part of the economic, in providing employment and means of livelihood for much of the nonagricultural population. Concerns about reversing the economic decline call for new and creative ways for making best use of this resource for building a strong economic base and achieving social integration. However, it is difficult to devise effective strategies for developing microenterprises because of their small size, dispersed location, and informality.

Two main strategies are conceivable for supporting microenterprises: they can be loosely characterized as a top-down/indirect approach and a bottom-up/direct approach. The first strategy, the top-down approach, seeks to improve the business environment by operating on macroeconomic variables such as prices, government regulations and policies, and by building up the physical infrastructure. Microenterprises have specific needs in this respect which should be taken into consideration more fully. The second strategy, the bottom-up approach, aims at supporting microenterprises directly by mobilizing indigenous resources and with the active participation of beneficiaries. The real challenge is to strike a proper balance between these two approaches which complement and enhance each other.

This paper is the result of a survey of the literature and extensive discussions with practitioners and its primary focus is the direct approach in support to microenterprises. One model that has proven extremely successful combines the so-called minimalist and process approaches, and involves gradually broadening the scope of the assistance program on the basis of self-assessment of needs by participants in order to remove one bottleneck at a time. The effectiveness of this model is enhanced where there exists a tradition of family business and cottage industry.

Perhaps the simplest objective to pursue is access to credit, particularly in more commercial and industrial environments and for established entrepreneurs, but success in this area can nonetheless be exceedingly difficult to achieve. The main lesson from experimentation in this field is that the poor are bankable and can be served relatively inexpensively, provided nontraditional lending methods are utilized such as group-lending where clients join in groups and assume responsibility for selection and credit repayment. Important components of financial assistance programs are savings mobilization, and the linking of formal financial agencies with informal financial institutions which offer quick and flexible unsecured lending to serve a multitude of purposes.

Technical assistance and support services can be provided to help first-time entrepreneurs set up their own business, to assist microenterprises in their daily business, or to help them graduate to a larger size. The latter type of intervention is the most common. However, its scope is limited by the fact that most microenterprises will never graduate, largely because horizontal diversification is an important risk-spreading strategy. The main challenge is to provide relevant technical assistance and support services. Self-

identification of assistance needs by participants helps enhance the relevance of the services provided, and reduces the cost of such projects.

Entrepreneurship and self-employment development programs aim at translating a business idea into a viable venture. The tendency of existing programs is to focus on the creation of small modern businesses, on the basis of the somewhat arbitrary distinction between self-employment and entrepreneurship. Also, they tend to focus on individual enterprises and their vertical expansion, rather than on the business community upon which these enterprises depend. Thriving business communities are, and have historically been, a major factor in enabling some enterprises to successfully reach the next scale of operation or to venture in new trades. The discussion on entrepreneurship and self-employment development restricts itself to conceptual aspects of such programs and does not delve into technical questions of training materials and courses.

The task of reaching microenterprises requires small, flexible, and responsive organizations, with sufficient autonomy to make *ad hoc* decisions, yet with adequate coordination at the national level. Therefore, a main device for reaching microenterprises is to institute a two-tier arrangement with specialized resource institutions. Different types of organizations can be used imaginatively as intermediaries in such a scheme, on the basis of their respective characteristics and the (multiple) purposes they serve. Such organizations include PVOs, NGOs, cooperatives, banks, business associations, churches, and women's groups. In this respect, cooperation with NGOs could be greatly facilitated through longer term commitments by donors, clearly defined appraisal criteria, and early reconciliation of the social objectives of NGOs and of the assistance program's requirements for economic efficiency.

Capacity building of the intermediary should be incorporated as an explicit objective of microenterprise support programs and be budgeted for. The objective is to establish viable support institutions, in order to enhance the effectiveness of tier arrangements and the quality of the services provided. Shifting the focus of assistance from beneficiaries to support institutions can be a very effective way of reaching the most marginal groups, particularly for large international donor agencies such as the World Bank.

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EXECUTIVE SUMMARY

Irrigation in Sub-Saharan Africa: The Development of Public and Private Systems

By Shawki Barghouti and Guy Le Moigne

The seven papers which are included in this publication have been prepared in an attempt to provide background information and guidance to those who are designing agricultural strategies and irrigation investment projects for Sub-Saharan African (SSA) countries. Specifically, it seeks to clarify the role which irrigated agriculture might play in these strategies and how that role can be effectively realized. It reviews problems which have arisen in past attempts to expand irrigated agriculture in SSA as well as examples of successful irrigation development, and proposes considerations for future design and implementation based on the lessons of the past.

The Physical Potential for Irrigation Development

Several of the papers stress the potential importance of irrigated agriculture in a continent where rainfall is frequently marginal and erratic, or confined to a limited portion of each year. The total physical potential for expanding irrigation in SSA is examined in Chapters 2, 3 and 4 with the conclusion that the 5 million hectares presently under irrigation, equal to 2 percent of the presently cropped area in SSA, could eventually be expanded to about 20-25 million hectares. While this potential is less per capita than in Asia or Latin America, it nevertheless represents a substantial potential increase in agricultural output since yields on irrigated land average three and one half times those from rainfed farming. The countries with the largest physical potential for expansion are Angola, Zaire, Sudan, Mozambique, Tanzania, Nigeria, the Central African Republic and Chad, according to a 1985 FAO study, although irrigation could play an important subsidiary role in many other SSA countries.

Past Problems in Irrigation

A number of the papers describe the problems encountered in past irrigation strategies and projects. While about 75 percent of all SSA irrigation projects reviewed in a recent Bank study achieved or exceeded the expected rate of economic return, some major projects failed.

Cost Overruns are a fairly frequent cause of reduced rates of economic return. The commonly held view that irrigation installation costs per hectare are higher in SSA than in other areas of the world is examined in several of the papers; the conclusion is that with adequate planning and careful design, costs should be no higher in Africa than elsewhere.

Institutional factors are cited as the basis for deteriorating maintenance and declining output from large scale public irrigated schemes. The widespread decline in the effectiveness of public institutions in Africa has had its effect on these systems as well.

The policy environment for irrigation is cited in Chapters 3 and 7 as an important determinant of the success or failure of individual projects, including the availability of inputs, adequate budgetary resources, accessible markets, reasonable producer prices, and an adequate physical infrastructure. These conditions frequently are not met in SSA, although conditions may be improving in countries undertaking structural adjustment reforms.

Technical design issues can also lead to failures if improper choices of location or design are made.

Cultural factors are cited in several of the studies as an important determinant of project success or failure, although several instances of successful transitions from pastoral communities to irrigated farming are mentioned.

Environmental problems resulting from expanded irrigation are described in Chapter 4. These include the increased incidence of disease, especially schistosomiasis and malaria, and the reduction in size of floodplains and swamps with its impact on fishing, wildlife and cultivation at the edges of these areas.

Past Successes in Irrigation

A pervasive theme which emerges from a number of the papers is the relatively successful record of small scale private irrigation systems in contrast to the spotty record of large scale public schemes. Chapters 1 and 3 elaborate on the reasons for this difference, and Chapter 8 presents interesting examples of successful small scale irrigation strategies in three SSA countries.

Several of the papers point out that small scale irrigation has certain design and institutional limitations and may not always be the correct solution in every case. But the evidence is clear that where applicable, the chances of successful irrigation development are greatly enhanced when small scale private systems can be used.

Suggestions for How to Proceed

Chapter 1 outlines twelve general factors to take into account in the design of private sector irrigation projects, including choice of technology, defining the role of government and the possible need for regulation, institutional arrangements, land tenure, and the general macro-economic setting.

Chapter 3 provides information regarding the basis of choice for selecting alternate systems for water supply, conveyance, and field application, concluding that privately owned pumps and small scale tank irrigation systems are usually the most appropriate for SSA conditions. Chapter 3 also suggests a "growth centers" strategy where irrigated areas with high potential and reasonable infrastructure could be linked to other more backward areas in an expanding network.

Chapters 4, 5, 6 and 7 make recommendations regarding the measures that need to be taken when expanding investment in irrigation in order to improve the prospects for success. Chapter 4 stresses the need to improve the data base, rehabilitate existing systems, conduct research and carry out pilot projects to test new technologies, improve cultivation practices, put more emphasis on planning and monitoring water studies, and take into account environmental and social factors. Chapter 5 stresses the need for a carefully formulated irrigation subsector strategy and the need to develop institutional capacity for analyzing, formulating and managing the subsector programs.

Chapter 6 stresses that irrigation schemes should not be too large for the development environment, the importance of an integrated approach, keeping capital costs at a reasonable level, cost recovery policies conceived and agreed in advance, and technology

appropriate for the African scene. Chapter 7 stresses the need to assure both a favorable policy environment and careful project preparation and management.

Summary

Taken together, the papers make a strong case for the important role which irrigated agriculture can and should play in SSA's future development. The actual possibilities will vary considerably by country, and careful project choices and designs will be needed to avoid the mistakes of the past. But each country agricultural strategy should consider what role irrigated agriculture can play in a given situation, with special emphasis on the prospects for small scale private irrigation systems where the best results have been achieved in the past.

Reconstruction in Afghanistan, Indochina, Central America, Southern Africa, and the Horn of Africa

AFTER THE WARS

Anthony Lake and contributors

After a decade or more of fighting and destruction in various regions of the world, new policies in Washington and Moscow as well as fatigue on the ground are producing openings, at least, for peace. Negotiations are at different stages regarding Afghanistan, Indochina, Central America, Southern Africa, and the Horn of Africa—but all share new possibilities for peace.

This volume analyzes the prospects for postwar reconstruction and development in these regions, tackling the difficult quandaries they face individually and collectively: Among realistic potential alternatives, what kinds of new political structures can best manage postwar reconstruction and development? Which economic policies would be most effective in maintaining peace and political coalitions? Should the focus be on the reconstruction of prewar economic life or on creating new patterns of development? What are the prospects for democracy and human rights?

The authors thus consider the relationship of economic planning and likely political realities. For example, might diplomats seeking to stitch together a fragile coalition in order to end the fighting also be creating a government that cannot make the hard economic choices necessary for sustained peace? Might economists calling for postwar economic programs which are theoretically sound but politically unsustainable threaten a tenuous peace?

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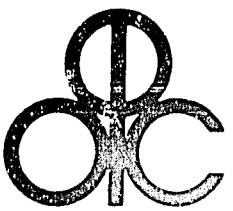

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U.S. DEPARTMENT OF STATE

Office of the Assistant Secretary/Spokesman

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July 31, 1990

STATEMENT BY
SECRETARY OF STATE JAMES A. BAKER, III
AT THE
ASIA-PACIFIC ECONOMIC COOPERATION MEETING

APEC PARTNERSHIP FOR EDUCATION

Tuesday, July 31, 1990
Singapore

Today, I would like to announce an American initiative that will expand our ties and bonds across the Pacific. The initiative is in the area of human resources development -- specifically, education. As President Bush has made clear, education is a critical building block for a more tolerant, democratic society -- domestically and globally. We believe that investing in education is investing in the future. Education is vital to the continued growth and prosperity of the APEC region.

As many of you know, the United States has in fact a comparative advantage in higher education. We have been an education magnet. Far more foreign students are enrolled in universities in America than in any other country. Some 350,000 foreign students were enrolled in U.S. universities in 1986 and over half of those students were from East Asia and the Pacific.

We have learned throughout our history that effective education requires a partnership of both the public and private sectors. The private sector is especially important because it offers resources and provides a "real life" classroom for training the business leaders of tomorrow.

To enhance educational links across the Pacific, I am pleased to announce today the "APEC Partnership for Education." This Partnership will include the U.S. and other interested APEC governments, educational institutions throughout the region, and private enterprises.

This program will have three components: First, support for educational partnerships between American and other APEC institutions in science, engineering, business, and management; Second, widening of private sector internships and other outreach programs for APEC students studying in the U.S.; and Third, expansion of U.S. Government-sponsored private sector training programs in the U.S. and in APEC member countries.

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Our overall objective is to help train the trans-Pacific leaders of the next century through expanded educational opportunities. Over the next five years, we aim through the Partnership to:

- Establish 10-15 partnerships between leading U.S. educational institutions and their APEC counterparts;
- Involve a minimum of 20,000 Asia-Pacific students studying in the United States directly in on-campus activities sponsored by the Partnership -- such as specialized courses and seminars focused on the particular needs of the region;
- Enroll 5,000 of those students in private sector internships and cooperative education programs;
- Train 2,500 Asian private sector employees in their countries and, from this number, select 500 for additional short-term courses in America; and
- Reach more than half of the almost 200,000 Asia-Pacific students in the United States through newsletters and other outreach channels that will keep them current on Partnership-sponsored activities and events.

The APEC Partnership for Education will emphasize the various programs of the Agency for International Development and the United States Information Agency. Both are very active across the region in solidifying society-to-society ties. These agencies fund a variety of scholarship activities, including the Fulbright program, and support university linkages, international visitor and youth exchanges, and other programs.

Combined private and public sector resources should reach $30 million over the next five years. We have already had preliminary contacts with U.S. academic institutions which have reacted with great interest. Other APEC members may want to join us with parallel programs.

We look forward to discussing with you our ideas for an APEC Partnership for Education at the next session of the Human Resources Working Group.

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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 BY CLAYTON YEUTTER SECRETARY OF AGRICULTURE TO THE AMERICAN CHAMBER OF COMMERCE

Hong Kong
August 17, 1990

It is a pleasure for me to visit this vital Pacific Rim market that serves as a beacon for all of us who believe in the benefits of free trade. I also welcome this opportunity to discuss the goals of our U.S. agricultural trade policies. Put simply, those goals are to resolve multilateral trade issues by working through the General Agreement on Tariffs and Trade (GATT) to create freer and fairer trade for everyone -- exporters and importers alike. In short, to have an open, world trading system as exemplified here in Hong Kong.

Hong Kong never fails to amaze visitors, whether it is their first visit or an oft-repeated one. It is indicative of this city-state's importance as a trading partner that, though halfway around the world from the U.S., and with only 5.8 million people, Hong Kong is our 15th largest individual market for American agricultural exports.

Although U.S. farmers and food processors may be a great distance away, the United States stands as the second largest supplier, after China, of agricultural products to Hong Kong.

U.S. agricultural products have done very well here in the past decade. Our market share of Hong Kong's food purchases has increased from 13 percent in the early 1980's to nearly 20 percent this year. It is particularly noteworthy that the already significant U.S. agricultural trade to Hong Kong jumped 26 percent in 1989 -- to $615 million.

This, more than anything else, tells us that we have become a valued and reliable agricultural supplier to this marketplace. It is a trust we hope to build on in the years ahead -- well beyond 1997.

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While we are proud of our farms -- and farmers -- back home, much of the overall success of our export efforts stems from the untiring work here in Hong Kong by the many United States Department of Agriculture market development cooperators active in this market. In 1990 alone, about 30 market development cooperators and allied organizations will carry out nearly 300 activities in this local market, to strengthen the daily ties between American agricultural producers and Hong Kong consumers.

If we pause to ask ourselves why these people are so willing to put so much effort into this market, the answer is readily apparent. There are few nations in the world that come as close to embodying the principles of free trade as does Hong Kong. Indeed Hong Kong is virtually a model of the open economy that so many others profess to be working toward. People wanting to sell American food products come here because they can get results; they are unhampered by trade-distortive government import policies.

Hong Kong is not only a model of free trade, it is a living testimony for it. Hong Kong's real gross national product has increased tremendously over the last two decades. It has brought its people the second highest per capita gross domestic product in Asia. This growth has been unmistakably driven by trade.

Some of our trading partners in the GATT who want to retain trade-restrictive agricultural policies ought to come here and take a closer look at the economic potential they are precluding by not moving to promote freer trade.

On a related matter, the U.S. recognizes that Hong Kong's trade future depends heavily on China, a close neighbor. As you know, President Bush has recommended that the United States' MFN treaty with China be extended for another year. We at USDA have supported that recommendation because we realize how essential that status is to current business relations involving Hong Kong, China, and the United States. China is also the largest export market for U.S. wheat.

Because of the importance of trade to countries around the world, the time has come for the United States, Hong Kong, and others to resolve fundamental trade problems. That is why we in the U.S. have intensified our efforts in the Uruguay Round of the GATT to bring about trade reform in agricultural products.

Agriculture is an especially difficult challenge in the GATT negotiations. The world agricultural trading system is currently characterized by constant bickering, protectionist pressures, and pervasive trade distortions. It's time to move beyond all that.

Achieving a world trading system in which farmers around the world can compete freely and fairly is one of the United States' top trade policy priorities. And the quickest way to achieve this goal is through the Uruguay Round -- which is rapidly drawing to a close. It's scheduled to be completed by mid-December of this year, and there's recently been some progress that we hope will move the agricultural talks off dead center.

Last month the Chairman of the Negotiating Group on Agriculture presented the GATT member nations with a draft framework agreement on agricultural trade reform. Four areas -- market access, export subsidies, internal farm support programs, and sanitary and phytosanitary standards -- were covered. In that last area -- sanitary and phytosanitary regulations and barriers -- an actual draft agreement has been developed.

The Chairman's proposal has now been adopted as the means for intensifying negotiations for fundamental reform in agriculture. GATT nations have agreed that such reform holds the key to successful conclusion of the Uruguay Round negotiations.

Such an agreement would provide room in the world market for agricultural exports from efficient producers to increase dramatically. Major food importers, such as Hong Kong, would gain from increased stability in world markets and security of supply.

Gains in the GATT multilateral negotiations also would give added meaning to the Bush Administration's policy of continuing support for the long-term trade relationship between Hong Kong and the United States.

But if the Uruguay Round is to move ahead, we must use the profile agreement put forward by the Agricultural Negotiating Group Chairman in Geneva as a basis for defining solutions. While the U.S. negotiators have reservations about some areas of the de Zeeuw paper, we also feel there is much in it that all GATT nations can embrace -- solutions that give no one an unfair advantage.

The world's nations cannot afford to ignore the necessity of quickly reaching an agricultural trade resolution in the GATT. Unless we achieve multilateral agreement to reform agricultural trade -- soon -- we will face a very real danger of escalating trade disputes.

Regardless of what happens in the Uruguay Round, agricultural production and trade policies will change -- in the United States and in other countries. The question is whether collectively we will choose to guide that change in a constructive way, or whether we will simply let it occur capriciously, responding only through crisis management and tit-for-tat measures that often do more harm than good.

We welcome Hong Kong's continued support for expanded trade liberalization through the GATT talks. The United States appreciates the fact that Hong Kong has been such an active and constructive participant in the Uruguay Round. At the same time, Hong Kong deserves special recognition for demonstrating that truly open markets can bring continued growth and prosperity for all its citizens.

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September 18, 1990
Manila, Philippines

16. BEGIN TEXT ARMITAGE STATEMENT. SECRETARY MANGLAPUS, SECRETARY BENGZON, DISTINGUISHED MEMBERS OF THE PHILIPPINE DELEGATION, COLLEAGUES AND FRIENDS, CITIZENS OF THE PHILIPPINES:

17. ON BEHALF OF THE AMERICAN DELEGATION I THANK YOU FOR THE WARMTH OF YOUR WELCOME. IT IS INDEED A PLEASURE TO RESUME OUR DELIBERATIONS WITH FILIPINO COLLEAGUES WHOSE PATRIOTISM, PROFESSIONALISM AND GOODWILL LEND A GREAT SENSE OF DIGNITY AND A SOUND SERIOUSNESS OF PURPOSE TO THESE PROCEEDINGS. AS REPRESENTATIVES OF THE DEMOCRATIC GOVERNMENT OF PRESIDENT AQUINO, YOU REPRESENT THE FILIPINO PEOPLE. AND, NEEDLESS TO SAY, THIS DEMOCRATIC GOVERNMENT ENJOYS THE FULL SUPPORT OF THE UNITED STATES.

18. I HAVE BEEN INSTRUCTED BY THE PRESIDENT OF THE UNITED STATES TO SEEK A NEW AGREEMENT WITH THE REPUBLIC OF THE PHILIPPINES CONCERNING U.S. FACILITIES ON PHILIPPINE MILITARY BASES. MY CHARTER FROM THE PRESIDENT HAS, QUITE NATURALLY, CAUSED ME TO CONCENTRATE MY ATTENTION ON THE DEFENSE ASPECT OF OUR BILATERAL RELATIONSHIP. I WISH TO ACKNOWLEDGE, HOWEVER, BOTH THE TRUTH AND PERTINENCE OF THE POSITION ADOPTED BY PRESIDENT AQUINO AND HER VERY ABLE FOREIGN SECRETARY: THAT THE RELATIONSHIP BETWEEN OUR COUNTRIES AND PEOPLES CANNOT, SHOULD NOT AND WILL NOT BE ARTICULATED SOLELY OR EVEN PREDOMINANTLY IN TERMS OF MILITARY BASES AND MUTUAL DEFENSE. WE ARE PROUD, FOR INSTANCE, TO BE YOUR LARGEST TRADING PARTNER AND INVESTOR. WE ARE EAGER TO SEE THE PHILIPPINES TAKE OFF ECONOMICALLY. WE ARE GRATEFUL FOR CONTRIBUTIONS FILIPINOS HAVE MADE TO OUR OWN DEMOCRACY AND WE HOPE THAT DEMOCRATIC INSTITUTIONS CONTINUE TO MATURE HERE. IN SHORT, IT IS NOT APPROPRIATE, PERMISSIBLE OR EVEN FEASIBLE FOR AMERICANS TO REGARD THE PHILIPPINES MERELY IN TERMS OF MILITARY GEOGRAPHY. TO THE EXTENT THE PHILIPPINE SIDE BELIEVES IT IS USEFUL TO TRY TO INTEGRATE OTHER ASPECTS OF OUR RELATIONSHIP, IN ADDITION TO ITS DEFENSE DIMENSION, INTO A BROAD AGREEMENT, WE WILL DO OUR LEVEL BEST TO ACHIEVE THIS WITH YOU.

19. MUCH HAS BEEN SAID AND WRITTEN ABOUT THE HARD CHOICES FACED BY THE PHILIPPINES CONCERNING THE FUTURE OF U.S. FACILITIES ON PHILIPPINE MILITARY BASES. MY OWN READING OF HISTORY, PARTICULARLY THE COMPLEX HISTORY OF PHILIPPINE-AMERICAN RELATIONS, REINFORCES IN MY OWN MIND THE DIFFICULTIES FACED BY FILIPINOS AS THEY TRY TO SORT THIS OUT AND DO WHAT IS RIGHT FOR THEIR COUNTRY. I BELIEVE THAT MOST FILIPINOS, NOTWITHSTANDING THE UPS AND DOWNS OF OUR 92-YEAR RELATIONSHIP, LIKE AMERICANS AND RESPECT THE UNITED STATES. BY THE SAME TOKEN, AMERICAN FRIENDSHIP AND RESPECT FOR THE PHILIPPINES RUN DEEP. WE SHARE A DEMOCRATIC HERITAGE, AND AMERICA'S SUPPORT FOR DEMOCRATIC GOVERNMENT IN THE PHILIPPINES WILL NOT WAIVER. YET THOSE SENTIMENTS DO NOT NECESSARILY ANSWER OR REMOVE THE QUESTION

20. IT IS OBVIOUS THAT THIS QUESTION WILL NOT AND CANNOT BE DECIDED BY THE U.S. SPECIAL NEGOTIATOR. ALL I CAN DO IS ACKNOWLEDGE, OUT OF RESPECT FOR THE COMPLEX HISTORY THAT BINDS OUR TWO PEOPLES, THAT THE QUESTION IS INDEED A FAIR ONE. I CAN ONLY SUGGEST THAT THE ANSWER WILL, IN THE END, BE DICTATED IN THE MAIN BY THE ISSUE OF SOVEREIGNTY. I DO NOT BELIEVE ANY CITIZEN OF THIS COUNTRY COULD ACCEPT A PHILIPPINE-U.S. MILITARY RELATIONSHIP INCONSISTENT WITH THE SOVEREIGNTY OF THE PHILIPPINES.

21. SOVEREIGNTY, IN MY VIEW, IS AS MUCH AN ATTITUDE, A STATE OF MIND, AS IT IS AN EMPIRICAL FACT. ALTHOUGH ONE DICTIONARY DEFINES THE WORD AS "ENJOYING AUTONOMY, INDEPENDENT, SELF-GOVERNING," NO NATION IS LITERALLY SOVEREIGN IN THE SENSE THAT IT CAN ACT, EVEN WITHIN ITS OWN BORDERS, WITHOUT ANY REFERENCE OR REGARD WHATSOEVER TO OTHER NATIONS. INTERNATIONAL LINKAGES OF COMMUNICATIONS AND COMMERCE MAKE NATIONAL BOUNDARIES LESS IMPENETRABLE THAN THEY MIGHT HAVE BEEN A CENTURY AGO. IN THIS CENTURY, AMERICA'S RELATIVE ISOLATION FROM THE OUTSIDE WORLD HAS BEEN TRANSFORMED TO AN INUNDATION OF IDEAS, GOODS, SERVICES AND SOCIAL DEVELOPMENTS THAT WE AMERICANS HARDLY EVEN THINK TO LABEL AS FOREIGN. YET THESE TIES THAT BIND THE UNITED STATES ACROSS THE SEAS, TIES WE WOULD LOOSEN ONLY AT OUR PERIL, IN NO WAY UNDERMINE OUR BEDROCK BELIEF THAT WE ARE MASTERS IN OUR OWN HOUSE.

22. FOR ALL COUNTRIES THE PRINCIPLE IS EXACTLY THE SAME. TO THE EXTENT THAT FILIPINOS DO NOT BELIEVE THEMSELVES TO BE MASTERS IN THEIR OWN HOUSE, AND TO THE EXTENT A U.S. MILITARY PRESENCE ACCOUNTS FOR THAT BELIEF, IT WOULD SEEM TO BE INCUMBENT ON THE LEADERS OF THIS COUNTRY TO DO SOMETHING ABOUT IT. I KNOW THIS IS A MATTER OF SERIOUS DEBATE WITHIN THE PHILIPPINES, AND I WILL NOT PRESUME TO SUGGEST HOW IT SHOULD BE RESOLVED. WHAT IS CRYSTAL CLEAR TO ME IS THAT IF WE AGREE UPON A RELATIONSHIP PROVIDING FOR SOME MEASURE OF U.S. MILITARY PRESENCE ON PHILIPPINE BASES, THE NEW RELATIONSHIP WILL, BY DEFINITION, EXPLICITLY ACKNOWLEDGE THE FILIPINOS AS MASTERS IN THEIR OWN HOUSE. A LESSER RESULT IS NOT EVEN OPEN FOR DISCUSSION. THE VERY FACT THAT YOUR DEMOCRATICALLY ELECTED GOVERNMENT WILL CHOOSE WHETHER OR NOT U.S. FORCES WILL REMAIN IS, IN AND OF ITSELF, A CELEBRATION OF INDEPENDENCE AND SOVEREIGNTY. THE VERY FACT THAT YOU CAN CHOOSE WHETHER OR NOT TO REMAIN AN ALLY OF THE UNITED STATES AND AN EQUAL PARTNER IN MAINTAINING REGIONAL PEACE AND SECURITY SHOULD BE EVIDENCE ENOUGH OF AUTONOMY, INDEPENDENCE AND SELF-GOVERNMENT. THAT WHICH IS CHOSEN IS BUT A DETAIL -- ALBEIT AN IMPORTANT ONE -- OF FOREIGN POLICY.

23. REGARDLESS OF HOW THESE DISCUSSIONS TURN OUT, TOGETHER WE SHOULD HONOR AND REAFFIRM THOSE ASPECTS OF OUR SHARED HISTORY IN WHICH WE CAN BOTH TAKE PRIDE, AND JETTISON THOSE ELEMENTS OF OUR COMMON LEGACY THAT ONLY PROMOTE ILL-WILL AND MISUNDERSTANDING. FRIENDSHIP BETWEEN THE PHILIPPINES AND THE UNITED STATES IS WHAT MUST LAST, AND FRIENDSHIP CAN ONLY EXIST IN THE CONTEXT OF EQUALITY, MUTUAL RESPECT, AND ABOVE ALL, SELF-RESPECT.

24. IN ITS DEALINGS WITH THE UNITED STATES IN THE TWENTIETH CENTURY, THE PHILIPPINES HAS CHOSEN A COURSE OF EVOLUTION INSTEAD OF REVOLUTION. THIS EVOLUTIONARY PROCESS CONTINUES TODAY. YOUR PATIENCE, STEADFASTNESS AND, ABOVE ALL, YOUR FRIENDSHIP AND LOYALTY IMPOSE UPON THE UNITED STATES THE DUTY TO HELP INSURE THAT FILIPINOS IN THE TWENTY-FIRST CENTURY FEEL PROUD OF THE COURSE CHARTED BY THEIR COUNTRYMEN IN THIS CENTURY. WE HAVE NO OPTION BUT TO TAKE THIS DUTY SERIOUSLY, FOR WHAT IS AT STAKE IS NOTHING LESS THAN THE FUTURE OF OUR RELATIONSHIP AS NATIONS AND PEOPLES.

25. IT IS CLEAR TO ME THAT THE DAYS OF A VERY LARGE PRESENCE OF U.S. SAILORS AND AIRMEN IN THE PHILIPPINES ARE COMING TO AN END. WHAT REMAINS FOR US TO DETERMINE IS THE RATE AT WHICH THIS PRESENCE WILL BE REDUCED AND THE NATURE OF THE SECURITY RELATIONSHIP OUR TWO GOVERNMENTS WISH TO PURSUE DURING AND AFTER THIS TRANSITIONAL PERIOD.

26. I BELIEVE THAT EVEN THE MOST ARDENT OPPONENTS OF THE U.S. PRESENCE ON YOUR BASES WILL AGREE, IF ONLY PRIVATELY, THAT A SUDDEN LIQUIDATION OF THAT PRESENCE CAN ONLY BE DESTRUCTIVE. IN THE HERE-AND-NOW OF PEOPLE TRYING TO EARN A LIVING AND COUNTRIES TRYING TO ADJUST TO A CHANGING WORLD, THE DIFFERENCE BETWEEN, SAY, TWELVE MONTHS AND TWELVE YEARS ARE MONUMENTAL. THE PHILIPPINES AND THE U.S. HAVE BUT ONE OPPORTUNITY TO MAKE, VOLUNTARILY, SUCH A FUNDAMENTAL RESTRUCTURING OF THIS VITAL RELATIONSHIP. LET US TAKE TIME TO DO IT RIGHT. LET US BE YOUR PARTNERS IN MANAGING THE CHANGES.

27. LET US GIVE THE FILIPINO EMPLOYEES AT THESE FACILITIES ADEQUATE TIME TO ADJUST TO NEW CIRCUMSTANCES WHILE AT THE SAME TIME TAKING INTO ACCOUNT U.S. REGIONAL RESPONSIBILITIES. LET US GIVE THE ARMED FORCES OF THE PHILIPPINES ADEQUATE TIME TO DEAL WITH THE INSURGENCY AND TAKE ON GREATER RESPONSIBILITIES FOR THE TERRITORIAL DEFENSE OF THIS REPUBLIC AS WELL AS A GREATER VOICE IN THE SECURITY OF THIS REGION OF THE WORLD.

28. EQUALLY, LET US GIVE THE U.S. MILITARY APPROPRIATE TIME TO RESTRUCTURE, AND GIVE THE FILIPINO BUSINESS COMMUNITY ADEQUATE TIME TO REPLICATE THE MANAGEMENT OF SOME OF THE VITAL SERVICES PERFORMED BY THESE FACILITIES. BUT DO SO IN A WAY WHICH DOES NOT PENALIZE YOUR AMERICAN ALLIES. LET US GIVE OUR FRIENDS IN THIS REGION ADEQUATE TIME TO ADJUST TO A WORLD IN WHICH SUPERPOWER RIVALRY IS BEING REPLACED, IT SEEMS, BY THE PROLIFERATION OF REGIONAL POWERS SEEKING DOMINATION OF THEIR RESPECTIVE NEIGHBORHOODS.

29. WHEN THE TRANSITION IS COMPLETE, AND THE NEW FILIPINO-AMERICAN PARTNERSHIP HAS GRADUATED FROM THE NEGOTIATING TABLE TO A FULLY DEVELOPED REALITY, LET US BEQUEATH ONE FINAL BLESSING ON THE GENERATION OF CITIZENS IN BOTH COUNTRIES WHO WILL INHERIT THE FRUITS OF OUR LABOR, FOR BETTER OR WORSE. LET THE ELECTORATE OF THE 21ST CENTURY DECIDE WHETHER OR NOT THEY BELIEVE A CONTINUED U.S. PRESENCE WILL BE HELPFUL.

30. WE AMERICANS HAVE DRAWN FROM THE WELL OF PHILIPPINE FRIENDSHIP MANY TIMES IN THE PAST. WE ARE BACK AGAIN, HOPEFUL THAT WE ARE SEEN IN THIS COUNTRY AS A PEOPLE CAPABLE ALSO OF GIVING -- GIVING OF RESPECT, FRIENDSHIP AND LOYALTY. REGARDLESS OF HOW WE ARE VIEWED, HOWEVER, WE KNOW OUR FILIPINO COUNTERPARTS WILL BE GUIDED NOT BY SENTIMENT BUT BY THE REQUIREMENTS OF THEIR COUNTRY AND ITS CITIZENS. I BELIEVE THAT BETWEEN THESE REQUIREMENTS AND THE DESIRES OF THE UNITED STATES THERE ARE NO FUNDAMENTAL DIFFERENCES. IF I AM WRONG ABOUT THIS, THEN I AM WRONG ABOUT MUCH MORE THAN BASES. BY THE SAME TOKEN, IF I AM RIGHT ABOUT THIS, THEN I AM RIGHT ABOUT MUCH MORE THAN BASES. ALL IN ALL, I'D RATHER BE RIGHT.

31. THANK YOU, MR. FOREIGN SECRETARY. THIS CONCLUDES MY STATEMENT. END TEXT. SCHRAGER

GAO

United States
General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

B-239036

May 24, 1990

The Honorable David R. Obey
Chairman, Subcommittee on Economic
Resources and Competitiveness
Joint Economic Committee
Congress of the United States

Dear Mr. Chairman:

This report responds to your request that we review Japanese foreign economic assistance and trade policies and determine the extent to which Japan integrates these policies. You expressed concern that U.S. foreign assistance programs are not integrated with U.S. international trade policies. Therefore, we also present information on U.S. programs and policies.

We limited our review to economic assistance programs, and thus excluded military assistance and Export-Import Bank lending.

Historically, promoting trade interests has been an important motivating factor behind Japanese assistance, producing a program that provides comparatively great commercial benefits due to its sectoral and geographic concentration. Japanese economic assistance is heavily oriented toward infrastructure projects. Such projects can provide significant commercial benefits, as they tend to require procurement of high value added goods with subsequent need for maintenance and repair, and can open new markets for donor country firms. Also, Japanese assistance is provided primarily to Asian countries, where it reinforces existing Japanese trade relationships. Japan requires recipients to procure significant portions of assistance-financed goods and services in Japan. Certain other aspects of the Japanese system also help to ensure that commercial benefits will accrue to Japan, primarily through a relatively high degree of private sector involvement in development assistance project planning and administration.

Japanese economic assistance funding has greatly expanded in recent years, largely as a means for Japan to make a contribution to responsibility sharing among leading western industrialized countries, commensurate with its status as an economic power. Japan has taken a series of actions to liberalize procurement requirements and to expand the program's geographic and sectoral focus. Nonetheless, the program largely

retains its traditional focus and so continues to be more commercially oriented than U.S. assistance.

The United States also requires recipients to utilize a significant portion of assistance funds to procure goods and services from U.S. firms. However, U.S. economic assistance has a different focus, which results in less of a direct commercial orientation. Trade promotion has not been a prominent consideration in U.S. assistance efforts. U.S. assistance is intended to advance several goals, including support for basic human needs and economic restructuring. The United States concentrates its economic assistance in countries of particular security and political interest with which the United States does not necessarily conduct a great volume of trade. The United States provides comparatively little support for projects in areas, such as transportation, construction, and telecommunications, that can provide substantial commercial opportunities. U.S. emphasis on economic restructuring may provide trade and investment benefits in the long term, as recipient economies improve and open up to foreign private investment.

The United States could increase the commercial orientation of its foreign assistance programs by emphasizing projects that provide greater trade opportunities and by assigning greater weight to U.S. foreign trade patterns in allocating funds among recipient countries. However, such changes would clearly require difficult choices among the numerous competing demands on the U.S. program, especially in light of federal spending limitations. U.S. assistance could also be more closely tied to procurement in the United States. However, this would have a limited trade impact without a corresponding shift in the sectoral focus of U.S. assistance. Also, reducing linkages between foreign assistance and trade promotion for all donor countries has been a long-standing U.S. policy objective.

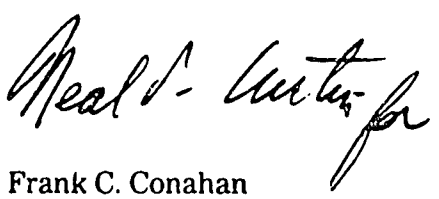
Further information on the results of our review are in appendix I. Appendix II presents details on the tying of U.S. assistance to procurement in the United States. Appendix III provides additional information on disbursement of U.S. assistance funds to U.S. and non-U.S. sources. Our scope and methodology are in appendix IV.

We did not obtain written agency comments on this report. However, we discussed it with officials of the Department of State and the Agency for International Development, and their comments have been incorporated in the report where appropriate.

As arranged with your office, unless you publicly announce its contents earlier, no further distribution of this report will be made until 30 days from its issue date. At that time, copies of this report will be sent to the appropriate congressional committees; the Administrator of the Agency for International Development; the Secretary of State; and other interested parties.

This report was prepared under the direction of Harold J. Johnson, Director, Foreign Economic Assistance Issues, who may be reached on (202) 275-5790 if you or your staff have any questions. Other major contributors are listed in appendix V.

Sincerely yours,



Frank C. Conahan
Assistant Comptroller General

Global environment

Protecting the South Pacific area

Two House Foreign Affairs panels will jointly mark up on Wednesday a resolution (H. Res. 398) calling for the United States to ratify an international convention designed to protect the environment of the South Pacific region.

The Convention for the Protection of the Natural Resources and Environment of the South Pacific Region was opened for signature Nov. 24, 1986, and has been adopted by eight of the 10 countries required for the treaty to enter into force; however, it has not been sent to the Senate for ratification.

The resolution, introduced May 22 by Rep. Robert J. Lagomarsino (R-Calif.), calls upon the president to send the convention to the Senate and urges the Senate to "without delay consider and give its advice and consent" to the treaty.

The resolution also says the United States should provide funds necessary to support the convention and the work program of the South Pacific Regional Environmental Program. The work program addresses marine pollution, pesticide control, climate change, sea level rise and other concerns.

The Bush administration supports the resolution, a human rights subcommittee aide said.

When: The human rights and pacific affairs panels will mark up the resolution at a joint hearing on human rights in South Asia. The hearing is scheduled for Wednesday, July 18, at 2 p.m. in 2172 Rayburn.

House Foreign Affairs contacts: Kerry Bolognese, majority (human rights), x67825; Nelle Temple, minority (human rights), x50004; Stan Roth, majority (pacific affairs), x67801; James McCormick, minority (pacific affairs), x67801. — *DR*

SABURO OKITA: The Dazzle of the Asian Economies

Japan's former Foreign Minister describes the 'flying geese' pattern of development in Asia—and argues that dynamic growth has only just begun

The Asia-Pacific region achieved a high rate of growth in the 1980s following the flying-geese pattern of development. The gross GNP of the region—including Japan, Australia, New Zealand, the ASEAN countries, Asian newly industrialized economies (NIEs) and China, but not including North America—grew from 16.8% of world GNP in 1975 to 23.5% in 1988, and this region has steadily become a more important part of the world economy.

Growth rates were particularly high in the Asian NIEs (Korea, Taiwan, Hong Kong and Singapore) where the average real growth rate in 1980 to 1988 was 8% and easily outdistanced the average real growth of 3% for the world economy during the same period. The Asian NIEs grew 12% in 1987 and 9.8% in 1988. The accelerating economic growth of the ASEAN countries (Indonesia, Malaysia, the Philippines and Thailand) is reflected in their average real 1987 and 1988 growth rates of 5.3% and 7.4% respectively. It should be noted that the ASEAN countries are rapidly closing the growth gap with the Asian NIEs and that the ASEAN countries are expected to have a higher 1989 growth rate. An especially impressive growth of 13% was achieved for Thailand, topping 1988's 11%.

Economic development in the Asia-Pacific region, centering on East and Southeast Asia, has occurred in successive and overlapping waves, with Japan taking off in the 1960s, the Asian NIEs in the 1970s and the ASEAN countries and China in the 1980s. This type of regional economic development is best characterized as the flying-geese pattern of development: the inverted-V pattern of development in which one country after another lifts off toward industrialization. It provides a snapshot of the dynamics of the relationship among countries as they shift from vertical to horizontal integration, and the less developed countries catching up with the front-runners. Countries which take off late benefit from the access to the other's capital and technology which enables them to bypass some historical steps and to grow very quickly, enabling them to catch up and gradually establish horizontal relationships.

There are many factors that have made this pattern of development possible. First is the success of export-oriented industrial development strategies. Expanding exports have given this region a larger share of world trade. Accounting for 14.3% of world exports in 1980, total exports from Japan, the Asian NIEs, the ASEAN countries and China were up to 21.5% by 1987. Likewise, these countries' imports increased from 14.7% of the world total in 1980 to 16.9% in 1987.

The regional spread of export-oriented industrial development strategies has accelerated East and Southwest Asian economic development. Thus it is misleading to claim that export promotion policies only increase exports. Instead, the enhanced purchasing power and greater economic interdependence that result also increase imports. In Thailand and Malaysia, for example, while exports grew 28.7% and 16.5% respectively in 1989, imports grew even faster—29% and 32.7%. At the same time, these countries' export structures are also changing. In Thailand manufactured goods' share of exports was 23.8% in 1975 but had increased to 57.5% in 1988. As a result, Thailand has a more stable economy than it did when it had to rely upon primary commodity exports.

The second factor that has made this flying-geese pattern of development possible is the overall expansionary trend in the world economy, which has proved hospitable to export-oriented industrial development strategies. World trade volume expanded 35% in 1980 to 1988, far ahead of the 23% growth in world production for the same period. Among the reasons for this is the progress made in trade liberalization during the 1964 to 1967 Kennedy Round and the 1973 to 1979 Tokyo Round of multilateral trade talks; the dollar's exchange strength and the booming U.S. economy in the first half of the 1980s; and, the yen's exchange strength and strong Japanese domestic demand in the second half of the decade.

Mr. Okita, formerly the Japanese Foreign Minister, is Chairman of the Institute for Domestic and International Policy Studies in Tokyo.

All of these factors have meant sharply expanded trade and investment for the region. This economic vitality had in turn generated greater intra-regional trade as seen in the fact that intra-regional exports by the 15 member countries of the Pacific Economic Cooperation Conference (PECC)—comprising the ASEAN countries, Asian NIEs, Australia, Canada, China, Japan, New Zealand and the U.S.—increased from 54.4% of their total exports in 1970 to 65.8% in 1988. Extra-regional trade also thrived. The Asian NIEs' exports to the EC grew an average of 37.8% per year in 1985 to 1988, outperforming Japan's 34.6% and the U.S.' 20.8%.

It is clear that expanding world trade and the existence of an international free-trade system that makes such expansion possible is crucial not only for intra-regional but also for extra-regional trade. Accordingly, the Asia-Pacific countries have a vital interest in rebuffing protectionism and ensuring that the GATT Uruguay Round is a success.

East and Southeast Asia are still excessively dependent upon the U.S. market, and a recession sparked by economic adjustments there would have a major deflationary impact on this region. This export dependence, however, has been gradually diminishing over the last few years. Japan's dependence has shrunk from 38% in 1986 to 37% in 1987 and 34% in 1988; the Asian NIEs' shrunk from 40% in 1986 to 37% in 1987 and 31% in 1988. These numbers are expected to be even lower in 1989.

As the Asian NIEs and the ASEAN countries expand their exports of manufactured goods, it is imperative that Japan become better able to absorb more imports from them by expanding domestic demand and making its markets more accessible. This will lower the countries' dependence upon the U.S. market and maintain the region's economic vitality. Japan's ratio of manufactured goods to total imports has risen from 31% in 1985 to over 52.3% by April 1990. Furthermore, as of July 1990, Japan entered the 44th month of a long-term economic expansion marked by real economic growth of 5.7% in 1987 and 4.9% in 1989. Japan is also a major supplier of capital goods to the other countries in the region, and access to the latest capital goods can have basically the same favorable impact on local productivity that technology transfer and independent development do.

The third factor making this flying-geese pattern possible is that the less developed countries have adopted catch-up industrial and trade policies drawing upon the comparative advantage provided by their large pools of inexpensive labor. These policies rely on the government's skill in mixing market mechanisms and government planning, and are particularly attractive when the private sector is still in the infant stage. Such policy thinking is central not only in the Asian NIEs and the ASEAN countries, but also in socialist China. The East European countries and the Soviet Union have also expressed interest in the "Japanese model."

More than import substitution strategies, export-oriented industrial development strategies heighten cost consciousness and encourage the efficient use of management and productive resources. This makes the entire economy more efficient. Accordingly, cost considerations have to be included even in central economic planning, and there is a need to develop plans that reflect effective market forces.

Benefiting from economic reform and openness, the Chinese economy recorded impressive average per annum growth of 10.8% from 1985 to 1988. However, this was also accompanied by considerable inflation. Even though China moved to tighter money in the second half of 1988, 1988's overall inflation rate was 18.5% and 1989's was 17.8%. With the Tiananmen incident in June 1989, real growth dropped to 3.9% for that year. Political stability is obviously a primary consideration in economic development, both for policy continuity and for implementing adjustments.

The Asian NIEs are entering a new stage of development. This is exemplified by Korea where—stung by the won's exchange strength and wage increases which have eroded international competitiveness since 1987, and by the suspension of preferential tariff treatment for the Asian NIEs by the U.S. since January 1989—export growth was only 2.8% over the previous year in 1989, a plunge from 1988's 28.4%. As a result, Korean real economic growth fell from 12.4% in 1988 to 6.7% in 1989.

Taiwan faces similar conditions, but strong domestic demand has enabled it to maintain 7.2% growth in 1989, the same as in 1988. As a result of these changes, the Asian NIEs are faced with the new need to find fiscal and monetary policies that will enable them to stimulate domestic demand while still containing inflation. This will have to be accompanied by measures for enhancing liberalization and democratizing their economies.

The fourth factor facilitating this flying-geese pattern is that the countries of East and Southeast Asia have, even in the initial stages, received aid that encouraged bootstrap efforts. Japanese aid has long been criticized for its small grant element. However, Asia's impressive development is arguably an eloquent vindication of aid policies firmly anchored in the idea of economic efficiency. Attracted by high rates of return on capital because of the comparatively low production costs, the relaxation of regulations on direct investment and the adoption of preferential treatment for investment, foreign capital infusions to the ASEAN countries have recently shifted from loans to direct investment.

Japan's overseas direct investment flow has grown sharply since the appreciation of the yen after the 1985 Plaza Agreement. The bulk of this money went to the Asian NIEs in fiscal 1986 and the first half of fiscal 1987.

In the latter half of fiscal 1987, however, the flow to the ASEAN countries picked up, and in fiscal 1988 investment was $13.6 billion in the ASEAN countries compared to $7.7 billion in the Asian NIEs. Japanese overseas direct investment for fiscal 1989 was $67.54 billion, up 43.6% from the previous year, with 12.2% spent in the Asian region. Another interesting development for the region is the increase in direct investment by the Asian NIEs in the ASEAN countries.

These trends are part of a bigger trend in which the PECC member countries account for almost 80% of the direct investment in the Asia-Pacific region. The confluence of the worldwide savings shortage, the bloating of the U.S. net foreign debt to $663.7 billion in 1989 and the flow of capital to Eastern Europe has fueled fears that the developing countries of Asia may no longer have access to the capital they need. In turn, this has made it all the more imperative that the OECD countries maintain or raise their domestic savings rates. In particular, the U.S. must raise its domestic savings rate, rein in its massive budget deficit, reduce its trade deficit by improving its export competitiveness and once again become a capital exporter.

East and Southeast Asia are still excessively dependent upon the U.S. market, and a recession sparked by economic adjustments there would have a major deflationary impact on this region.

The Asia-Pacific region contains a diverse mix of elements in an intricate weave of competition. The difference between the European economic integration scheduled for 1992 and Asian-Pacific economic cooperation is the difference between integration among relatively homogeneous political and economic systems and the gradual creation of a cooperative relationship premised upon diversity among countries. Organizations promoting this cooperation, such as the PECC and Asia Pacific Economic Cooperation (APEC) formed in 1989, are well aware of the need to maintain the dynamism of this region while reconciling the sometimes conflicting interests of the various countries. Both groups are discussing strategies to prevent protectionist policies and to support the global free-trade system, while respecting the potential of the region's developing countries. Economic cooperation grounded in liberalization is a prerequisite to sustaining regional activity in a region with the kind of multifaceted character that makes the flying-geese pattern of development possible. This regional cooperation is nondiscriminatory toward countries outside of the area and is an effective means of promoting global free trade. In this sense, Pacific economic cooperation provides a sensible model for realistic international economic policy coordination. Despite the fact that the real growth rate for PECC member countries slowed, it was still better than the comparable figures for the world economy and indicates that the Asia-Pacific region will continue to be a center of world growth and dynamism.

If China continues to pursue open economic policies and to promote industrialization and development, it is very possible that these coastal areas could develop along the same lines as South Korea, Taiwan and Hong Kong. The addition of coastal China would make the East and Southeast Asian region roughly equivalent to North America or the EC in both GNP and population by the year 2000.

Latin American countries are expressing interest in Pacific economic cooperation, and they can be expected to join the flying-geese pattern of development as international cooperation to alleviate their massive debts progresses. Momentum is building for peace in Indochina, including the June 1990 Tokyo Meeting on Cambodia. The attainment of political stability there, as well as concerted efforts for economic development in Vietnam, Laos and Burma could result in the emergence of a new economic region of the Indo-Chinese Peninsula.

In July 1986, Gorbachev unveiled the Soviet Union's new Asia-Pacific-oriented policy, and the Sino-Soviet summit meeting in May 1989 agreed to normalize governmental and party relations between these two countries after a 30-year hiatus. Against the background of reduced East-West tensions, Gorbachev held an historic first meeting with South Korean President Roh Tae Woo in June 1990, and this has in turn greatly increased the possibility that the leaders of South and North Korea may soon hold their first summit meeting since the division of the Korean Peninsula.

Another sign of stability for Asia is the restoration of diplomatic relations between China and Indonesia, relations that have been severed since 1967.These developments represent the political realities facing this region. With the end of the East-West Cold War, a new regional security framework is needed in the Asia-Pacific region. This structure will not be limited to economic considerations but will also gradually encourage the formation of cooperative relationships for peace and stability. ♦

LOS ANGELES TIMES, September 25, 1990

PACIFIC PERSPECTIVE

Opening to New East Asian World

■ The Cold War ended and erased in the process the scheme of regional relations. A unified Korea could be the key to a cohesive new framework.

By KYONGSOO LHO and SERGEI GONCHAROV

The Cold War ended with the dismantling of Soviet military-political alliances. In its wake, America's network of alliance systems worldwide has also begun to unravel. While the end of the Cold War can only be welcomed, the post-Cold War era has not yet fully begun. Even in Europe where a new structure of security is being built upon the foundations provided by the Helsinki process, concerns remain about the durability of the new order. If questions about stability still remain in Europe, then such questions apply even more broadly to East Asia, the next region in line to undergo the transition out of the Cold War.

In fact, the heat of superpower confrontation in East Asia has already diminished to a considerable extent, which in turn will inevitably lead to a fundamental restructuring of existing arrangements. We already see the first manifestations of this process in the improvement of Soviet and American relations with former adversaries in the region. Moscow has normalized relations with Beijing and was soon on the same with Seoul and in time, with Tokyo. The United States has started a dialogue with Vietnam and is ready to see a resolution to the conflict in Cambodia.

The two superpowers also face the daunting task for redefining their alliance relations in the region. Moscow has reduced its presence in Vietnam, and now confronts the need to fundamentally reorder its relationship with North Korea. Washington must also contemplate a new set of relations with its regional allies such as Japan, South Korea and the Philippines.

On the whole, the unfolding dynamic in East Asia is a healthy one. However, there is at the moment no alternative framework capable of providing new sources of cohesion among the various countries within it. Without such a framework, continued erosion of the present system can create new sources of tension, even as it removes Cold War-inspired ones. For example, a Soviet-Japanese resolution of the Northern Territories (Kuril Islands) issue will remove the basis for the U.S. military presence in Japan, and thereby undermine one of the central pillars upon which postwar Tokyo-Washington relations have been built. Inevitably, other dimensions of the bilateral relationship between these two countries will also be affected.

Similarly, if North-South Korean talks proceed smoothly, calls for removal of U.S. troops from Korea will also grow.

Uncertainties arising from erosion of U.S.-led alliances, however, pale in comparison to the unpredictability inherent in any comprehensive change of Soviet regional policy. For example, reduced Soviet support could lead the North Koreans to initiate reforms of their own or, by raising their frustration to extreme levels, trigger vengeful and destructive actions.

If the postwar military alliance networks that the United States and the Soviet Union forged with various East Asian states become increasingly less relevant, what sort of post-Cold War arrangement can we envision that would ensure both cohesion and continued progress for the region? Who is to provide leadership in creating a post-Cold War order in East Asia? Conventional wisdom has long held that a multilateral arrangement for regional security and cooperation is not feasible. This line of reasoning, however, resulted from the fact that no agreement could be expected among the powers so long as Cold War tensions remained. In such a confrontational environment, moreover, no state could be accorded legitimacy to initiate steps toward building such a framework.

'Few in the region would like to see an increase in Japan's political clout alongside its already preponderant economic role.'

Thus, questions remain about future structure and leadership for the region. The United States may wish to hold onto its pre-eminent regional position, but its growing reluctance to underwrite the costs of leadership suggests that it cannot retain its current position over the longer term. Japan clearly possesses the economic and financial wherewithal sure to be required for such leadership. Unfortunately, few in the region would like to see an increase in Japan's political clout alongside its already preponderant economic role. The Soviet Union is clearly in no position to assume leadership. China certainly is not up to the task, either.

Some have been tempted to argue for a condominium of sorts between the United States and Japan, with the former providing the larger balance of political leadership while the latter takes a relatively bigger role in economic matters.

Such thinking, however, is seriously deficient. Neither Beijing nor Moscow is likely to view the emergence of such an arrangement favorably. It is not clear that other countries in the region would fully welcome it, either. Also, such thinking seeks to preserve the status quo at a time when farsighted policies are needed.

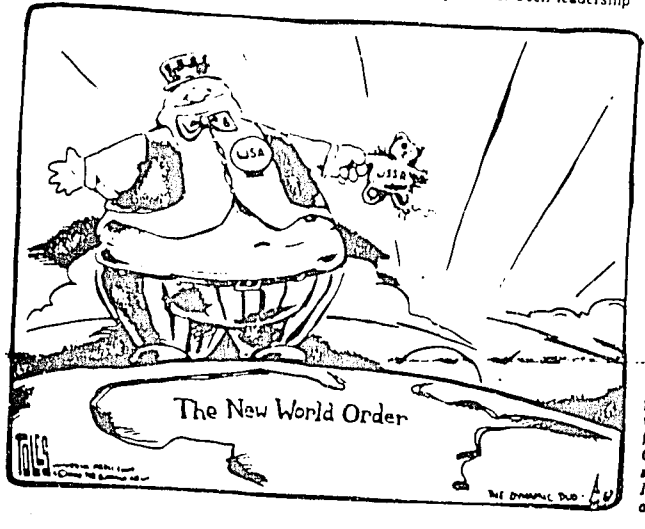
Taking all this into account, let's consider the international role for a unified, democratic and economically strong Korea. There are several reasons why this new nation could have the necessary legitimacy to initiate steps toward the creation of a post-Cold War multilateral arrangement.

In marked contrast to the other powers in the region, Korea does not have a history of external aggression or interference. A unified Korea would still be in no position to seek dominance in Asia. Also, having long endured the consequences of superpower machinations, Korea would have a genuine interest in seeing a stable arrangement worked out that will balance the interests of the big as well as the smaller states in the region. Finally, though it will be in no position to have hegemonic ambitions, a unified Korea will not be an insignificant regional power. With a combined population of 64 million, enhanced economic and political power and cultural affinity with most of the actors in the region, Korea's voice would be respected but not feared.

It is clear that Korea, divided as a result of confrontation between the major powers, cannot be united without mutual cooperation. In turn, this Korean state will be in a unique position and have a vital interest in ensuring that the momentum created by unification leads to a broader effort toward the creation of a regional, multilateral framework.

Such a future is possible but not inevitable. Several developments could undermine it. A resumption of hostile conflict between the two Koreas would end all prospects for unification. Another negative outcome could result from the superpowers' attempt to use the reunification process for short-term gains. For instance, if Moscow sought to use Korea as a lever against Japan, or if the United States sought to prolong division in order to retain the basis for its military presence in the region, then neither unification nor a regionwide framework is likely.

At a minimum the major powers must recognize and work to prevent the outbreak of armed hostilities on the peninsula. Even more important, they must not perceive the end of division in Korea as merely the removal of one hot spot among many in the world. They must see Korea's unification as a key to opening the way to the creation of a new order in East Asia.



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EDITORIAL RESEARCH REPORTS

CAN DEMOCRACY SURVIVE IN THE PHILIPPINES?

by Dan Chapman

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Four years after the Philippines' democratic revolution, the country is still plagued with poverty, corruption and $27 billion in foreign debt. Although President Corazon C. Aquino is still personally popular, she is accused of being indecisive and unable to deal effectively not just with the moribund economy, but also with rebellious factions in the military and Communist rebels. Many experts say the Philippines now must chart a course independent of the United States — a move that could affect the outcome of the current negotiations over the future of the U.S. military bases there.

By the time Philippine President Corazon C. Aquino visited Washington in September 1986, the United States had been consumed by the same euphoria that had swept her homeland seven months earlier. America's closest Asian ally — and former colony — had cast off years of despotic and corrupt rule by ousting Ferdinand E. Marcos. And Americans, via the wonders of instantaneous, worldwide communication, had watched as the diminutive, former housewife dressed in yellow rallied her countrymen during the dramatic final days of the Marcos regime.

Dan Chapman is a free-lance writer who lives in Winston-Salem, N.C. He spent two months in the Philippines earlier this year.

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Aquino quickly became America's darling, as was evident the morning of Sept. 18 when Aquino addressed a packed, joint session of Congress. Members of Congress, diplomats, Cabinet members and even journalists were wearing suits, dresses, ties and handkerchiefs bearing Aquino's trademark yellow. House Majority Leader Jim Wright, D-Texas, ordered that 200 yellow roses line the approach to the dais where the Philippine president would speak.

Aquino's carefully crafted speech didn't disappoint her audience. "To all Americans, as the leader of a proud and free people, I address this question: Has there been a greater test of national commitment to the ideals you hold dear than what my people have gone through?" Aquino asked. "You have spent many lives and much treasure to bring freedom to many lands that were reluctant to receive it. And here you have a people who won it by themselves and need only the help to preserve it. Today, I say, join us, America, as we build a new home for democracy, another haven for the oppressed, so it may stand as a shining testament of our two nations' commitment to freedom."

Thunderous applause followed. Normally subdued congressmen rushed to shake her hand. Promises of aid gushed forth. Aquino could do no wrong. Or so it seemed.

Four years after taking Washington by storm — and receiving pledges of billions of dollars in aid — Aquino has discovered that high political drama does not translate into concrete solutions to a moribund economy or political instability. The factionalized military has tried six times to oust Aquino, and most Filipinos expect another coup attempt. Although the Communist rebels now have fewer comrades under arms, they are still a real threat in both Manila and the countryside.

"The economic crisis is unprecedented in modern Philippine history," states a recent report by the Congressional Research Service.[1] The Philippines owes $27 billion to foreign creditors. Per capita income is only $727 a year. The World Bank estimates that 52 percent of the population lives in poverty.[2] And many of Aquino's economic objectives, particularly land reform, remain unfulfilled.

"I think the Aquino administration has been a failure," says Renato Constantino, a newspaper columnist and professor at the University of the Philippines near Manila. "If you go out into the streets and board the buses and the jeepneys [elongated four-wheel drive vehicles that transport as many as 20 people], you hear a lot of people cursing the high prices, the lack of social services, the brownouts and the traffic lights that don't work. And with the deterioration of conditions and an unaccountable military ... it could motivate another [coup] attempt. The conditions are so depressing."

Not everybody believes that Aquino has failed or that she is to blame for the tremendous difficulties that bedevil this Southeast Asian nation. Her supporters contend that the problems Aquino inherited were overwhelming and that they couldn't be solved in just four years. Instead, they argue, Aquino should be credited for returning democracy to the Philippines by instituting free and fair elections and a new constitution, limiting executive powers and restoring all civil liberties.

"We are trying our damndest to implement the empowerment of the people," says Tomas "Buddy" Gomez III, Aquino's press secretary. "A populist democracy is the most difficult way to govern, but it's the only way to govern. In the long run ... the country will be sturdier and stronger."

Whether the myriad problems besetting the Philippines are the result of Aquino's leadership style or whether they are endemic and long-entrenched in Philippine politics, there is near-unanimity on one point: Aquino wasted a golden opportunity at the beginning of her presidency to effectively seize control of a troubled nation and set it on the path to political, economic and social renewal.

Stanley Karnow, who won the Pulitzer Prize this year for his book, *In Our Image: America's Empire in the Philippines*, says that Aquino "was reluctant to take advantage of her immense popularity to impose her leadership, preferring instead to rule by moral example. She gradually began to assert herself ... but she squandered her initial momentum, thereby losing a unique opportunity to introduce reforms. Into the vacuum poured a multiplicity of undisciplined, selfish, querulous factions eager to advance their own ambitions."[3]

But Karnow acknowledges that Aquino's leadership style is not the only factor hampering the political evolution of the Philippines. He also points to the pervasive influence of the United States on Philippine society. "Few countries ... have been more heavily shackled by the past than the Philippines," he writes. "And, after one of the longest continuous periods of Western imperial rule in world history, Filipinos are still freighted with what they lament as their 'colonial mentality.' "[4]

During the United States' almost 50-year rule of the Philippines, from 1898 to 1946, its style of democracy prevailed not only in the government, but also in the business, cultural, educational and military sectors of Philippine society. A number of experts on U.S.-Philippine relations say the attempt to impose American-style democracy placed the Philippines at a disadvantage because it didn't allow the fledgling, Third World country a chance at self-styled nation-building.

"I think that our American style of democracy is *sui generis*, unique, to the United States," says Paul K. Kreisberg, a senior associate at the Carnegie Endowment for International Peace in Washington. "The way it works [here] makes it inevitable that it will not work in ... Asia. Democracy requires strong institu-

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tions, and if you don't have that, . . . the stability of the democratic system is probably going to be uncertain." But others argue that it's still too early to write off the Philippines' attempt at Western-style democracy. "It's not fair to compare the standards of your country with the Philippines today," Gomez says. "America has been a democracy for 200 years. Here, it's only been around for four years."

Filipino and American experts agree that because of the Philippines' dependence on the United States throughout the 20th century, many Filipinos lack a sense of identity. But, they say, rising nationalist sentiment in the country is a positive step toward the Filipinos' gaining a sense of who they are and what they want their country to be. But that could prove detrimental to American interests, especially in light of the ongoing negotiations concerning the fate of the U.S. military installations in the Philippines.

Subic Bay Naval Base and Clark Air Base are among the largest and most strategic of U.S. overseas bases. Despite a lessening of U.S.-Soviet tensions and budgetary realities at home, the Pentagon insists the bases are crucial for global security. Many U.S. government officials, citing regional security and the high cost of transferring the U.S. military presence elsewhere, want the United States to maintain the bases at least for the short-term.

But a growing body of policy-makers in both Manila and Washington says the bases should go. (*See "At Issue," p. 457.*) For many Filipinos, the bases serve as an unwanted reminder of American colonialism. They argue that the only way the Philippine experiment in Western-style democracy can succeed is if the Philippines goes it alone and finally develops its own identity. "Many feel that now is the best time to ask the Americans to leave the country," says Dr. Jose V. Abueva, the president of the University of the Philippines. "What we Filipinos need is to break our dependency on the United States and to assert our independence."

'People Power Revolution' brings Aquino to power

By the time Aquino assumed the presidency, the Philippines was ready to revolt. Twenty years of Marcos misrule was responsible for grinding the 7,000-island archipelago almost to a halt — economically as well as politically. Ten years of martial law had emasculated the courts, the press, the military and most of the political opposition. Marcos and his corrupt and brutal military added thousands to the rolls of the Communist New People's Army. At the same time, Marcos and his wife, Imelda, were accused of stealing billions from the country's coffers to line their pockets and ensure their security. Others charged that Marcos had allowed his business cronies, who already controlled most of the arable land, to monopolize the nation's budding industries.

The U.S. government largely ignored Marcos' authoritarian rule, preferring to focus on the possibility that without Marcos the Communists could topple the government. But after exiled opposition leader Benigno S. Aquino was murdered upon his return to the Philippines in 1983, the U.S. government could no longer ignore the situation. The killing was the proverbial match that lit the powder keg of discontent. Massive demonstrations in Manila were joined by increasingly loud, yet still unofficial, calls from Washington that Marcos step down. Marcos replied that he had no intention of resigning and, instead, called "snap elections." In December 1985, Benigno Aquino's widow, Corazon, agreed to run for president after she was presented with 1.2 million signatures urging her to challenge Marcos.

"It's not fair to compare the standards of your country with the Philippines today. America has been a democracy for 200 years. Here, it's only been around for four years," says Tomas "Buddy" Gomez III, Aquino's press secretary.

The Feb. 7, 1986, election was like many others in the Philippines with one big exception: The United States was watching. Election Day violence resulted in 30 deaths, and there were widespread reports of vote fraud. Although Marcos claimed victory, the U.S. government called for an honest vote count. Then, on Feb. 22, Philippine military leaders seized an army installation in Manila and declared their loyalty to Aquino. As thousands of civilians surrounded the base to protect it from Marcos loyalists, the U.S. government sent private and public messages urging

the beleaguered president to step down. On Feb. 26, Marcos and his family were whisked out of Manila and granted exile in Hawaii.

Seven months later, Aquino told the U.S. Congress that her success was a victory for democracy. "Today, we face the aspirations of a people who had known so much poverty and massive unemployment for the past 14 years and yet offered their lives for the abstraction of democracy," Aquino said. "Wherever I went in the campaign, slum area or impoverished village, they came to me with one cry: Democracy!" But Aquino would soon discover that the restoration of civil and political liberties would be a lot easier to achieve than would economic and political stability.

Aquino moved swiftly to erase all reminders of Marcos' misrule. On March 25, she revoked the Marcos-dictated constitution of 1973 and shut down the legislature. A new constitution was approved overwhelmingly by national plebiscite in February 1987. It called for a single, six-year term for the president and vice president; a bicameral legislature; automatic financing of Philippine courts to ensure the independence of the judiciary; restrictions on the president's power to impose martial law by requiring legislative and judicial approval; and more autonomy for local governments. In May 1987, pro-Aquino candidates won comfortable majorities in both houses of Congress, giving the president the opportunity to further her political and economic agenda.

Early in her administration, Aquino began peace negotiations with the Communist insurgents. The number of armed guerrillas and their sympathizers had risen dramatically during the Marcos era. By the time Aquino took office, there were at least 23,000 Communist-led insurgents operating in almost all of the Philippines' 73 provinces. The Communist Party of the Philippines (CPP), the political arm of the NPA, was active in 20 percent of the 41,000 barangays, or local governmental units.[5]

In December 1986, at Aquino's request, a cease-fire went into effect, and the CPP began discussions with the Aquino government. The Communists insisted that they be part of a coalition government, that all key industries be nationalized and that the U.S. military be kicked out, among other demands. Aquino refused, and the cease-fire ended.

After extending the olive branch, Aquino used a two-pronged approach to weaken the insurgency. On the one hand, she promised that rebels who came down from the hills and turned in their weapons would not be punished. Instead, they would be given land or jobs and easy access to loans to help them reintegrate into society. But she also promised to get tough. She outlined this aspect of her policy in her speech to the U.S. Congress. "I will not stand by and allow an insurgent leadership to spurn our offer of peace and kill our young soldiers and threaten our new freedom," she said. "I will do whatever it takes to defend the integrity and freedom of my country." Aquino's carrot-and-stick approach has resulted in a diminution in the overall number of armed guerrillas — according to one report, the number of armed insurgents had dropped to about 19,000 in early 1990 — and experts say the CPP top leadership is disorganized.[6]

But even though the overall number of Communist rebels has decreased, they still pose a serious threat to the Aquino government. In the last few months, during preliminary negotiations over the future of the U.S. bases (*see p. 455*), the NPA has targeted U.S. soldiers and civilians, hoping to convince an already skeptical American public that the cost of retaining a military presence in the Philippines is too high. Ten Americans have been murdered by the NPA in the last three years.

With more killings expected as the base talks continue, Americans are taking no chances. Many U.S. Embassy officials and businessmen are trying as much as possible to avoid the congested Manila streets and drive only in steel-plated cars. U.S. military dependents are offered free one-way tickets home. And on June 27, the U.S. government ordered that all Peace Corps volunteers in the Philippines be evacuated to the United States for their own safety.*

Large foreign debt hampers economic recovery

The Communist insurgency is only one of many problems facing Aquino. Four years after the "People Power Revolution," there is widespread disappointment and disillusionment with the president's economic program. Aquino has made progress in some areas — notably the dismantling of monopolies, increasing foreign and domestic investment and reforming the tax system — but the overall economy is still in a shambles.

"The euphoria was over a year after Edsa," says newspaper columnist Renato Constantino, referring to the highway where Aquino and thousands of her countrymen stood their ground against Marcos' tanks during the climatic final days of the former regime. "In 1986, when I was saying . . . that nothing new would happen, that it would just be a change in faces and leaders at the top, I was severely ostracized. Four years later, the people who were cursing me then are now more vehement in their protestations than I have ever been."

Aquino's supporters, however, say the disillusionment, both in the Philippines and abroad, is unwarranted, considering the daunting problems she inherited. "Let's be realistic," says Gomez, the press secretary. "What other historic and euphoric event

*Nicholas Platt, the U.S. ambassador to the Philippines, announced Aug. 6 that the United States plans to bring back its Peace Corps volunteers "as soon as it is considered safe and agreeable to [the Philippine] government."

carried on for two years? None. Cory Aquino at Edsa is a hard act to follow. It's not hopeless. But there is anger."

That "anger" is tangible throughout Manila. Families of squatters still live in cardboard and tin hovels along the polluted Pasig River. The slums of Tondo are home to thousands of malnourished children. In nearby "Smoky Mountain," Manila's largest garbage dump, hundreds of people scour the trash heaps daily looking for recyclable metal or plastic.

Overpopulation is one reason why more than half of the Philippines' 61 million people live in poverty. The World Bank reported in 1989 that the population in this mostly Roman Catholic country was growing at a rate of 2.4 percent per year.[7] Another factor contributing to the moribund economy is the $26.7 billion foreign debt, making the Philippines one of the world's most indebted countries and fueling a host of other economic problems. Forty percent of the national budget goes for debt repayment.

Although the economy grew at a respectable rate of 6 percent the last two years, the gross national product (GNP) growth rate is expected to dip below 5 percent this year, according to an official with the Manila-based Asian Development Bank (ADB) who asked that he not be identified. The official blamed the drop on the political instability; foreign investors, on whom Aquino is relying to prop up the sagging economy, are wary of putting their money into a country that might experience a violent change in government any day.

"I'm definitely not bullish on the Philippines," the ADB official says. "Foreign investors from Taiwan, Hong Kong, Singapore and Japan were starting to come in in a big way [until this year]. The feeling now is that existing companies with expansion plans are going ahead whereas potential foreign investors are sitting on the fence."

The ADB's parent bank, the World Bank, isn't as pessimistic, at least not publicly. "The Philippines is going through a major period of economic restructuring and reorientation," says its 1989 report. The World Bank credits the Aquino administration for "structural reforms" to the economy, including trade liberalization, public investment and privatization of the financial institutions. "A substantial economic recovery has taken place based on a more efficient allocation of resources than in the past," the report states. "Nevertheless, substantial problems remain to be faced."[8]

Since Aquino's election, the United States has tried repeatedly to help the Philippine economy. In November 1987, Sens. Richard G. Lugar, R-Ind., and Alan Cranston, D-Calif., and Reps. Stephen J. Solarz, D-N.Y., and Jack F. Kemp, R-N.Y., proposed a $10 billion, Marshall Plan-type aid package for the Philippines with international banks and foreign governments chipping in. The proposal, known as the Philippine Assistance Program, went into effect in July 1989. Fifteen countries and three multilateral institutions pledged $3.5 billion, with part of the money set aside for debt reduction. Altogether, the United States gives about $500 million annually to the Philippines.

But the Aquino government hasn't been totally successful in utilizing the massive aid donations. An unwieldy bureaucracy, unclear objectives and similar problems have led to a $3 billion backlog in aid disbursement, fueling criticism at all levels that Aquino's government is incompetent.

"Things were better under Marcos," says Roger Santiago, a cabdriver. "He built homes for the squatters. There was always enough food. Now the poor people can't afford a kilogram of chicken. It costs 42 pesos [about $2]. And for somebody making 50 pesos a day, they can't afford that." But Rodrigo de los Reyes, president of the Philippine American Life Insurance Co. and an ardent Aquino supporter, disagrees. "It has gotten better. No question about that," he says. "We haven't eradicated poverty. It's still there. But more people are enjoying more things than in the past. It is reflected in our sales."

Unrest in the military means another coup attempt is likely

Many of the serious economic problems facing the Aquino government can be traced to the rule of her predecessor. The foreign debt, for example, more than doubled during the last six years of Marcos' presidency. Another problem predating Aquino is the widespread disaffection in the 250,000-man military.

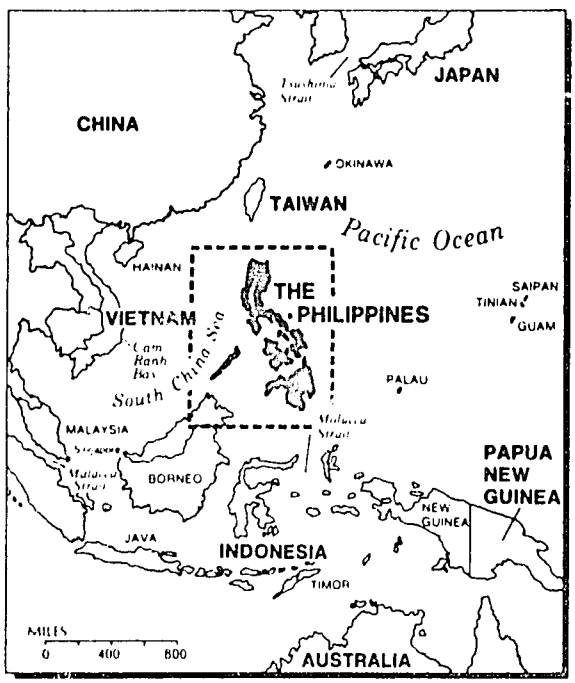
Marcos, under the guise of combating the Communist insurgency, more than doubled the size of the military. Critics charge that Marcos and his cronies, including Juan Ponce Enrile, his defense minister, and Gen. Fabian Ver, the armed forces chief of staff and Marcos' cousin, used the military to line their pockets, award patronage and provide protection for themselves.

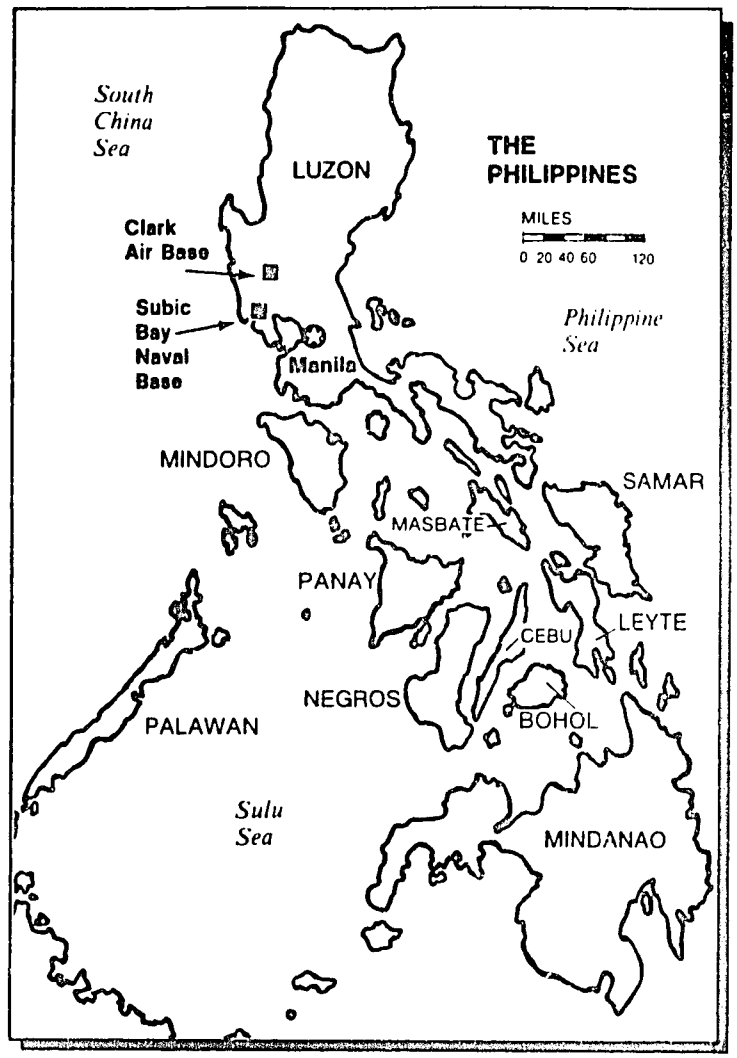
When Aquino became president, the highly politicized military was unwilling to bow to civilian rule, especially when the commander in chief was a woman without military experience. Some factions within the military also are said to be dissatisfied with Aquino's peace overtures to the Communists. One faction, the Reform the Armed Forces Movement, or RAM, has been the main force behind the six attempts to oust Aquino. Poor pay and a lack of even the most minimal of resources, including medicine and boots, have fueled dissatisfaction at the lowest levels of the military.

Last December, 3,000 of the military's most elite troops seized downtown Manila's Makati business district and demanded that Aquino step down. The Young Officers' Union, or YOU, was the leading force behind the Makati siege and is now perhaps the

The Strategic Philippines

Subic Bay Naval Base and Clark Air Base are among the largest and most strategic of U.S. overseas bases. Despite a lessening of U.S.-Soviet tensions, the Pentagon insists the bases are crucial for keeping the sea lanes from India to Japan open. Relocating the forces stationed at Clark Air Base would be relatively easy, but finding a new home for the Navy would be difficult. Subic Bay is the best deep-water port in the region.





most-feared rebel military faction. In an interview last March, one of YOU's leaders explained why Aquino must go. "The bottom line is that we just want a more responsive government," said the officer, a lieutenant who asked that he not be identified. "Strong nationalism is the common denominator that keeps us together." The lieutenant promised — and just about everybody else in Manila and Washington agrees — that there will be another coup attempt. "It's more a question of when than if," he said.

Aquino's supporters point out that YOU and RAM do not speak for the average Filipino. Instead, they insist, the renegade soldiers just want to impose a military dictatorship not unlike the Marcos regime. "The coups are a refusal of a sector of the country to give up their grab for power," says Gomez. "The failed coups were financed and executed by the very people whose dreams for power were frustrated by Edsa."

Gomez adds that Aquino has taken steps to quell the dissatisfaction in the Armed Forces of the Philippines (AFP) by increasing soldiers' pay, promoting capable officers and retiring many Marcos-appointed officers. He also points out that Aquino is still popular with the Philippine people, a fact substantiated by the 58 percent approval rating that Manilans gave her last March.[9]

But others say that Aquino hasn't done enough to pacify her critics and that the result will be another coup attempt. They cite, for example, the less-than-severe punishment Aquino handed down after a coup attempt in 1987: Officers responsible for plotting the coup were jailed briefly and ordered to do pushups. Her critics also say that Aquino has failed to eradicate corruption in the military.

Aquino's supporters say she has learned a lot in the past few years. They point out that after last December's coup attempt, Aquino got tough and ordered loyal troops to hunt down the coup plotters. Many were arrested and await trial. Enrile and others also were charged with plotting to overthrow the government, a charge that Enrile, who is now a senator and a candidate for president in 1992, denies.

The July 16 earthquake that devastated parts of central and northern Luzon may have bought time for Aquino. Natural disasters tend to unify a country as other serious problems are set aside. But while Filipinos

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generally have been supportive of Aquino since the earthquake, there have been grumblings that her administration's response to the disaster has been slow and inefficient. "I think she has come under more criticism than praise," says the Carnegie Endowment for International Peace's Paul Kreisberg. "People are asking 'Why do we have to go to outsiders for help? Why do we have to rely on the Americans [to dig us out]? Why was there not more appropriate heavy equipment?' It just hits her again in the areas of why her government isn't working better."

Questions about Aquino's commitment to land reform

Aquino's leadership in pushing her coveted land reform program has also come under attack. Aquino's goal was to raise living standards for poor farmers nationwide and, consequently, fuel an economic revival in the countryside. Aquino also reasoned that if the peasants had land and money, they would be less likely to join the Communist New People's Army.

In 1987, the Philippine Congress passed a land reform law, keenly sought by Aquino, that would allow farmers the opportunity to buy small plots of land from landowners. And in March 1989, Ambassador Alan Woods, the administrator of the Agency for International Development, told a U.S. House of Representatives subcommittee that land reform was working. "The government has made an impressive start in implementing the agrarian reform program," he testified. "By September 1988, the government had slightly exceeded its total annual target, distributing about 100,000 acres . . . to over 106,000 beneficiaries." [10]

But according to newspaper columnist Renato Constantino, much of that land was already set aside by Marcos for redistribution. He also points to two cases where Aquino had the opportunity to show her commitment to land reform, but in his view failed to do so. The first case involves Hacienda Luisita, the Aquino family sugar estate in central Luzon. Many Filipinos expected the president to turn over the 15,250-acre estate to the farmers who work the land. Instead, the farmers were issued stock certificates that entitle them to future ownership of the sugar fields. Critics like Constantino call the stock issuance a "sham," arguing that the farmers will never be able to control the enterprise, and thus get the land rights they are entitled to.

More recently, Aquino's nominee for agriculture secretary — her fourth in as many years — failed to receive Senate confirmation. Constantino, who notes that Aquino's political party holds a majority in the Senate, says that the president wasn't committed to the nominee and allowed the nomination to falter.

Aquino's press secretary denies that the president's push for land reform has faltered. "Her commitment to land reform is embodied in the law," Gomez says, "although there is some delay." Some possible reasons for the delay were spelled out in the May 1990 study by the Congressional Research Service. Among the "major obstacles" to land reform the report cited were "the likely high cost of a program, resistance from politically powerful landowners, loopholes in the law, and bureaucratic limitations that could effect implementation." [11]

Aquino is also coming under attack for the energy crisis now affecting Manila and its environs. For years, daily brownouts affected the Philippines. But the situation became so bad in April that the government decided that about 350 business and government buildings would be shut down one day a week for five weeks to help conserve energy. Since then, the Aquino government has randomly shut off power to businesses and government buildings. Brownouts continue to affect the entire city, hitting without warning.

Critics say that Aquino knew as early as 1986 that an energy crisis was imminent, but did nothing to head it off. In an effort to get rid of all vestiges of the Marcos regime, Aquino scrapped the Energy Ministry, which the World Bank had lauded as one of the few success stories of the Marcos era. A severe drought, antiquated power-generating equipment and the mothballing of a nuclear power plant added to the energy crisis. "Human incompetence and Mother Nature have conspired to turn out the lights," John McBeth wrote in the authoritative *Far Eastern Economic Review*. He estimated that economic growth could be reduced by as much as 1.1 percent this year because of the blackouts and brownouts.[12]

Authoritarianism vs. consensus politics

Even some of her supporters concede that Aquino's leadership style exacerbates many of her country's problems. Aquino rules by consensus, turning to Cabinet members, family, Catholic Cardinal Jaime Sin and even the Filipino people before coming to a decision. "We are a democracy, of course, and each side has got to be heard from," says businessman de los Reyes, "but I always believed in strong leadership, decisive leadership, and that you have to exude confidence. The way I see it, decisions ought to be forthcoming more quickly."

Rigoberto Tiglao, a reporter with *The Far Eastern Economic Review*, was less charitable: "Big business can plan to deal with coups and dictatorships — but no company can hedge against incompetence. The crux is Aquino's inability to spot problems before they develop into crises, and to achieve even the most rudimen-

tary governmental coordination to prevent them in the first place. [That] is why her administration is becoming tarnished by systematic incompetence." [13]

But Aquino's supporters say that democracy requires a consensual approach and that she purposefully avoids the heavy-handed style of her predecessor. "The only way to overcome that [policy by consensus] is to go back to authoritarianism," says Gomez. "We are trying to implement the empowerment of the people. It's the most difficult way to govern, but it's the only way to govern. They say she is slow. I say she is deliberate."

There is another criticism leveled against Aquino: that because, at the beginning of her administration, she failed to capitalize on her incredible popularity and prestige to corral the military, gut the Communist insurgency, right the economy and enrich the peasants in the countryside, she lacks the political capital she needs to make a positive impact before the 1992 presidential election. "She still has one and a-half years left," says Richard D. Fisher, a policy analyst with the Heritage Foundation, a conservative think tank in Washington, "but instead of building upon reforms that should have been undertaken by now, Corazon Aquino is, very unfortunately, in a fortress, self-defense mode. We will not be seeing any bold initiatives on the economic front or towards political stabilization."

W. Scott Thompson, a professor at the Fletcher School of Law and Diplomacy at Tufts University, agrees. "She's paralyzed because she doesn't believe that there is anything that she can do," he says. "She thinks things are unsolvable except by direction from God. But there was a God-given situation for a creative leader to start from scratch and govern strongly and purposefully. Instead, she allowed the vested interests to come back and dominate the country. When she had the emergency powers [at the beginning of her administration], she could have structured her government for cause-oriented people to run things. She threw away every opportunity to do the right thing, like land reform, for example."

Thompson, who was a 1989 Fulbright scholar in the Philippines, also says that Aquino's lack of control is having a deleterious effect on Philippine-American relations. "The relationship is unraveling for a variety of reasons, partly because there's a government in place that can't govern," he says. "There's more than a little frustration [in Washington due to] a sense of inefficiency in the Aquino government which is exacerbating the confidence of potential investors."

Paul Kreisberg of the Carnegie Endowment agrees that Aquino squandered some chances at the beginning of her administration, but adds, "that's also one of the easy shots to take. You can't really tell [what would have happened] if she had gone another route. For example, if she had used her authority by edict to impose land reform, would it have worked? Would the oligarchs have given up their land? I think that there is no question she has not been a strong leader and there were things that could have been done that she didn't do. [But] it's just so easy to be cynical and pessimistic. I just think that running a country is hard work."

Many observers say that the Philippines was, and remains, unsuited for the free-wheeling, yet systematically sound democracy that the United States introduced at the turn of the century. Fisher of the Heritage Foundation says that the odds were against American-style democracy from Day One. "When the Americans took over the Philippines in 1898, they inherited essentially a feudal society with a very strong, politically active Catholic Church," he says. "The American colonial period was characterized by an attempt to create a Philippine version of an American democracy. To a large degree, it failed. Even today, it is questionable as to how deep democracy is in the Philippines."

Fisher says the United States' ill-fated efforts in another Southeast Asian nation offer a clue as to why democracy is in trouble in the Philippines. "The lessons of Vietnam are crystal clear," he says. "If democracy cannot be fostered and developed by an indigenous population, then it sure as heck cannot be imposed from abroad."

Aquino's supporters say that the mere fact that political and civil liberties can survive in such a turbulent atmosphere shows that democracy is working in the Philippines. "The critical factor is less the quality of how democracy works per se in any one particular year than in the fact that it survives," says U.S. Sen. Richard G. Lugar, a strong Aquino supporter who was instrumental in forcing Marcos out. "It's like the metaphor of a tree: The roots of democracy grow and grow and grow."

But Philippine businessman Rodrigo de los Reyes questions whether American-style democracy, with its emphasis on individual liberties, is suitable for a country as poor as the Philippines. He says that there are varying degrees of democracy throughout Asia and that many Asian countries, like Singapore, South Korea and Thailand, do not follow the American model of democracy yet are relatively free — and prosperous. Historically, those countries have gradually introduced democratic freedoms and civil liberties, but only after achieving a certain level of economic success. "Can we afford American-style democracy?" de los Reyes asks. "My feeling is that once we are prosperous, . . . I think we can support democracy as now practiced in the United States."

For a businessman, political stability equals prosperity. To that end, de los Reyes and other influential Filipinos are casting about for a tough, no-nonsense candidate to run in the 1992 presidential election. Singapore Prime Minister Lee Kuan Yew, whose country is respected for its economic successes, is often mentioned as a prototypical leader for the Philippines. De los Reyes believes that the Philippines needs

such a leader, but he realizes that a Marcos-like leader would be unpalatable to a Philippine public that recently cast off 20 years of authoritarian rule.

Aquino's press secretary says that although the Philippine style of democracy is imperfect, the alternative — the return to strong-arm rule — would be worse. "I still think that in the long run, a rambunctious democracy is the way to go," Gomez says.

For democracy to succeed, say a growing number of experts in both Manila and Washington, the Philippines must break its near-suffocating dependence on the United States and develop a uniquely Filipino cultural and political identity. Only when the Philippines is truly independent, the argument goes, can the country develop viable political, economic and social institutions that are essential to any democracy. "There is a growing feeling that the Philippines must try harder to stand on its own feet," reporters Philip Bowring and John McBeth wrote in *The Far Eastern Economic Review*. "The thesis that the Philippines lacks nationalist self-respect is powerful. Foreigners are constantly astounded at the shallowness of many Filipinos' commitment to their nation. In one direction, provincial loyalties remain very strong, overriding national goals. In the other, there is a fixation with the U.S. [Both] retard the development of [a] national identity and keep the Philippines' gaze firmly fixed across the Pacific." [14]

A U.S. government source who helps shape U.S.-Philippine policy says that American policy-makers also are beginning to question the Philippines' dependence on the United States. "It's a part of the Filipinos' culture and belief that the Americans will always be there and will always be responsible for good and evil," says the official, who asked not to be identified. "We saw that during the whole Marcos drama when Marcos' people came in and said, 'Save us,' and anti-Marcos people said, 'Get rid of Marcos.' There is that psychological dependence which is not healthy. There's not a sense of national identity, and that's a problem."

Never was that too-close-for-comfort relationship more pronounced than during last December's nearly successful coup attempt. As rebel soldiers converged on Malacanang, the presidential palace, Aquino requested American help. Two U.S. Phantom jet fighters responded with a show of force, a measure that showed the coup plotters on whose side the mighty Americans stood. The coup attempt fizzled, and the United States was credited with saving Aquino.

But the Phantom incident may, in the long run, backfire against the United States, especially where the future of the U.S. bases is concerned. In the highly charged atmosphere of Philippine politics, Aquino is perceived as indebted to the Americans for saving not only her presidency, but perhaps her life. And with rising nationalist sentiment throughout the Philippines, Aquino's critics say that she is nothing more than another "Amboy," a derogative term used to characterize Filipino politicians who kowtow to the Americans.

A member of the Armed Forces of the Philippines who is laying the groundwork for the base talks says that "the perception now is that the government owes a bit of a debt of gratitude to the United States. There's a perception that they will give in on the bases because they have to pay [the United States] back for the Phantoms."

Bowring and McBeth raise another point resulting from the U.S. intervention: "It has also sparked self-disgust and soul-searching. Educated Filipinos now see the umbilical cord to the U.S. as dangerous, not through any fault of the U.S., but because it gives Filipinos an easy way out. Happy though the majority may have been with the outcome, it brought home a growing feeling that the Philippines had reached a point where it should escape its unhealthy dependence on the U.S." [15] And many Filipinos, as well as many Americans, view the termination of the bases' agreement as the only way the Philippines can truly assert its independence.

Future of U.S. bases is still in doubt

The bases — Subic Bay Naval Base, Clark Air Base and four smaller installations — have been a constant source of friction in U.S.-Philippine relations. The two countries originally agreed in 1947 to a 99-year lease on the facilities. In 1966, the term was revised to 25 years. Negotiations on the future of the bases are now under way; the next round of talks is scheduled for late August in Manila. Hundreds of millions of dollars in annual U.S. aid is tied to the current base agreement, set to expire in 1991,* and the negotiations are expected to focus on Philippine demands for additional assistance.

American defense planners insist the bases are crucial bulwarks against potential Soviet expansion in the Pacific and are essential for keeping the sea lanes from India to Japan open. Ninety percent of Japan's oil imports and 60 percent of the Philippines' oil imports pass through the region, according to information provided by the Public Affairs Office at Subic Bay. And maritime blockades in either the Molucca Straits off Indonesia or the Tsushima Straits off Japan would severely threaten international trade. (*See map, p. 452.*) The bases also serve important communications, resupply, training and repair roles for the U.S. 7th Fleet, which is based in Hawaii. During the Persian Gulf War in 1988, for example, the 7th Fleet relied

*The United States and the Philippines can't even agree on when the United States must vacate the bases if a new agreement isn't reached. The Philippine government says the expiration date is Sept. 16, 1991. The U.S. government argues that under the terms of the lease, which specifies a year's notice before abrogation of the agreement, U.S. forces could remain until September 1992.

heavily on the resupply and repair capabilities of Subic Bay, America's largest overseas naval depot.

Opponents of a continued American presence in the Philippines point out that the Soviets no longer pose a serious threat to regional security. And reports last spring that the Soviets were pulling out much of their sea and air capabilities from Cam Ranh Bay in Vietnam, across the South China Sea, lend credence to the argument that the threat of Soviet aggression in the Pacific has lessened.*

But Lt. Cmdr. Kevin M. Mukri, the public affairs officer at Subic Bay, says that although the Soviets seem to be pulling back, the security role of the United States has not diminished. "Certainly everybody is optimistic, but you have to look at their military capabilities," Mukri says. "They are very strong in this part of the world. They're building aircraft carriers. And who's to say that they won't put the planes back in?"

The American military presence is also important to the Philippines. With the Americans protecting the archipelago from outside aggression, the Philippines can concentrate on internal problems, like containing the Communist NPA. It also saves the Philippine government from having to spend millions of dollars annually for their defense. The bases benefit the Philippine economy in more direct ways as well. According to the Congressional Research Service, the bases contribute more than a half-billion dollars annually to the Philippine economy and provide employment for more than 40,000 Filipinos and support for hundreds of thousands of their dependents.[16] And the protection and stability the bases provide are a major incentive for foreign investors to do business in the Philippines.

Although Filipinos generally recognize the bases' economic contributions, an increasingly vocal minority now favors termination of the bases' agreement. They see the bases as a symbol of American imperialism. Others hope to use the bases as leverage to increase U.S. military and economic aid. Many Filipinos were angry that Congress provided $96 million less than the Reagan administration had originally proposed for fiscal 1990.

Philippine negotiators realize that it would cost the Americans billions of dollars to move the bases. Relocating the forces stationed at Clark Air Base would be relatively easy. Andersen Air Force Base on Guam is capable of accommodating the larger aircraft, such as B-52s, as well as fighters. And Singapore has indicated that it would be willing to provide room for more planes. But relocating the Navy is another matter altogether. As political scientist Lawrence E. Grinter notes, "Subic Bay is one of the finest deep-water ports in the entire Asian/Pacific/Indian Ocean region. With over 60,000 acres of land and water, Subic is the major U.S. ship repair and storage facility west of Hawaii."[17]

Guam, Palau and Singapore have been suggested as alternatives to Subic Bay. But according to Grinter, neither the small Apra harbor at Guam, nor the primitive Malakal or Babelthuap harbors in the Palau Republic, nor Singapore's commercial harbor is a suitable replacement for Subic Bay. Guam's main problem is that it is four steaming days from the Philippines, and six days from the Malacca Straits. Moreover, Guam's harbor currently has only one-quarter of the capacity of Subic and would have to be dredged to accommodate an aircraft carrier. Singapore's harbor is more ample, but it is crowded with commercial shipping, which would present security problems.

Mukri concedes that it would be difficult to move the bases, but he says the United States will not be held hostage to Philippine economic demands. "If we did leave," he says, "it would be a little harder and more costly. But that's not to say that if we depart we would be unable to carry out our capabilities in this part of the world."

Similar thoughts are being heard increasingly on Capitol Hill. "If the Philippines think that they are going to be able to extract all sorts of foreign aid commitments out of us for keeping the bases, they are absolutely wrong," says Rep. Patricia Schroeder, D-Colo., who chairs the House Armed Services Subcommittee on Military Installations and Facilities. Sen. Alan Cranston, D-Calif., chairman of the Foreign Relations Subcommittee on East Asian and Pacific Affairs, agrees, adding: "The bases really are somewhat less vital to us now in view of the end of the Cold War. If they ask too much, there will be those who say we might do better elsewhere."

Schroeder also expresses concern about the increasing violence against Americans in the Philippines. "As the security issue becomes more and more critical over there, the bases' negotiations become irrelevant," she says. "We just can't keep people there if they are under threat of life and limb."

Rep. Jim Leach, R-Iowa, the ranking minority member on the House Foreign Affairs Subcommittee on Asian and Pacific Affairs, says that if the Philippines and the United States can't agree on the economic, military and political necessity for the bases, then it might be best for both countries to close the bases. "If there is not a shared commonality of security interests and a perception of the same, then the United States doesn't want to become the center point for antagonism," he says.

Already, 15 of the 23 Philippine senators are on record as opposing the continued presence of the Americans. By law, two-thirds of the Senate must approve any new base agreement. Aquino still has not revealed her own position on the subject, saying she wants to keep her options open.

Some of those familiar with the negotiations expect

Continued on p. 458

*For more information, see "Should the U.S. Reduce Its Pacific Forces?" *E.R.R.*, April 20, 1990 (Vol. 1, pp. 221-236)

Continued from p. 456

that a compromise eventually will be reached under which the United States will be asked to give up the bases, but not for at least five years. During that time, they say, the United States can transfer its military facilities elsewhere and the Philippines can prepare the bases for commercial use.[18] Jose Abueva of the University of the Philippines, for example, says Subic can be transformed into a commercial port with ship repair facilities, fuel depots and an airport.

Abueva argues that the Philippines needs to be able to deal with the Americans as an equal partner. "We should assert our national sovereignty," he says. "We will be masters of our own ship, and I think that is very important."

Scott Thompson at the Fletcher School of Law and Diplomacy says that while a termination of the bases agreement might help the Philippines to end its overdependence on the United States, it's not feasible now. "All children need to break loose from their fathers — to use a Philippine metaphor — but it's rather a serious break," he says. "I'm all for it in principle, but what fills its space for the Philippine economy? It imposes some very serious dilemmas even if it would be gratifying for the Philippines and perhaps psychologically important for them. But it's just not realistic right now."

Sen. Cranston says the continued presence of the U.S. bases should not prevent the Philippines from developing its own identity. "I don't think that our presence in the bases deprives [the Filipinos] of the opportunity to stand on their own two feet," he says. "Our presence there is economically helpful for them."

Rep. Leach warns that the increasingly loud calls in the Philippines for a nationalist sense of identity could backfire. "The impact of nationalism could easily go two different directions," he says. "On the one hand, it could be used . . . to generate social cohesiveness. On the other hand, nationalistic sentiment can be used . . . to make internally counterproductive decisions. For example, in economic terms, 'nationalism' is a code word for protectionism."

Sen. Lugar supports any solution that would allow the Americans to continue to foster Philippine democracy. "We have to begin to talk about two, mature, independent, sovereign countries and what kind of mutually advantageous relationship we want to have," he says. "Our relationship is tied up with the success of democracy."

Lugar believes the situation in the Philippines may offer the United States valuable lessons as it develops policies toward the newly emerging democracies of Eastern Europe. "It would be a major mistake if we allow courageous revolutions to founder after the most difficult part has been achieved," he says. "I think it would be a mistake not to make sure that adequate economic resources [are made available]." Lugar says that despite all the changes in the world in the past few years, much of American foreign policy remains focused on containing communism and retaining a military presence around the world. "There is a tremendous interest in our system of democracy," he says, "but the focus of American foreign policy is not directed, in certain ways, to [fostering democracy]. One of the first lessons [we have to learn] is that we have to have faith in the democratic process ourselves."

NOTES

[1] Congressional Research Service Issue Brief, *Philippines Under Aquino*, May 14, 1990, p. 5.

[2] The World Bank, *Trends in Developing Economies 1989*, September 1989, p. 373.

[3] Stanley Karnow, *In Our Image: America's Empire in the Philippines* (1989), p. 423.

[4] *Ibid.*, p. 25.

[5] Congressional Research Service, *op. cit.*, p. 7.

[6] *Ibid.*, p. 9.

[7] World Bank, *op. cit.*, p. 373.

[8] *Ibid.*, p. 372.

[9] *The Manila Bulletin*, March 18, 1990, p. 1.

[10] Woods spoke March 7, 1989, before the House Foreign Affairs Subcommittee on Asian and Pacific Affairs.

[11] Congressional Research Service, *op. cit.*, p. 7.

[12] John McBeth, "People Powerless," *Far Eastern Economic Review*, May 10, 1990, p. 36.

[13] Rigoberto Tiglao, "Muddle in Manila," *Far Eastern Economic Review*, March 18, 1990, p. 49.

[14] Philip Bowring and John McBeth, "Basis of Dependence," *Far Eastern Economic Review*, April 12, 1990, p. 21.

[15] *Ibid.*, p. 20.

[16] Congressional Research Service, *op. cit.*, p. 12.

[17] Lawrence E. Grinter, "Policy of the United States Toward East Asia: Tough Adjustments," in Young Whan Kihl and Lawrence E. Grinter, *Security, Strategy and Policy Responses in the Pacific Rim* (1989), p. 38.

[18] See *Far Eastern Economic Review*, April 12, 1990, pp. 20-26.

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INTERNATIONAL MONETARY FUND

Fiscal Affairs Department

The Taxation of the Windfall from Internationalization of the Korean Capital Market

Prepared by Walter Mahler *

Approved by Karim Nashashibi

June 1990

Abstract

The paper describes the evolution of the corporate stock and bond markets in Korea and the Government's role in this evolution and its policy with regard to internationalization of the capital market. The paper analyzes problems encountered in gradually opening the Korean capital market to foreign participation and suggests alternative methods of taxing the windfall that will be generated. It also discusses the desirability of taxing the capital gains on financial assets as part of the global income tax in Korea.

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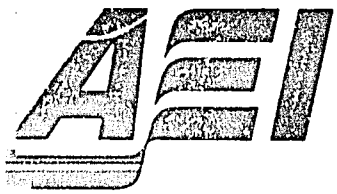

on the issues

The Coming Collapse of North Korea

By Nicholas Eberstadt

PYONGYANG, North Korea — Forty years to the week after the outbreak of the Korean War, the Cold War continues on the Korean peninsula. More than a million and a half Korean troops confront each other across the 130-mile "demilitarized zone." Communication between the two sides is all but nonexistent. In the north, Stalinism with Korean characteristics has not only been established, but perfected by Great Leader Comrade Kim Il Sung. In the south, more than 40,000 American troops and an undisclosed number of nuclear weapons remain today to deter North Korea from launching another surprise attack.

If East-West relations are markedly less tense today than in the recent past, precisely the opposite is true in Korea. In April, for example, it was reported that the Pentagon had revised its estimate of warning time in the event of another Korean war downward to only twenty-four hours.

In spite of such unpromising fundamentals, the forced division of Korea is becoming increasingly unsustainable.

Germany and Korea

It would, of course, be unwise to draw too many parallels between the German and Korean situations. Nonetheless, Germany has already demonstrated just how suddenly a long contest between rival states in a divided nation can com to an end. In Korea too, the race betwee north and south is now drawing to a clos

There was a time—thirty years ago—when the command planning system of the Democratic People's Republic of Korea seemed to be evincing better material results than the Republic of Korea's mismanaged, aid-fed and inward-looking economy. That, however, is ancient history. True, Pyongyang, the North Korean capital, is a clean city of tall buildings and cheerful colors that, despite a somewhat surreal, movie-set quality, compares favorably in a number of ways with Moscow and Beijing. At the same time, however, no one who has been to both cities could honestly say that living standards in Pyongyang even approach those in Seoul, the capital of South Korea. The contrast is reflected even in the faces of children. In Pyongyang, the most common skin irritation visible among schoolchildren is ringworm— an infection typically associated with poor hygiene or lack of soap. In Seoul, the corresponding affliction is acne— typically associated with a diet too rich in fats and oils.

In the countryside, the disparities between the two societies are even greater. The hillsides of North Korea have a brownish hue. The vegetation and underbrush have been stripped for firewood, forage, perhaps even food. Even in the poorest regions of rural South Korea, hillsides are generally green; peasants no longer

need to pillage the landscape for their sustenance.

North Korea's economy is animated by political enthusiasm; South Korea's, by personal incentives. The difference shows, and the gap can be expected to widen in the future.

As one might expect of a society based upon and driven by political fervor, North Korea, now in its fifth decade, is approaching exhaustion. Uniformed military personnel are everywhere to be seen, engaged not in traditional defense activities, but rather in ordinary construction and factory work. Such militarization, of course, can be read in many ways, but one interpretation is that special, conscripted units are now needed to do jobs previously entrusted to the regular civilian workforce.

North Korea has been built under, and around, a single ruler. Whatever one may think of him, Kim Il Sung has been an extraordinary force—a force, moreover, that has been consistently underestimated in the West. But this force is now 78 years old. Once a powerful orator, he now slurs and stumbles his way through pretaped television speeches. "Spontaneous" demonstrations of support for the Great Leader broadcast over North Korean TV today seem to lack their once characteristic hysteria.

Prospects for his son and heir-designate, Beloved Leader Comrade Kim Jong-il, are at best uncertain. Voluntary transfer of supreme power is consistent neither with the communist experience nor with the dynastic tradition of East Asia. The longer the transfer of supreme power from the regime's founding presence is deferred, the more fragile the inherited polity is likely to be.

In the diplomatic arena, the contest between the two Koreas for international recognition and legitimacy was, for a time, quite evenly matched. But by 1988, when Seoul served as host for the Summer Olympic Games, South Korea had clearly pulled ahead. With this month's meeting between Mikhail Gorbachev and South Korea's President Roh Tae Woo, the contest has moved to the endgame.

For more than forty years, North Korea has been able to count on support from its two communist neighbors, China and the Soviet Union. Now both China and the Soviet Union have developed strong trade links with South Korea—links they dearly wish to make even stronger. With the recent improvement in Sino-Soviet relations, moreover, North Korea's utility to Moscow and Beijing has diminished substantially. The Soviet Union reportedly continues to supply North Korea with arms, and to transfer some technology. Yet for all intents and purposes, the Gorbachev Politburo seems to have written off North Korea several years ago. Though symbolically important, the "surprise" meeting between Mr. Gorbachev and Mr. Roh was not so much a breakthrough as a public announcement of a pre-existing fact.

Western commentators described the meeting as a deft Soviet move. Examined more closely, Mr. Gorbachev's "coup" has many markings characteristic of a diplomatic blunder. Soviet officials, it now transpires, did not inform North Korea during the many months of preparation for the meeting that it was in the works. Soviet spokesmen went out of their way to make insulting comments about North Korea to the media before the meeting. Even by the most charitable reading, such behavior was ill-advised. The Soviet Union's allure to South Korea lies not in its commercial markets, but in its potential influence over the north—an influence Soviet actions have been busily and deliberately dissipating. Mr. Gorbachev may well have altered the "correlation of forces" in Korea, albeit inadvertently. The overall fact of Soviet decline, and the graceless first steps of the Soviet Union's new Korea policy, would seem to leave the United States with greater influence in

the Korean peninsula as a whole than it has enjoyed in decades.

How can the United States use this influence to encourage a free and peaceful reunification of Korea? First and foremost, it must retain its security commitment to Seoul. American power has helped maintain the peace in the Korean peninsula for thirty-seven years. It would be the utmost in folly to shun America's allies in the south at this point, when prospects for upheaval and instability in the north are rising actuarially.

Second, the United States can take steps to lessen needless misunderstandings—as opposed to fundamental disagreements—with North Korea. Scholarly contact and increased travel between the United States and the north are two possible avenues for nurturing the "human element" that has always figured so prominently in Korea's relations with the outside world.

Third, the United States can encourage its friends in Seoul to amend certain policies toward North Korea that are driven by emotion, and are manifestly self-defeating. It can no longer serve any good purpose, for example, to jam broadcasts from the north. North Korean propaganda is utterly unlikely to turn students in the south against their own government. A policy based on strength and reason would be to declare South Korea unilaterally open to broadcasts, mail, and visits from the north—and to invite North Korea to reciprocate.

Personalized Power

Fourth, the United States must start to think about encouraging South Korea to embrace fully the rule of law. Despite its open and competitive mass elections, the South Korean political system still lacks many essentials of the Western liberal order. Impartiality before the law, for example, cannot be taken for granted, and personalized, even vindictive, exercise of official power frequently occurs. Such qualities are troublesome and unpleasant today, but they will become incalculably more costly if South Korea should be in a position to set the basic terms of reunification in the not-too-distant future. In living memory, the north has known only harsh Japanese colonial rule and communist dictatorship. Bitterness runs deep in Korea, and regional animosities predate by centuries the surprise attack of 1950. Under the best of circumstances, Korea will take a long time to heal. Capricious, arbitrary, or predatory abuse of authority will only postpone that healing process.

From 1945 to the present, American policy in Korea can be read as a history of being taken unawares by events that were largely predictable. (This is but one of many differences between the Korean and the German situations.) The coming reunification on the Korean peninsula is a predictable event. The human cost—both in Korea and beyond—of the transition might be mercifully reduced if American policymakers began to think about it in advance.

[from the *Wall Street Journal*, June 26, 1990]

Nicholas N. Eberstadt is a visiting scholar at the American Enterprise Institute. His latest book is *Foreign Aid and American Purpose* (AEI, 1989).

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JOURNAL OF COMMERCE, September 19, 1990

Korean Failure on Farm Trade

By ROBIN BULMAN

SEOUL, South Korea — Increasing calls from all sectors of Korean society to pull out of the agricultural trade negotiations of the Uruguay Round underscore the shortcomings of a government that is not known for resourcefulness under pressure.

The problems farmers will face by market opening have been clear for many months, even years. And whatever settlement comes out of

ASIA VIEW

the Uruguay Round, which is being conducted by the General Agreement on Tariffs and Trade, will affect almost every major trading nation, not just South Korea. GATT is the Geneva-based agency that governs most world trade in goods.

Yet the South Korean government has chosen to blame the farmer's plight on insensitive trading partners rather than its own inability to implement real agricultural reform.

It is difficult to blame international calls for market opening on:

• Poor distribution systems that provide farmers with near-subsistence level incomes and at the same time gouge consumers at the supermarket.

• Poor planning that has farmers planting the wrong crops or raising the wrong livestock at the wrong time and then suffering the consequences.

• Growing stockpiles of rice that now threaten to spill out of government warehouses.

Now that the day of reckoning in Geneva is at hand, the South Korean government has offered little more than palliatives. As tension builds, the government sits passively on the sidelines as public opinion rallies 'round the farmer.

The image replayed almost daily in the nation's media pits the United States — a mighty force bent on bullying its way into agricultural markets worldwide — against the poor Korean farmer, a man who is doing his best to produce food for his country and keep a roof over his family.

These are powerful images in South Korea. Most Koreans are just one generation removed from the farm. Young, affluent office workers and business people may drive Hyundai sedans and live in fashionable apartments in Seoul, but their fathers, mothers, aunts and uncles often remain in the many towns and villages that dot the Korean countryside.

U.S. congressmen and women who want to understand why the average South Korean consumer is willing to pay three or four times the international price for rice would learn much by visiting South Korea during "Chusok," Korea's day of thanksgiving.

They would find millions of Koreans offering food, drink and prayers at the burial mounds of their ancestors. These mounds often are located in the middle of rice paddies, and they remind Koreans that their agricultural roots were severed not so long ago.

No can dispute that the Korean farmer has missed out on his share of South Korea's economic miracle.

While the nation's overall economy expanded 6.7% last year, the output of the agriculture sector declined by 1.6%. The percentage share of agriculture in the nation's gross national product has fallen from 23.4% in 1970 to 10.3% last year.

Sixteen percent of South Korea's population was engaged in farming last year. That's down from 23% in 1980 and 37% in 1975, but it still represents nearly 7 million people.

The farmers may be declining in numbers, but their voices are growing louder as they become radicalized in the face of what is being portrayed as a foreign threat.

At an annual meeting of farmers outside Seoul late last month, angry farmers booed and hurled cans and rocks at Agriculture Minister Kang Bo-seong, forcing him to step down from the podium in the middle of a speech. He had been telling them how the government would strive to minimize any damage resulting from an agreement in the Uruguay Round to reduce farm subsidies and barriers to agricultural imports.

A week later, South Korea's black-helmeted riot police clashed with an estimated 10,000 protesting farmers in nine cities. The protesters opposed the Uruguay Round negotiations. They also called for higher government purchase prices for rice. Even in protest-hardened South Korea, pictures of riot police clubbing farmers did not sit well with the public.

Most recently, a group of Korean academics signed a petition opposing the Uruguay Round agricultural negotiations.

A high-ranking official in the Agriculture Ministry said the recent outbursts and protests have "shocked" the government.

In an attempt to soothe the angry farmers, the government recently said that beginning in 1992, all customs duties collected on imports of agricultural and fishery products will be used to develop rural areas.

In addition, the government announced the creation of a special presidential adviser on agricultural issues. A high-ranking official described the new post as a "symbolic" gesture to farmers who have been feeling "ignored" by the government lately.

One can only wonder whether the farmer who felt the sting of tear gas in his eyes and the club of a riot policeman on his back in the recent protest rallies appreciates the government's symbolism.

Robin Bulman is Seoul correspondent of The Journal of Commerce.

CAMBODIA

Bush Team Rethinking Aid As Hill Wariness Grows

Effort to give assistance to non-communist rebel groups carries risk of helping infamous Khmer Rouge

The Bush administration has begun to reconsider its policy of providing assistance for the non-communist resistance in Cambodia, partly in response to growing congressional restiveness over the issue.

Secretary of State James A. Baker III, in an interview July 8 on a public affairs television program, said, "I think it's fair to say that we are rethinking the question of assistance to the non-communist resistance."

R. MICHAEL JENKINS

Baker says the administration is reviewing its policy.

A department spokesman said subsequently that the administration is undertaking a review of its entire Cambodia policy.

The review comes at a time when pockets of opposition to the administration's policy are emerging on Capitol Hill.

In the most significant action to date, the Senate Intelligence Committee voted June 28 to cut off an estimated $10 million in covert aid to the resistance, according to congressional sources.

The committee action came as part of its markup of the fiscal 1991 budget for the intelligence community (S 2834). But the program could be revived when the House Intelligence panel marks up its companion bill.

Members of the committee, whose proceedings are classified, and others in the House and Senate have expressed concerns about news reports that the two resistance groups backed by the United States are coordinating their military actions with the Khmer Rouge. There also have been reports that the Khmer Rouge has indirectly received U.S. aid.

The United States currently is supporting rebel groups led by former Cambodian leader Prince Norodom Sihanouk and Son Sann, a former prime minister.

The two form a loose coalition with the Khmer Rouge, which murdered more than 1 million Cambodians when it ruled the country in 1975-79.

There have been indications during the past few weeks that the Khmer Rouge is growing in strength vis-à-vis the non-communist resistance, which also reportedly led to the administration's decision to reassess the policy.

Sen. David L. Boren, D-Okla., head of the Intelligence Committee, would not discuss the action but said, "For me to favor any aid to the resistance, none of it should help the Khmer Rouge."

Boren also rejected the notion of aiding the resistance secretly, which precludes open discussion of the issue.

"It is a policy question that should be publicly debated," he said.

Similar sentiments have been expressed by other members, including many in the House. But after a floor debate about the issue, the House last month adopted an amendment to the fiscal 1991 foreign aid appropriations bill (HR 5114), which allows the administration to provide up to $7 million in non-lethal aid to the resistance. *(Weekly Report, p. 2078)*

The non-lethal portion of the aid will next be taken up by the Senate Appropriations Subcommittee on Foreign Operations, as part of its consideration of the fiscal 1991 foreign aid appropriations bill.

The House Intelligence Committee is scheduled to consider covert aid for the rebels when it marks up the fiscal 1991 intelligence authorization bill. That action could come the week of July 16, said Chairman Anthony C. Beilenson, D-Calif.

An Emotional Issue

Despite the comfortable margin of the House vote (260-163), the Bush administration appears less than sanguine over prospects for final approval of the total aid package, including its covert component.

"We were worried even before the [Senate] Intelligence Committee action," said one official.

In part, that is because of the highly emotional nature of the Cambodian aid issue.

Even aid supporters, such as Stephen J. Solarz, D-N.Y., chairman of the House Foreign Affairs Subcommittee on Asian and Pacific Affairs and sponsor of the aid amendment, are uncomfortable with the specter of indirectly helping the Khmer Rouge.

"Everyone agrees that our goal should be to prevent a Khmer Rouge victory," Solarz said. "The disagreements are over how best to achieve the goal."

Solarz, along with the administration, said he believes that aid to the resistance will pressure Cambodia's Vietnam-backed government to seek a political settlement under the auspices of the United Nations.

Despite the slow pace of current

By Carroll J. Doherty

multiparty negotiations about Cambodia. Solarz said, "It would be unwise and premature to rule out a political settlement."

The administration also is counting heavily on the talks to achieve a political settlement. "Our policy is focused on the efforts of the five permanent members of the U.N. Security Council to design a comprehensive settlement," said a State Department spokesman.

The next round of negotiations by the U.N. Security Council is scheduled for July 16 in Paris.

While stressing a political resolution to the Cambodian conflict, the administration and Solarz rejected the charges that U.S. assistance is benefiting the Khmer Rouge.

Solarz said, "There is no credible evidence that any of the aid is currently going to the Khmer Rouge." And Beilenson agreed with that view.

If such a circumstance were to occur, said Henry J. Hyde, R-Ill., a supporter of the Solarz amendment and a member of the House Intelligence panel, "the administration still has the option of pulling the plug on the aid."

Indeed, a number of congressional sources read Baker's July 8 statement, made on ABC News' "This Week With David Brinkley," as an indication that the administration is preparing to do just that. But Solarz said that, despite the policy review, the administration remains committed to supporting the resistance.

Debating Covert Aid

Opponents of the policy, among them Senate Majority Leader George J. Mitchell, D-Maine, voiced skepticism that a political settlement can be achieved, and said the sole U.S. interest in Cambodia should be in keeping the Khmer Rouge out of power.

Mitchell became involved in the debate last month, issuing a statement highly critical of current U.S. policy in Cambodia.

While his statement stopped short of calling for an aid cutoff, Mitchell advocated withdrawing U.S. diplomatic support for the antigovernment coalition's seat in the United Nations. "This U.S.-engineered coalition gives the Khmer Rouge international legitimacy it does not deserve," he said.

"In the literal sense of the word," Mitchell's statement said, "the administration's Cambodia policy is incredible. It is unsupportable. It must be changed."

Patrick J. Leahy, D-Vt., chairman of the Senate Appropriations Subcommittee on Foreign Operations, also has expressed reservations about the aid program, although he, like Mitchell, did not call for an aid cutoff.

Leahy said he is "troubled" by reports that aid is benefiting the Khmer Rouge. "I can't support anything that would allow that to happen," he said.

In the House, meanwhile, aid for the resistance has fared better, primarily because of the deep divisions among Democrats over the issue. Chester G. Atkins, D-Mass., whose district is home to thousands of Cambodian immigrants, led the fight against the Solarz amendment.

Like the Senate Democrats, Atkins opposed the amendment on the belief that the aid would serve to strengthen the Khmer Rouge. "In effect, we're providing a program of assistance to forces that, under our policy, we don't want to win," he said.

But while a majority of Democrats backed Atkins, a substantial number (107) supported the Solarz amendment. Republicans voted overwhelmingly for the amendment, and it passed easily.

With the Democrats so badly split, the House leadership was largely silent on the issue. Majority Leader Richard A. Gephardt, D-Mo., did sign a letter to colleagues, written by Atkins, urging the defeat of the Solarz amendment.

Solarz, who also is a member of the Intelligence Committee, said he believes the committee will take the lead from the full House and support covert aid for the resistance. "The members of the committee voted for my floor amendment by 16-3," he said.

But another member who formerly voted in favor of the aid, but now opposes the program, said he believes the vote could be much closer. "The continuous reports of cooperation between the resistance and the Khmer Rouge have caught the attention of many of us," he said.

Another committee member opposed to the program said, "To be candid, there are very few congressmen who have focused on the issue. But when you mention the Khmer Rouge, you wake people up."

Atkins predicted more defections, especially in light of the Mitchell statement and the Senate panel's rejection of covert aid. In addition, he said, there is declining Hill support for covert programs in general.

Solarz acknowledged that the idea of secretly backing resistance groups concerns many in Congress. But, he said, "the fact is there is really no need for covert aid qua covert aid. It's more of a question of supporting the resistance, regardless of what form the aid is in." ■

Views on Cambodia

Rep. Stephen J. Solarz, D-N.Y.: "Everyone agrees that our goal should be to prevent a Khmer Rouge victory. The disagreements are over how best to achieve the goal."

Senate Majority Leader George J. Mitchell, D-Maine: "In the literal sense of the word, the administration's Cambodia policy is incredible. It is unsupportable. It must be changed."

THE PENTAGON

New Chief Named To SDI Program

Defense Secretary Dick Cheney on July 10 appointed Henry F. Cooper Jr., a former arms negotiator, the first civilian director of the beleaguered strategic defense initiative (SDI).

Cooper succeeds Air Force Lt. Gen. George L. Monahan Jr., who is retiring. Chief U.S. negotiator in defense and space talks with the Soviets from 1987 to 1989, Cooper takes over SDI as it faces growing Hill demands for cuts.

His appointment was hailed by Jon Kyl, R-Ariz., a leading House proponent of the program. "It means the administration is very serious about SDI," Kyl said. Cooper recently finished a study for Cheney recommending that the Pentagon go ahead with "Brilliant Pebbles," a network of space-based interceptor missiles. "He will be able to go toe to toe with anybody on this program," said Kyl. ■

THE WASHINGTON POST, September 21, 1990

Elizabeth Becker

Cambodia: A Peace Plan With a High Price

It took nine years, the collapse of ommunism in Eastern Europe and haustive diplomatic bargaining, it finally a United Nations peace an has been agreed upon for Cambodia. It accomplishes the essential als of verifying the withdrawal of Vietnamese occupation troops d ensuring a free and fair election a new government under U.N. pervision but at a very high cost.

This high price is not the $5 lion needed for a U.N. force, a m that will invariably be halved; it letting the Khmer Rouge off the ok to achieve international consus. Pol Pot and his followers are ing accorded the same rights and ivileges as all other Cambodians, th immediate and far-reaching nsequences. They put Son Sen, man who had authority over Pol Pot's Gestapo-like security system, on a new interim council for Cambodia. They will be free to campaign during elections with huge campaign funds from China—the essence of this bargain for peace

Fortunately, the U.N. peace plan is so elastic the damage can be limited, especially if countries such as the United States act now. At a minimum, Congress could add on humanitarian aid for the people inside Cambodia to the Solarz aid package for the Cambodian noncommunist resistance. If the United States gave this aid through international organizations and posted an American diplomat in Phnom Penh now to oversee that aid, all the better. This would demonstrate America's commitment to its oft-spoken pledge not to allow the Khmer Rouge back in power.

For the war continues. The Khmer Rouge have not stopped their terrorist attacks, and they are trying to choke supply routes, with the tragic result that once again in Cambodia food and medical supplies are running short. Until a peace treaty is actually signed, there is no cease-fire in Cambodia and no date for holding elections. Peace may be tantalizingly near, but so, too, are the Khmer Rouge, with their midnight massacres of village chieftains and their threats to undermine the peace process.

The United States is not solely responsible for this peace plan. It is important that individuals as diverse as Soviet leader Mikhail Gorbachev, French diplomat Claude Martin, U.S. congressman Stephen Solarz, Australian foreign minister Gareth Evans, Thai prime minister Chatichai Choonhaven and U.S. Secretary of State James A. Baker III all played pivotal roles to bring about peace. But in the end, the final U.N. framework is nearly identical to one designed at a 1981 conference on Cambodia that calls for the withdrawal of foreign forces, a cease-fire, free elections under the U.N. and all within a "comprehensive political settlement." In other words, the bargain was struck nine years ago to uphold international laws forbidding foreign occupation and to ignore laws forbidding gross human rights abuses and genocide—to win peace by including rather than excluding the Khmer Rouge.

That is now history. The issue today is how to ensure that the consequence of this peace is not another war, to borrow a phrase from John Maynard Keynes. Someday there may be a trial and everyone from Pol Pot to Hun Sen to Prince Norodom Sihanouk could be judged for their roles in the Cambodian tragedy. Today, all the nations that have worked so hard to craft this framework should show up in force inside Cambodia, now, before final treaty signatures, and not only give aid but show with their presence that stalling tactics won't work and that this peace is not a prelude to another war.

The writer, a special correspondent for The Post, is the author of "When the War Was Over: A History of the Cambodian Revolution."

China: Most Favored Prison

How American Consumers Support a System of Slave Labor

By Charles D. Gray

YOU MAY have thought that there is an inherent and unbridgeable conflict between a communist dictatorship and American free enterprise. Not so. Not if the price is right, as it is in the People's Republic of China.

Despite the bloody Beijing massacre of June 1989, American business has found the communist climate of the People's Republic quite congenial. Trade with the United States continues to flourish. U.S. exports to China last year were valued at $5.8 billion, and imports from China to the United States reached nearly $12 billion—a total trade increase of 30 percent over 1988 levels.

Garments, toys, games, electronics, and footwear accounted for more than half of those imports into the United States. Many American toy companies, clothiers and department stores are doing a landoffice business with products carrying "Made in China" labels. In China, the profits go into the pockets of Communist Party officials who either double as businessmen themselves or parachute their sons, nephews and uncles into the offices of commercial enterprises.

Strangely, that kind of mutual backscratching of communists and capitalists has been praised as a sign that Chinese communism is reforming. But what those so-called reforms mean, mostly, is that American and other foreign business interests are free to enter into unholy partnerships with the Communist Party to exploit the Chinese people.

The events in Tiananmen Square—televised live to the world—showed the world how far the communist regime would go to repress its own people. How many other realities of life in communist China would shock the world if they could be viewed on television? Let us describe one, the Chinese prison system.

The 20 million persons now in China's prisons are more than prisoners. They are part of China's labor force, making products both for domestic and foreign consumption—everything from socks and textile goods up to machine tools and automobiles. There is no problem about constructing new jails in China—prisoners build them. One huge dam and water-power project was built by 1 million prisoners over a 10-year period. The total output of goods and services from prison labor is so large that it is routinely included in the country's GNP statistics. In fact, each prison has two names, one for its connection with the Public Security Department, such as Jail No. 1 of Cheng Tao, and the other for its role as a normal business enterprise, such as Cheng Tao Machinery Factory.

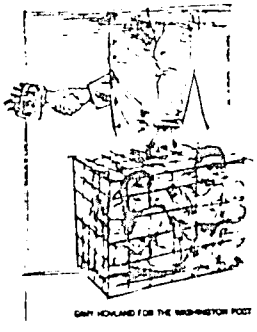
(It is not easy to identify which of the "Made in China" products reaching U.S. shores are made in prison. Senate investigators, however, recently did identify one: Dynasty wine, a joint venture between the Tianjin "wine-makers cooperative" and the French company Remy-Martin. The company said prisoners on farms had been used to supply grapes from 1982 to 1986 without its knowledge.)

The ingenuity of China's elite to exploit forced labor seems to know no bounds. Prisoners are also now available for leasing to private factories owned by foreign businessmen. In one case, a Chinese intermediary going by the name of Charles Chu offered to lease prisoners to any Western company wishing to open a factory in China.

China's prisons, its *gulags*, serve a political function that is even more important than their economic role. The prisons form a part of the communist structure to exercise tight political control and discipline over the people of China. Political prisoners serve as constant reminders to millions and millions outside of prison that they had better not deviate from party dictates.

Non-prison labor is kept under control through the All-China Federation of Trade Unions, which the party formed only months after taking power in 1949. The party's so-called "unions" exercise discipline over workers in plants and offices, large and small, making sure that they keep working at the pittance that the government thinks they deserve.

What really frightened China's ruling elite last year was the danger of decreased party control over workers. The student demonstrations were embarrassing enough, but hundreds of thousands of workers were joining them on the streets. Even worse, the workers were taking the daring step of forming their own Workers Autonomous Federations in Beijing and other major cities. China's aging leader, Deng Xiaoping, had long made known to his henchmen that he would not tolerate spread of the "Polish disease"—the founding of a movement like Solidarity—and so when the workers refused to retreat from their independent stance, he ordered a brutal military crackdown.



GARY HOWLAND FOR THE WASHINGTON POST

It so happened that shortly before Tiananmen Square erupted last year, President Bush had to decide whether to continue a trade privilege first granted to the People's Republic in 1980 designation as a "most favored nation"—a status that opens the way to low tariffs for a country's exports to the United States. Despite some criticism, Bush recertified China's status as a "most favored nation" for another year. At the end of this May, the president again endorsed the coveted MFN status for China, even as he withheld it from the Soviet Union.

Now it is up to Congress to overturn his decision. Why? Because China does not deserve to be one of our "favored" nations. It maintains a nation-wide network of slave labor camps. Its autocratic leaders have arrested and killed workers who courageously tried to form free trade unions. They forced world-renowned astrophysicist Fang Lizhi and his wife to flee for their lives to a refuge in the U.S. Embassy in Beijing. And they ordered the massacre in Tiananmen Square a year ago. Do we really want to favor that kind of nation?

Those who favor MFN for China offer a number of rationales.

- *The United States needs to support the Chinese communists as a buffer against the Soviet communists.* The truth is that China's leaders side with our geopolitical interests when it suits them, and *only* then.
- *We need to support U.S. business which would lose its large stake in China if Beijing lost MFN status.* Well, that's just too bad. What has happened to the old conservative argument that free enterprise and communism are incompatible? Is American capitalism so weak that it relies for its profits on a system propped up slave labor?
- *We must protect the interests of poor ordinary Chinese who benefit from U.S. trade.* Oddly enough, we hear this refrain mostly from American business lobbying groups, as though they, of all people, can speak for ordinary Chinese workers. Few Chinese workers are able to speak for themselves, but one who can—a woman now in the United States—told a recent public forum she favors sanctions, even more of them, and specifically cancellation of China's MFN status. Wouldn't that hurt Chinese workers? she was asked on CBS News. The short-term sacrifice, she said, was necessary to make gains for freedom.
- *We must defend the interests of poor American consumers, who desperately need all those "cheap" Chinese-made shoes and toys and dolls.* This rationale is offered at a time when consumers are deprived of ivory because of concern for elephants, when women are pressured not to wear fur coats because of concern for minks, when tuna fishing in the Pacific is restricted because of concern for dolphins. Would it be too much also to expect some concern for the working men, women, and children of China?

And concern, too, for American workers? After all, what happens in the thousands of workplaces of, say, China's Guangdong Province, next to Hong Kong, affects not just the workers there but workers right here in the United States. Why are New York City and some other cities suddenly faced with an outbreak of child labor? One reason is the exodus of young children, under 14, from Guangdong Province classrooms into garment factories that export clothes by container-loads to the United States. Why are women in the garment and textile plants of Pennsylvania and South Carolina working at pay barely above the federal minimum-wage level? One reason is that young women by the tens of thousand are working long hours in the garment and textile plants of Guangdong Province at below-subsistence wages, producing goods flooding the American market.

American business and Chinese communism have formed a partnership that is most favorable to themselves. They are conspiring to deprive both Chinese and American workers of their rights. It is high time to give that odd partnership a severe shock. It is high time to cancel China's most-favored-nation status.

Charles D. Gray is executive director of the AFL-CIO's Asian-American Free Labor Institute.

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EDITORIAL/OPINION

China's Economic Outlook

Last month the Joint Economic Committee released a report by the Central Intelligence Agency entitled "The Chinese Economy in 1989 and 1990." The following excerpt describes the prospects for China's economy and economic reforms in this decade.

As China's leaders enter the 1990s, they face a dilemma: their top priorities are to keep a lid on social unrest — thus maintaining party control — and to convince foreign bankers, investors and China's trading partners that life has returned to normal.

But they probably cannot meet these objectives over the long run without returning to the reforms abandoned in the past several years, which relied on decentralizing decision-making authority. Their short-term solution evidently is to ease credit gradually while extending central controls to keep inflation in check.

Such a policy, however, contains no lasting solutions to China's problems of economic instability. Industrial efficiency almost certainly will remain depressed because the expanded scope of central planning is likely to erode incentives by reducing managerial autonomy and forcing factories to sell goods at low, state-set prices.

Equally important, the increased allocation of raw materials and energy inputs to large state enterprises will further squeeze the dynamic non-state sector, hampering its integral contribution to economic growth — providing inputs for state enterprises, producing goods for export and absorbing labor from the over-saturated agricultural sector.

Beijing's strategy of merging essentially bankrupt companies — with their bloated work forces — with healthy enterprises is likely to introduce an additional drag on efficient production. Thus large state enterprises will not become engines of growth for the economy. Moreover, increased price and enterprise subsidies, combined with slower growth in state revenues, probably will increase the budget deficit.

If intensified government support to large state enterprises does not produce quick results, political pressures may force Beijing to open the credit spigot wider. Because China is resource-rich, such a move would spur growth, but without market-oriented reforms, easier credit alone will not improve the efficiency of investment, and increased aggregate demand will worsen China's energy and transportation bottlenecks.

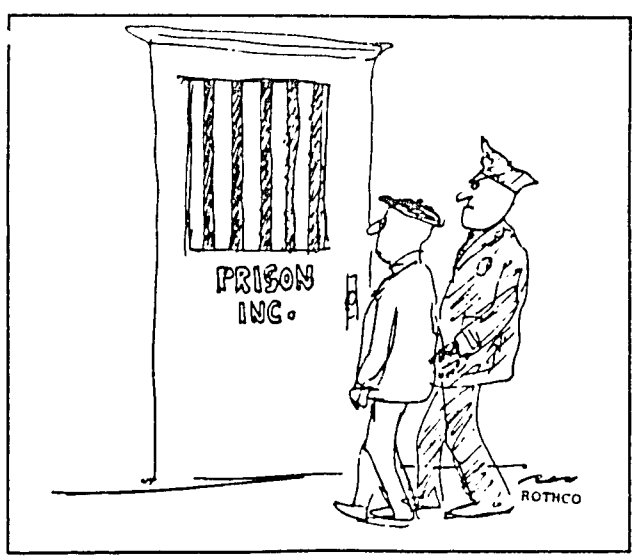
Indeed, policies of the past 20 months have treated the symptoms rather than the causes of China's overheating-prone economy, raising the specter of renewed inflation and a return to the boom-bust cycles that have plagued China's economy for the past decade.

Moreover, because China's macroeconomic management techniques are inexact and the economy responds with a lag to credit changes, Beijing might not know the economy is overheating until it is too late to take corrective action.

The large overhang of personal savings contributes to the likelihood of a renewed surge in inflation, once prices start to rise, people will quickly withdraw savings and purchase consumer goods.

As for the prospects for a return to reform policies, Beijing recently has been taking a softer line, probably in part to ease Western economic sanctions. For example, Beijing has reiterated its support for the Special Economic Zones, or SEZs, in southern China and recently approved Shanghai's Pudong district for preferential treatment to encourage foreign advanced technology investments and spur economic growth.

The official Chinese press also has announced approval for opening China's first futures market — for wheat — with eventual expansion for rice, corn and pork. Press accounts also have discussed opening a stock market in the Shenzhen SEZ and the development of experimental securities exchanges in Shanghai and Shenzhen. In addition, Beijing has announced increases in state-controlled prices of some raw materials and agricultural products.



The prospects for return in the near term to comprehensive, market-oriented reform nevertheless appear dim. Political support for reform has been weakened by leadership squabbling and the removal of two reform-minded party general secretaries in the past three years.

While it is unlikely that many senior officials want to return to the command economy and isolationist policies that dominated China before 1979, there are those in the leadership who want to place strict limits on the development of the non-state sector and to increase the party's role in enterprise management. Economic policy probably will be dominated by stopgap measures aimed at ensuring stability rather than by longer-term strategies for growth and development.

The inability to proceed with comprehensive, market-oriented reforms could slow Beijing's efforts to rebuild economic ties to the West, dimming China's long-term development prospects and widening the economic gulf between China and its market-oriented East Asian neighbors. The continued slower pace of foreign investment will impede Beijing's ability to acquire needed foreign exchange as well as foreign marketing and management skills.

Moreover, although Beijing has been able to adjust during the past year to the downturn in economic relations with the West, failure to proceed with reform could slow lending by international financial institutions, even if formal 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 also will stifle the pace of China's economic development.

THE JOURNAL OF COMMERCE, July 30, 1990

Putting Pressure on Beijing

By MICHAEL S. KNOLL

Many years ago, Thales of Miletus, a Greek philosopher, was confronted with the following query: "If you're so smart, why aren't you rich?" Rising to the challenge, he cornered the winepress market and made a mint.

More than 2,500 years later, economists have found a new way to use their smarts to earn money — as expert witnesses in anti-dumping and countervailing duty investigations before the U.S. International Trade Commission. Like Thales, who understood supply and demand, they are making money because they understand how markets work.

In the last few years, the role of economics in ITC anti-dumping and countervailing duty investigations has grown substantially. Because several commissioners use economic analysis for their statutory duties, petitioners and respondents increasingly are turning to economic experts.

Experts, however, do not come cheap. Lawyers who earn their living in international trade, and have long considered it their private preserve, are complaining that litigation costs have increased. Of course, it is not the legal fees they consider excessive, but the fees of the newcomers, the economists.

What these critics fail to appreciate is that economists are vital to the ITC proceedings. This is not a matter of economic hubris. The anti-dumping and countervailing duty laws require the ITC to answer an economic question in every investigation: "Is the domestic industry materially injured by reason of the dumped or subsidized imports?"

To answer this, one has to assess the economic impact of the dumping or the subsidy, which is a fact-based economic inquiry, not a legal one.

For several years now, economists have been appearing before the ITC armed with their economic models, replete with regression coefficients, confidence intervals and t-statistics.

Detractors like to point out that economists' models rely on assumptions about such things as the elasticity of demand and supply of the relevant product and the degree of market power. Because these models make assumptions, the answers they provide are seen as hypothetical and too imprecise.

Absolute precision, however, is not required in these cases. The commission must make a threshold determination; it only has to decide if the impact of the unfair trade practice is large enough to meet the statutory standard of material injury. It is sufficient to make a ballpark estimate, a task for which economic analysis is amply suited.

Lawyers may claim that the statutes call for a legal determination. But even though the anti-dumping and countervailing duty laws are statutory creations, they require an economic conclusion, not a legal one.

Lawyers have no inherent insight into the relevant phenomena. When they approach economics, lawyers are true sophists — providing plausible but fallacious answers and making the weaker argument appear the stronger.

Lawyers do play two important roles in the process. First, litigation in the ITC is a matter of advocacy, for which lawyers are trained. Second, ITC investigations are conducted in accordance with statutes that have to be interpreted. Although economics has a role to play in statutory interpretation, statutory interpretation essentially is a legal exercise.

Although lawyers play the role of advocate for their client in every case, statutory interpretation is likely to be important in only a few cases. The law does not need reinterpretation for each new case.

Economists, on the other hand, must assess the impact of the dumping or subsidization in every case, not because the economic analysis is different, but because the facts are different.

The issue of the proper role of economics in anti-dumping and countervailing duty cases is likely to erupt later this summer when the ITC rules on whether sweaters imported into the United States from Hong Kong, South Korea and Taiwan are injuring competing U.S. producers.

This sweater case is the largest anti-dumping inquiry to come before the ITC in some time. If the ITC rules in the affirmative, $1 billion worth of sweaters imported into the United States each year could be subject to indefinite tariffs. This is a high-profile case, and it gives the ITC a chance to demonstrate to a broad audience that it uses proper economic techniques to execute its statutory mandate.

Improving the economic analysis on which the ITC bases its determinations need favor neither protectionist nor free trade interests. It will, however, make the process more rational and transparent.

That will go a long way towards blunting our trading partners' criticism that individual anti-dumping and countervailing duty decisions are unduly subject to political influence.

Proper economic analysis is necessary for the enforcement of the ITC regulations. As long as the anti-dumping and countervailing duty statutes demand an economic answer, the participation of economists will remain crucial to the process.

Michael S. Knoll, a lawyer and economist, is an assistant professor at the University of Southern California Law School. He served as a special assistant to the two most recent chairmen of the ITC.

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Reconstruction in Afghanistan, Indochina, Central America, Southern Africa, and the Horn of Africa

AFTER THE WARS

Anthony Lake and contributors

After a decade or more of fighting and destruction in various regions of the world, new policies in Washington and Moscow as well as fatigue on the ground are producing openings, at least, for peace. Negotiations are at different stages regarding Afghanistan, Indochina, Central America, Southern Africa, and the Horn of Africa—but all share new possibilities for peace.

This volume analyzes the prospects for postwar reconstruction and development in these regions, tackling the difficult quandaries they face individually and collectively: Among realistic potential alternatives, what kinds of new political structures can best manage postwar reconstruction and development? Which economic policies would be most effective in maintaining peace and political coalitions? Should the focus be on the reconstruction of prewar economic life or on creating new patterns of development? What are the prospects for democracy and human rights?

The authors thus consider the relationship of economic planning and likely political realities. For example, might diplomats seeking to stitch together a fragile coalition in order to end the fighting also be creating a government that cannot make the hard economic choices necessary for sustained peace? Might economists calling for postwar economic programs which are theoretically sound but politically unsustainable threaten a tenuous peace?

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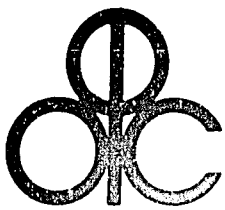

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QUARTER 3, 1990

WASHINGTON ECONOMIC WATCH

A Digest of Development Policy Information

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EASTERN EUROPE

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Secretary Baker

Current
Policy
No. 1289

Assistance and Reform: Eastern Europe and Central America

United States Department of State
Bureau of Public Affairs
Washington, DC

Remarks by Secretary of State Baker at the G-24 Ministerial Meeting, Palais D'Egmont, Brussels, Belgium, July 4, 1990.

Almost one year has passed since leaders at the Paris economic Summit asked the European Commission to coordinate Western assistance in support of fundamental reform in Poland and Hungary. Since then, the commission and the member states of the G-24* have committed more than $14 billion in economic assistance and investment credits to support the transition of these two countries to democratic governments and market-oriented economies. I would like to congratulate President Delors [France] and his colleagues, especially Vice President Andriessen [Netherlands], as well as the commission as a whole for their highly capable efforts.

This is a transition never before undertaken by so many so quickly. The G-24's broad support for reform in Poland and Hungary is based on the recognition of a simple fact: the people of these two countries are determined as never before to shake off the mistakes of the past. In April 1989, President Bush indicated that our support for Poland was predicated on tough decisions that only the Polish people could make. Under the leadership of Prime Minister Mazowiecki, the Polish government, supported by a majority of the people, has not hesitated to make such tough decisions.

We have also begun to work constructively with Prime Minister Antall and the other members of the new, freely elected Hungarian government. We are pleased that on September 6, this new government will open the Budapest Environmental Center, an idea first proposed by President Bush last year. With a Hungarian executive director, an American program manager, and broad European support, the center will become a prime example of transnational cooperation for progress in Central and Eastern Europe.

We look forward to hearing assessments from our Polish and Hungarian colleagues on the progress they have made and on how our efforts can be channeled to meet the challenges ahead.

But, today, we have another important task before us—to welcome Czechoslovakia, Yugoslavia, Bulgaria, and the German Democratic Republic into this process. In December, we opened the way for G-24 coordinated assistance for these countries as soon as they met the political and economic criteria for such assistance. Now, they have done so.

In the June 8-9 election, the Czech and Slovak people firmly endorsed the "velvet" revolution and the leadership of Vaclav Havel, Civic Forum, and the Public Against Violence.

Yugoslavia has embarked on an ambitious program of economic and political reform. Just last week, the Markovic government announced a broad expansion of its economic reform program. We believe this program charts a solid course for Yugoslavian prosperity. The Republics of Slovenia and Croatia have

* The G-24 comprises the 24 countries of the Organization for Economic Cooperation and Development. At the July 1989 Paris economic summit meeting, the leaders agreed on the need to coordinate Western assistance to support political and economic reform in Poland and Hungary. The European Community Commission, which was asked to coordinate the process, has convened a series of meetings of the 24 countries.

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recently held free elections, and other republics are expected to hold such elections in the near future.

Set against this progress, however, are rising internal tensions, particularly in the province of Kosovo. This concerns us greatly. We of the G-24 should collectively call upon the people, and the leaders, of Yugoslavia and its republics to resolve their difficulties peacefully and with full respect for human rights. Political and economic reform, even when fully supported and nurtured by friends and neighbors, cannot succeed if it is undermined by intolerance from within.

In Bulgaria, we have expressed our deep concern about the fairness of the recent elections. Nevertheless, pending formation of the new Bulgarian government and assuming continued democratization, we believe that progress toward reform has been sufficient for Bulgaria to be eligible now for G-24 assistance. The United States will continue to monitor closely the process of democratization and free-market reform in Bulgaria. We are prepared to provide tangible support for this process. At the same time, we need to keep in mind that G-24 conditionality is not a one-time threshold but a continuing requirement.

The German Democratic Republic is, of course, a special case and needs to be treated as such. I believe the events of this week are the first steps toward a bright economic and political future for all the people of Germany. Pending German political unification, however, it is appropriate for the G-24 to recognize the tremendous progress that has been made in the GDR toward political and economic reform.

Unfortunately, Romania has not yet met the conditions required for G-24 support. The Iliescu regime's complicity with the miners' violent repression of demonstrators and the arrest of the political opposition raised serious questions about its commitment to democratic reform and basic human rights. We look forward to the day when we can include Romania in the G-24 process. However, we will require demonstrable progress on both political and economic reform and respect for human rights before that day can come.

The United States believes it is essential that we maintain the integrity of the G-24 process. As I noted at the outset, this process was established to support Poland and Hungary as they moved to embrace the principles of political and economic freedom. Following those principles, the G-24 has helped both countries to follow through on their own decisions to join the community of democratic nations. Our decision to expand the process to the other countries of Central and Eastern Europe recognized their progress in political and economic reform. The commission, working with the G-24 member states, has developed the following five criteria that should determine eligibility for G-24 coordinated assistance:

- Adherence to the rule of law;
- Respect for human rights;
- Introduction of multi-party systems;
- The holding of fair and free elections; and
- The development of market-oriented economies.

These criteria—the criteria that our CSCE [Conference on Security and Cooperation in Europe] meetings in Bonn and Copenhagen have set for all of Europe—send a clear message to reformers and thinkers alike. Western assistance is designed to support fundamental political and economic reform. Its purpose is not to maintain the status quo or to revert to the problems of the past.

We also appreciate the contributions of the IMF [International Monetary Fund], World Bank, OECD [Organization for Economic Cooperation and Development], and the Paris Club [official bilateral creditors]. These institutions are playing major roles in assisting the political and economic transition of Central and Eastern Europe. And our policies of assistance should complement the programs of these international institutions.

We believe that other international institutions that play significant roles should also be invited to participate in G-24 ministerials and senior experts' meetings. For example, the ILO [International Labor Organization] plays an important part in the working group on training, and the effective handling of labor issues is essential to successful economic reform in Central and Eastern Europe.

We also need to be creative about adapting current institutions to meet new needs. Therefore, I propose that the OECD create a new *affiliate status* to meet a new need. This new status would be available for those states that have developed democratic political systems, committed themselves to creating market economies, participated in the OECD Center for European Economies in Transition, and shown an interest in eventual OECD membership. Affiliate involvement in OECD activities would be tailored to their unique needs and interests. Affiliate status would, in short, be one more way to foster a greater sense of inclusion for the newly democratizing countries.

Before closing, I would like to say a few words about our proposal for a G-24 effort in Central America. Recognizing the great success of the G-24 mechanism in Europe, the United States has proposed to the 12 EC foreign ministers, President Delors, Japan, and Canada that we develop a G-24-like mechanism to broaden support for democracy and development in Central America. I have discussed it with a number of you and with the Central American presidents.

At their June 18 economic summit, the presidents welcomed the idea

as a way of maintaining international attention on the region's economic and political progress, despite competing events in Eastern Europe and the Soviet Union. They believe, as we do, that we cannot let the great events of Europe lead us to overlook other opportunities and needs elsewhere.

We have not yet worked out specifics of the structure and functioning of the mechanism, because we wanted to solicit views from the Central Americans and other interested governments. Although inspired by the East European G-24, the mechanism for Central America would be a separate and distinct process, reflecting the different realities of the two regions.

At this point, we see the mechanism serving two main functions: **1)** bringing together developed countries and the Central American states to discuss needs and resources, and **2)** acting as a clearing house for information. It might also prove useful for: **3)** preparing coordinated needs assessments, and **4)** pursuing a small number of joint projects too large for any single donor nation.

Let me close with this observation. Last year when the European commission and the member states of the G-24 undertook the task of coordinating Western assistance to Poland and Hungary, it was truly a leap into the unknown. Now we are fully engaged in a task with a great redeeming purpose: helping to bring the long-denied benefits of democracy and economic liberty to the nations of Central and Eastern Europe. Working through the commission and the G-24, our collective efforts must continue to quicken the courage of the peoples we have promised to help in their quest for freedom and prosperity. □

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The Bank's Eastern and Central European Program

The World Bank's Eastern and Central European Program (ECEP) is an initiative originally designed to deepen understanding of the problems confronting economies in transition from central planning to market institutions. The Bank launched the ECEP in February 1989 with the specific objective of enriching the analytical dimension of policy advice and, more generally, strengthening the quality of the assistance programs. The following approaches were endorsed:

- First, intensify work on critical aspects of economic reform where little is known, or where solutions to policy problems are not evident.
- Second, widen the Bank's contacts with outside researchers and institutes engaged in work on Eastern and Central Europe.
- Third, increase the Bank's capacity to advise governments on appropriate policy reforms.

The Chief Economist of the Europe, Middle East, and North Africa Region has formed a steering group to help design and guide the program. Members represent the Bank's research complex, including the Socialist Economies Reform Unit (CECSE), EDI, Strategic Planning, the Sector Policy Department, and the China Department.

In the wake of last year's revolutions and the tremendous interest and work in Eastern and Central Europe, the ECEP has now taken on a more formal role. As part of the ongoing reorganization of the World Bank's European department, a full-time position for ECEP administrator has been established in the Director's office. It is now the locus for establishing priorities for the Bank's analytical and research efforts—it funds important comparative work on transition problems and disseminates information on what the Bank and others are doing. Repeated urgings at G-24 meetings to avoid duplicating efforts while dispensing reasonably consistent policy advice underscore this preoccupation.

In its first year of operation, after convening an "expert group" of policymakers from Eastern Europe, distinguished academics, and IMF and Bank staff, the ECEP has concentrated on three main areas:

- Macroeconomic management during the transition to a more market-oriented economy, particularly the associated questions of how to abandon central control of prices while avoiding excessive inflation, and how to sequence policy changes to minimize economic costs.
- Enterprise behavior and reform, including issues of monopolies, restructuring, and privatization.
- Safety nets to deal with the social costs of adjustment, including severance and unemployment compensation, pension reform, and housing.

Much has been accomplished in these areas, both in developing analyses as well as through disseminating information through conferences and workshops (e.g., the Privatization Conference, reported on the first page of this issue of our newsletter).

Analytical priorities

Over the next year the ECEP intends to focus on the following work:

- The most urgent analytical and research priority is *enterprise reform*. The responsiveness of micro-units to the changing economic environment in reforming socialist economies is problematic: it is not clear that market structure, internal enterprise organization, technology, management, and attitudinal patterns are conducive to a strong supply response once prices are liberalized and financial constraints are applied. Without a strong supply response at the enterprise level, however, reform programs will flounder.
- *Privatization and ownership issues* are likely to be proceed slowly. In a broad sense governments will need to manage and "regulate" not only their "natural" monopolies but also firms that will be privatized. While considerable knowledge exists on the regulation of natural monopolies, little work has been done on mechanisms for managing other firms as central controls fall away.
- *Reform of the CMEA* is another area of concern. CMEA trade will be conducted principally at international prices and settled in convertible currencies by early 1991. Because the most substantive proportion of this trade is the exchange of Soviet oil, natural gas and primary commodities for inferior manufactures from East and Central Europe, the smaller CMEA countries will likely experience substantial terms of trade losses. The Soviet Union may well need to finance the ensuing balance of payments deficits to smooth adjustment over a few years. In the process, however, countries will become more heavily indebted, raising new issues for the continuing flow of Western commercial bank credits.
- The *role of the state* in all the reforming countries of Eastern and Central Europe can be expected to undergo major changes as governments withdraw from numerous activities. This will be reflected in a major reorganization and reorientation of fiscal systems as both the content and composition of expenditures change, and as revenue sources are shifted from turnover taxes and archaic company and payroll taxes to more modern systems of consumption, profits, and income taxes. The manner in which this transition will be accomplished and its relationship to the other reforms that are being contemplated are a continuing focus of an analytical work.

• Very little work has been done on *local government*. Not only are local governments responsible for the delivery of vital social services (including housing), they are often the effective owners of a large number of enterprises. Their role is likely to change significantly as reforms accelerate.

• Work on *social "safety nets"* is a major focus of attention and will continue to be part of the economic and sector work program. In each country, policy advice will cover such topics as unemployment compensation and retraining schemes, old-age pensions and social security schemes, and financing and delivery of health care. (Housing sometimes falls under this heading.) In addition, however, the ECEP will sponsor comparative analytical work and disseminate the information to the countries.

• The *environment* is a major issue. The Bank is playing a very prominent role in assisting countries in developing standards and regulations, incentive policies, and upgrading management capacity. Much of the Bank's effort is through sector and project work, for instance, in the recent loan to Poland. An increasingly important topic is assessing the macroeconomic costs of reducing pollution in Eastern Europe.

For more information on ECEP, contact Farid Dhanji in EM4CO, (202) 473-2968 or Christine Kessides at (202) 473-2962. ■

Quotation of the Month

"Recognizing political constraints, I would urge five economic initiatives [for Eastern Europe], some of which may be out of sync with our allies.

"The first is debt forgiveness, a new Bush Plan for Eastern Europe to complement the Brady Plan for Latin America. Neither political party is contemplating foreign aid increases or granting the Executive Branch anything like the flexibility it needs to manage prudently our existing foreign aid program. While geostrategists within the leadership of the majority party have propounded the stunning thesis that the United States should proffer direct aid to an economically unreconstructed Soviet Union, my sense is that the driving priority ought to be for the United States to emphasize, above all, the need to preserve the gains for freedom in Eastern Europe. In this context, we have little choice but to emphasize reducing old debt rather than raising false expectations about substantial new commitment.

"Accordingly, I have introduced legislation that authorizes the President to write down public sector debt in Eastern Europe on a case-by-case basis.

"Attendant to such an approach are three perplexing issues: the obligations of the commercial banks; the attitude of Western European official creditors; and the problem of precedent.

"Treasury is particularly concerned that the cart not come before the horse, that commercial banks not have their credit liabilities strengthened at official expense. However, that is unlikely, in part because official debt is so much larger than commercial debt in Eastern Europe, that the private sector will go first. The strategy should thus be to induce commercial debt reduction in tandem with official.

"Western Europeans, who hold the brunt of current debt, have misgivings, but despite this it is the obligation of an American Presidency to lead. Precedent exists with the Brady Initiative, with the mutual decisions of the past several years to write down sub-Saharan Africa debt, and with the London Accord of 1953 in which the allies agreed to reduce $2 billion of German debt in order to strengthen democratic governance in Bonn.

"Given the Marshall Plan and post-war German debt restructuring, we have every right to speak to our allies with moral force. If the Europeans are discomforted, so be it. The fact is that just as the Brady Plan changed the landscape of international finance with its very introduction, a personally stamped Bush initiative of this nature would so change the expectational framework in Eastern Europe that in one form or another Western European governments would be hard-pressed not to accede. We can't prudently go it alone; we can insist on allied unity, not for our sake, but for the sake of stability on their continent.

"The second initiative, on which the U.S. Congress has already made a down-payment, is to provide modest direct aid, preferably to advance private sector development rather than bolster social programs or debt service.

"Third, the President and Congress should exhort American business to invest in Eastern Europe. The President has agreed to help orchestrate private sector volunteer efforts, but there is no substitute for real American entrepreneurial commitments. Investments in jobs as well as ideas are in order.

"Fourth, and perhaps most important, the United States ought to negotiate a free trade agreement with the countries of Eastern Europe and the Baltics, beginning with Poland.

"Fifth, despite budget problems at home and the contingent liabilities implicit in lending through international financial institutions, the United States should become a constructive partner in the proposed European Bank for Reconstruction and Development. At a time when substantial troop reductions are under serious consideration in the European theater, the United States should replace military leadership with economic. Now may be a time to reduce troops; it isn't time to reduce economic ties. America cannot turn its back on Europe, especially at this time of such wrenching — and hopeful — economic and political transition."

Remarks delivered by US Representative Jim Leach at a seminar on Eastern Europe sponsored by the IMF and Georgetown University, May 18, 1990.

Cato Policy Report

July/August 1990 Volume XII Number 4

The Preconditions for Eastern Europe's Economic Recovery

by John G. Greenwood

During the past few years academics and political observers have frequently discussed two alternative models for the reform of communist societies. The first model, pursued by President Mikhail Gorbachev in the Soviet Union, starts with political reforms and follows on with economic reforms. That pattern is now being repeated across much of Eastern Europe, although Hungary, which has experimented with some degree of economic liberty over the past 20 years, is an exception. The second model, best represented by China, starts with economic reform and moves to political reform only later. However, in the case of China the political reform movement was snuffed out abruptly on June 4, 1989, by the massacre in Tiananmen Square and the subsequent campaign of repression.

Those two models are naturally somewhat simplistic. Economic freedom is only one component of a broader concept of freedom that includes political freedom. There is also in practice much overlap between the two areas of freedom. For example, a country that accorded its citizens both political and economic freedom would presumably permit an individual to buy or sell a copy of a book by either Mao Zedong or Milton Friedman. It is hard to envisage a situation in which it would be permissible to buy copies of such books without also being allowed to advocate the ideas contained in them. Therefore, economic freedom is probably not feasible without some degree of political freedom.

Conversely, the overthrow of communist regimes in Eastern Europe and the emergence of greater political freedom suggest that there will be growing pressures for economic reforms (i.e., greater economic freedom stemming from political freedom). To date that hypothesis is largely untested, although five years of glasnost in Russia does not appear to have achieved very much perestroika (economic restructuring). It is therefore quite likely that there will be considerable opposition from vested interest groups to extensive economic reforms in other parts of Eastern Europe. Also, political freedom alone is not enough to ensure economic success. On one level, political freedom implies the ability to participate in the democratic process of selecting government representatives. On another level, political freedom implies the existence of a whole range of civil liberties such as freedom of speech, freedom of association, and the protection of private property rights under the rule of law. For example, Hong Kong has never enjoyed democracy, yet under British administration its people have enjoyed a high degree of civil liberties and private property rights, which have enabled the economy to grow at an astounding rate for over four decades.

These initial observations suggest that the introduction of democracy may in fact be the easy part of reform in Eastern Europe. To judge from the record of Hong Kong and other successful economies, economic prosperity is

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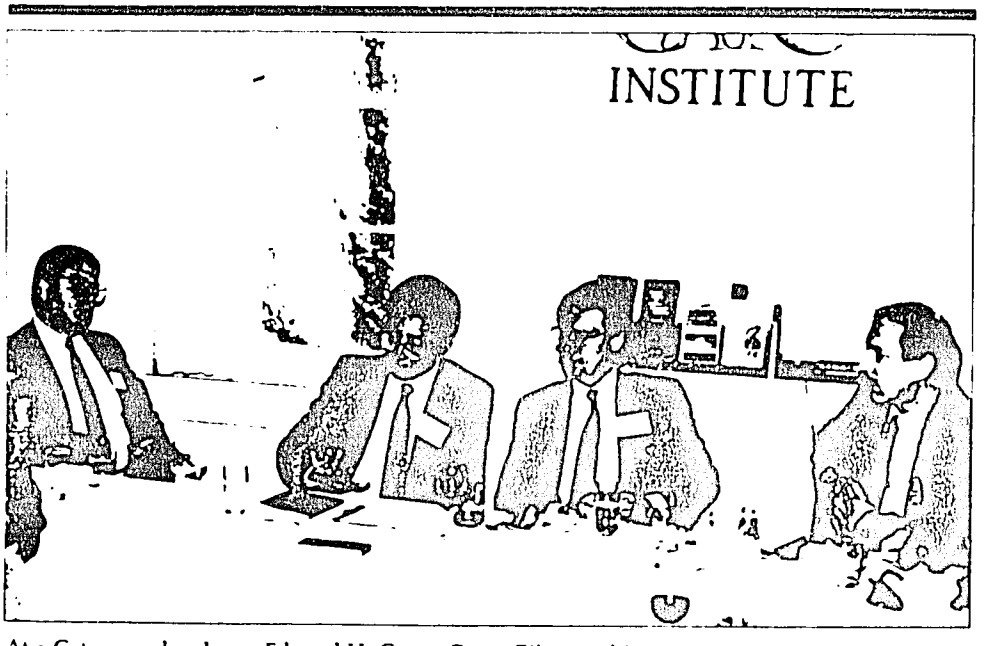

At a Cato press luncheon, Edward H. Crane, Roger Pilon, and James A. Dorn listen as Martin Lee, former member of the Hong Kong Basic Law Drafting Committee, discusses the difficulty of creating democratic institutions before the 1997 Chinese takeover of Hong Kong.

Eastern Europe (Cont. from p. 1)

built on five fragile foundations:

1. the rule of law,
2. a relatively incorrupt bureaucracy and independent judiciary,
3. predominantly private ownership of property (homes, farms, factories, and so on),
4. free-market prices, and
5. a stable monetary system.

Using that framework one can set up some simple measuring rods against which to monitor progress in Eastern Europe over the next few years.

The Rule of Law

The rule of law implies equality of individuals or companies before the law. The legal framework may be based on common law or civil law, or on more feudal concepts such as those on which Japanese law was based during the 19th century, but in all cases it must be clear what the freedoms, rights, and obligations of individuals in the society are. The legal system defines and provides for the protection of those freedoms and for the protection of property rights. Most communist societies virtually abolished the rule of law as we know it in western society and have relied on the arbitrary rule of the Communist party, which has typically shifted its ideological base as one leader followed another. Before World War II, most of the countries of Eastern Europe enjoyed the benefits of a legal system, but with the adoption of communism after the war, the law and respect for it atrophied. If a fundamental revival of liberty and prosperity is to take place in Eastern Europe, the legal systems will have to be rebuilt around such basic concepts as individual liberty and the notion that politicians and governments are not above the law. That task will not be rapidly accomplished.

Integrity and Independence

The rule of law also emphasizes the supremacy of *law* rather than that of *men*, which requires a relatively incorrupt bureaucracy and an independent judiciary. Those are implicit in the rule of law, but their existence is so important that it justifies separating them from the rule of law itself. Other agencies charged with law enforcement, such as the police, require similar attributes of independence from the people or party in power and a relatively high level of integrity. Their loyalty must be to the law or to the system itself, not to a particular party or governing group of individuals. Societies that have been successful economically are typically also societies in which every individual is equal before the law and firms have an equal opportunity to secure government contracts through open competition. Where there is discrimination on the basis of ideology or personal contacts, or where there is outright corruption based on the amount an individual is willing to pay under the table, the process of government seldom works to the advantage of the people as a whole.

> **"Legal systems will have to be rebuilt around such basic concepts as individual liberty and the notion that politicians and governments are not above the law."**

Yet in communist societies where the wish of the party was absolute, there was no room for decisions based on objective rules. Party members, bureaucrats, and sometimes judges were above the law. For a telling insight into the relationship between communism and the rule of law, consider the experience of Miklos Vasarhelyi, the only living survivor of the 1958 show trial of Imré Nagy, the deposed Hungarian leader, and nine others. Vasarhelyi had been a member of the first anti-Stalinist study groups in 1953. He became Nagy's press secretary and served a four-year prison term before he was released in 1960. After 12 years as a blue-collar worker he was allowed to resume academic work. Recently, he summarized the lessons of 40 years of communism: "We saw in 1953 that Stalinist structures could not work. So Nagy started outlining reforms that are a lot like what Gorbachev is trying to do in the Soviet Union today. We didn't know then that you can't reform communism. We didn't know that dictatorship and legality are incompatible."[1]

In the economic arena, too, the absence of the rule of law and state ownership of the means of production effectively eliminated the possibility of free and open competition. The system gave special privileges to particular state enterprises and eliminated the possibility of government contracts being allocated on the nondiscriminatory basis of the best price at tender. The consumer got a bad deal and so did the government. In general terms, communist societies virtually abolished the mechanisms for protecting individual freedoms and property rights and simultaneously destroyed the competitive conditions that stimulate innovation and cost cutting. They substituted instead a powerful machinery for ensuring that the wishes of the Communist party were not countered in any area of activity—political or economic. For Eastern Europe to prosper in the years ahead, it will be necessary to reconstruct the machinery for the maintenance of the rule of law; without it there is a risk of reversion to the rule of party or the rule of men.

The rule of law and the relative incorruptibility of the bureaucracy and the judiciary are the essential mechanisms for the protection of civil liberties and property rights in any society. Without them it is doubtful that a society can expect its brightest talents to emerge.

Private Property

Incentives are the key to material progress. Private ownership of property offers the strongest incentive linking work and reward. If the government takes 100 percent of a man's output, what incentive is there for him to work? Moreover, the incentive to maintain assets in working order and to create new wealth derives from people's ability to acquire assets (farms, homes, factories, businesses) by their own labor. Since communist societies generally

abolished private property, incentives for work and innovation were largely destroyed. Three sayings widely repeated in Russia today illustrate that point: About the incentive to work, the Russians often say, "Under communism we pretended to work, and the government pretended to pay us." About the incentive to maintain assets in good condition, they say, "What everybody owns, nobody owns." And, in the same vein, "In a communist system who will get up in the night to tend the sick cow?"

It follows that unless East European economies introduce private property ownership on a large scale, it is highly unlikely that they will achieve any significant reforms in their economic systems. Hungary offers a case study of the problem. Despite 20 years of economic reforms (1969-89), economic growth has averaged a miserable 1.6 percent per year since 1980. State-owned enterprises still dominate the economy, and little real competition has been allowed. In the transportation sector, as in all other sectors of the economy, access to credit and capital equipment by private operators has been so restricted as to prevent any significant competitive threat to Volan and Hungarocamion, the two state-owned enterprises that dominate the trucking business. As Alan Walters concludes, "Perestroika has been largely a sham" (unpublished manuscript, 1989).

Market Prices

Free-market pricing is essential for the efficient allocation of resources and to ensure that the income that people (and capital) receive reflects their contribution to society as measured by the market. More fundamentally, prices act as a crucial signaling device conveying information about the relative abundance or scarcity of goods and services, labor and capital, to everyone in the system. That information is so widely dispersed that no one person or central government agency could ever conceivably coordinate it sufficiently to set prices at the levels necessary to produce the right amounts and quality of goods and services.

Yet communist systems by and large abandoned free-market pricing in favor of centralized control. As a result, they have never produced what consumers demanded, and suppliers have never been able to obtain adequate supplies or distribute their output to meet demand. The Swedish economist Anders Aslund reported:

> The shortages are so great that people have little motivation to work, even as sloppily as before; enterprises see even less reason to deliver goods to other enterprises. At the same time, few of the previous commands from above—from planners and ministers—are being issued. Those that are issued are frequently disobeyed.
>
> A telling example of this chaotic situation has been the refusal of southern republics to deliver fruit and vegetables to the Russian heartland. Trainloads of food have stood rotting on the tracks in Moldavia and Azerbaijan.
>
> The supply situation got so bad in Leningrad that the authorities had to order thousands of railway cars to the city. The result was complete chaos at the railway stations—so that food ended up rotting on the tracks in Leningrad, too.[2]

"Free-market pricing is essential for the efficient allocation of resources and to ensure that the income that people (and capital) receive reflects their contribution to society."

Some communist countries have experimented with free-market prices without private ownership. That, according to Warren Nutter, is the great delusion of socialism.[3] Without the ability to buy and sell factories, farms, trucks, and machinery, no producer can adjust the quality or scale of his output in accordance with the needs of the market. As Paul Craig Roberts says, it's no good reforming prices if resources are not free to follow prices.[4] China has attempted a partial reform of prices without permitting private ownership (except on the farms) and ended up with a disastrous dual-track pricing system. With some prices fixed at artificially low levels and others floating freely at more realistic levels, it became a great temptation for bureaucrats and local government officials to appropriate state property—buying in the official market and selling in the free market.

As always, communism bred corruption. According to William Pfaff in the *International Herald Tribune:*

> All of the Eastern European economies are vulnerable (to asset stripping, corruption of officials, etc.). Only Hungary has an embryonic stockmarket to facilitate privatisations. Nowhere is there systematic and standardised accounting. The very vocabulary of international accounting is unknown. Crucial privatisation decisions are in the hands of managers and local officials with no experience in how the private economy functions. Reform government leaders are more likely to be journalists or poets than economists.[5]

Similarly, when the Polish Communist party transformed itself into a social-democratic organization, officials at various levels started helping themselves to state property, either appropriating it for themselves or selling off the assets and pocketing the proceeds. Lech Walesa was right to complain: "The illegally acquired property of the former communist party belongs to the whole society. None of the newly created parties has the right to take possession."[6] East European economies will therefore need to privatize on a massive scale *and* move to free-market prices if they are to achieve major advances in efficiency.

Stable Money

Finally, a stable monetary system is essential if long-term investment con-

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tracts are to be entered into and honored. If the value of money is allowed to depreciate rapidly at unpredictable rates, individuals will seek to protect themselves in any way they can—particularly by removing their wealth from the country or hoarding it in the form of rare coins and jewelry, instead of investing it in productive resources. As East European societies shift from fixed-price regimes to market prices at world levels, all of them will suffer from an enormous, once-for-all shift in the level of prices that will discourage many would-be reformers. (Thus, for example, prices in Poland have risen 540 percent over the past year.) At the same time, their currencies will depreciate sharply as they abandon overvalued, artificially fixed exchange rates and move to more realistic, free-market exchange rates. In addition, if their governments continue to run budget deficits that are financed by the creation of money and credit instead of by borrowing, there is the real possibility of Eastern Europe's sliding down the slippery path followed by Latin American countries (where hyperinflation is endemic) or the path followed by Yugoslavia (where political pressure from six semiautonomous republics has led to credit creation sufficient to generate an annual inflation rate of 530 percent).

Conclusion

Against the current background of elation and euphoria at the collapse of the totalitarian regimes that have suppressed human dignity and economic progress in Eastern Europe for so long, these assessments may seem rather negative. There is undoubtedly much to hope for, and a huge range of possible outcomes. One possibility is that East Germany and Hungary will introduce East European equivalents of the Chinese Special Economic Zones, along with a legal framework that permits and encourages not only foreign investment but high rates of domestic investment. No doubt foreign aid and foreign investment will be important factors in the early stages of Eastern Europe's economic recovery, but in the long run countries have to depend largely on their own efforts. Even under the Marshall Plan, foreign aid never amounted to more than 3 or 4 percent of the GNPs of the recipient European economies.

To achieve real, self-sustaining progress over a number of years, East European countries will need to foster most if not all of the five essential bases of economic prosperity listed above in order to stimulate sufficient domestic savings to finance investment at 15 to 20 percent of their GNPs. It will be worthwhile in the excitement—and in the inevitable times of disillusionment—to make reference to those five fragile foundations to see whether or not they are being laid. If they are, the upside potential is obviously enormous; if they are not, frustration, disillusion, and even the reversal of the reform movement will be all too probable. ■

> **"Political freedom implies the existence of a whole range of civil liberties such as freedom of speech, freedom of association, and the protection of private property rights under the rule of law."**

Footnotes

[1]Jim Hoagland, "New Hungary: Patient Victory for Simple Decency," *Washington Post*, January 30, 1990.

[2]Anders Aslund, "Soviet Union: The Economic Impasse Leads Nowhere," *Washington Post*, January 30, 1990.

[3]G. Warren Nutter, "Political Economy & Freedom: A Collection of Essays," Liberty Fund, Indianapolis, 1983.

[4]Paul Craig Roberts, "What's to Be Done in the Soviet Union," *Wall Street Journal*, European edition, June 28, 1989.

[5]William Pfaff, "Bracing for the Carpetbaggers," *International Herald Tribune*, February 3-4, 1990.

[6]Ibid.

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World Wildlife Fund
The Conservation Foundation

July 1990

Eastern Europe Environment Program

World Wildlife Fund and The Conservation Foundation's Eastern Europe Environment Program was launched in 1988. The program initially focused on Poland, but has since expanded to include other countries.

Major goals of the program include:

- empowering the public of Eastern Europe;
- strengthening the environmental management of public institutions and state enterprises in Eastern Europe;
- promoting appropriate technology transfer and environmentally sound investment in Eastern Europe;
- building domestic U.S. support and understanding of East European environmental concerns.

Major activities include:

Promoting an Environmentally Sensitive European Bank for Reconstruction and Development. The new bank, scheduled to be ratified by April 1991, will house $12 billion of capital for the express purpose of fostering "the transition towards open market-oriented economies" and promoting "private and entrepreneurial initiative in the Central and Eastern European countries committed to and applying the principles of multiparty democracy, pluralism, and market economics." The bank has great potential to make a positive contribution to the restoration of the environment of Eastern Europe. Its Articles of Agreement contain a provision "to promote in the full range of its activities environmentally sound and sustainable development." WWF and CF is now completing a detailed study of this new bank, which will include recommendations for bank structure and policies.

Strengthening U.S. Bilateral Assistance to the Region. WWF and CF monitors U.S. assistance to Eastern Europe. It provides background material and analyses and participates in the policy development, with particular emphasis on the so-called SEED Act--Support for East European Democracy -- passed by Congress last year.

Eastern Europe Environmental Affairs Network. This network has grown to over 170 members since its inception in December 1988. Members include individuals from government agencies, environmental groups, foundations, academia, and other organizations. Periodic meetings of the network have featured presentations by European visitors, including the principal founder of Hungary's Danube Circle, the Vice-Chairman of the Polish Ecological Club, the Director of IUCN's East Europe Program, and Polish Environment Minister Bronislaw Kaminski. In addition, WWF and CF also hosts a series of meetings concerning environmental affairs in the Soviet Union.

Cooperative Policy Research. In July 1989, WWF and CF signed a memorandum of understanding with the Polish Ecological Club for cooperative activities. These have taken many forms, including travel, preparation of papers for professional conferences, participation in joint research, and development of grant proposals. Policy advice has been provided on an informal basis to senior officials and advisors in the Polish Environment Ministry, and to other members of the international WWF family working on a debt-for-nature swap in Poland. WWF and CF is pursuing additional cooperative opportunities in Poland as well as in other countries of Eastern Europe.

Technical Assistance and Training. WWF and CF is expanding its Environmental Information Service, now operating in Latin America, to include Eastern Europe. The service assists government agencies and Non-Government Organizations (NGOs) by responding to questions concerning environmental science, technology, and policy. WWF and CF is also expanding its established programs in NGO Training and in Environmental Dispute Resolution to include Eastern Europe. In cooperation with the United States Information Agency and other exchange organizations, WWF and CF provides assistance and information to visitors from Eastern Europe and the Soviet Union.

World Wildlife Fund and The Conservation Foundation works to preserve the diversity and abundance of life on earth and the health of ecological systems by protecting natural areas and wild populations of plants and animals, promoting sustainable use of natural resources, and promoting more efficient use of resources and energy and the maximum reduction of pollution. With one million members in the United States, WWF and CF is part of an international family of twenty-seven WWF organizations throughout the world.

For more information, contact Dr. Richard A. Liroff, Director of the Eastern Europe Environment Program. (Phone: 202/778-9644 Telefax: 202/293-9345 Telex: 64505 PANDA)

7/5/90

Restoring Eastern Europe's Ecosystems: Imperatives for United States Policy

--Richard A. Liroff

> Whole sectors of industry are producing things in which no one is interested, while things we need are in short supply. . . . Our outdated economy is squandering energy. . . . We have laid waste to our soil and the rivers and the forests our forefathers bequeathed us, and we have the worst environment in all of Europe today.
>
> -- Vaclev Havel, President of Czechoslovakia

President Havel's assessment of his nation's economic and environmental ills applies broadly across Eastern Europe. The lifting of the Iron Curtain has revealed truly appalling environmental conditions. Eastern Europe has been savaged by economic development policies indifferent to the carrying capacity of its ecosystems and to the health and well-being of its citizens. The East's central planners have demonstrated they can be as environmentally callous and cavalier as the worst private sector managers in market-oriented economies.

The United States, together with Western Europe, is supporting the economic and political transition of Eastern Europe. The United States should offer a balanced, integrated program of environmental and economic assistance that supports fully restoration of a healthy environment in Eastern Europe. This program can help reduce the region's contribution to global warming and encourage use of both American technologies and innovative approaches to prevention of pollution.

The Environmental Challenge

Eastern Europe's environment is a mess. Comparable, reliable monitoring data are rare, but it appears that the German Democratic Republic, Czechoslovakia and Poland are in especially bad shape. The region's most pressing environmental concerns include:

o Air Pollution. The German Democratic Republic, Czechoslovakia, and Poland are among the world's largest emitters of sulfur dioxide. The air pollution does not respect national boundaries. The East European states export from 59 percent to 74 percent of their sulfur dioxide emissions. From 36 to 59 percent of the sulfur dioxide deposited in these nations originates in other countries. The forests of western Czechoslovakia, southwestern Poland, and the southern German Democratic Republic have been devastated. Budapest, Prague,

Krakow, and other major cities routinely have air pollution readings way above existing health standards.

o Water Pollution. Drinking water supplies throughout Eastern Europe are heavily contaminated. Vast reaches of the Vistula River in Poland, which drains much of the country, are classified as unfit for use even by industry. The Baltic and Black Sea Coasts are badly degraded by domestic sewage, agricultural runoff, and heavy metals and organic pollutants from industry. Water quality problems are both domestic and trans-boundary; domestic progress in combatting pollution has been slow and multilateral cooperation negligible.

o Soil Pollution. Industrial discharges have contaminated soils and domestic food supplies. In the Upper Silesia region of Poland, for example, lead, zinc, cadmium, and mercury in samples of garden produce are 30 to 70 percent higher than World Health Organization norms.

o Hazardous and Solid Waste. Eastern Europe's mines and industries yield prodigious amounts of solid and hazardous waste. Waste generators in Hungary reportedly dispose of over 500,000 tons of hazardous wastes annually in illegal landfills. In addition, substantial amounts of hazardous waste have been shipped east from the West. The GDR has reported importing one million tons of waste annually, but Greenpeace contends that the amount of imports has been disguised and is really five times greater. Few safeguards have been developed to assure appropriate management of the wastes.

o Effects on Human Health and Welfare. Anecdotal evidence and more systematic data indicate dramatically elevated rates of respiratory disease, reproductive and developmental problems, and shortened life spans in especially contaminated regions. Such regions include Poland's officially designated ecological disaster areas, coal-burning and industrial areas of Czechoslovakia and the German Democratic Republic, and industrial centers in Romania and Bulgaria. Upper Silesia, one of Poland's ecological disaster areas, has circulatory and respiratory disease rates that are, respectively, 15 and 47 percent higher than national norms. Human populations have been removed from some contaminated areas or have been offered economic incentives to remain in them. For example, in Bitterfeld, GDR, labeled by Der Spiegel as "the dirtiest city in Europe," wages are comparatively high to attract workers to the area. Also residents are given extra money to buy vegetables, to compensate them for the loss of contaminated home-grown produce.

Economic and Political Roots of the Problem

Eastern Europe's heavy industries are inefficient, requiring larger inputs of energy and raw materials than counterpart industries in Western Europe. On average, East European economies use about twice as much energy and water per unit of Gross Domestic Product as do West European economies. Little has been spent on pollution control, and there is virtually no domestic pollution control industry. Countries have been unwilling to spend scarce hard currency on western pollution control technology.

Eastern European societies have not been "societies of law" in the Western sense. Even when strong environmental laws have been enacted in these nations, they have had little impact, because decision-makers have not been held accountable for enforcing them. Watchdog nongovernmental organizations (NGOs) have been scarcely tolerated.

The environment has had very low priority in planning. Heavy subsidies for inefficient industries and the lack of real pricing of goods have undercut any meaningful role for fines, penalties, and other economic tools in environmental protection. For example, Poland levies fines on polluters, but they constitute just a very small percent of cleanup costs. Until a few years ago, they were negotiated away in talks between the environment ministry and other ministries. Discharge fees in other Eastern Europe nations have had similarly small impact. State environmental functionaries generally have had little success policing state industrial enterprises. The fox has been guarding the chicken coop.

Five Rules of Thumb for a U.S. Response

The principal U.S. programs to assist Eastern Europe in its economic, political, and environmental transition are authorized by Congress in the Support for Eastern European Democracy (SEED) Act of 1989. The United States Agency for International Development, Environmental Protection Agency, Department of Energy, Peace Corps, and Overseas Private Investment Corporation, among others, are authorized to launch multi-million dollar assistance programs in Poland and Hungary. SEED's environmental programs include a regional environmental center in Budapest, a report to be prepared by EPA on environmental problems and priorities in Hungary and Poland, and clean coal retrofitting, air monitoring, drinking water, and wastewater projects for Krakow, Poland. Reflecting the rapid pace of change in Eastern Europe, Congress is considering new legislation (SEED II) that will expand programs to other Eastern European nations and authorize the United States' participation in a new multilateral development bank for Eastern Europe.

Five environmental rules of thumb should guide United States policy in Eastern Europe:

1. Emphasize energy efficiency. Many of Eastern Europe's environmental problems stem from mining and burning poor quality brown coal. Slowing or reducing energy demand can reduce stress on the environment in a significant, cost-effective way. As East European governments restructure their economies and, more particularly, as they eliminate subsidies for energy, they will encourage energy efficiency. If the U.S. and other western nations transfer efficient technologies, they will hasten this process.

2. Stress pollution prevention. The United States should encourage East European governments to promote process changes in manufacturing, in lieu of their taking "end of the pipe" approaches to pollution control. The United States is only just now emphasizing process changes in U.S. domestic environmental policy, after having emphasized "end of the pipe" solutions for more than twenty years. These end of the pipe controls have generated large amounts of waste to be disposed. Because Eastern Europe is starting fresh environmentally, it can be a fertile testing ground for pollution prevention approaches.

3. Promote Cost-Effective Appropriate Technologies. The U.S. government also should encourage East European governments to develop cost-effective solutions to pollution problems at existing sources. Hordes of vendors of pollution control technology have descended upon Eastern Europe, hoping to sell the new governments pollution control technologies that can remove nearly all the pollutants from waste streams, but often only at a very high monetary or energy cost per unit of pollutant removed. It might be better to promote broad use of alternative technologies that, on a pound for pound basis, cost less to operate. By doing so, more clean-up of existing sources might be obtained at less cost. All new sources should be required to meet the most stringent western standards.

4. Build Self-Reliance by Strengthening Education and Institutions. Eastern Europe boasts a well-educated population and a rich tradition of scientific innovation. Unfortunately, in recent years, it has been cut off from the latest developments in environmental science and technology. The United States should invest in the development and upgrading of environmental curricula, the training of officials at all levels of government, and the education of a new cadre of industrial managers. Both ministries and enterprises will need assistance taking an integrated approach to management that incorporates economics, technology, and administration. The U.S. should take as an example a landmark World Bank-funded program for Poland. The Bank is funding the staffing and training of a new planning and

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investment unit in the Environment Ministry, creation of a new regional regime for managing watersheds, and development of environmental auditing for state-owned industries.

As part of its institutional investment, the United States should promote innovative economic approaches to environmental management. Domestically, the United States has relied heavily on "command and control" approaches that prescribe the techniques that must be used to reduce discharges. These have been supplemented on a small scale with such economic incentives as EPA's policies for trading air emission privileges. East European officials have expressed considerable interest in economic incentive approaches, recognizing that these may produce environmental protection more efficiently than traditional regulatory approaches. The United States should support the East Europeans' development of these innovative techniques, and their multi-media approaches that take an integrated approach to reducing discharges to air, land, and water.

The investment in people should include the NGO community. Environmental awareness and organizing have grown dramatically in Eastern Europe; nascent environmental organizations have been key players in the region's democratization. But environmental organizations suffer from lack of information and resources. In many cases, they lack the most basic supplies and equipment needed to carry out their activities. They need technical information, and they could benefit from training in organizing programs and reaching out to the public more effectively.

The United States government should encourage East European countries to adopt strong policies for informing and involving the public as they revise their environmental programs. The United States' tradition of public information and involvement is markedly stronger than that of Western Europe. In Eastern Europe, until recently, environmental data have been treated as state secrets, and environmental dissent has been suppressed; the United States should push hard for freedom of information and involvement.

5. <u>Encourage Environmentally Sound Investments</u>. The United States should press an environmental agenda on the new, $12 billion European Bank for Reconstruction and Development, in which it holds a 10 percent share. (The European Community nations hold just over 50 percent.) The bank will be investing in both the public and private sector in Eastern Europe. It already has become the first multilateral development bank whose charter requires promotion of "environmentally sound" development. But that mandate must now be acted upon. Priority should be given to clean, efficient technologies and to ensuring that new investments are scrutinized for their environmental soundness.

The European Community nations are pushing for an environmental code of ethics for western investors in Eastern Europe, and the United States should join in this effort. Occidental Petroleum, a U.S. corporation, provides a promising

example in this regard; as a matter of corporate policy, it builds new facilities in foreign lands that meet U.S. or local environmental standards, whichever are more strict.

The United States, together with other western nations, should encourage development of a pollution control industry in the East to serve both eastern and western markets. Strong U.S. support for strict enforcement of laws by new environmental administrators in Eastern Europe will further foster home-grown pollution control industries.

The Challenge Ahead: The Need for Sustainable Development in Eastern Europe.

Development strategies in Eastern Europe have been both an economic and an environmental failure. Much of Eastern Europe is a wasteland. Tens and perhaps hundreds of billions of dollars will be required to restore the environment.

One frequently hears the question, "Will the East Europeans be willing to pay for clean-up?" This question assumes there is a trade-off between economic well-being and a sound environment. Trade-offs and hard choices undoubtedly will be necessary, but they should not be overstated. First, an enormous economic price already is being paid. Poland's present pollution is imposing damage estimated at 10 to 20 percent of its Gross Domestic Product. Second, many of the worst polluters may be the most inefficient operations. As subsidies for energy are eliminated, market prices introduced, and other adjustments made, many facilities will become uncompetitive and will shut down. The environment will benefit. Third, steps taken to make remaining operations more economically efficient, by reducing resource consumption and making other process changes, will yield additional environmental benefits.

Political forecasts about Eastern Europe have been notoriously wide of the mark in the last few years. But it is reasonable to believe that in heavily impacted regions where forests are dying, babies are born prematurely, children are retarded, men and women die young, and the search for clean air takes people to distant areas, there will be considerable public willingness to endure unemployment and other economic dislocations for the promise of an economically and environmentally sustainable future.

--Richard A. Liroff directs the Eastern Europe Environment Program at World Wildlife Fund and the Conservation Foundation.

Romania 7/5/90

Relatively little is known about environmental conditions in Romania, because of the Ceausescu regime's veil of secrecy over environmental data.

Romania is much less dependent on coal for its energy than other East European nations. It relies on imports from the Soviet Union and domestic oil and gas for 64 percent of its energy needs.

The Danube Delta is Romania's most noteworthy ecological feature. One of the largest reedbeds in the world, and home to more than 160 breeding species of birds, the delta is a major stopping point for birds migrating between Europe, the Mediterranean, the Middle East, and Africa. In the late 1960s and early 1970s, hundreds of thousands to over a million ducks were counted in the region during the winters. The Delta has been damaged by draining and diking, a product of Ceausescu's promotion of irrigated agriculture and construction of a shipping channel.

Pollution is greatest in five heavily industrialized regions. There is serious contamination of air, water, and soil by heavy metals. Characterizing the impact of two factories in the town of Copsa Mica, a New York Times reporter has written, "For about 15 miles around, every growing thing in this once-gentle valley looks as if it has been dipped in ink."

Poland 7/5/90

Mining and burning of coal lie at the root of many of Poland's environmental problems. It is the world's fourth largest producer of coal and seventh largest emitter of sulfur dioxide. Coal supplies 78 percent of the country's domestic energy needs. Coal mining operations discharge 7,000 tons per day of salts into the headwaters of Poland's two major rivers, the Oder and the Vistula. Mines and industries produce large amounts of solid and hazardous waste; severe pollution of land and water by heavy metals is reported.

Between the late 1960s and early 1980s, Poland's water quality deteriorated dramatically. The proportion of rivers (measured in kilometers) classified as suitable for municipal water supply dropped from 33 percent to 6 percent, while the proportion so polluted as to be unfit even for industrial use rose from 23 percent to 38 percent. About 60 percent of the Vistula is unsuitable for industrial use.

The government has designated 27 "areas of ecological hazard", encompassing 11 percent of the country's area and just over a third of its population. Five of these are "areas of ecological disaster." The five include Gdansk on the Baltic Coast, the copper mining and refining region of Legnica-Glogow in west central Poland, and the contiguous, industrially-impacted areas of Upper Silesia, Krakow, and Rybnik in southwestern Poland.

Hungary 7/5/90

Oil and gas satisfy sixty percent of Hungary's energy demands, yet air pollution is a serious problem. It is especially pronounced in Budapest; automobile emissions are a major culprit.

Water pollution is a priority concern. Most of Hungary's water enters the nation in degraded condition from its neighbors. (This includes the Danube, which enters Hungary after passing through West Germany, Austria, and Czechoslovakia.) Groundwater contamination from overuse of agricultural chemicals in Hungary poses a risk to public health. Water in hundreds of villages and towns is unfit to drink. Lake Balaton has been the focus of a major clean-up effort; much progress has been made eliminating the phosphorus that contributed to the lake's decline.

The proposed Nagymoros Dam on the Danube River has been the most prominent Hungarian environmental issue in recent years. The dam is the lower portion of a large hydroelectric project that will affect about 200 kilometers of the Danube. (An upper dam is being built at Gabcikovo in Czechoslovakia.) After having ignored several years of public outcry and scientists' fore[illegible]s that the project would disrupt the groundwater system supp[illegible] Budapest's drinking water, the Hungarian government recent[illegible] agreed to abandon the dam.

Yugoslavia 7/5/90

Yugoslavia's environmental problems have not drawn as much attention in the West as those of other East European nations.

As they enter Yugoslavia, the Danube and other rivers are substantially degraded, a result of upstream industrial, municipal, and agricultural discharges. (West Germany, Austria, Czechoslovakia, and Hungary are upstream on the Danube.) Yugoslavia's largest internal river, the Sava, flows through the greatest industrial concentration in the country. The Sava is categorized as suitable only for irrigation and industrial uses or as requiring special treatment prior to any use.

Northern Yugoslavia is more industrialized than the south, producing concomitantly greater pollution, but concern about industrial discharges is found throughout the country. Yugoslavia's forests are subject to lower levels of sulfur dioxide deposition than forests in the German Democratic Republic, Czechoslovakia, and Poland, so they have not experienced the substantial damage found in these other nations, but there is concern that levels of sulfur dioxide may increase in the future.

German Democratic Republic 7/5/90

The German Democratic Republic (GDR) is the richest nation in Eastern Europe, as measured in terms of Gross National Product per capita. But this conventional measure of economic well-being fails to capture fully the toll the GDR's industrial machine is taking on human health and the environment.

The GDR depends on brown coal for 70 percent of its domestic energy demand. It is one of the largest emitters of sulfur dioxide in the world. Until recently levels of air pollution were treated as state secrets. Data now being released reveal that in such centers of heavy industry as Leipzig, Halle, and Bitterfeld, average annual levels of sulfur dioxide in the air are five times the U.S. standard and average annual levels of particulate are thirteen times the U.S. standard.

The impact of pollutants on human health is readily visible. In the Pirna area near Dresden, children have unusually high rates of neurological and motor development problems. Near the coal processing facility of Espenhain, fifty percent of the children suffer from respiratory ailments, and 33 percent suffer from eczema.

The GDR is the most industrialized nation in Eastern Europe but, by one estimate, as much as 60 to 70 percent of its chemical industry could be forced to shut down if it were subjected to West German environmental standards. Much of the industry might be uneconomic to operate anyway. One chemical plant near Bitterfeld discharges 44 pounds of mercury into the Saale River each day, ten times as much as the yearly discharges of mercury by the major BASF chemical facility in West Germany.

The GDR has been a major dumping ground for West German domestic and industrial wastes. West Germany is now being reunited with its wastes and will need to address this legacy.

Czechoslovakia 7/5/90

Czechoslovakia, dependent on brown coal for 60 percent of its domestic energy, is the sixth largest emitter of sulfur dioxide in the world. Northern Bohemia bears the brunt of the impacts of coal-mining and burning. Government studies leaked several years ago indicated that life expectancy in northern Bohemia is several years lower than the average for the balance of the country, and rates of infant mortality, childhood illness, and respiratory illness are markedly higher. Those willing to work in the area for ten or more years receive cash bonuses; skeptics among the citizenry label the funds "burial money." As in the German Democratic Republic, large swaths of forest are devastated by air pollution.

As are other East European nations, Czechoslovakia is reassessing the role of nuclear power in meeting its energy demands. The Chernobyl accident raised public concern throughout Eastern Europe about the safety of nuclear power, but the public's ability to change government policies was limited. In January 1990, the government announced it was suspending plans to construct two nuclear reactors in Temelin, in southern Bohemia near the Austrian border. (Two others are scheduled to go on line there in 1992.)

Prague, Czechoslovakia's capital, suffers from severe air pollution problems, especially in winter. The pollution stems from auto emissions, household burning of coal, and factories. (Prague's factories generate 11 percent of Czechoslovakia's industrial production.)

Prague's city planners cannot account for about 80 percent of the estimated 40,000 tons of hazardous waste produced in the city each year.

Bulgaria 7/5/90

Bulgaria, less industrialized and less dependent on coal for its energy, does not have as pervasive an air pollution problem as other East European countries. But it does have "hot spots" of industrial pollution. Health statistics, previously treated as state secrets, have only recently been released. Bulgarians living near industrial complexes have markedly higher instances of numerous diseases and, in some cases, levels of heavy metals two to four times standards set by the World Health Organization.

Because of widespread harvesting of trees, heavy contamination of air, water, and soil from industrial pollutants and agricultural chemicals, and for other reasons, 40 percent of the country's bird species, 25 percent of its mammals, reptiles, and amphibians, and 20 percent of its plant species have been designated by the Bulgarian Academy of Sciences as endangered or rare.

Bulgaria's coastal resort trade is threatened by continuing decline in the quality of the Black Sea. The Danube River, which forms part of the boundary between Bulgaria and Romania, drains the agricultural, industrial, and municipal waste of eight highly industrialized countries into the Sea. (Other nations with Black Sea coasts include the USSR, Romania, and Turkey.) Under the stress of these discharges, and as a consequence of reduced inflows of freshwater from rivers that have been dammed for energy and irrigation, the depth of the oxygenated upper freshwater layer of the Black Sea has diminished.

A Most Deadly Trade

Poisonous wastes, products, and even entire industries are heading to the Third World and Eastern Europe as environmental regulations tighten in the West.

BY HILARY F. FRENCH

One of the many skeletons that has emerged from Erich Honecker's closet since the fall of his oppressive East German regime in November of last year is full news on the extent of toxic waste imports from the West, particularly West Germany. Greenpeace West Germany has estimated that more than 5 million tons of waste was imported by East Germany annually. Since the revolution last autumn, enraged East German citizens have demanded, and largely received, official assurances that the deadly trucks will no longer be crossing their borders.

The inter-German toxic trade holds a particular irony. Towns on the West German border had long worried that their aquifers were being contaminated by East German dumps filled with Western waste; Now that the country is to be reunified, West Germany faces the added liability of financial responsibility for cleaning them up.

As regulations tighten and disposal costs rise in the industrialized world, toxic waste is being shipped around the world for burial. In a similar vein, as chemicals like pesticides are more tightly regulated, the industry is looking abroad for markets for those products that have been banned or severely restricted at home. In some instances, whole industrial plants are being exported to locations where environmental regulation is lax and labor cheap.

The tightening of environmental regulations in the West is resulting in the export of hazard to vulnerable Third World and East European countries. Though the German predicament is a special case, it serves as an apt metaphor for the global trade in poison. As the Germans are so painfully learning, shipping problems across borders does not make them go away.

Ships of Fools

There had been rumors of attempts to ship hazardous wastes to the Third World for years, but in 1988 confirmation came in the form of two highly publicized shipments of toxic ash from Philadelphia's municipal incinerator that would read like a comedy of errors if their results weren't so tragic.

The *Khian Sea* set sail in August 1986. For a year and a half, it quietly toured the Caribbean Sea looking for a taker for the ash. It gained notoriety in January 1988 when it dumped a portion of its load on a Haitian beach, claiming it was fertilizer. When the true identity was discovered, the Haitian

government demanded that the ash be reloaded and taken away. At that point, the ship up-anchored in search of another home, leaving behind a pile of ash that remains today.

After touring five continents and changing its name three times, the *Khian Sea* discharged its toxic cargo in an undisclosed country in late 1988, or so its owners say. The international environmental group Greenpeace claims the ash was dumped in the Indian Ocean in November 1988.

The Bark, owned by the Norwegian firm Bulkhandling Inc., illegally dumped its load on an island near Conakry, the capital of Guinea, in late February and early March of 1988. After a diplomatic furor in which the Norwegian Consul General to Guinea was arrested, Bulkhandling finally agreed to haul the ash away in July.

The coup de grace, though, was the discovery of the Koko, Nigeria, hazardous waste disaster. In 1988 the small fishing village found itself in the international spotlight when 8,000 drums of highly toxic waste, including methyl melamine, dimethyl formaldehyde, ethylacetate formaldehyde, and about 150 tons of polychlorinated biphenyls (PCBs), were discovered in the backyard of villager Sunday Nano. An Italian waste disposal firm was held responsible.

Visitors to the site described conditions worse than anyone's imagination. Some drums were "popping from the sun." Others were smoking. Acid fumes reportedly engulfed the village.

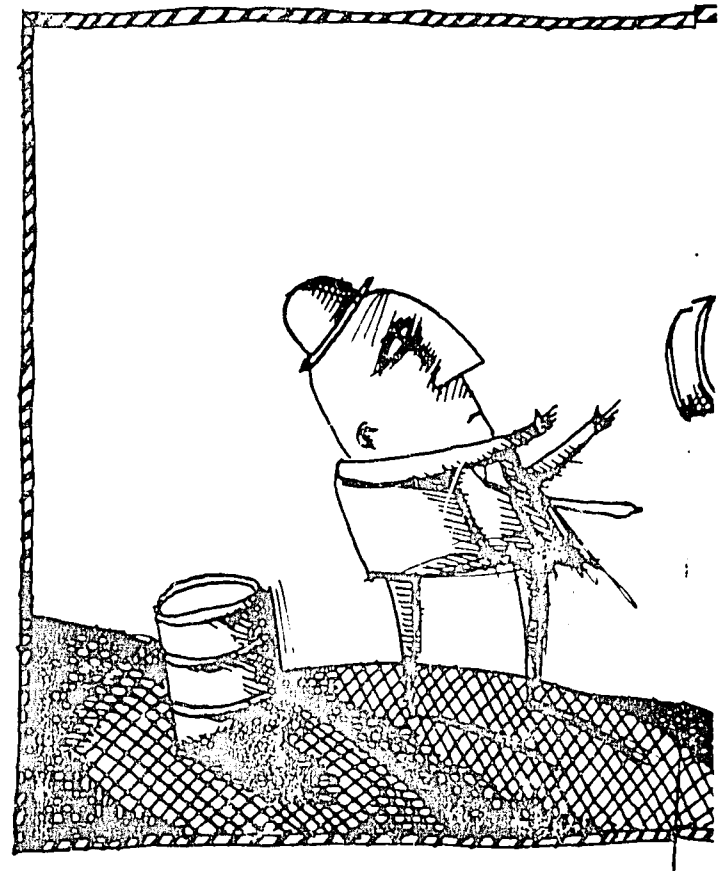
The local villagers were appallingly ignorant of the danger posed by the waste. "The odor comes to the compound. It is everywhere," Nano told the *African Concord,* a weekly Nigerian newspaper. "But, to be sincere, it has not worried my health. I even walk in some places with bare feet. My children do the same."

It's impossible to know how many other Kokos there are around the world. Because much of the trade is presumed to take place illicitly, no reliable tallies or records exist. Greenpeace estimated in 1988 that more than 3.5 million tons of toxic waste were shipped to less-developed countries between 1986 and 1988, of which roughly 3 million tons went to East Germany. At the time, Greenpeace stressed that this was undoubtedly the "tip of the iceberg," a hunch confirmed by the group's subsequent estimate of the more than 5 million tons that ended up in East Germany each year.

Professors Andrew Blowers of Britain's Open University and Denis Smith of Trent Polytechnic estimate that Western companies dumped more than 24 million tons of hazardous wastes in West Africa alone during 1988. Of that, Guinea-Bissau received 15 million tons and Benin up to 5 million.

The United Nations Environment Program (UNEP)'s magazine, *Our Planet,* reports that as many as 115 shipments of waste have been received by 15 developing countries, among them Argentina, Morocco, Senegal, and Thailand.

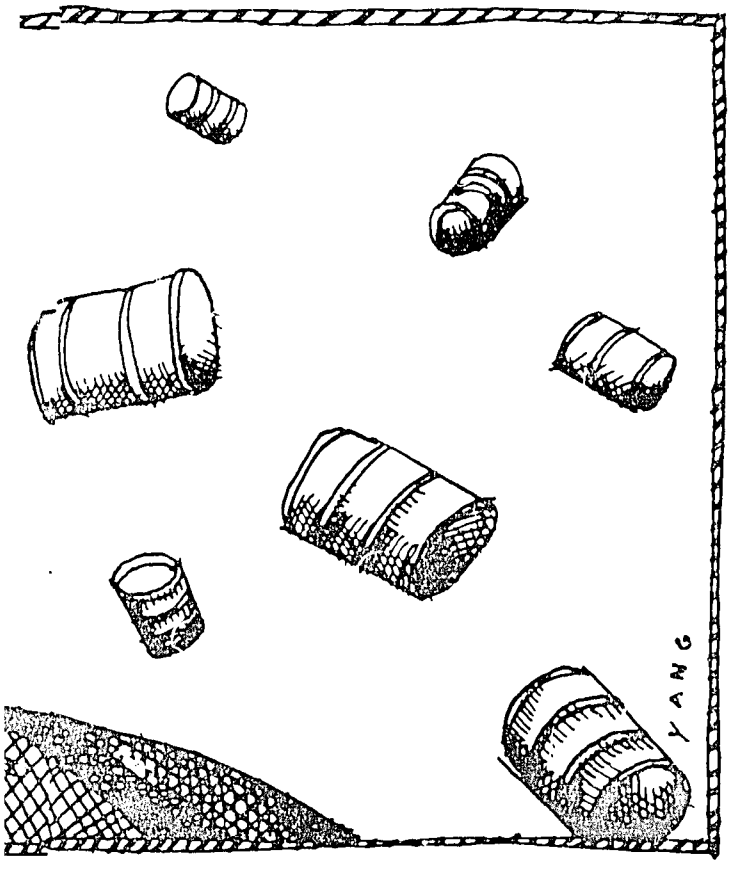
In the United States, the hazardous exporting trend is clearly headed upward: Notifications of intent to export hazardous waste filed with the Environmental Protection Agency (EPA) went from 12 in 1980 to 626 in 1989. Though the bulk of these notifications are for Canadian-bound cargos, proposals for shipments to the Third World account for a growing share.



Getting Tough with Dumpers

The incident at Koko jolted the world into action on the growing toxic trade. Several proposed waste shipments to the Third World were exposed in the press; most were subsequently abandoned. The Organization of African States issued a stinging declaration, calling the export of wastes "a crime against Africa." Many developing countries began the process of passing laws to prohibit the import of waste, with penalties to exporters ranging from stiff jail terms and multi-million-dollar fines, to the death penalty in Nigeria's law. At last count, 81 countries have passed import bans.

The outcry against Koko and other highly publicized waste export schemes injected a new sense of urgency into talks already under way in Basel, Switzerland, under the UNEP auspices to develop an international treaty regulating transboundary waste shipments. The treaty that emerged in March 1989 would put in place a system of "prior informed consent," requiring exporting nations to notify recipient governments of intended shipments and receive their approval. Also, the proposed disposal facility would have to be "environmentally adequate." Although the treaty has been signed by 53 nations, it has been ratified by only four. It cannot enter into force until 20 countries have ratified it, which may take a few more years.



Many environmentalists and leaders of developing nations were disappointed with the results from Basel. They had hoped for a complete ban on the trade in hazardous wastes, noting that "prior informed consent" could easily be subverted by corrupt or unethical governmental officials, or by bureaucratic or logistical obstacles. Many Third World countries had lobbied for a clause stating that disposal sites meet the standards that exist in the shipping nation. This provision was deleted in the final negotiations due to objections from industrial countries. African countries refused to sign the treaty due to its inadequacies, although Nigeria indicates it is now willing to do so.

Environmentalists also objected to the exclusion of radioactive wastes from the Basel treaty. Although no confirmed cases of radioactive waste export exist, there have been numerous rumors. In separate efforts, the European Community and the International Atomic Energy Agency are drafting treaties to regulate radioactive waste exports with a system of prior informed consent.

Those disappointed by the Basel Accord can take heart in a European Community agreement reached on March 22nd of this year to ban exports of toxic and radioactive waste to the 68 former European colonies in Africa, the Caribbean, and the Pacific. For their part, the developing countries party to the agreement have consented not to import wastes from any non-EEC countries. While this pact is the biggest step taken to date against toxic trade, it still leaves more than 50 developing countries vulnerable to exports.

Efforts to introduce strengthened legislation in the United States have been less successful. A system of prior informed consent that has been in place since 1984 was found by an internal EPA audit to be riddled with holes. Numerous bills in Congress have been introduced over the last few years aimed at tightening the law by banning exports except under stipulated circumstances, such

ILLUSTRATIONS BY JAMES YANG

as to countries with whom the United States has bilateral agreements. Not one has passed.

In Eastern Europe, where political liberalization is slowly revealing the past extent of the toxic trade, new restrictions are being implemented. By one estimate, East Germany earned 10 to 20 percent of its hard currency income from waste imports under the old regime. Poland, Hungary, and Romania are also known to have engaged heavily in the waste trade.

After touring five continents and changing its name three times, the Khian Sea *discharged its toxic cargo in an undisclosed country in late 1988, or so its owners say.*

Now both East Germany and Poland have banned all industrial waste imports. But concern persists that the new governments, desperate for money, will allow waste to slip through the cracks either by falsely declaring it to be harmless household waste or by misleadingly claiming that the imported waste will be recycled.

Pesticides that Kill More than Bugs

A less dramatic but perhaps more insidious form of hazardous export is the sale in other countries of products banned or restricted for use at home, such as pesticides, chemicals, and pharmaceuticals.

Reliable data on the extent of this global trade just don't exist, but it's safe to say the export of outlawed pesticides is big business. For example, the United States, which accounts for a quarter of world pesticide production, exports between 400 and 600 million pounds of pesticides annually. The U.S. General Accounting Office (GAO) estimates that about 25 percent of this are pesticides either banned or severely restricted for domestic use.

As with hazardous waste, developing countries are ill-equipped to confront the threat posed by pesticides. Most don't possess the regulatory mechanisms to evaluate the risks of various pesticides or to ensure that the chemicals are used according to instructions. Also, protective gear for pesticides is worn infrequently because it isn't suitable for tropical climates. Additionally, warning labels on imported pesticides are often written in languages farm workers can't read.

The World Health Organization (WHO) estimates that one million pesticide poisonings occur annually around the world, 5,000 to 20,000 of which result in death. The vast majority of poisonings and deaths occur in the Third World.

There are indications that pesticide manufacturers are eagerly eyeing the East European market. Indeed, U.S. Secretary of Agriculture Clayton Yeutter toured Poland and Hungary last November and concluded that U.S. pesticides and fertilizers were just what farmers in those countries needed to boost their output. Many of the chemicals subsequently requested by the Polish and Hungarian governments were unregistered, severely restricted or about to be phased out in the United States.

Paternalism or Protection?

The international community has made significant progress in recent years in moving to control the export of hazardous pesticides and other products. In 1989, the U.N. Food and Agricultural Organization successfully negotiated an agreement on a system of prior informed consent for a list of potentially dangerous pesticides. UNEP negotiated a similar treaty covering the export of other hazardous chemicals. Both treaties are expected to enter into force this year. As in the negotiations over hazardous waste export, there was considerable controversy over whether or not bans would have been preferable to prior informed consent.

A similar debate is taking place in the United States. Current law requires notification but does not stipulate the need for consent. A bill has been introduced in

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Congress that would ban the trade in outlaw chemicals outright, although the EPA, for one, opposes it. "The bill takes an extremely paternalistic view, imposing U.S. criteria for risks and benefits on the rest of the world," says Linda Fisher, EPA's assistant administrator for pesticides and toxic substances. "We need to strengthen, support and respect other countries' regulatory programs and decisions, not impose our regime on them."

Advocates of prior informed consent in the case of both hazardous wastes and hazardous products argue that a ban violates the sovereignty of the importing country by denying it the freedom to make the risk/benefit analysis for itself. The other main concern, if not the main concern, with unilateral bans is that companies in other exporting countries could just step in to fill the breach. International bans would avoid this problem.

Proponents of the "ban" approach—Greenpeace, other environmental groups, and many developing countries—counter that prior informed consent does not work. Studies by the GAO and EPA's own internal watchdog group have exposed numerous cases in which required notifications were either incomplete, grossly misleading, or never sent. In addition, the notifications are frequently not written in the recipient country's language, or do not reach the right person.

Secondly, ban opponents point out that developing countries themselves generally support a ban because they know they are ill-equipped to handle something so bureaucratically burdensome as a notification scheme. For example, corrupt officials can easily be bribed by prospective exporters into signing the necessary consent form.

Finally, an industrial nation that allows hazardous exports pays an indirect cost. Shipping wastes out serves as a disincentive to reducing the generation of waste at home, which is the only true solution to the problem over the long run. In addition, it penalizes domestic waste haulers who play by the rules, because their customers might look for less-expensive disposal options overseas. With pesticides, harmful residues often return on imported food, a phenomenon known as a "circle of poison."

Industries in Search of Lax Laws

Perhaps the ultimate form of hazardous export is the relocation of whole manufacturing plants to parts of the world where standards are unusually lax.

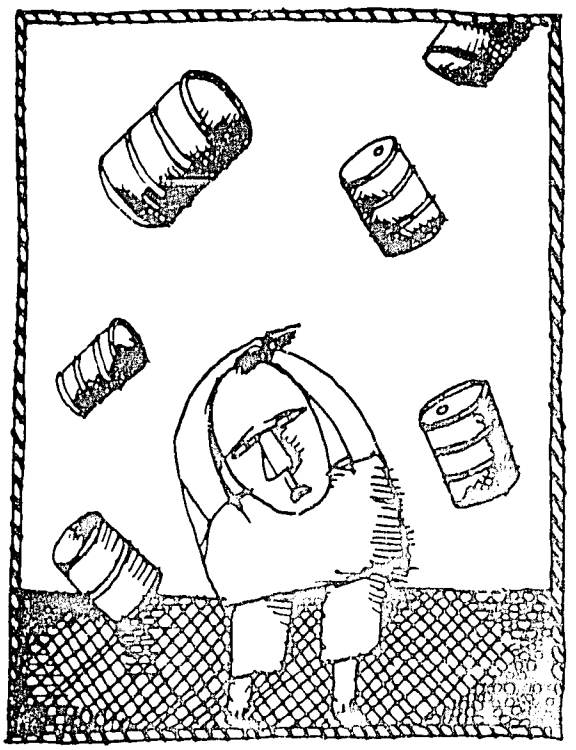
With the prospect of reunification, West Germany faces the added liability of cleaning up the hazardous waste it dumped on its eastern neighbor.

Somewhat paradoxically, the first concerns about Western industries seeking "pollution havens" in the Third World were voiced not by those concerned for health and environment in the recipient nations, but by industrial and labor interests at home that argued against the adoption of strict domestic environmental legislation in the industrialized world on the grounds that massive unemployment would result as industries fled.

Though these fears of a wholesale exodus have not been borne out, H. Jeffrey Leonard, senior fellow at World Wildlife Fund/The Conservation Foundation, headquartered in Washington, D.C., has found significant amounts of flight in the case of very hazardous industries, such as asbestos, benzidine dyes, a few pesticides, and some mineral-processing industries.

He has also found that certain countries, such as Ireland, Mexico, Romania, and Spain, have intentionally pursued "pollution haven" strategies to attract foreign investment.

According to Richard Forrest, Japan expert for the National Wildlife Federation, it is generally accepted in Japan that as environmental regulations became stronger at home, hazardous industries fled overseas. For example, an affiliate of Japan's Mitsubishi Chemical Company, the Asian-Rare



Earth Company, extracts compounds for electronic equipment from monozite ore near the small town of Bukit Merah, Malaysia. Local environmentalists believe the plant's dumping of radioactive thorium just outside its gates is to blame for unusually high leukemia rates in the region. Asian-Rare Earth's managing director, Tamio Shigenobu, admits in a recent book that it would have been impossible to locate the facility in Japan due to tighter regulation.

The Soviet Union and Eastern Europe are also vulnerable to pollution dumping. With the dismantling of the Iron Curtain, there has been an explosion of interest in joint business ventures between Western firms and Eastern Europe and the Soviet Union. Much of the proposed investment is in environmentally harmful industries such as oil development, mining, and chemicals.

"The USSR risks being transformed into an 'ecological colony'—a 'raw material' adjunct for the development benefit of capitalist countries," wrote Soviet political economist Valentin Katasonov in a recent article in the *Earth Island Journal*.

Controversial projects cited by Katasonov include a petrochemical complex involving Japanese, West German, U.S., and Italian companies in the Tyumen region of Siberia and a joint venture by U.S., Japanese, and Italian firms to build a gas and chemical plant near Guriev in the north Caspian region. Katasonov and other environmentalists fear that the plants will not adhere to Western environmental standards.

Another joint venture, a polyvinyl chloride plant to be built in the Ukraine by Occidental Petroleum Corporation, was recently put on hold in the face of protests by Soviet and American environmentalists. The New York-based Natural Resources Defense Council (NRDC) expressed deep concern about the proposed plant: "Occidental appears to want to engage in a form of 'environmental dumping'; that is, taking advantage of cheap feed stocks produced with minimal or no pollution controls in the Soviet Union to manufacture less expensive products for the world market."

The export of hazardous industries raises interesting policy questions. It is sometimes suggested that one way of tackling the problem would be to require multinational corporations operating in foreign countries to meet the environmental standards of their home country. A panel of the Japanese Bar Association recently recommended that Japan pass a law to mandate this. Similar legislation has been introduced into the Japanese parliament, although it is not expected to pass.

The debate over such proposals resembles the "To ban or not to ban?" controversy regarding dangerous wastes and products. It is commonly argued that requiring industries operating abroad to meet domestic environmental standards would violate the right of the receiving country to set its own standards —in effect to choose for itself if it wishes to accept pollution as the price of prosperity.

Others counter that the governing elites in much of the world are not responsive to the best interests of the majority of their peoples. Given this reality, shouldn't the governments of exporting countries retain the right to guarantee that their overseas investment is not harming human health and the environment?

An alternative strategy would be to level the environmental playing field by imposing an import levy on products produced in

countries with low environmental standards. Lax environmental standards can create a formidable international trade advantage: The U.N.-sponsored World Commission on Environment and Development reports that in 1980 the industries of developing countries exporting to Organization for Economic Cooperation and Development countries (i.e. Western Europe, Japan, the United States, Canada, and Australia) would have incurred pollution control costs of a minimum of $5.5 billion if they had been required to meet the environmental standards then prevailing in the United States.

Taxing products of the impoverished Third World might seem tantamount to protectionism against those most in need of open markets. However, notes the World Commission report, "It is in the developing countries' own long-term interests that more of the environmental and resource costs associated with production be reflected in prices." One way to make such a tax more palatable in the developing world would be to link it with financial assistance for environmental protection.

What all of these measures are pointing towards is a world where environmental regulations are harmonized at the level of the highest common denominator. Toward this end, an effort is being made within the United Nations to develop a non-binding, environmental "code of conduct" for multinational corporations. In addition, Western Europe is rapidly moving in the direction of common standards in preparation for creation of the European Common Market in 1992. Environmentalists are pushing for Eastern Europe to be included in any environmental agreement so that it does not become the dumping grounds of Europe.

Global Sovereignty

The core argument against strict controls on the trade in toxic wastes, products, or industries is that such controls would violate the heretofore sacred principle of national sovereignty. But this argument neglects one critical reality: in an era when both the environment and the economy are global, traditional notions of sovereignty are no longer adequate.

For example, wastes dumped in one country can contaminate an aquifer or a river that supplies drinking water to several different countries. Pesticide residues on food affect not only the citizens of the country where the food was grown, but the consumers in the many different countries that might import the produce. Industrial accidents can send dangerous winds or effluents across borders. One country setting itself up as a pollution haven penalizes countries and industries that are trying to be clean. In such a world, safeguarding health and environment is no longer purely a national concern.

Yet international law does not yet adequately reflect this reality. According to David Wirth, senior attorney with NRDC, the law generally recognizes a country's responsibilities to consult its neighbors on any activities that might be likely to result in transboundary pollution, but hazardous exports don't qualify. Even environmental impact assessments of hazardous exports, which would give potential recipient countries the data necessary to make informed decisions, are usually not required.

The outline of an international law that might fill this gaping hole is contained in the 1987 report of the World Commission to the United Nations. Out of the set of legal principles it recommends, article 13 is perhaps the most important. It declares that "states shall apply as a minimum at least the same standards for environmental conduct and impacts regarding transboundary natural resources and environmental interferences as are applied domestically"—i.e., do not do to others what you would not do to your own citizens.

The U.N. Conference on Environment and Development, to be held in Brazil in 1992, provides an opportune time to translate this recommendation into a binding agreement that settles the matter once and for all.

Just as West Germany has discovered that sending its waste to East Germany was not a lasting solution, so must the world understand that shifting hazard to others is morally unacceptable and environmentally disastrous. ◎

Hilary F. French is a senior researcher at the Worldwatch Institute.

THE WASHINGTON POST, July 10, 1990

Henry Kaufman

Where's The Cash For Eastern Europe?

While we all should applaud the turn of Eastern Europe, and the embryonic turn of the Soviet Union, to more democratic and market-oriented societies, we must ask where the funds are to come from to finance this transformation.

Only one country, East Germany, will have good access to funds. This is because West Germany stands ready to provide the credit. West Germany is financially strong. Its financial institutions are well capitalized, and its business corporations are generally highly liquid.

Moreover, the risks of providing funds to East Germany are limited. The economic and financial integration of the two countries will be followed by political unity. Thus, East Germany will become part of the business and financial structure of the West. This is an important singular difference from the other Eastern European countries, especially from a financing perspective.

To be sure, all this will not come cheap. Rebuilding East Germany will add to financing demands on the Federal Republic. German interest rates will be increased in order to quell inflationary pressures. But while its cost will rise, credit will be available.

No other country in the East is in such a fortunate position. With the exception of Romania, all still have large external debts to both Western governments and private bank creditors. These amount to about $50 billion for the Soviet Union, $40 billion for Poland, $20 billion for Hungary, $18 billion for Yugoslavia, $10 billion for Bulgaria and $6 billion for Czechoslovakia. To service this debt, all will need to generate either a trade surplus, borrow additional funds or have foreigners make substantial equity investments.

Where are these funds to come from? Some corporations are likely to be attracted to the new market potential in Eastern Europe. They will therefore use their own credit strength to put in place some factories, products and services with the expectation that in the long run they will be able to repatriate earnings. A few, such as Pepsi, will take vodka or something else in exchange.

These corporate investments will be modestly helpful, but no more. The political uncertainties that are bound to prevail during the transition to a decentralized economic system will deter larger-scale investment. Thus, corporate funds cannot be expected to overcome the heavy burden of a weak infrastructure and a decaying industrial plant and can hardly lift the Eastern European countries to an internationally competitive position.

Another traditional source of funds might be the large international commercial banks, but here, too, access is likely to be very limited. Besides the substantial indebtedness already owed by the Eastern European countries, recent experience with international lending generally has been very disappointing. Western European banks have already written off many of their loans to less-developed countries, and American banks are still provisioning for them. In addition, all major banks are now required to maintain tougher capital ratios than a few years ago when international lending to developing countries was flourishing, and their loan portfolios relative to their assets are extremely high historically.

The currently high level of interest rates globally also militates against the Eastern Europeans gaining access to private institutional funds. Even the most credit-worthy borrowers in the industrial countries are borrowing at near record inflation-adjusted interest rates, ranging from 3 percent in Japan to over 7 percent in Canada. The Eastern European countries and the Soviet Union would not be viewed by the marketplace as prime borrowers and thus would have to pay stiffer rates to gain access to funds on commercial terms. But high interest rates increase the debt burdens, a very serious consideration for marginal borrowers.

The only viable alternative, therefore, is the provision of sizable official financing from the major industrial countries. A Marshall Plan of the type that reinvigorated Western Europe after World War II might be in order. The United States, however, is not in a position to spearhead such an effort. Immediately after the war, the United States towered over all other nations in all major respects—military, politically and economically. Our financial institutions were strong and highly liquid, and our corporations had the capacity to expand. Moreover, the aid provided by the United States went to countries with an embedded history of economic decentralization. The situation is far different today.

Given today's realities, an alternative version might be a consortium of major industrial countries that would provide grants, aid and soft loans to the countries in the East. Such an initiative would clearly put the issue in the correct light—namely, that meeting Eastern Europe's financing needs is a political priority and not a matter that can be left to a standard market determination of risk and reward.

But no one is seriously talking about an official funding program anywhere near the size of the Marshall Plan. That effort was huge: measured in current (1990) dollars, it amounted to more than $125 billion. Some claim an ambitious aid package today for Eastern Europe would be more in the neighborhood of $50 billion. Yet, governments in the West are not clamoring to fund such a consortium.

The U.S. government has a huge budget deficit. The United Kingdom is in a period of tight money. Japan will most likely go slow until it has settled its dispute with the Soviet Union over the Northern Islands. While Germany has its first allegiance to financing East Germany, it nevertheless is urging financial aid for Eastern Europe, especially for the Soviet Union. In part, this reflects the German effort to win support from the Soviet Union for political unification of Germany.

The recent creation of the European Development Bank is a very modest step in the right direction. It is an official institution widely supported. But it will lend money, not give grants.

On balance, it seems that the West, in dealing with the assistance to the Eastern European countries, will be long on advice, technical help and moral support, but rather short on cash.

The writer is president of Henry Kaufman & Co., Inc., a money management and

FINANCIAL TIMES, July 10, 1990

FOREIGN AFFAIRS

Where are you, Marshall and Monnet?

Edward Mortimer puts the case for an eastern European recovery programme

Exactly a year ago this column argued that western Europe should take the lead in drawing up "a new Marshall Plan" for eastern Europe. The idea was not very popular among western economists, but politically I was on the right wavelength. A few days later, at the G7 summit in Paris, the European Commission was entrusted with co-ordinating aid to eastern Europe from a group of 24 countries.

A year later the discussion appears to have moved on. The G7 leaders in Houston are locked in argument about aid to the Soviet Union. The case for aid to eastern Europe is taken as read.

Ten days ago the Organisation for Economic Co-operation and Development, in its six-monthly report on the world economy, stressed, quite correctly, that "the key to successful development is not primarily finance from abroad, although this can help." That in no way contradicts the validity of the Marshall Plan concept. The Marshall Plan was, precisely, an effort by the US to help Europeans help themselves, and today there is an argument among economic historians about the nature of the help it gave: was it an objective economic stimulus, or was its importance really in the psychological field, convincing Europeans that there was hope, that hard work and investment could bring rewards? It doesn't matter all that much, because either way the precedent is relevant to the situation in eastern Europe.

Many people probably imagine that the equivalent of a Marshall Plan for that region is already in place. It is not. The bad news in the OECD report is that on present form there is no prospect of finance from abroad materialising on anything like the scale that is needed. In fact it questions whether net resource flows from the West will even compensate eastern European countries for the income they will lose by the ending of Soviet energy subsidies (conservatively estimated to have been worth $5bn a year).

Particularly desperate is the plight of Poland, which has been by far the boldest country in taking the leap straight to market prices, with consequent severe hardship for much of the population, and now the prospect of rapidly rising unemployment as well. According to the Polish finance minister Leszek Balcerowicz (hero of western monetarists), "without a solution to the Polish debt problem society cannot improve its standard of living, and it is not known how long the public's patience can be stretched." It is against this background that the rising political tensions within Solidarity should be understood.

Other eastern European countries have less acute debt problems, but in all of them there is a real danger that, without western financial assistance, balance-of-payments problems will choke off the recovery of investment, and of living standards. And probably even more significant in the long run is access to the western European market, especially for agricultural products. Historically, eastern Europe was an important source of food for western Europe. This pattern was disrupted by the cold war, but now the EC's common agricultural policy threatens to perpetuate the disruption. As the Commission's "background brief" euphemistically puts it, "self-restraint agreements covering agricultural products are in force with most eastern European members of Comecon. Trade in these products is therefore excluded from the corresponding co-operation agreements."

In short, while eastern Europeans still have a great deal to do "to help themselves," their chance of success depends on the West, and especially western Europe, taking a much more generous attitude than it has so far done. Meanwhile it has become a western fashion to wring one's hands, as the Archbishop of Canterbury was doing on Sunday, about "the spectre of fresh and rival European nationalisms which have been the ultimate cause of two global wars."

The Archbishop called on other Christian leaders to respond by learning "to speak and act together on a wider level than the nation state." That may sound like pious rhetoric, but in the 1940s it was precisely what western political leaders did. In western Europe today nationalism can still cause violence on a small scale (especially after football matches) but no one expects it to provoke another global war, or even a local war between nation-states. Why? Because the economies and societies of western Europe have been woven together in a shared prosperity. That did not happen by accident. It was brought about by acts of policy, of which the two most significant were the Marshall Plan and the creation of the European Coal and Steel Community.

The bad news is that on present form there is no prospect of finance coming from abroad on anything like the scale needed

Both were largely the work of Europeans, but stimulated by American leadership and American economic leverage. Throughout the late 1940s and early 1950s the unification of western Europe was one of the main objectives of US foreign policy. Americans had twice in 30 years been caught up in wars caused by "rival European nationalisms" and were determined to avoid another. Marshall did not announce a unilateral US aid programme to the Europeans to agree on a joint recovery programme which the US would finance. The programme was in fact drawn up (with American advice and assistance) at a conference of European states, later institutionalised as the Organisation for European Economic Co-operation, which later still expanded into the OECD.

One feature of it was the creation of a European Payments Union, which lasted until 1958. This enabled European states to assist each other's recovery by retaining and spending within Europe the currency they earned from exports to each other. This too was encouraged by the US although it involved discrimination against American goods and was contrary to deeply-held American economic principles.

Not long afterwards Jean Monnet persuaded Robert Schuman to launch his plan for a pooling of France and Germany's most strategic interests, arguing that an interpenetration of the two economies under a supranational authority would make war impossible in a way that mere intergovernmental co-operation never could. This project too was encouraged by the US, as was its abortive (because premature) successor, the plan for a European Defence Community.

Isn't it about time a similar connection was drawn between economic need and political danger in eastern Europe? This time last year I identified intra-east-European co-operation as one respect in which the Marshall Plan precedent regrettably could not be followed, because of "the uneven pace of political development in different eastern European countries," at that time only Hungary and Poland appeared ready to undertake the necessary reforms. Now Czechoslovakia has joined them (we need not worry about East Germany), and the Balkan countries are in a state where economic leverage could well tip the scale between democracy and dictatorship. The difficulties about economic co-operation arise from jealousies and suspicions between the states concerned, and from a shared dislike of the phoney unity previously imposed through Comecon. But those are actually reasons why an initiative from outside is necessary, and why it must come from the West.

The Soviet Union is clearly more problematic, if only because of its sheer size, and needs to be treated as a case apart. But western Europe can and should play its part in the consolidation of last year's democratic revolution in eastern Europe. The time has come for the EC to proclaim its willingness to provide financial assistance, and market access on preferential and concessionary terms, to those eastern European states that will join together in a programme of recovery through co-operation and the pooling of resources.

U.S. Aid to Eastern Europe Far Exceeds Original, Modest Offer

By John M. Goshko
Washington Post Staff Writer

When President Bush last July declared in Poland and Hungary that "the Iron Curtain has begun to part," no one had any idea that a year later the United States would be spending more than $1 billion to back his pledge to help Eastern Europe "walk its own path" away from communism.

Since then, America's involvement with Eastern Europe has ranged from major international efforts such as organizing $14 billion in support from the world's 24 richest industrial countries to halt Poland's runaway inflation to smaller "nation building" ventures such as helping Poles and Hungarians fathom the intricacies of parliamentary procedure, voter registration and small-business management.

These efforts have far outstripped Bush's original, modest offer of $100 million in grants to Poland and $25 million to Hungary to nurture democracy and free enterprise. That was only 1 cent on the dollar of the $10 billion Poland's Solidarity leaders wanted.

Bush said then that the United States couldn't afford more. But, pressured hard by Congress, he had agreed to raise the figure by the end of 1989 to a total of almost $1 billion.

Critics insist that more is needed. R. Mark Palmer, a former U.S. ambassador to Hungary now heading a private investment consortium, recently told a congressional hearing that "the scale of the effort has been too small and the pace of implementation too slow."

"We are doing our share and then some," replied Robert L. Barry, a senior aide to Deputy Secretary of State Lawrence S. Eagleburger, who oversees the program that has made the United States—along with West Germany and Japan—one of the big three among Western governments aiding Poland and Hungary.

On the surface, the $1 billion U.S. contribution is a distant third behind West Germany's $4.3 billion and Japan's $2 billion. But while most of the German and Japanese aid, as well as those of most other contributing nations, is for debt relief and credits with stringent restrictions on how the Polish government can use them, 70 percent of the U.S. aid is in relatively unrestricted grants that do not require repayment. This puts Washington neck and neck with Bonn as the region's biggest financial angel.

And the U.S. program is still expanding. Although Bush remains reluctant to extend direct U.S. aid to the Soviet Union, the program is stretching beyond Poland and Hungary to Czechoslovakia and Yugoslavia and could also be extended to Bulgaria and Romania if the communist governments still in power show a genuine commitment to democratic pluralism.

And, as it did last fall, Congress appears determined to boost aid for Eastern Europe in the coming year well above the $300 million first proposed by Bush.

The Senate Foreign Relations Committee yesterday approved legislation that includes roughly twice as much direct aid as the administration had proposed, and also authorizes technical assistance to the Soviet Union. The action came after the $535 million bill was approved by 10 committee Democrats, in the face of a boycott by the committee's Republicans.

Similar aid legislation that does not provide for technical assistance to Moscow has already been approved by the House Foreign Affairs Committee.

The administration demand for what a senior U.S. official called "maximum flexibility" to shift money to deal with unexpected new events and circumstances reflects a strong administration feeling that the new Eastern Europe needs sums far greater than the Western allies can provide. Underscoring this worry, U.S. officials say, is disappointment over the apparent reluctance thus far of private U.S. firms to risk investment in Eastern Europe.

Henry Kaufman, a leading Wall Street economic consultant, agrees that private-sector contributions will be limited at best. He recently noted that "corporate investments will be moderately helpful, but no more." Eastern Europe, Kaufman added, must find its major sources of new funding elsewhere.

He pegged "an ambitious aid package today for Eastern Europe" at around $50 billion, but noted that Western countries "are not clamoring to fund such a consortium, and the United States is not in a position to spearhead such an effort . . . It seems that the West, in dealing with the assistance to the East European countries, will be long on advice, technical help and moral support, but rather short on cash."

Said one U.S. official, "We were forced to jump into the deep end without really knowing what we were doing. We spent most of the first year learning how to swim." He noted that some 25 federal agencies are involved in aid giving, "and had to have their duties and priorities sorted out."

So, the administration set up the "coordinating mechanism for Eastern European assistance" headed by Eagleburger with Michael J. Boskin, chairman of the Council of Economic Advisers, and John E. Robson, deputy Treasury secretary, as his deputies—"the czar and the little czars," to others in the bureaucracy.

U.S. officials say it will be three to five years before most East European nations can effectively absorb massive aid for major structural changes in their economies.

In Czechoslovakia, President Vaclav Havel's new democratic government has not decided on the long-range economic direction to follow. Even in countries such as Poland and Yugoslavia, where the governments know where they want to go, there is an acute shortage of trained managers to help them get there.

For that reason, many U.S. officials favor a relatively small amount of aid—up to $40 million—earmarked for helping Eastern Europe end four decades of communism and move toward "democratization" of politics and "privatization" of economic life.

The agencies helping include the Peace Corps, whose volunteers are fanning out through the region; the National Endowment for Democracy, a federally funded private institution already helping Eastern Europe's fledgling democratic parties to learn the techniques of voter registration and education; the Agency for International Development, which has contracted with various American universities and think tanks to provide technical aid in business and municipal management, and the USIA, which is trying to expand greatly the limited cultural and educational activities it was allowed there before the collapse of communism.

The USIA has divided its activities into four broad areas. They are the Alexander Hamilton Program, for free enterprise, management training and entrepreneurship; the Samuel Gompers Program, free trade unionism and labor-management relations; the Noah Webster Program, for English teaching, educational curriculum reform and creation of a free press, and the John Marshall Program, devoted to the rule of law and legislative and judicial reform.

USIA and other agencies have a growing list of activities, from exchange programs to bring American experts to Eastern Europe and potential East European leaders here; to creation of an American chair at the Budapest School of Economics (formerly Karl Marx University); and the translation into Polish, Russian and Hungarian of seminal works on American democracy such as the Constitution and the Federalist Papers.

The administration expects shortly to name the director of the U.S.-funded media institute, to help create newspapers, magazines and broadcasting operations free of government control. To oversee things, USIA hopes within the next year or two to establish U.S. cultural centers in Warsaw, Prague and Budapest, and libraries in Bratislava and Leipzig.

The objective is to create cadres of younger, flexible, outward-looking people able to help their countries compete with the West through changed work habits, modernized industrial plants, improved environmental conditions, reduction of mammoth foreign debts and access to credit and investment funds.

These "big ticket items" will continue to absorb most U.S. aid. Congressional sources expect about $75 million to be earmarked for the recently created European Bank for Reconstruction and Development, which will lend money to overhaul the East European economies; most of the balance will go into direct grants for similar purposes, especially for a start toward cleaning up Eastern Europe's badly abused environment.

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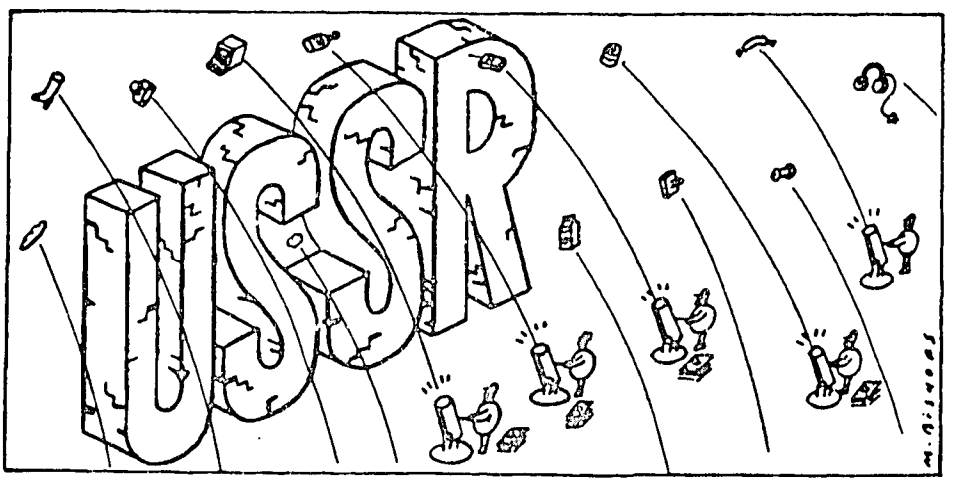

Mario Bakarić

Prague's Plan to Aid Moscow

By Anthony M. Solomon and John Edwin Mroz

While the economic summit meeting in Houston is focused on the question of aid to the Soviet Union, hardly anything is being said about the fragile economies of Poland, Czechoslovakia and Hungary, which are suffering from the monetary and economic unification of the two Germanys. There is a way to address both issues simultaneously.

Anticipating bankruptcies and plant closures, East German companies are canceling import and export contracts right and left. As a result, East Germany's trade with Poland, Czechoslovakia and Hungary has fallen by 15 percent to 20 percent in the last six months.

In the long run, these three nations should restructure their economies to respond to the dynamic growth of a unified Germany. But the transition from subsidized and centralized state economies to global markets and hard currencies is bound to be drawn out and painful.

What can be done? The Czechoslovaks have an interesting regional solution.

They are calling on the West to establish a special fund in the new European Bank for Reconstruction and Development. The money would finance exports of industrial and consumer goods from Poland, Czechoslovakia and Hungary to the Soviet Union. This plan would accomplish two things: alleviate shortages in the Soviet Union and combat rising plant closures and unemployment in the three countries. It would also enable the countries to maintain a major portion of their mutual trade (however uneconomic and uncompetitive by the standards of the West), which serves our interest in a stable transition to democracy and free markets.

West's credit to help East's trade.

France's President, François Mitterrand, and the German Chancellor, Helmut Kohl, are pushing for large direct credits to the Soviet Union. They may yet overcome Washington's resistance to such aid. But everyone's interests can be better secured by the indirect approach put forward by the Czechoslovak Government.

Poland, Czechoslovakia and Hungary would be required to use the money they earn on such exports for modernizing their production facilities and infrastructure.

The Soviet Union would "repay" the dollar credit by investing in its own economy (in rubles) an amount equal to the total credit. The investments would be subject to approval by Western financial experts.

How much would be needed? The Czechoslovaks suggest $16 billion — $5 billion annually over three years to be spent on East European goods plus $1 billion for Soviet purchases of Western equipment. But even more moderate sums would achieve the plan's twin objectives.

In addition, it is essential that the West provide the working capital for a temporary clearing and payments union to help the three countries maintain mutual trade, production and employment during the transition period. The countries have agreed, beginning next January, to price their trade with each other at world market prices payable in hard currencies. But unless there is a clearing arrangement to liquidate the net balances periodically, trade volumes will drastically decline. The money, it should be pointed out, would be paid back as the transition process moves farther along.

The world did not anticipate the impact that German monetary and economic unification would have on neighboring countries, which are already struggling with the transition to market economies. There is a danger — to date, only privately expressed — of a new division between rich and poor countries along the eastern border of a united Germany.

Bonn has expressed a sense of political responsibility for its neighbors, but its spending on unification is already massive and the source of some controversy at home. Thus, Bonn should agree to shoulder the primary financial responsibility for the Czechoslovak plan, but not to foot the entire bill. If the plan is to succeed, it will have to have the support of all the Western industrial powers. □

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Junk Central Europe's Factories and Start Over

By PETER F. DRUCKER

Everybody in the fall of 1989—a few short months ago—was sure that German unification would take years. Similarly, the current common wisdom is that liquidating the Stalinist economies of Central Europe—East Germany, Czechoslovakia and Hungary (all areas that before World War II were economically fully developed)—will take many years. Actually, the changes are coming with lightning speed, and there is no slowing or stopping them. For the goods turned out by Central Europe's plants have become unsalable.

By 1995, Volkswagen expects to make 250,000 Rabbits in a plant in Zwickau, East Germany, that last year turned out 50,000 of the tiny, expensive and chronically malfunctioning Trabant cars. But what is that plant going to make during these next five years? Not a single Trabant can be sold now that East Germans can buy, for less money, bigger and infinitely better Western-made Fords, Volkswagens, Opels or Fiats. Central European-made textiles, appliances, toys, hand tools, processed foods and shoes have all become similarly unsalable and are, indeed, no longer on the store shelves in Berlin, Budapest and Prague. And even the lushest government subsidy could not make a Western manufacturer put into its automobile bodies the heavy and pockmarked sheet steel that Central European rolling mills turn out.

For Central Europe to regain a modicum of prosperity, its industries must become productive and competitive in no time at all. This requires, however, that industrial employment be slashed more drastically than it has ever been slashed, even in a severe depression. East Germany's total labor force numbers nine million, out of a total population of 16.5 million. West German economists, including those of the trade unions, estimate that between three million and four million workers will have to be laid off if East German industry is to survive in a competitive market. This, although East Germany has the most efficient industries of the entire Soviet Bloc.

Rapid Turnaround

A rapid economic turnaround has to be Central Europe's top priority. Without it there will be neither social nor political stability. But the region's fragile democracies could not stand prolonged mass unemployment. They need something unprecedented: radical job cuts coupled with employment maintenance or, at least, income maintenance. This is the turnaround challenge of Central Europe.

And it is the prosperity and stability not just of Central Europe that is at stake, but that of Western Europe as well. A successful turnaround of Central Europe offers unprecedented opportunities to Western Europe, and above all to West Germany. It promises a long investment-led boom that would make Europe the world's economic leader.

But failure to turn around the economies of Central Europe, and fast, would surely trigger a mass exodus of despairing people from the East—a larger-scale repetition of the flight of 3,000 East Germans a day that inundated West Germany before the Berlin Wall crumbled last autumn. And if prolonged mass unemployment were the price for the turnaround, it would evoke the same response: "I am optimistic," said a West German publisher when he told me of his buying a number of East German newspapers. "But it's a high-low poker game with the biggest stakes ever."

To produce 250,000 cars a year in Zwickau, Volkswagen expects to employ no more people than had been employed in the same plant to build 50,000 Trabants. In other words, four out of every five Trabant workers should never have been on the payroll.

Central Europe's most efficient steel mill, Witkowice in Czechoslovakia, produces about the same tonnage it did in 1938, but with a substantially larger work force. In the West, even an inefficent steel mill turns out 2½ times the tonnage per worker it did 50 years ago, or about three times what Witkowice does.

Even the plants in Central Europe that have kept abreast of technology are overstaffed. The Tungsram works outside of Budapest, of which General Electric recently acquired control, make a first-rate light bulb. But they employ almost 50% more people, proportionately, than do GE, Siemens and Philips in their light-bulb plants in the West.

These are not isolated examples. In a Stalinist economy, overstaffing is not mismanagement, it is a virtue and built into the system. All incentives reward putting more people on the payroll: capital available for investment in the plant, raw materials allocated to the plant, managerial pay and managerial perks. As a political system, too, Stalinism pushes overstaffing. Large plants are expected to create jobs to reward the party faithful.

A Stalinist economy also *mis*-employs. All its emphasis is on the heavy industries of the 1920s: coal mining, steel, commodity chemicals. As a result, employment in Central Europe is concentrated in the "smokestack" industries in which there is overcapacity worldwide. A good many, some very big employers among them, will shut down. A likely candidate for the padlock is the large chemical complex in Bitterfeld. East Germany, probably Europe's biggest. Because its raw material is lignite—a sulfur-laden, ash-rich, soft coal—its costs are double those of its petroleum-using competitors across the border in West Germany. And reducing lignite's life-threatening pollution to the minimum acceptable level would drive up costs by an added two-fifths or so.

Yet, typically there is little alternative employment available in the areas in which these overmanned or obsolete plants are located. Stalinism deliberately organized its political control around one big plant or industry that dominates its region. Zwickau, Witkowice and Bitterfeld are all single-employer towns. It is precisely there, however, that jobs will have to be cut the most.

There are substantial employment opportunities in Central Europe. Many workers will be needed, for instance, to rebuild the obsolescent, dilapidated factories that are Stalinism's legacy. To convert Zwickau into an efficient Volkswagen plant should keep one-third of its present work force busy. Rebuilding Central Europe's industry could provide jobs for something like 5% of the total industrial work force, it is estimated. It won't come cheap, though. Volkswagen, for instance, plans to invest $3 billion in Zwickau—more than it should cost to build such a plant from scratch. In East Germany capital will not be much of a problem, however. West Germany has deep pockets. In Hungary and Czechoslovakia, too, capital to rebuild the plants seems to be available from the West.

Another substantial employment opportunity—perhaps for as much as another 5% of the work force—lies in rebuilding the run-down infrastructure of Central Europe. East Germany, for instance, has fewer telephones now than it had before World War II; its railroads and highways also have fallen well below pre-war standards. The biggest infrastructure need in all of Central Europe is housing: communist regimes always treat it as a stepchild. What is needed is not public housing but housing that gives privacy, is privately financed and privately owned. "If only," a Czech friend said, "we could find someone like your Mr. Levitt who built the Levittowns in Long Island and around Philadelphia after World War II."

But the biggest employment opportunities lie in services. Communist regimes consider them "bourgeois" and are hostile to them. There is, therefore, tremendous demand all over Central Europe for every kind of service: retail and wholesale distribution, repair and maintenance, banking and insurance, restaurants, laundries, dry cleaners and so on. Services, as we know, can come into being practically overnight and without much investment. All they require is a local entrepreneur. And since factory workers in Central Europe have been badly paid, shifting into service work often means making more money. Europe's best chance for a successful turnaround may then lie in rapidly building a thriving service sector.

The biggest question regarding Central Europe's turnaround is a political one. Will governments refrain from doing the wrong things, however popular they might be?

The worst thing Europe's governments could do—and the one they are, alas, most likely to do—is subsidize continuing industrial overstaffing. Unless Central Europe's manufacturing plants become competitive very fast, there will be no turnaround. Cutting piecemeal is the wrong move in a turnaround, and the most expensive move in the end. One must be able to tell people, "We're done with cutting. Let's start building." Otherwise no one does any work.

Productive Jobs

Any financial assistance given—and quite a bit will be needed—should be aimed at creating new, productive jobs. There might also be a need to provide income maintenance—e.g., following early retirement. But subsidizing unproductive and redundant jobs can only obstruct economic recovery. It ultimately endangers social stability.

Equally dangerous would be protecting Central European industries from competition within Europe. There will be high barriers in Europe against Japan and South Korea. But rapid European economic integration must not be sacrificed to the short-term problems of Central Europe.

Finally, there is the legacy of 40 years of Stalinism: the hostility to Central Europe to services and especially to the independent entrepreneur. "We need 500 house painters in Prague alone," my Czech friend said, "and there'd be more than enough work for them. But the government monopolies wouldn't sell them ladders or paint brushes or paint. They'd consider them antisocial and parasites." In the last analysis, Central Europe's turnaround may therefore well be as much a matter of political courage and political will as of investments and of economics.

Market economics and free enterprise, it is now being said, have won over communism. This is not really true. Communism collapsed from within: economically, politically and, above all, morally. It defeated itself. Free enterprise and market economics—and democracy, as well—will have won only when they have turned around Central Europe.

Mr. Drucker is a professor of social sciences at the Claremont Graduate School in California.

Drucker on Management

"If only," a Czech friend said, "we could find someone like your Mr. Levitt who built the Levittowns in Long Island and around Philadelphia after World War II."

THE WALL STREET JOURNAL MONDAY, JULY 30, 1990

Trail-Blazing Poles Now Begin Privatization

By THERESE RAPHAEL

WARSAW – Poland is writing the first textbook on the transition to a market economy from a communist system. On July 13 the Poles continued to spearhead East Europe's reform movement when the parliament passed a historic bill on privatization of state enterprises.

More than 7,600 state enterprises are to be handed over to the state treasury and transformed into limited liability corporations with shares to be sold to the public within two years. The government is awarding every adult Pole free "privatization bonds" exchangeable for shares in the company of his or her choosing. Workers will be given preferential prices (at one-half market price) for up to 20% of their company's shares. To quell the fears of many Poles of foreign ownership, foreigners need official permission to purchase more than 10% of a company's shares. The transition process will be overseen by a newly created Ministry of Ownership Transformation.

There are still many wrinkles to be ironed out. Because of the absence of developed markets, setting a price for the shares involves a lot of guesswork. Which illuminates the more general conundrum: You need to have a private market in order to get one. Nevertheless, Poland must get on with the process even if it means windfalls for some bargain hunters.

But even given reasonable pricing there are problems. Andrzej Byrt, the Polish commercial counselor in Brussels, maintains that "if you take all the financial resources in the hands of Polish citizens, they could only purchase about 6% of all state-run companies."

The Polish reform program has been depicted as a sort of reckless leap into the unknown. But this ignores a central truth. The country was on the verge of implosion, the salvation of which required drastic and immediate measures. The new government responded to the crisis by embracing far reaching measures. It set about to "import" competition so as to rationalize the price structure and effect a Darwinian industrial selection process. Against the advice of many a nonbeliever, the zloty was made internally convertible – that is, convertible for trade transactions, but not yet for capital transfers – at about 9,500 zlotys to the U.S. dollar. Trade barriers such as import quotas and excessive tariffs were eliminated or sharply reduced. The government sold some assets of small state enterprises to aid entrepreneurs. Meanwhile, domestic price controls and subsidies were abolished.

As a result, shortages are practically non-existent, foreign goods readily available and hyperinflation stamped out. May's $2 billion trade surplus exceeded that for the entire previous year.

Many reports cite a 35% drop in production as proof of the failure of the reform. But these figures ignore a dramatic increase in private production – it is estimated that 50% of food products are now sold directly by farmers – unaccounted for in the statistics of socialized industry. State production now shows signs of stabilizing, as companies that initially reduced production and raised prices after subsidies were withdrawn investigate ways to produce appealing products inexpensively.

Despite these improvements, the economy is still in a recession and saddled with a $42 billion foreign debt. The World Bank, the International Monetary Fund and other sources are rapidly funneling more aid into Poland. The debt has been rescheduled again. But while foreign aid may help infrastructure development, too often it can relieve pressure for painful reforms.

International trade, needed to pull Poland to its feet, requires a favorable climate for foreign investors. As it stands, a foreign investor can own up to 100% of a company, with a minimum initial investment of $50,000. Foreign investors also have no wage restrictions and receive an automatic three-year tax holiday, extendable up to six years if the business is deemed vital to Poland's economic growth. But here the clarity is blurred by complicated tax laws, vague property statutes and an outdated commercial code (unchanged since 1934).

Western investors also resent Poland's restrictions on the repatriation of profits. In an effort to prevent capital flight, the government has limited the amount a company can repatriate to the excess of its export revenues over its import spending. Where there are no export revenues it may repatriate 15% of all earnings. This is a sore point among Western investors who resent the obstruction of free mobility of profits.

Potential investors also cite the need to bring the telecommunications and banking systems up to snuff. Although both have been deregulated and can have 100% foreign ownership, they remain seriously inadequate. Preliminary evidence suggests that it will take 10 years and $10 billion to give Poland an adequate communications system.

One thing Poland could do immediately to please foreign investors is eliminate the wage controls imposed in January. The controls had a certain unpleasant logic when there was nobody to bargain with workers for wages except socialist managers indifferent to profit and loss. The concessions they made to their employees drained the economy, exacerbated inflation and significantly reduced real wages. Now that a privatization framework is being established, however, the labor market must be freed.

The reform program has been propelled by a rare political consensus for parliamentary democracy and speedy integration into Europe. Lech Walesa's oft-questioned bid for the presidency poses no threat to Poland's progress. Quite the contrary, his experiences at the very heart of afflicted socialist industry, his commitment to pluralism and speedy reform and his tremendous popular support would make him a powerful asset to the Solidarity government.

The real danger to political stability comes from third-way activists who throw hurdles in front of reform by pointing to misleading production and income statistics. At a recent conference in Vienna, Jeffrey Sachs, the Harvard economist who advises Solidarity, warned that claims that real incomes have plummeted by 40% because of the reform program are misleading. These claims are based on comparing the nominal prices of goods in December – when those goods were in practice unavailable – with their prices now that they are freely available. The statistics do not account for the elimination of six hour lines for certain commodities and the general feeling of improved living standards.

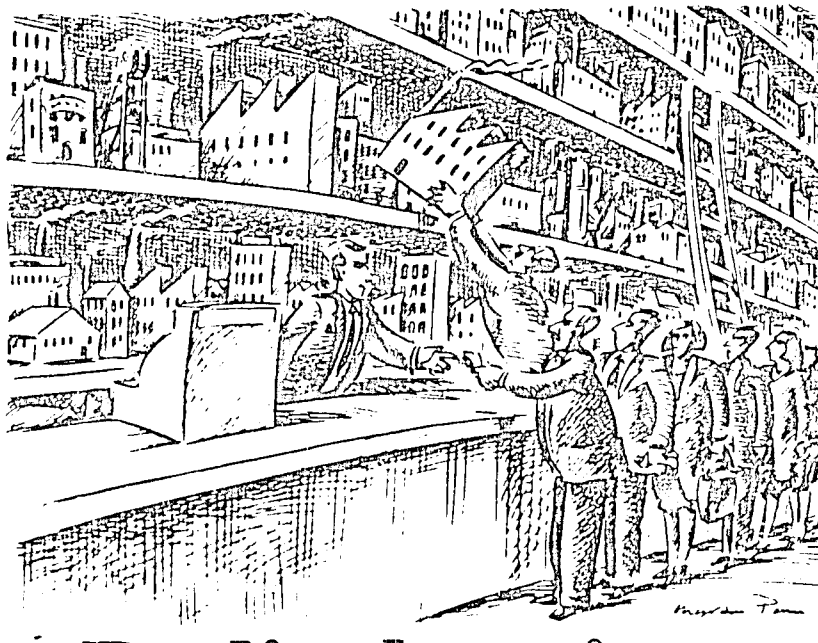
As the largest country in Central Europe with a 36 million-strong consumer market, many acres of uncultivated land and plenty of natural resources, Poland has much to offer. Reform must be taken in bold strokes – the alternative is to go the way of the Soviet Union where reform trickled in and the expectation of bold results goes unfulfilled.

Poland's challenge is therefore to stay the course. The privatization bill was another monumental step in the right direction. Continuing in this fashion, the unwritten chapters of the Polish textbook will tell of the abjuration of Poland's endemic economic deadweights and a successful transition to a market economy.

George Melloan is on vacation.

Miss Raphael is an editorial page intern at The Wall Street Journal Europe.

In the second article on economic reform in Poland, **Christopher Bobinski** and **Martin Wolf** outline a ground-breaking solution



Radical options for privatisation

Privatisation is about to begin in Poland. Following a vote of 328 to two (with 39 abstentions) in the lower house of the Polish Parliament last month, and passage through the Senate last week by 60 votes to seven (with two abstentions) the Government has now effectively obtained the desired legislative sanction. It is only waiting for the legislation to be approved by the President.

The passage of the law by such impressive majorities shows that the consensus for radical reform has survived the hardships of half a year of stabilisation. If successfully, and above all rapidly executed privatisation should create a revolution in the economy as fundamental as last year's elections did in Polish politics.

Poland wishes to "return to Europe." But, paradoxically, it can do so only if it rejects the orthodox European method of privatisation. The Thatcher Government has only privatised some two dozen enterprises, while there are more than 7,000 significant state enterprises in Poland (accounting for 90 per cent of industrial output). The British path of reorganisation before privatisation is a cul de sac. On this path, the Polish economy would remain traditionally East European for at least a century.

Time-consuming reorganisation has to precede privatisation when only one company at a time is being privatised because otherwise the risks for individual purchasers are too great. But when people can obtain a portfolio of the entire economy, unanticipated losses in some enterprises will be offset by gains elsewhere. Reorganisation can then follow privatisation, allowing the whole process to be rapidly speeded up.

It is not yet clear whether the Government is seized of this point, though some of its members are, notably Mr Leszek Balcerowicz, the Deputy Prime Minister and Minister of Finance. The legislation itself leaves the Government with its options open. A simple enabling bill, it has the following main features:

- A new Ministry of Property Transformation (MPT) is to be set up. The new ministry will oversee the old Foreign Investment Agency, which has been in the foreign trade minister's domain until now.
- Once selected for privatisation, either by the MPT or at the initiative of their own management and workers' councils, state sector companies are to be transformed into wholly state-owned joint stock companies and their shares sold within 24 months.
- Apart from sales of shares to large numbers of individuals the MPT may auction companies as well as negotiate direct sales with individual buyers.
- Coupons, with which shares can be "purchased", may also be distributed to the population.
- 10 per cent of shares may be bought by foreign investors without a special permit from the FIA.
- Dividends to foreigners may be repatriated, though under what remain restrictive general foreign investment rules. The entire after tax proceeds of share sales may be transferred abroad without special permits.
- As a concession to Poland's vociferous worker self-management lobby and its advocacy of Employee Share Ownership Schemes, workers in a privatised company will be able to buy up to 20 per cent of the shares at half price. As long as half the shares are in state hands a third of the board will be elected by the workers. As soon as the state relinquishes its majority share the board will be elected by the shareholders.
- Parliamentary control over privatisation is to be minimised, to the chagrin of some deputies. Parliament will merely set out the "basic directions" for privatisation once a year and fix the ends for which the proceeds are used. Action is also under way. Several hundred companies are expected to close in the next 12 months and their fixed assets will either be sold or leased by the state. More formal privatisations are also in the offing, the first being scheduled for September.

Four leading companies, including the Exbud construction conglomerate in Kielce and a cable factory in Czechowice in the south, will be in the first batch. The consulting arms of several UK banks, including Samuel Montagu and Barclays, their fees paid by Britain's aid funds (which foster development of know how suitable for the emerging market economy), are to prepare more in the next few weeks.

The starting point for the Polish privatisation is thus the familiar one of selling off individual companies. But this is only an opening gambit. The Government is seriously considering a free distribution of shares to the population. This would mark a significant turnaround for a Government that argued, at first, that such a free distribution amounted to "economic bolshevism." Now the Government appears to be waiting to see how the first sales of shares go, before bringing in the coupons on the assumption that the market dries up.

Some of the arguments used for such a wider distribution of shares look like excuses rather than the reasons. The oft-cited lack of domestic savings and the fear that foreigners may obtain assets too cheaply are either specious (since the lack of savings merely determines the price that can be obtained) or easily dealt with (by prohibiting foreigners from purchasing too high a proportion).

A more plausible explanation is that the Government is under pressure to speed up the process, particularly from Mr Lech Walesa, the Solidarity leader and his backers in the Centre Agreement, a right-of-centre Solidarity faction critical of the present Government. But such pressure merely reinforces what some members of the Government recognise. Only free distribution can achieve Mr Balcerowicz's goal of privatising much of the Polish economy within a couple of years. That goal must, indeed, be attained, since, as Ms Irena Grosfeld, an adviser to the European Community's programme for Poland, points out: "The case for privatisation is precisely the case for the market environment" (1).

The need for speed is one reason for Poland to take a radical approach. But equity is another. Polish enterprises already belong to the Polish people.

The need for speed is one reason for Poland to take a radical approach. But equity is another. Polish enterprises already belong to the Polish people. They may not be worth much, but they are what remains from their 45 years under communism. If, by contrast, enterprises were sold to a narrow class of beneficiaries, the gains for some of them could be huge. Worst of all, foreigners might figure among them. The legitimacy of private ownership could be destroyed by the asset stripping that would ensue.

There is another, more pressing danger that of spontaneous privatisation by existing managers. In his discussion of the shift to the market in eastern Europe, Mr Manuel Hinds, a staff economist at the World Bank, argues that "having socialised enterprises own themselves means that nobody owns them" (2). The managers are in a perfect position to exploit the absence of owners for their personal benefit. While spontaneous privatisation might improve the efficiency with which assets are used, the fruits of privatisation must not go to the more corrupt members of the erst while nomenklatura, especially when many workers are experiencing unemployment for the first time.

Workers' ownership, though politically more acceptable, is both inequitable and inefficient. Not only is the value of the company in which one works a matter of luck, but the capital employed in the firm was supplied by the forced savings of the population as a whole. Moreover Yugoslav experience with worker self-management underlines the dangers of short termism. As Sherlock Holmes might have said, when you have eliminated the impossible (or entirely undesirable), whatever remains, however improbable, is the answer. What remains is swift and comprehensive privatisation via the widest possible distribution of the benefits of ownership, but concentration of its responsibilities. Each Polish citizen can hardly be granted more than 7,000 shares and each Polish enterprise can hardly have more than 20m shareholders.

Intermediaries will have to be created instead. Their shares would be held by the public and they, in turn, would hold shares in individual enterprises. Two questions remain:

- whether these institutions should be holding companies, with outright control of a designated number of companies, or rather mutual funds limited to sizeable minority shareholdings, instead;
- and whether the allocation of shares in individual enterprises should be imposed by the Government or itself be the result of an auction.

Holding companies were proposed by Mr Richard Layard, of the Centre for Economic Performance at the LSE, and Mr Olivier Blanchard of MIT, in the FT (July 11 1990). But they are not the best solution. A limited number of large holding companies, each possessing majority control of many enterprises, could reinforce existing tendencies towards monopoly, an ill managed holding company would have hundreds of enterprises at its mercy, the soft budget constraint that has long bedevilled the socialist economies might be recreated in a different guise, since bankruptcy of a large holding company would be inconceivable, and it would also be politically impossible to allow these dominant companies to fall under foreign control. The Government itself seems to believe that mutual funds are a better alternative. Under this approach individual funds would hold enough shares to exercise considerable influence over a given company, but without exercising sole control over it.

A more subtle way of distributing shares than by simple fiat has been recommended by Mr Andrzej Rapaczynski and Mr Roman Frydman, both academics from the United States who are advising Democratic Action, the Solidarity faction that supports the Government of Mr Tadeusz Mazowiecki.

They recommend that vouchers with no nominal value be issued to the population. These could be transferred to mutual funds, themselves emerging spontaneously, in return for shares in those funds. In the absence of the relevant domestic expertise these funds would in the main be run by western banks and investment houses, which would then use the coupons they received to "buy" shares in individual state enterprises.

Such details are still to be decided but a proposal to establish mutual funds is now being examined by the Government. Under it, 10 per cent of the shares in each enterprise would be given to the workers, 10 per cent to a bank (or banks) and 20 per cent to the mutual funds (with a limit of 10 per cent for any one of them), while 60 per cent would be retained initially by the state, though as a sleeping partner. Two directors would be appointed by the funds, two by the workers and one by the banks. This process could, it is believed, start in some 15 months.

Privatisation of an entire economy would break new ground, not merely for Poland, but for the world. First, the Government would have to thwart spontaneous privatisation now taking place and then it would privatise Polish industry by allowing the birth of a limited number of capitalist intermediaries, while vesting ultimate ownership in individual citizens. Thus might the people of Poland share in the long term benefits of reforms made possible by their courage, by their patience and by their efforts.

(1) Irena Grosfeld, "Prospects for Privatisation in Poland, 1989-90," European Economy, March 1990.

(2) Manuel Hinds, "Issues in the Introduction of Market Forces in Eastern European Socialist Economies," World Bank, March 1990, mimeo.

THE WASHINGTON TIMES, July 19, 1990

GEORGIE ANNE GEYER

Getting in the way of progress?

In December 1981, a week before martial law was declared in Poland and the Solidarity free-trade unions fell, Lech Walesa went to dinner with the U.S. ambassador — and that night made suggestions that shocked the very devil out of the entire embassy.

One diplomat told me the day after, with utter wonder in his voice: "Do you know what he wanted? He wanted the U.S. to give $5 billion to Poland, and he wanted it given directly to Solidarity!"

Shrewd labor leader Mr. Walesa was ever then clearly reading the ominous warnings of communist military crackdown, and he had been railing against his own Solidarity radicals all that fateful fall. So the idea that at the last possible moment he would make such an absurd suggestion, even going so far as to try to go around the Communist Party government, struck us all as revelatory, a clue to a character trait to tuck away for future reference.

Now, Mr. Walesa — worker-hero of the whole world, the man who almost single-handedly opened the Iron Curtain, brilliant labor organizer and shrewd tactician — is at it again. And some of his recent, increasingly fractious and angry utterances are giving people still a more sobering cause for concern about Poland, a concern heightened by the decision of his critics within Solidarity to form their own alliance.

- "I don't want to become president, but I must become president," he demanded in a recent interview with Gazeta Wyborcza. "Poland needs a president with an ax in his hand . . ."
- Or consider his words when he recently summmoned Solidarity members of parliament to "return to your origins" in Gdansk's Lenin shipyards. "The question is whether you're going to be above us," he shouted at the elected legislators at one point. "One blow from the farmers and the miners will put all your laws into the wastebasket." Then he proceeded to dress down the lawmakers for six hours — all of this, ironically, in the same "name of the working class" that the communists so long and so phonily extolled.

The kind interpretation for the actions of the admittedly ebullient Mr. Walesa is that he is (1) concerned about the communists still in positions of power, and (2) fighting for a further democratization of Poland in order to buy political time for the painful market reforms that are necessary. But this is too simple.

My own, less kind interpretation is that we are seeing the release of traits and beliefs shadowed until now by the glow of Mr. Walesa's national and international celebrity.

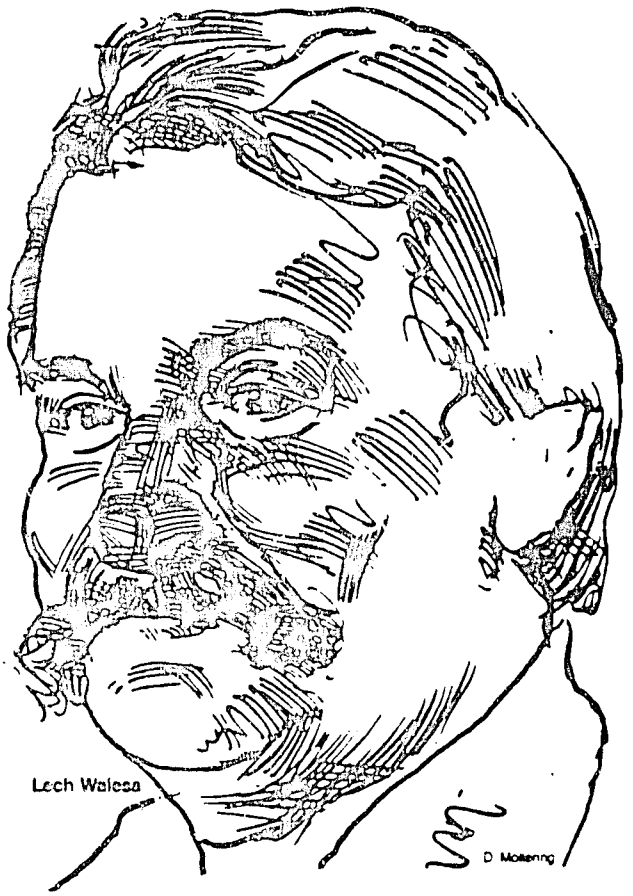
When the Solidarity-communist coalition government was agreed to a year ago last winter, Mr. Walesa was far and away the most popular man in Poland. And today? A government poll just taken showed that the soft-spoken, distinctly uncharismatic prime minister, Tadeusz Mazowiecki, himself appointed by Mr. Walesa, now is the most popular politician in Poland, with 61 percent supporting him as a possible presidential candidate — against only 32 percent for the proud and preening Mr. Walesa.

It is the form and potential of Mr. Walesa's response that is becoming increasingly wornisome. He demands that Solidarity legislators come like supplicants to "Walesa's" Gdansk, where he humiliates them. He performs what some angry senators are calling Walesa's Bolshevik show, in effect cynically taking over the communists' old "class struggle" for his own behalf.

Most dangerous of all, he now derides and disdains Solidarity's intellectuals, managers and planners, supposedly all on behalf of the "working people" who still largely follow him unquestioningly. In so doing, he slides back into what Solidarity always was: a Roman Catholic communitarian and socialist movement wanting forms of security and guarantees from the state, not by any measure a Western-style labor union. And so, particularly in weakening the intellectuals and economists who alone can save the country, he endangers the entire delicate process.

In many ways, Poland again stands at the forefront of change in Eastern Europe. Only today, Poland stands as a warning of all the retrogressive, "return-to-old-chauvinisms" that now threaten so much of Eastern Europe. Mr. Walesa, for whatever personal devils, in bringing back the old hatreds and conflicts of the past is endangering the new economic future that Mr. Mazowiecki is just beginning to form.

It would indeed be tragic if Mr. Walesa were to halt the very process that now slowly gives hope to Poland. But it would not be the first time in history that yesterday's hero turned out to be today's riddle and tomorrow's autocrat.



Lech Walesa

It would indeed be tragic if Mr. Walesa were to halt the very process that now slowly gives hope to Poland. But it would not be the first time in history.

Georgie Anne Geyer is a nationally syndicated columnist.

Walesa Wants Reform Fast. He's Right.

By Josef Kucio
and Maciej Zalewski

"United we stand, divided we fall," Lech Walesa said nearly 10 years ago, and it became the guiding principle of the Solidarity movement.

Today, Mr. Walesa is dividing Solidarity. Unity is no longer necessary because Solidarity's powerful opponent, the Polish United Workers' Party, has disappeared. Mr. Walesa believes that the time has come for open competition — for the groups within Solidarity to declare themselves, form separate parties and advance their own programs.

Mr. Walesa's statements and actions have met with the resistance of several key ex-advisers. Prime Minister Tadeusz Mazowiecki interprets his call for the acceleration of reform as a threat to the difficult process of transforming the economy. Bronislaw Geremek, the leader of Solidarity's parliamentary wing, says that Mr. Walesa's rhetoric and decision-making style are a danger to Poland's fragile democracy. Adam Michnik, editor-in-chief of Gazeta Wyborcza, warns that open political competition could release long-suppressed forces of xenophobia and anti-Semitism.

As a result of this political dispute (it is not a personal squabble as some have portrayed it), two new parties are taking shape. Mr. Walesa's opponents have formed the Alliance for Democracy, which favors cautious, evolutionary change; in general, they justify their approach by arguing that to do otherwise would be to "destabilize" the situation.

Mr. Walesa and his supporters have founded the Center Alliance, which calls for accelerating reform — that is, early parliamentary and presidential elections and the creation of a multi-party democracy. The reasoning is clear: the Polish people will not continue to bear the burden of economic reform in the absence of deep, prompt, visible changes in the political sphere.

The same old Communist-appointed managers are not only bungling things as before, but are also appropriating or looting state-owned property while they still have a chance. The average Pole, whose already low standard of living has fallen by nearly half since December, is likely to rebel and may reject the free market economy now in its infancy.

Jarosz Kapusta

Thus, members and former members of the *nomenklatura* must be stripped of their special privileges and of the property and wealth they acquired though them. To do so will require new legislation — which has been blocked by the Communist-dominated lower house of Parliament.

Hence, it will also be necessary to oust the Communists and their allies from Parliament by way of truly democratic elections as soon as possible. The railway strike that crippled the northern part of the country in May is a warning we can't ignore.

Those who criticize Mr. Walesa for his political style are hardly beyond reproach themselves. This band of intellectuals dominates Solidarity not because it is representative of society at large, but because it was the group that took part in the round-table negotiations with the old regime that led to Poland's new democracy. Now it claims that democracy in Poland is so fragile that it could be ruined by ... more democracy. What these intellectuals really fear is the loss of their dominant position.

Mr. Walesa said he was ready to do political battle, and he meant it. Isn't that a part of democracy? Which is more dangerous to democracy — open, sometimes bad-tempered criticism or subtle manipulation? Mr. Walesa is already well known for the former, if elected president, he would swing a "sharp ax," he has said, adding that he would rule by decree ... necessary until a new constitution ... in place.

But we should keep in mind the small group of Solidarity deputies who engineered Gen. Wojciech Jaruzelski's election as president last summer. And we should recall that the front page of Michnik's Gazeta Wyborcza (which regularly conflates news with editorial commentary, by the way), still carries the Solidarity logo, though the paper was taken over by a private company headed by Mr. Michnik himself.

There are those who say they are concerned about a flare-up of xenophobia. Such concern — even if it is justified, even if the danger of racism and nativism is higher in Poland than elsewhere in Europe — does not warrant limitations on parliamentary democracy.

But his opponents seem afraid to let Poles choose for themselves.

Mr. Walesa, however, trusts Polish society — which, after all, maintained its faith in the fundamental values of democracy through decades of totalitarian rule, built a peaceful mass movement in defense of its rights and didn't resort to acts of terrorism or revenge against a group it does hate: the Communists. It may be that those who don't trust Polish society don't trust it to vote for them.

Mr. Walesa has staked his claim against his former political allies. Now he wants the people to decide who should lead Poland. If the voters choose his party, he wants to be president. He feels he is the best-qualified candidate with a strong sense of society's mood and the authority, vision and determination to implement radical changes. When everyone else had failed, he succeeded last month in talking the railway workers out of a strike that could have plunged the country into chaos.

Nearly two years ago, Lech Walesa began the preliminary talks that marked the beginning of the transition from Communism. Now he wants to bring this transition to a rapid close, and lead Poland out of Communism for good. Is this what society wants? He says: Let society choose.

Josef Kucio is an editor of "Uncaptive Minds," a magazine on East European politics. Maciej Zalewski is deputy editor of Tygodnik Solidarnosc, the Solidarity weekly, and a member of the executive committee of the Warsaw region of Solidarity.

THE WALL STREET JOURNAL, September 15, 1990

Saddam Takes Eastern Europe Hostage Too

By Anne Applebaum

"Hard luck never walks in the mountains, but stays in the valleys among the people." This is how they say, "It never rains but it pours" in Czechoslovakia, and this was the response of a Prague official when asked what he thought about the Iraqi invasion of Kuwait. He meant to make a joke, but he frowned immediately afterward. There is no light way to talk about the combination of high energy prices and foreign trade problems that are about to hit Eastern Europe as a direct result of Saddam Hussein's aggression.

The energy crisis will come first. Since World War II, the nations of the former socialist bloc have received virtually all of their oil and natural gas from the Soviet Union. Within the framework of Comecon, the East Bloc's trade organization, prices were set for five years in advance, according to the average world price of the preceding five years. This meant that prices were way out of line with the world market. It didn't matter much though, because Comecon members paid the Soviet Union not with money but with goods.

So, dozens and dozens of bureaucrats in every country were required to coordinate shipments of shoddy electronic equipment, outdated machinery, poor quality clothes and food products to the Soviet Union through centralized, state-owned foreign trade enterprises. Calculations were made in a nontransferable "currency" called the transferable ruble, whose exchange value with the zloty, the crown or the forint depended on whim and political weather. In retrospect, it is hard to believe that this elaborate system of comradely barter kept factories in business as long as it did.

As of January, though, barter officially comes to an end. Eastern Europe must buy its oil and petrol from the Soviet Union for hard currency at world prices. East Bloc newspapers and governments have been worrying all year what the change will do to their economies. Now the Iraq crisis means that those prices are much higher than anyone expected.

Where will Poland, with its $40 billion debt, or Hungary, with its $20 billion debt, find the hard currency to buy energy at world prices? The region's total energy needs could require between $6 billion and $10 billion next year. No one can explain where this money will come from. The goods once sent to the Soviet Union in exchange for energy are precisely not the things that anyone there, or anywhere else, is going to use hard currency to buy.

Consumer goods and light machinery made in the West are going to be both better and cheaper than the things the Soviet Union once bought in Eastern Europe. Better, because technology is higher; cheaper, because the West started devising ways to save on energy costs long ago. Eastern Europe's old Soviet markets will shrink, and shifting the same goods to Western markets will not happen quickly.

Enormous structural faults on the micro level of individual firms and the macro level of the entire economy are in fact Comecon's greatest legacy. Eastern European companies that designed goods for the Soviet Union never had any incentive to improve quality or quantity, or least of all to economize on energy. Whole industrial sectors in East Europe developed on the premise of cheap oil, cheap raw materials and infinite markets. Hungary, a nation without iron ore or major energy resources, possesses a vast steel industry.

Mere exposure to competition coupled with changes in monetary policy, the kinds of economic reform tools which the West itself uses, will not produce overnight change in Eastern Europe. The East German products now competing for the first time with Western goods are the best proof of this problem. These things, from radios to canned vegetables, are going unpurchased because they are both lower quality and more expensive. The factories that make them are not going to switch quickly to another kind of production. They are going to close down and fire their workers. Restructuring, quality improvement and energy efficiency all cost money in the short term, and there are no resources to keep the plants in operation until the long term benefits can be felt.

Massive Western investment and aid for re-training and re-tooling for every country in Eastern Europe on a scale much greater than anything discussed so far—perhaps something like the $500 billion West Germany, it is estimated, could soon be spending in East Germany—is one solution. But where will Western industrialists, now facing sudden energy prices rises, find the spare cash to invest in the Romanian auto industry or Polish textiles? Where will Western governments, now realizing that even the collapse of the Soviet Union doesn't make the world a safe place, find the spare cash to re-train the steel mill workers of a few tiny, insignificant democracies? The so-called "peace dividend," the money expected to flow back into national budgets after deep cuts in defense spending, no longer looks imminent.

Less expensive, temporary measures on the part of the West, like lending money to the Soviet Union for the express purpose of purchasing East European products, could help. Reduction in import duties and taxes on East European goods will also make a difference. But the readjustment to capitalism will now succeed or fail depending on the speed of the East European governments themselves: How fast they can clear up the tangle of ownership problems, what kinds of tax laws and interest rates are set and how quickly, how long it takes for new companies, domestic and foreign, to set up business.

All of these problems existed before the Iraqi invasion of Kuwait. The crisis, by bringing back higher oil prices and diverting the energy and the attention of the West, has simply heightened them. The expected readjustment period and the accompanying possibility of political instability will arrive more quickly and with greater severity than expected. Time for debate has already run out.

Reconstruction in Afghanistan, Indochina, Central America, Southern Africa, and the Horn of Africa

AFTER THE WARS

Anthony Lake and contributors

After a decade or more of fighting and destruction in various regions of the world, new policies in Washington and Moscow as well as fatigue on the ground are producing openings, at least, for peace. Negotiations are at different stages regarding Afghanistan, Indochina, Central America, Southern Africa, and the Horn of Africa—but all share new possibilities for peace.

This volume analyzes the prospects for postwar reconstruction and development in these regions, tackling the difficult quandaries they face individually and collectively: Among realistic potential alternatives, what kinds of new political structures can best manage postwar reconstruction and development? Which economic policies would be most effective in maintaining peace and political coalitions? Should the focus be on the reconstruction of prewar economic life or on creating new patterns of development? What are the prospects for democracy and human rights?

The authors thus consider the relationship of economic planning and likely political realities. For example, might diplomats seeking to stitch together a fragile coalition in order to end the fighting also be creating a government that cannot make the hard economic choices necessary for sustained peace? Might economists calling for postwar economic programs which are theoretically sound but politically unsustainable threaten a tenuous peace?

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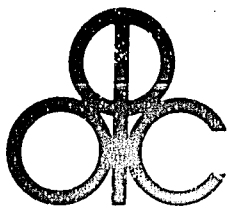

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LATIN AMERICA
QUARTER 3, 1990

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THE WHITE HOUSE

Office of the Press Secretary

For Immediate Release September 14, 1990

The Enterprise for the Americas Initiative Act of 1990

The President will transmit to the Congress a legislative proposal to implement the investment, debt, and environmental elements of his Enterprise for the Americas Initiative. The purpose of this legislation is to encourage and support market-oriented reform and economic growth in Latin America and the Caribbean through inter-related actions that will promote investment reforms, debt reduction and environmental protection.

In the investment area, the proposed legislation will provide for contribution by the United States to the Enterprise for the Americas Investment Fund, a multilateral investment fund to be established at the Inter-American Development Bank.

Authorization for contributions of $500 million to the Fund and authorization of appropriations for the contribution will be sought. The President will seek $100 million a year over five years for the Fund. The Fund is designed to foster a climate favorable to investment in Latin American and Caribbean countries and would support efforts in these countries to facilitate investment and the reflow of flight capital. It would advance specific, market-oriented investment policy initiatives and reforms and finance technical assistance for privatization efforts, business infrastructure, and worker-training and education programs. The Secretary of the Treasury will seek contributions from other countries to the Fund.

The proposed legislation will also establish the Enterprise for the Americas Facility in the Department of the Treasury to support the objectives through administration of debt reduction operations for nations that meet certain investment reform and other policy conditions.

The legislation would establish criteria to govern eligibility to participate in the debt reduction operations under the Facility. These criteria will aim to encourage economic reform, including measures to liberalize investment regimes. An eligible country should:

- have in effect an International Monetary Fund (IMF) stand-by arrangement, extended fund arrangement, or an arrangement under the structural adjustment facility or enhanced structural adjustment facility, or, in exceptional circumstances, an IMF-monitored program or its equivalent;

- more -

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- as appropriate, have received structural or sectoral adjustment loans under the International Bank for Reconstruction and Development (World Bank) or the International Development Association (IDA);

- have in place major investment reforms in conjunction with an IDB loan or otherwise be implementing open investment regimes; and

- as appropriate, have agreed on a satisfactory financing program with commercial banks including, if appropriate, debt and debt service reduction.

Clear authority will be necessary to undertake the actions proposed in the debt element of the Initiative. The Administration will seek authority to reduce concessional loans extended under the Foreign Assistance Act of 1961 (FAA) and credits extended under title I of the Agricultural Trade Development and Assistance Act of 1954, as amended (P.L. 480). This reduction would be accomplished through an exchange of new obligations for obligations outstanding as of January 1, 1990. Once agreed by the President, the responsibility for executing an exchange of obligations that will result in the debt reduction rests with the agency that holds loans or credits to be affected. Such agency will act at the direction of the Facility.

Once an exchange is undertaken, principal payments on new obligations will be paid in U.S. dollars and credited to the accounts established to receive principal payments on the old debt obligations. Interest payments will be at a concessional rate and will be made in local currency if the debtor country has reached an environmental agreement with the United States establishing an Environmental Fund. Under such an agreement, interest payments would be deposited in an Environmental Fund and jointly programmed by the U.S. and debtor country government. In the absence of such an environmental agreement, interest would be paid in U.S. dollars into the account established for interest payments of the obligations exchanged therefor.

The President would be authorized to enter into agreements with countries receiving debt reduction under the Initiative which, in addition to establishing Environmental Funds and providing for joint programming, could specify the uses of monies in the Funds. The President intends to encourage the involvement of local private environmental groups in decisions on the use of grant funds and to consult with non-governmental organizations in the United States and abroad regarding the establishment, structure, and operation of the Environmental Fund program.

In addition to the authority to reduce concessional debts, the President would be authorized to sell, reduce, or cancel loans made to an eligible country under the Export-Import Bank Act of

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1945, as amended, and assets acquired as a result of credit guarantees made in connection with export sales to eligible countries under programs authorized pursuant to the Commodity Credit Corporation (CCC) Charter Act, as amended, or section 4(b) of the Food for Peace Act of 1966, as amended. Such sale, reduction, or cancellation would only be undertaken for those loans made or assets acquired prior to January 1, 1990 and would be consistent with terms or conditions of prior agreements relating to the loans or assets.

Eligible purchasers for Eximbank loans and CCC assets would depend on the presentation of satisfactory plans for engaging in debt-for-equity or debt-for-nature swaps. Once an eligible purchaser is identified, the Facility will notify the agency that holds the loans or assets to be affected, and that agency will carry out the sale, reduction, or cancellation. Prior to such a transaction, consultations would be undertaken with the eligible country regarding the amounts to be affected and their uses for debt-for-equity or debt-for-nature swaps. The proceeds of any sale, reduction, or cancellation of a loan or asset would be credited to the account established for the repayment of that loan or those assets.

Such sales, reductions, or cancellations of loans or assets would be carried out in a way to maximize return to the U.S. Government. These transactions would not be required to be registered pursuant to the Securities Act of 1933 and, for the purposes of that Act, neither Eximbank nor CCC would be deemed an issuer or underwriter with respect to any subsequent sale or other disposition of such loan or asset pursuant to a debt-for-equity or debt-for-nature swap.

The President would transmit an annual report to Congress on the operation of the Facility.

Implementation of the Initiative

The key investment, debt, and environment components of the "Enterprise for the Americas" initiative are as follows:

(1) Contributions to the Enterprise for the Americas Investment Fund to be administered by the Inter-American Development Bank (IDB).

(2) Development of an investment sector lending program in the IDB to provide loans in support of investment reforms.

(3) Creation of the Enterprise for the Americas Facility within the Treasury Department to support the

objectives of the Initiative through debt reduction operations for eligible nations.

(4) Reduction of concessional (AID and PL 480) debts owed by eligible countries.

(5) Use of interest payments on reduced concessional obligations to support environmental programs in the debtor country.

(6) The sale, reduction, or cancellation of Eximbank loans and CCC assets to facilitate debt/equity or debt-for-nature swaps.

The following provides further detail on the expected operation of these elements.

Enterprise for the Americas Investment Fund

This fund is expected to be multilateral in nature, although it could commence operations based initially on U.S. contributions if other contributions are not available. The Administration will be seeking authority to contribute (as grants) $100 million annually to this Fund over five years beginning in FY 1992.

The Fund is expected to provide support for investment policy initiatives and reforms and to finance technical assistance for privatization, development of business infrastructure, and worker training and education programs.

The Administration discussed this proposal with other G-7 industrial countries at the Houston Economic Summit and will continue to seek contributions from European countries, Japan, and Canada.

Although the IDB would manage the Fund, contributing countries would be expected to provide guidelines for disbursement of grants to eligible countries.

IDB Investment Sector Loan Program

The President has proposed the establishment of an IDB sector lending program to provide fundamental support for investment reforms. Liberalization of investment regimes is particularly important as a means of attracting the scarce capital critical to sustained growth. The objective for Latin America and the Caribbean must be to compete effectively for investment in a world of limited resources and to attract the capital of their nationals back home.

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The U.S. Government will work with the Inter-American Development Bank to develop an investment sector lending program consistent with these goals.

Enterprise for the Americas Facility

The Enterprise for the Americas Facility will support the objectives of market-oriented reform and economic growth, investment reform, and environmental protection through the administration of debt reduction operations for eligible countries.

To be eligible for debt reduction, Latin American and Caribbean countries must:

- Have in effect International Monetary Fund/World Bank economic reform programs;
- Have in place major investment reforms in conjunction with an IDB loan, or otherwise be implementing an open investment regime; and
- For countries that owe a substantial part of their debt to commercial banks, have negotiated a satisfactory financing program with commercial banks, including debt and debt service reduction if appropriate.

Decisions on country eligibility, based on these criteria, will be made through an interagency process chaired by the Secretary of the Treasury. The Enterprise for the Americas Facility will issue instructions to the appropriate Federal agencies to effect the debt reduction, sale, or cancellation which has been negotiated with eligible countries (see below). It will also provide technical support for an interagency team, to include relevant agencies, which will negotiate the terms of debt reduction with individual countries.

Reduction of Concessional Debts

Decisions on the extent of debt reduction on Agency for International Development and P.L. 480 obligations of individual eligible countries will be made through an interagency process chaired by the Secretary of the Treasury.

Debt reduction will be effected through the exchange of outstanding obligations for new, reduced AID and P.L. 480 obligations bearing concessional interest rates (see environmental support discussion below).

Reduction, Sale, or Cancellation of Eximbank and CCC Obligations

Decisions on the amount of Eximbank loans (and loans acquired pursuant to its guarantee and insurance programs) and the amount of CCC assets acquired as a result of its export sales guarantees which will be available for reduction, sale or cancellation for eligible countries will be made through an interagency process chaired by the Secretary of the Treasury.

Such reductions, sales, or cancellations will be made solely to facilitate debt/equity swaps or debt-for-nature swaps. Specific mechanisms will be developed to assure that this objective is realized.

Enterprise for the Americas Environmental Funds

The Administration will seek to negotiate an environmental agreement with each country determined eligible for debt reduction. Conclusion of such an agreement would allow the eligible country to make interest payments on new obligations resulting from debt reduction in local currency. The agreement would establish an Environmental Fund to receive interest payments and would determine the operation of the Fund and the use of its resources to provide grants for environmental projects and programs.

The local currency interest payments would be deposited in an eligible country's Environmental Fund and would be jointly-programmed by the United States and that country. It is contemplated that local committees -- composed of U.S. Government representatives, eligible country representatives, and representatives of local private environmental groups -- would have a significant role in formulating programs and projects funded by each country's Environmental Fund.

The Administration is committed to encouraging the involvement of local non-governmental environmental groups in the decision-making process. We have heard preliminary views from non-governmental organizations in Washington and believe it will be important to consult with these groups regarding the establishment, structure, and operation of the Environmental Fund program.

We anticipate that annual programs for individual countries would be formulated at the local committee level, as would proposals for specific projects to be funded. Annual programs would be subject to the joint approval of the USG and the debtor government.

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

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STATEMENT OF THE HONORABLE
DAVID C. MULFORD
UNDER SECRETARY OF THE TREASURY FOR INTERNATIONAL AFFAIRS
BEFORE THE SUBCOMMITTEE ON
INTERNATIONAL DEVELOPMENT, FINANCE, TRADE, AND MONETARY POLICY
COMMITTEE ON BANKING, FINANCE, AND URBAN AFFAIRS
U. S. HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I appreciate this opportunity to discuss with your Committee the President's new "Enterprise for the Americas" initiative and the legislative proposal the President transmitted last week to begin its implementation.

While the events of the past month have drawn the world's attention to the grave situation in the Middle East, we realize that other regions also need our support and hold prospects for mutually beneficial cooperation. The dramatic emergence of Eastern Europe over the past year holds both challenges and opportunities for international economic policy.

At the same time, a quieter but no less important revolution has occurred in Latin America, where a new generation of leaders has turned increasingly to market forces as they have pursued economic reforms designed to encourage growth. In June, President Bush announced his Enterprise for the Americas initiative, a cooperative endeavor to boost growth, trade, and investment in the Hemisphere. The President reaffirmed his fundamental commitment to the Enterprise initiative in his remarks on September 14 upon signing the legislative proposal prepared by the Administration to begin its implementation.

The White House announcement of the initiative on June 27 followed a broad Administration review of U.S. economic policy toward Latin America and the Caribbean that the President commissioned after his visit to Colombia in February for the Andean Summit. That review underscored the fundamental importance of our economic, political, and financial relations with the Caribbean and Central and South America.

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Geography makes all of us in this hemisphere natural allies. We share a rich historical and cultural heritage and strong economic ties that go back centuries. People, capital, and goods flow in abundance across our borders. Following the recent democratic transitions in Latin America and the Caribbean, we share more interests and values than ever before.

Yet economic conditions in many of these nations have not allowed us in recent years to make the most of these close ties.

Many Latin American and Caribbean economies remain burdened by a decade of poor economic policies, over-management by governments, and a difficult world environment. The debt crisis has constrained the resources needed for growth and tested the resolve of nearly every government in the region. Countries have suffered diminished trade, debilitating financial imbalances, the flight of their own citizens' capital, and the harsh results of low growth.

Meanwhile, for our part, the United States has developed a large trade deficit with the region as economic hardship in many Latin and Caribbean countries choked the appetite for imports while still compelling expansion of exports. At the same time, U.S. foreign direct investment in the region has declined -- both in relation to overall U.S. foreign direct investment and to U.S. investment in developing countries. In short, these countries are much less competitive in attracting vitally needed capital.

These problems have overshadowed potential opportunities for more productive hemispheric relations. They call for decisive action to improve the prospects for growth and prosperity throughout the Hemisphere. The Enterprise for the Americas initiative reaches out to our neighbors to support economic reform and sustain growth. For the first time, the three economic issues of greatest importance to Latin America -- trade, investment, and debt -- have been joined in a single endeavor. These are the three pillars of the Enterprise initiative. A recognition of the complex interrelationships among these three policy areas is an indispensable precondition for Latin America's long-term recovery of growth and prosperity.

The initiative also sets a challenge for Latin America. Its leaders will have to forge and implement policies to make their countries competitive in a world short of resources. Their reward will be expanded trade and investment within our hemisphere, reduction in their stock of official bilateral debt, and local currency resources for environmental programs.

The Three Pillars

The first pillar of the initiative aims to expand trade. The successful completion of the Uruguay Round remains the most effective way of promoting long-term trade growth in Latin

America and the Caribbean and of integrating the region into the global trading system. As part of this effort, we will respond to the particular interests of Latin and Caribbean countries by seeking deeper tariff reductions in the Uruguay Round on products of special interest to them.

To build further on the trend toward free markets, we will seek to establish a free trade system that links the entire Hemisphere. The President announced in the Enterprise initiative that we will be prepared 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. The Free Trade Agreement with Mexico is our first priority. Others will follow, and in the meantime we are already negotiating bilateral framework agreements to open markets and develop closer trade ties with countries that wish to move in this direction.

The second pillar of the initiative consists of a broad program to help Latin American and Caribbean countries attract the capital needed to expand their economies. Countries must compete today for capital in a world of scarce resources. To do so effectively, they must establish stable economies and regulatory systems hospitable to investors both at home and abroad. The initiative includes two proposals to create incentives for investment reform:

- a new lending program in the Inter-American Development Bank to support investment sector reforms; and

- a $1.5 billion multilateral investment fund administered by the Inter-American Development Bank to provide support and technical assistance to carry out investment reforms.

We are now seeking contributions from Europe, Japan and Canada.

The third pillar offers official debt reduction for those countries that establish sound economic policies and liberalize their investment regimes to promote domestic and foreign investment. First, we have proposed that the IDB immediately join the IMF and World Bank in making available enhancements to support debt and debt service reduction negotiated with commercial banks under the Brady Plan. Second, and of particular significance for the many countries with large proportions of official debt, the U.S. will undertake to reduce both concessional development assistance loans and non-concessional obligations to Eximbank and the Commodity Credit Corporation (CCC). In the case of non-concessional debt, we propose to sell a portion of such assets to facilitate debt-for-equity and debt-for-nature swaps.

We believe that this program will be effective in supporting strong economic growth throughout the hemisphere. To help ensure the sustainability of this growth, however, we must take into account the finite environmental resources with which we are

endowed. We must take care not to use up today the resources vital to growth and prosperity tomorrow.

With this in mind, the President's proposal includes dedication of resources to the environment as a component of the restructuring of U.S. concessional debt. Interest payments on restructured AID and PL-480 claims, therefore, will be made in local currency and targeted to fund appropriate environmental projects jointly supported by the United States and the participating government. We will seek a strong role in this process for local non-governmental organizations with expertise in the environment and conservation.

The Atmosphere in the Region

Leaders throughout Latin America and the Caribbean have reacted enthusiastically to the President's Enterprise initiative. Last month I visited a number of the larger countries of Latin America. Seldom in my experience has an initiative caught so aptly the prevailing mood of those it targets for attention. The timing of President Bush's announcement of the Enterprise initiative just prior to the Houston Economic Summit was not lost on Latin America's leaders. They understood, as did our industrial country partners, that the Bush Administration attaches a special importance to our relationship with Latin America, and in particular to the potential for mutual economic benefits.

Not surprisingly, expectations in Latin America are running high. Many of the medium and smaller countries of the region that are heavily burdened with official debt recognize that the Enterprise reaches past the Brady Plan to touch their particular situations. We welcome the enthusiasm we are finding, and of course it is critical that the Administration, with the help and support of Congress, follow up with rapid implementation.

Expectations, can however, be difficult to fulfill because too often the beneficiary's responsibilities are forgotten. Policy reform is indispensable to success. And policy reform is needed on a broad front in many countries. Improved macroeconomic policies need sustained implementation to bring success. Confidence is a fragile plant that requires careful tending. Sound macroeconomic policies need to be supported by reforming restrictive investment regimes that have hampered efforts to attract capital, freeing up rigid trade restrictions, and taking steps to reverse capital flight.

Reforms have begun in Latin America and the Caribbean. New leaders are moving for genuine economic change. Given the reluctance of banks to lend new money and with attention focused on Eastern Europe and the Persian Gulf, they know they have to act to be competitive and to attract finance.

I can feel the shift that is taking place in many countries as commercial bank financing packages fall into place -- many

involving substantial debt and debt service reduction -- and as new leaders undertake policy reforms to make their countries more competitive. This combination of reforms and debt reduction is removing a major obstacle to investor confidence.

Chile has set a commendable example in its progress on economic reform. Its experience, which has resulted in low trade barriers and greatly reduced state intervention in the economy, has been watched by many in the region. Chile is reaping rewards from its efforts -- the highest level of foreign direct investment in the region, low inflation, impressive growth, and a sharp reduction of its stock of commercial bank debt. Chile will be an early beneficiary of the Enterprise initiative.

Opportunities are expanding in other countries as well. Mexico has made great strides toward opening its economy, and we have recently seen an increased determination to attract investment. Mexico is also turning the corner on its debt problem. Private investors already sense the change. Smaller countries in Central America and the Caribbean are joining the trend to reform their economies. And in Argentina, large-scale privatizations are being used to effect domestic policy changes and, through debt-equity swaps, to reduce significantly the stock of external debt.

The potential benefits from closer cooperation -- for Latin American countries and for the United States -- are becoming evident. Economic and investment reforms, and mutual trade liberalization can provide strong sustenance for agriculture and industry throughout the region. Joint ventures and cooperative business endeavors can furnish essential private support for policy reforms undertaken by governments.

Momentum has clearly been established, and confidence in the region is building. Investment regimes are opening, and capital has begun to flow anew.

This progress must be sustained and expanded to countries throughout the region. Overall, much remains to be done. For some countries, debt problems continue to be a serious obstacle; large fiscal deficits in many countries also need to be reduced. In many countries, the reform process has only begun.

Building the more productive relationship envisioned by the initiative will depend upon the committed policy response of Latin American and Caribbean nations, not just today, but tomorrow and in the days after.

Implementation

Success also depends on action by the United States to follow through on the program put forward by the President. The Administration has been working since the announcement of the initiative to prepare for full implementation. In a wide range

of meetings, we have laid out the elements of the initiative for Latin American and Caribbean government officials. We have also proceeded with internal discussions to clarify the details of implementation in order to assure close coordination among the many agencies involved.

At the Houston Summit and at subsequent bilateral meetings, we have discussed the initiative with the leading industrialized nations, which have been quite supportive. We are continuing discussions about their financial participation in the multilateral investment fund that the President proposed be established in the Inter-American Development Bank.

In the meantime, we have begun discussions with the Inter-American Development Bank regarding the establishment of the sector lending program proposed by the President to provide fundamental support for investment reforms. Liberalization of investment regimes is particularly important as a means of attracting the scarce capital critical to sustained growth. The objective for Latin America and the Caribbean must be to compete effectively for limited resources while also attracting the flight capital of their nationals back home.

We must work with the Inter-American Development Bank to develop an investment sector lending program consistent with these goals. Appropriate macroeconomic policies are, of course, essential. In addition, specific measures need to be taken to remove impediments to investment and to open productive sectors to private ownership.

In the trade area, we are moving quickly under the leadership of Ambassador Hills to establish closer ties with Latin American and Caribbean countries. The first step in this process is a free trade agreement with Mexico. In addition, since the President's June speech, bilateral framework agreements have been signed with Colombia and Ecuador. We have begun discussions of such agreements with several other countries and groups of countries in the region -- such as the regional alliance formed by Argentina, Brazil, and Uruguay. Our highest priority for the moment, however, is the successful completion of the Uruguay Round negotiations by December of this year.

<u>The President's Legislative Proposal</u>

Despite these significant steps taken in the last 2 1/2 months, we must have authority from Congress to move forward to implement the initiative -- in particular to begin work to create the multilateral investment fund, to reduce official bilateral debt through exchanges of concessional debts and sale of market-rate debts, and to establish the environmental elements of the initiative. The President transmitted on September 14 a legislative proposal that would provide these authorities and allow us to respond to the readiness of Latin American and Caribbean nations to begin the new partnership outlined on June 27.

The President's legislative proposal:

- Authorizes $500 million to the Enterprise for the Americas Investment Fund in the Inter-American Development Bank.
- Establishes a Facility in the Treasury Department to support the objectives of the initiative by administering debt reduction for those countries that meet the investment reform and other policy conditions.
- Sets out the country eligibility criteria for debt reduction.
- Provides authority to reduce AID and PL-480 debts outstanding as of January 1, 1990 through the exchange of old obligations for new obligations carried out by each agency at the direction of the Facility.
- Gives the President authority to enter into an environmental framework agreement with each country eligible for debt reduction that would provide for the establishment of an Environmental Fund by that country.
- Allows for payment of interest on reduced AID and PL-480 obligations in local currency if the country has entered into such an environmental agreement.
- Provides for the deposit of local currency interest payments in the Environmental Fund, over which the U.S. and the debtor government would hold joint programming control.
- Emphasizes that the President should consult with local environmental groups in negotiating environmental framework agreements and that he should encourage the involvement of these groups in decisions on the use of grant funds.
- Also provides for consultation with environmental NGOs regarding the establishment, structure, and operation of the overall Environmental Fund program.
- Gives the President authority to sell, reduce, or cancel Eximbank loans and CCC assets to eligible countries extended or acquired prior to January 1, 1990 in order to facilitate debt-for-equity or debt-for-nature swaps agreed with debtor governments.
- Designates that the President will transmit an annual report to Congress on the operation of the Facility.

This proposal is the product of intense consultations within the Administration. It represents a concerted effort to formulate guidelines that will bring about quick and successful implementation of the initiative.

The Administration's goal is to secure passage of this legislation during this Congress. We recognize that this is an ambitious objective. Yet we believe that the tasks of promoting increased investment and improved growth in Latin America and the Caribbean cannot wait. President Bush has captured the imagination of the leaders and people of the region. To retain their enthusiasm for our joint endeavor, we must not delay action in the critical investment, debt, and environment elements of the Enterprise for the Americas initiative well into 1991. We must be in a position to move as soon as possible to respond to their efforts. We look forward to working with you to this end.

U.S. DEPARTMENT OF STATE

Office of the Assistant Secretary/Spokesman

For Immediate Release June 18, 1990

PRESS CONFERENCE BY
SECRETARY OF STATE JAMES A. BAKER, III
FOLLOWING MEETINGS WITH CENTRAL AMERICAN PRESIDENTS

Ramada Inn, Antigua, Guatemala
Monday, June 18, 1990

SECRETARY BAKER: Ladies and Gentlemen, I have a statement and then I'll be delighted to respond to your questions.

As I said to the six Presidents this morning, they have completed I think, an historic summit meeting, and it is a symbol of the changes that are transforming this region. For the first time in history, all of the Presidents attending their summit have been democratically elected. Also, for the first time, the principle subject for discussion is regional economic development, not the resolution of conflicts. And, of course, Panama is attending for the first time.

Here in Antigua, the Presidents have adopted a far-reaching agenda for regional economic integration and development and we congratulate them on this achievement. When President Bush took office this was a region in crisis and many argued that the United States faced only two choices -- accommodation to dictatorship or disengagement.

President Bush instead has pursued a new regional policy with four elements. First, support for the regional peace process begun in Esquipulas. Secondly, enlisting the cooperation of the Soviet Union to end the conflicts in this region. Third, engaging our European allies and Japan in support of regional democratization and development. And fourth, building a bipartisan base in the United States for our policy toward Central America.

We believe that this region has an historic opportunity today to realize three goals: democracy, disarmament and development. We also recognize that there are fears in Central America that the United States and the industrial democracies will be diverted by the changes in Eastern Europe and ignore this region at this moment of historic opportunity.

I'm here today at the request of President Bush to make it very clear that the United States will continue to be fully engaged and fully supportive of this regional peace process. That's why we are exploring with Japan, with the European community, Canada and other industrial democracies, possible ways to achieve more support for democracy and development in Central America. I have discussed these proposals with the six Presidents and they tell me that they welcome this effort. We will continue to consult closely about the best way to proceed.

The bottom line, I think, is this -- Central America is poised as never before to consolidate democracy, achieve lasting peace and disarmament, and create the conditions for growth and opportunity in which all of the peoples of this region, particularly the poor, can share.

The United States wants to do everything that it can to help this region's leaders seize this historic opportunity.

Any questions?

Q: An American official today said that he felt that the arms levels in Central America were excessive and pointed to Costa Rica as an example to be emulated in the future. I would like to ask you Mr. Secretary, if you agree with that and if you think that the help to be offered by the G-24 will have to be preceded by cuts in both levels in armaments and troops in the region?

SECRETARY BAKER: I would not anticipate that the G-24 would expressly condition their willingness to support democracy, disarmament and development, by requiring total disarmament in advance. So I would not see that as an absolute pre-condition. Costa Rica, of course, has a rich tradition of pursuing democracy and freedom and disarmament and it is a tradition that the United States has supported for many, many years in the past and continues to support.

Remember, there are three goals: democracy, disarmament and development. And in trying to encourage additional support from the G-24, we would be trying to encourage support for all three goals.

Q: I understand that the G-24 is not going to operate on the basis of pre-conditioning, but there will be some kind of ordering of assistance on the basis of pre-defined projects. Isn't that right?

SECRETARY BAKER: Yes, and there will be as it appropriately should be, conditionality with respect to G-24 efforts, just as there is conditionality with respect to the efforts the G-24 has made to support democracy and freedom in Eastern Europe. For example, there were certain events in Romania here during the course of the last several days which did not move in the direction of respect for human rights, freedom and democracy. And the G-24, at least for the time being, put on hold or temporarily suspended its efforts with respect to Romania.

Q: In the past when the United States participated in efforts of this kind it imposed a number of conditions, one of which was the establishment of democratic regimes. I would like to ask in this case, what requirements the United States intends to impose in order for countries to get assistance and get it on a timely basis, because the pressure of poverty and misery in the countries at this time does not allow them to continue under the present circumstances.

SECRETARY BAKER: First of all, if it was a cooperative effort through the G-24, whatever conditions were imposed would be imposed through the cooperative efforts of the G-24 countries and not just the United States. But, secondly, the United States conditions its assistance now on respect for human rights, freedom, democratic traditions and we make no bones about that. We're quite proud of that, because these are principles that we believe very strongly in. Furthermore, we believe these principles more and more are being adopted by countries around the world, not just in Eastern Europe, not just in Central America, but indeed in Africa and Asia as well.

Q: In order to cooperate in this disarmament effort is the United States willing to reduce its military aid to El Salvador, for instance, and the presence of its military advisors?

SECRETARY BAKER: Well, the United States only has 55 advisors there and that's the same number we had, if I'm not mistaken, when I first came to Washington with President Reagan in 1981. But further to the point of your question -- the United States is for the first time willing to condition its military assistance to El Salvador and we are in the process of having discussions with our Congress to that effect now. We should be careful not to interpret that in the wrong way. There is a major insurgency going on in El Salvador in which some are seeking to reverse the results of the ballot box with bullets and bayonets. That's not our idea of democracy and that's not our idea of an approach to freedom.

Q: Mr. Secretary, you mentioned the Soviet Union and I would like to ask you what might be the political and economic contribution of the Soviet Union to the development of Central America to which the United States and the other countries in the G-24 are going to be contributing?

SECRETARY BAKER: Well, hopefully, the Soviet Union will stop supporting regimes in this hemisphere that support attempts to reverse decisions at the ballot box with bullets and bayonets, as I said a moment ago. The Soviet Union has indicated to us that they are prepared to do this, and so we hope that's one contribution. We think it was a contribution with respect to what happened in Nicaragua. We've had discussions with the Soviet Union about the prospects of their continuing the assistance to Nicaragua that they furnished during the period of time of the Sandinista government. We make the point that it would be nice to see them support a freely, democratically elected government in this hemisphere since they themselves now profess to support the idea of democratization. We'll see whether or not they're able to do that although they've indicated to us some prospect that they will be able to continue some assistance to this freely elected democratic government in NIcaragua.

Q: Thank you.

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Melvyn Levitsky

Current
Policy
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The Andean Strategy To Control Cocaine

United States Department of State
Bureau of Public Affairs
Washington, DC

Following is a statement by Melvyn Levitsky, Assistant Secretary for International Narcotics Matters, before the Subcommittee on Western Hemisphere Affairs of the House Foreign Affairs Committee, Washington, DC, June 20, 1990.

I welcome the opportunity today to discuss the President's Andean strategy and outline our policy goals and objectives in this area. Cocaine control is our number one priority and our main focus has been, and will continue to be, the Andes.

The President's historic meeting in Cartagena, Colombia, in February signaled a new era in narcotics cooperation with our Andean partners. No longer is the drug issue simply a law enforcement problem. We are working with Colombia, Bolivia, and Peru to explore ways to strengthen law enforcement, military, intelligence, and economic cooperation, including opportunities for expanded trade and investment in order to attack the drug trade in a comprehensive way. The President's Andean strategy seeks to bolster these countries' capabilities on all fronts. The programs we have are cooperative programs. We cannot do the job without a strong effort from the Andean countries, the countries that surround the Andean region, and the transit countries through which cocaine passes.

The Andean strategy is a multifaceted approach to the complex problem of cocaine production and trafficking. Of course, the main front in this war is here at home. But as we work to diminish our own demand for and consumption of drugs, we must also work hard to reduce the international supply; otherwise, it will be more difficult to sustain effective domestic programs in law enforcement, education, prevention, and treatment.

In 1989, the administration completed a comprehensive plan to work with the three Andean governments to disrupt and destroy the growing, processing, and transportation of coca and coca products within the source countries in order to reduce the supply of cocaine entering the United States. In September 1989, the President's National Drug Control Strategy directed that a 5-year, $2.2 billion counter-narcotics effort begin in FY 1990 to augment law enforcement, military, and economic resources in Colombia, Bolivia, and Peru. After careful negotiations between the United States and each of the individual cooperating governments, implementation plans have been prepared to ensure effective use of the assistance.

The administration's $2.2 billion plan provides a cooperative approach for working with the three major Andean governments to disrupt and destroy the growing, processing, and transportation of coca and coca products within the source countries in order to reduce the supply of cocaine from these countries to the United States. Congress has authorized and appropriated funds for the first year of this plan. For FY 1990, approximately $230 million in economic, military, and law enforcement assistance is being offered to the three Andean countries for counter-narcotics-related initiatives. In 1991, we are asking for $423 million, including narcotics-related economic assistance.

Objectives

The Andean strategy has three major objectives.

First, through concerted action and bilateral assistance, it is our goal to strengthen the political will and institutional capability of the three Andean governments to enable them to confront the Andean cocaine trade. With new governments in Colombia and Peru, it will be essential for the US Government to help them address the full range of their drug-related problems.

Second, we will work with the Andean governments to increase the effectiveness of the intelligence, military, and law enforcement activities against the cocaine trade in the three source countries, particularly by providing air mobility for both military and police forces and making sure they are well equipped and trained and that they cooperate in an integrated strategy. It has become clear that the Andean countries cannot conduct effective anti-narcotics operations without the involvement of their armed forces; this is especially true where the traffickers and insurgents have joined forces, as in Peru. Specific objectives include efforts to isolate key coca growing areas, block the shipment of precursor chemicals, identify and destroy existing labs and processing centers, control key air corridors, and reduce net production of coca through aerial application of herbicides when it is effective to do so.

Our third goal is to inflict significant damage on the trafficking organizations which operate within the three source

countries by working with host governments to dismantle operations and elements of greatest value to the trafficking organizations. By strengthening ties between police and military units and creating major violator task forces to identify key organizations, the bilateral assistance will enable host government forces to target the leaders of the major cocaine trafficking organizations, impede the transfer of drug-generated funds, and seize their assets within the United States and in those foreign nations in which they operate. Intelligence is a critical component of this strategy. We have worked closely with the intelligence community and law enforcement agencies to focus intelligence collection on these targets. In short, we have developed a strategy that is coherent, focused, and determined.

A major tenet of this strategy is the incorporation of expanded economic assistance beginning in FY 1991 and directed toward offsetting the negative economic dislocations we know will occur. This assistance will, in turn, strengthen the political commitment of the three Andean nations to carry out an effective counter-narcotics program. US economic assistance is, in general terms, linked to counter-narcotics performance and to follow-through with economic policy reform. In harmony with the views of the three Andean governments, our direct economic assistance and other initiatives support economic alternatives for those directly involved in the cultivation of and trade in coca. Examples of such assistance include crop substitution and other economic alternative activities, drug awareness, administration of justice, balance of payments, and export promotion. The assistance reflects our conclusion, incorporated in the Declaration of Cartagena, that a comprehensive, intensified counter-narcotics strategy must include understandings regarding economic cooperation, alternative development, and encouragement of trade and investment. As vigorous host government programs against the drug trade and economic policy reform initiatives become more effective, our economic assistance will increase in the outyears (1991-94) of the Andean strategy. We are not seeking to impose law enforcement, security, or economic assistance on these countries. These are programs that require cooperation and mutual agreement. Our intensive dialogue with the Andeans is refining a common understanding of what is needed and what is possible on both sides.

Misconceptions About Militaries' Roles

Let me deal directly with concerns which have been raised regarding the role of the Andean militaries in the drug war and potential human rights abuses. There is no reason to expect that US military aid will undermine democracy or civilian rule in the Andes. On the contrary, I believe it will help to strengthen both democracy and the international struggle against illegal narcotics for the following reasons:

- US security assistance will be negotiated with and delivered through the civilian governments;
- An impoverished, poorly trained and equipped military, unable to feed its troops, is far more susceptible to corruption and human rights abuses; and
- The military is far more likely to take a constructive approach if actively engaged in the drug war as opposed to being left to criticize civilian efforts from the sidelines. The involvement of the military, as in our own country, can bring a significant resource in the war against drugs if properly coordinated and directed by civilian authorities.

I would also like to set out a number of points that address misconceptions that have grown up in recent months about the so-called militarization of the US counter-narcotics effort. Like many slogans, the use of emotionally charged and sometimes politically motivated words like "militarization" is a gross oversimplification that does not do justice to the effort either to understand or deal with the complex problems of international narcotics.

In the first place, the level of our security assistance is only a part of our total effort. Of some $129 million in counter-narcotics funds requested for Peru in FY 1991, for example, only about $40 million is for military assistance, and much of that is for maintenance support and infrastructure improvement. Nor do we contemplate large levels of US military presence in the Andes. We have never maintained such a presence, and our strategy includes as one of our tenets the determination not to Americanize the effort to work with local governments.

Second, our decision to encourage greater participation of the local militaries in the counter-narcotics efforts parallels the evolution of our own policy that projects a greater role for the Department of Defense in the war on drugs in the United States. Indeed, the militaries in the Andean states are an important component of the governments and their involvement is a sign of greater overall national commitment in dealing with the problem.

Third, while we believe the militaries of the Andean states need to play a more constructive role, we never have nor will force military assistance on these countries. Nor is the assistance we are providing of a nature to create large, new forces in the region. We are developing the specialized skills and units required to conduct or support meaningful counter-narcotics operations, not creating major combat units. We should remember the immense size of the countries we are dealing with and that the narcotics processing facilities and growing areas are spread over large areas, often in remote locations. Narcotics law enforcement units are neither equipped nor trained to address the increasingly paramilitary nature of the problem. Further, as the case of Bolivian military support for counter-narcotics operations demonstrates, military support in some cases can be an effective way to avoid duplicating a parallel military capability within police narcotics enforcement agencies.

The financial resources of the narcotics traffickers, such as those in Colombia, enable them to hire private armies and terrorists on a national and international scale. Their ability to buy manpower and equipment surpasses the police capability and, in some cases, calls into question even the military's ability to respond effectively. These capabilities permit the narco-traffickers to challenge or defy the sovereignty of local governments in a way unprecedented in our experience.

US counter-narcotics policy, therefore, should not be characterized as a "militarized" effort, but rather one that seeks to provide legitimate governments with the tools and assistance to help defend their political sovereignty.

But the problem does not end there. There is now a further complicating factor, and that is the degree to which so-called guerrilla organizations are becoming involved in narcotics trafficking, either in providing protection in return for profit or in engaging in the production and sale of coca.

The effort of the United States to help these countries deal with "narco-insurgents" has raised the specter of counter-insurgency—specifically, whether the United States should engage in supporting Andean militaries, some with past records of human rights abuses, in waging a struggle against insurgent groups which

are clearly involved in many aspects of narcotics trafficking. We cannot gloss over past abuses in some countries. We do not support these and never will. But neither should we succumb to the romantic notion of downtrodden peasant masses protesting in arms against social injustice, nor depict organizations like the *Sendero Luminoso* (Shining Path) of Peru or the FARC (*Fuerzas Armadas Revolucionarias de Colombia*—Armed Revolutionary Forces of Colombia) in Colombia as champions of human rights. Moreover, these groups are now becoming narcotics traffickers themselves, profiting from the environment of drugs and using drug monies to finance further violence.

In such groups, we are dealing with professional organizations of tight-knit cadres whose human rights abuses, indiscriminate bombings of civilian targets, use of torture, terrorism on a national scale, and barbaric brutality are plainly part of the public record in Colombia and Peru. While the US attitude toward these problems is well known, the United States has not provided significant financial assistance to any of the Andean nations to deal with these specific problems. We are focusing our effort on counter-narcotics, not on counter-insurgency, but we cannot lose sight of the fact that it is the insurgents who have become involved in narcotics and, along with the traffickers, created a militarized situation.

Let me also point out the following. At this point, we have not concluded a security assistance agreement with the government of Peru. We have done some advance planning and held discussions with officials of the government, but no programs of assistance can go forward without such an agreement. While it is our belief that the narcotics situation in the upper Huallaga Valley cannot be dealt with effectively without the involvement of the Peruvian military, this is a Peruvian government decision. And, of course, it will be a decision as to whether the counter-narcotics performance of the Peruvian institutions involved in the struggle will justify the provision of economic assistance. Our request for economic assistance for Peru in 1991 is based on the assumption of effective counter-narcotics performance.

Our counter-narcotics work in Bolivia does not create a significant military capability; it, too, focuses on improving the military's ability to support counter-narcotics efforts. This includes improvements in riverine programs by the Andean navies to interdict the flow of precursor chemicals and drugs on Bolivia's waterways.

The involvement of the Colombian military in supporting counter-narcotics law enforcement operations over the past 2 years proves the effectiveness of this approach. Recently, the Colombian military, using equipment supplied by the United States, with the police seized over 18 tons of cocaine in one transportation complex deep in the Colombian jungle.

It is basic to our policy that human rights remain under continuous review to determine whether government policies justify, reinforce, or call into doubt our continued assistance relationship. State Department human rights reports on Colombia and Peru have been candid in their criticisms and, in fact, received praise from human rights groups. We will work with the Andean militaries to eliminate human rights abuses as they increase their involvement in anti-narcotics operations. Our training, in fact, will emphasize human rights and civic action.

Involvement of US military personnel and organizations is clearly defined, limited, and subject to continuing review. The US military role is to provide support and development of host country capabilities. It will provide training and operational support, materiel, advice, and technological and maintenance support to cooperating nations' counter-narcotics organizations. Defense personnel will not participate in actual field operations.

Contrary to some media reports, the levels of counter-narcotics based economic assistance planned for in the President's Andean strategy outweigh the levels of military assistance being offered. Over the 5 years that the strategy covers, from FY 1990 to 1994, economic assistance will total over $1.1 billion, versus approximately $676 million in security assistance. Moreover, this does not include other economic assistance such as food aid and trade preferences for the Andean region.

Further Initiatives

We are, of course, living up to the economic commitments made at the Cartagena summit. We are implementing the initiatives contained in the President's November 1 Andean trade package, including working with the countries in the region to develop further initiatives:

- In February, administration officials met with representatives from the European Community, Canada, and Japan to discuss ways we can help the Andean countries improve their trade performance.
- In March, the Office of the US Trade Representative (USTR) announced that 129 products were accepted for review under the US generalized system of preferences (GSP) special Andean review. Final results of the review will be announced in July.
- We have also conducted successful technical seminars on the GSP program in Colombia, Bolivia, Peru, Ecuador, and Venezuela to help the Andean countries take full advantage of the GSP. A US team is in the Andes the week of June 18 to conduct seminars on the US textile program.
- We have scheduled a workshop in Washington for the Andean countries the week of July 9 on ways to expand US-Andean trade and investment opportunities.
- We are exploring areas of potential cooperation with the multilateral development banks and have emphasized US support for World Bank efforts in the area of trade policy reform.
- On May 8, the United States and Bolivia signed an agreement to establish the US-Bolivia Trade and Investment Council, whose objectives are to monitor trade and investment relations, identify opportunities for expanding trade and investment, and negotiate agreements where appropriate.
- We also renewed our commitment to seek a new International Coffee Agreement (ICA).
- We have offered to accelerate negotiations on tariff and nontariff measures in the international trade negotiations now going on in Geneva. Andean participants have not yet responded to our offer.

In addition to the bilateral aspects of the Andean strategy, we are also working with the international community to gain support for Andean initiatives. The strategy suggests that a consultative mechanism with other developed countries be established to encourage closer coordination of international counter-narcotics efforts. I will be travelling to Europe at the end of this month to further this goal.

We are pleased with the work of the G-7 Financial Action Task Force on money laundering; the United States hopes to expand the number of countries that embrace the action recommendations of the task force to ensure that all countries have comprehensive domestic programs against money laundering and cooperate to the maximum extent

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possible in international money laundering investigations and prosecutions. Narcotics is also on the agenda of the Houston economic summit next month, and there we hope to gain greater G-7 support for precursor chemical control. As our own controls become more effective, the drug traffickers look to Europe and the surrounding countries for supply of these chemicals, and so we must bolster international efforts to limit their use to legitimate industry. Without essential chemicals, cocaine cannot be produced. We have just completed a State Department-Drug Enforcement Administration (DEA) mission to Europe to promote the control of essential and precursor chemicals. We will be conducting similar missions to Latin American countries.

In closing, I would like to take this opportunity to say that I believe that during the coming year, we and the Andean governments will have many opportunities for progress as we work together to attack all aspects of the cocaine trade. We are optimistic. The price of coca leaf is down in Peru and Bolivia. As a result, in Bolivia voluntary eradication of coca is up—this year has already surpassed last year's total—and increasing numbers of growers are moving out of the illegal industry. DEA laboratory analysis indicates that purity levels of cocaine at both the wholesale and retail levels are down and prices have increased at the wholesale level in many areas throughout the nation. Cartagena ended the argument over who is to blame for the drug crisis; we now have a consensus on the nature of the problems we face and a solidifying common front against the drug trade.

Success will not happen overnight, but we are beginning to see that our efforts are having an impact in the Andes, and on the streets of the United States. Provided we are prepared to sustain our activities and not allow our thinking to be clouded by false analogies and oversimplifications, I believe we will continue to make progress toward a goal the American people have made clear that they support. ◻

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Opening Statement

Hon Peter H. Kostmayer

The Andean Initiative (Part II)

June 20, 1990

The Subcommittee on Western Hemisphere Affairs will come to order.

This is our second hearing on the President's Andean anti-narcotics initiative. Two weeks ago we heard from experts on the three Andean countries--Colombia, Peru, and Bolivia. Today we will hear from the Administration. Further hearings may be scheduled.

I continue to have grave doubts about the militarization of the Andean anti-narcotics effort. I do not think this is fundamentally a military problem. It is fundamentally an economic problem, and a law enforcement problem.

By focusing the effort on the military we may lose the drug war, while actually exacerbating economic problems, human rights problems, and problems of civilian authority. Are we getting the United States involved through the back door in fighting guerrilla wars.

Our last hearing heightened my concerns.

The basic question we have to answer is: how will we approach this war?

Will we approach it in the time-honored--or I should say dishonored--fashion of throwing our weight around and telling other countries what to do? Or will we approach it in a new, cooperative, consultative spirit, with due respect for the sovereignty of the other countries?

Only the latter will work--but I'm afraid we are doing the former.

None of these countries want their militaries to be the main instrument of the drug war.

None of these countries is in fact using its military as the main instrument of the drug war.

All of these countries have the deepest concerns about the further empowerment of their militaries, and good reasons not to involve their militaries so centrally in the drug war. Yet apparently we insist on pressuring them to do so.

In each of these countries, the possibility exists of living with narcotics trafficking instead of expending lives and treasure fighting it.

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Bolivia could well decide to keep the jobs and the hard currency that the drug trade provides. Peru could do well to take the drug issue away from the Shining Path guerrillas, who gain support by protecting peasant growers. In Colombia we now hear talk that the real problem is narco-terrorism, not narcotics trafficking per se; in the recent election, half the electorate voted for candidates who advocated some form of accommodation with the drug cartel. For each of these countries, opting out of the war is a real possibility.

We can help make that happen if we continue to try to dictate to these countries while failing to help them with the resources they need to do the job. Instead of saying, "We will tell you our strategy and, if you want our aid, you will pursue it," we should be telling these countries, "Tell us what your strategy is, and what you need to accomplish it, and we will help within the limits of our resources if we agree."

To win this war we need allies, not subjects--and we ought to start treating these countries as allies, not subjects.

Why are we giving Colombia military aid that it has not asked for--when, according to testimony at our last hearing, 90 percent of the seizures have been carried out by the police, and the Colombian military has become one of the hemisphere's worst human rights violators in its conduct of the counterinsurgency war?

The drug war has cost Colombia more than $1 billion. To help offset these costs, why has the Administration failed to submit a package of trade preferences for Colombia to Congress--which Colombia has asked for and which the Administration has promised?

What is the Administration doing to get talks on the coffee agreement started again--which Colombia has asked for? The absence of an agreement is costing Colombia $400 million a year.

Why has the Administration failed to take the lead in putting together a credit package in the multilateral banks--which Colombia has asked for?

Why has the Administration failed to take effective action to prevent the export of assault weapons and precursor chemicals to Colombia--which Colombia has asked for?

Why have we failed to enact stricter laws against money laundering in our own country--which Colombia has asked for? The world's largest center of money laundering remains the United States.

In Bolivia there is no insurgency for the military to fight. The problem is to move people out of coca cultivation and into other economic areas. Bolivia has designed an alternative economic development program to do this.

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Why, then, do we insist on giving Bolivia military aid, which it has not asked for, instead of devoting these resources to economic aid, which Bolivia has asked for?

Why do we insist that Bolivia commit the military to the drug war, which Bolivia--for very good reasons--does not now want to do?

Why do we conduct our aid program in such a way as to increase the size and role of what our witness two weeks ago called "a uniformed kleptocracy"--the military that ruled the country for 18 years until 1982, has staged numerous coups throughout Bolivian history, and has itself been heavily involved in narcotics trafficking? As our witness also said, Bolivia has already had its Manuel Noriega in Gen. Garcia Meza, who ruled from 1980 to 1982--yet while Panama moves toward demilitarization, we encourage Bolivia to militarize.

Why do we press Bolivia to destroy the livelihood of the 40,000-to-60,000 families that depend on the cocaine economy for a living--and then underfund the alternative development programs that would provide these people with other ways to make a living? If we wanted a recipe for instability, we probably could not write a better one.

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In Peru, outgoing President Alan Garcia refused to accept the 1990 military aid package because it did not include assistance for economic development. The President-elect, Mr. Fujimori, while not rejecting military and police aid, has already indicated that most aid would be better spent on economic development.

Why do we insist on providing aid according to our own priorities and our own domestic politics, without taking Peruvian priorities into account?

According to the State Department's own human rights report for Peru for 1989:

-- More than half of Peru's population lives in "emergency zones" under military control;

-- "Peru's history of military coups has weakened civilian control over the military";

-- "There is little oversight of military activities in the emergency zones by civilian judges or prosecutors, and the constitutional rights of persons detained by the military are routinely ignored";

-- There is "a backlog of over 3,000 pending cases of disappearances"; and

-- "There were credible reports of summary executions, arbitrary detentions, and frequent use of torture by police and the military."

I am deeply concerned that we are jumping into this counterinsurgency effort without any debate over the wisdom of allying ourselves with this military--and, apparently, without any real effort to address the priorities of the civilian government.

We heard testimony two weeks ago that this is exactly what the guerrillas hope we will do; they think it will win them more converts and hasten the collapse of the government. Has the Sendero Luminoso written the script?

I recognize that there are no easy solutions. Precisely for that reason, we should be working closely and cooperatively with the government, and not trying to call all the shots from 4,000 miles away in Washington.

So, as our witnesses can see, I have many serious questions about our Andean drug war. And to anticipate a criticism of my remarks, I am <u>not</u> saying we should not fight this war--I <u>am</u> saying we should fight it "smart." We should fight to win--and <u>not</u> just to sound tough to the voters. Most of all, I am suggesting that to win, we have to cooperate, and not dictate.

RICHARD E. FEINBERG

EXECUTIVE VICE PRESIDENT
OVERSEAS DEVELOPMENT COUNCIL[1]

before the

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
SUBCOMMITTEE ON INTERNATIONAL
DEVELOPMENT, FINANCE, TRADE AND MONETARY POLICY

of the

UNITED STATES HOUSE OF REPRESENTATIVES

Hearing on the Enterprise for the Americas Initiative

September 18, 1990

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1. The views expressed herein are those of the author, and should not be attributed to the staff, Board, or Council of the Overseas Development Council.

Mr. Chairman, I am pleased to have been asked to testify on implementing legislation for the President's Enterprise for the Americas Initiative. The Initiative's mutually reinforcing provisions for trade liberalization and debt reduction are conceptually exciting and wholly appropriate for the 1990s. They hold the promise of greater economic prosperity for ourselves and for Latin America through more open markets, lower debt service, and a healthier ecology.

The impact of the President's bold and creative vision will depend on the capacity of Latin America to respond affirmatively, as well as on the way in which the vision is implemented. The Initiative's ultimate value will lie in its details.

In my testimony, I will focus on the Initiative's debt reduction provisions, which I believe are of greatest interest to the Committee today. There can be no doubt that Latin America and the Caribbean is suffering under a weighty debt burden which is lower living standards, impeding efforts at economic reform, and constricting import capacity -- to the disadvantage of U.S. exporters. Recognizing the damage that this persistent debt overhang has been causing to Latin American and U.S. economic interests, U.S. Secretary of the Treasury Nicholas Brady has called for the reduction of debts and debt service owed by heavily indebted developing countries to commercial banks. Previously, the United States had joined the other leading

industrial countries at the June 1988, Toronto economic summit in agreeing to a menu of options that includes forgiveness of bilateral debts owed by low-income countries. The President's Enterprise Initiative now extends the principle of debt reduction to bilateral debts owed by the primarily middle-income countries of this hemisphere.

According to the latest available information, some 80 developing nations were in arrears on debts to U.S. government agencies. The President's initiative would make de jure what has become de facto -- the non-payment of many official debts. In many cases actual cash flow may not be materially altered -- thus, the impact on U.S. government revenues may be small. But it is much better for both creditors and debtors when the books are cleansed and financial transactions are regularized.

How much will this new Initiative reduce Latin America's debt and debt service? The answer to this central question depends upon how the Initiative is implemented. Critical variables include:

-- The amount of debt eligible for reduction and the depth of the discount

-- The degree of participation of other bilateral donors

-- The terms under which countries become eligible

Estimates of Debt Reduction

Latin America owes U.S. government agencies about $12 billion, of which about $5.2 billion is owed to the Agency for International Development, $1.6 billion to the Food for Peace program (P.L.480), $4.2 billion to the U.S. Eximbank, and $1 billion to the Commodity Credit Corporation (see table 1). Under current terms, during fiscal years 1991 to 1994, debt service on these claims will equal about $4.7 billion, or an average of $1.2 billion per annum.

The administration has not provided estimates on the size of the discounts that will be applied to the different types of debts. My colleague at the Overseas Development Council, Frank Sader, and myself have estimated potential debt service reduction under these assumptions: that debts owed to AID and under P.L.480 are reduced by 50 percent, and debts owed to the Eximbank and CCC are reduced by 25 percent. Under these assumptions, Latin America would save about $1.6 billion from fiscal year 1991 to 1994, or about $400 million per annum (see table 2). Nine countries would save over $50 million during the four-year period: Argentina, Brazil, Chile, Colombia, Mexico, Peru, Costa Rica, the Dominican Republic and Jamaica.

Participation of Other Donors

A detailed breakdown of the debts of Latin America owed to other bilateral donors is not available. However, under various sets of assumptions, an extension of the Bush initiative to other bilateral donors would yield an annual savings in debt service of between $1.6 billion and $2.3 billion (see appendix).

It is customary for bilateral debts to be renegotiated under the aegis of the Paris Club. This structure assures equality of treatment for all creditors. Otherwise, concessions granted by one creditor could simply allow the debtor to service claims of competing creditors. It would be an unfortunate break with tradition for the United States to forgive unilaterally bilateral debts without equal treatment being applied to other creditors. The impact of the Bush debt initiative will be several times greater if it is effectively multilateralized within the Paris Club framework.

Country Eligibility

The international financial community typically conditions debt reduction on the debtor nation's adherence to an economic reform program monitored by the International Monetary Fund and/or the World Bank. However, the administration is now proposing to add two additional conditions which could threaten to seriously delay implementation of the Enterprise Initiative.

The proposed legislation would require countries to, "if appropriate, have agreed with its commercial bank lenders on a satisfactory financing program." Whether this represents a reversal of U.S. policy depends on the unexplained "appropriate." The genius of the Brady initiative regarding commercial debts was to break the linkage between the actions of official agencies and the signing of agreements between the debtor and its commercial creditors. Previously, this linkage had placed the commercial banks in the enviable position of blocking official programs and loans, thereby increasing their bargaining power at the expense of the flexibility of official agencies. The Bush Initiative should not be hostage to the bargaining strategies of commercial banks.

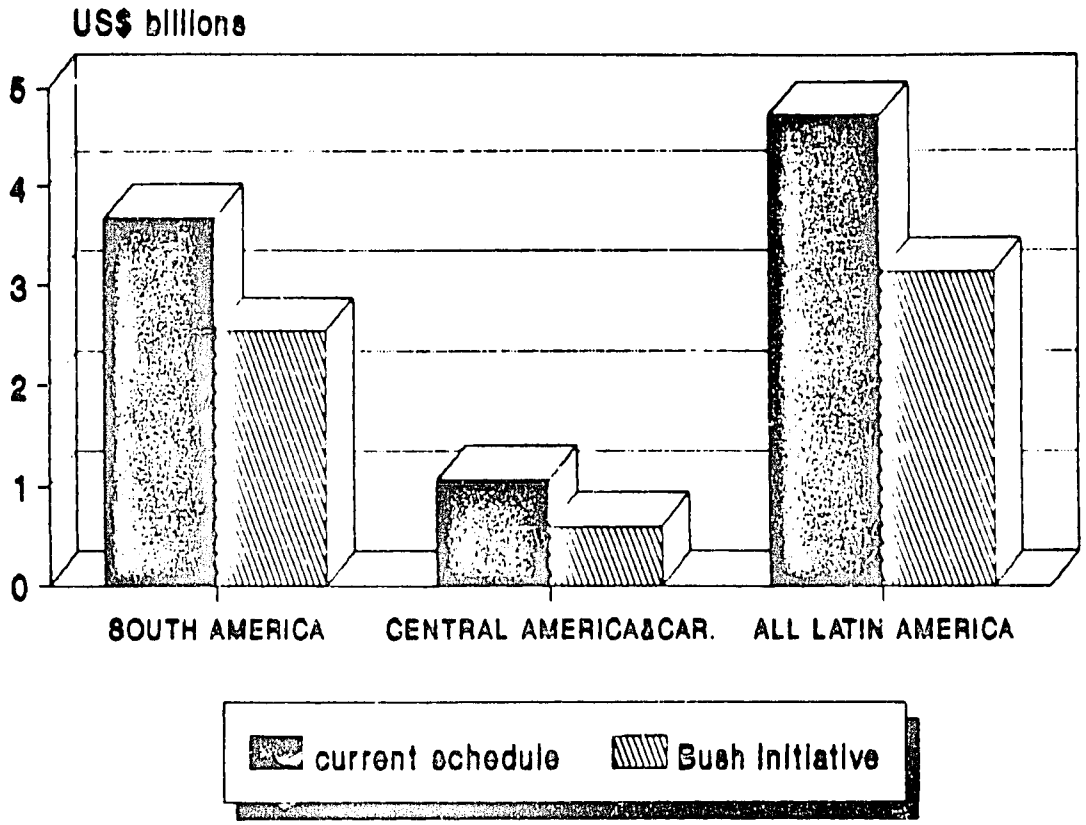
A second new condition is that the Latin American nation must "have put in place major investment reforms in conjunction with an IDB loan or otherwise be implementing an open investment regime." Certainly, this new condition could substantially delay the implementation of the Bush debt Initiative -- during which period countries will be tempted to simply run up arrears. Whether it ultimately restricts eligibility depends upon the content of the proposed reform packages. But is this additional stricture necessary? The most important measures that a government can take to create a favorable investment climate are already contained in IMF and World Bank reform programs. Adding another set of secondary considerations will delay debt reduction

-- itself a stimulus to investment -- and irritate the Latin Americans.

Conditioning debt reduction upon economic reforms -- which ought to be in the self-interest of the developing nation -- is accepted practice. But it would be unfortunate if overly restrictive conditions were to lessen the practical usefulness of the President's Initiative. Piling on secondary conditions could cost us the good will that the President's Initiative has generated throughout the hemisphere.

Mr. Chairman, it is praiseworthy that the administration is moving rapidly to seek Congressional authorization to proceed with its worthy Enterprise for the Americas Initiative. The final legislation should be consistent with the high-minded spirit with which President Bush outlined his vision this June. It should also urge the administration to seek the participation of other industrial nations, so that they shoulder their fair burden of the costs of reducing old debts. After all, our allies also stand to benefit from a more prosperous Latin America.

LATIN AMERICAN DEBT SERVICE TO THE U.S.
FY 1991-1994



Source: OVERSEAS DEVELOPMENT COUNCIL
based on U.S. Government statistics

Table 1:

TOTAL DEBT OUTSTANDING FROM LATIN AMERICA TO THE U.S. GOVERNMENT
(in US$ millions)

	Outstanding Debt (end 1987)						Arrears 9/30/89	
	ExIm	AID	PL480	CCC	DOD	Total	Principal	Interest
SOUTH AMERICA								
Argentina	405	0	54	0	0	459	141.12	90.18
Bolivia	27	304	137	0	6	474	0.00	0.44
Brazil	1,153	1,024	51	268	0	2,496	672.41	203.28
Chile	16	352	58	98	0	524	0.08	0.29
Colombia	577	573	8	0	16	1,174	13.38	4.39
Ecuador	33	123	21	0	30	207	5.52	4.74
Guyana	2	61	14	0	0	77	12.50	13.23
Mexico	1,478	29	0	392	0	1,899	28.34	15.22
Paraguay	0	38	2	0	1	41	1.81	0.46
Peru	57	343	190	95	29	714	332.77	87.13
Uruguay	14	44	5	0	0	63	0.00	0.00
Venezuela	83	6	0	0	0	89	0.72	0.19
SUBTOTAL	3,845	2,897	540	853	82	8,217	1,208.63	419.55
CENTRAL AMERICA AND CARIBBEAN								
Antigua & Barbuda	1	8	0	0	0	9	0.75	1.56
Bahamas	4	1	0	0	0	5	0.00	0.00
Barbados	0	7	0	0	0	7	0.00	0.00
Belize	0	24	0	0	0	24	0.00	0.00
Cayman Islands	1	0	0	0	0	1	0.00	0.00
Costa Rica	19	335	114	0	0	468	1.38	0.76
Dominican Rep.	107	333	202	126	15	783	142.22	80.82
El Salvador	0	300	260	0	100	660	13.92	11.90
Granada	0	1	0	0	0	1	0.00	0.00
Guatemala	2	180	60	0	2	244	2.33	2.13
Haiti	10	21	121	0	1	153	6.08	6.70
Honduras	3	295	67	0	34	399	12.07	8.15
Jamaica	46	401	205	0	3	655	0.48	3.94
Nicaragua	18	223	17	0	0	258	50.96	59.19
Panama	7	192	0	2	7	208	30.06	1.05
St. Vincent	0	5	0	0	0	5	0.00	0.00
Trinidad & Tobago	106	0	0	0	0	106	0.00	0.71
SUBTOTAL	324	2,326	1,046	128	162	3,986	260.25	176.91
TOTAL	4,169	5,223	1,586	981	244	12,203	1,468.88	596.46

Source: "International Finance" The National Advisory Council on International Monetary and Financial Policies, ANNUAL REPORT to the President and to the Congress for Fiscal Year 1988
"Report on Estimated Debt and Debt Service Owed to the U.S. Government by Foreign Obligors", Dept. of the Treasury and OMB, June 1990

Table 2:

DEBT SERVICE REDUCTION FOR LATIN AMERICA
UNDER THE BUSH INITIATIVE FOR FY 1991-1994
(in US$ millions; guarantees excluded)

	ExIm	AID	PL480	CCC	Total
SOUTH AMERICA					
Argentina	85.62	10.45	0.00	0.00	96.06
Bolivia	5.53	34.25	0.00	0.00	39.77
Brazil	128.95	125.78	6.00	26.12	286.85
Chile	4.04	63.33	19.41	19.12	105.90
Colombia	114.45	73.08	1.45	0.00	188.97
Ecuador	3.87	13.54	3.78	0.00	21.19
Guyana	0.00	7.17	1.83	0.00	9.01
Mexico	206.19	5.15	0.00	90.09	301.43
Paraguay	0.00	5.27	0.41	0.00	5.67
Peru	3.07	36.26	32.21	3.83	75.36
Uruguay	1.68	4.87	1.47	0.00	8.02
Venezuela	4.86	0.00	0.00	0.00	4.86
SUBTOTAL	558.24	379.14	66.56	139.16	1,143.09
CENTRAL AMERICA AND CARIBBEAN					
Antigua & Barbuda	0.00	0.26	0.00	0.00	0.26
Bahamas	0.00	0.00	0.00	0.00	0.00
Barbados	0.00	1.79	0.00	0.00	1.79
Belize	0.00	1.24	0.00	0.00	1.24
Cayman Islands	0.00	0.00	0.00	0.00	0.00
Costa Rica	2.47	34.09	21.44	0.00	58.00
Dominican Rep.	8.84	34.96	36.24	14.46	94.50
El Salvador	0.00	26.30	19.06	0.36	45.72
Grenada	0.00	0.00	0.00	0.00	0.00
Guatemala	0.00	19.11	9.80	0.00	28.91
Haiti	0.81	1.52	8.60	0.00	10.93
Honduras	0.00	26.92	5.27	0.00	32.19
Jamaica	8.17	54.18	39.41	10.94	112.70
Nicaragua	0.00	21.54	2.50	0.00	24.04
Panama	0.68	26.56	0.00	0.39	27.64
St. Vincent	0.00	0.08	0.00	0.00	0.08
Trinidad & Tobago	21.18	0.00	0.00	0.00	21.18
SUBTOTAL	42.16	248.57	142.32	26.15	459.19
TOTAL	600.40	627.70	208.87	165.31	1,602.28

Assumed is a debt reduction of 50% under AID and PL 480, and 25% under ExIm and CCC.
Based on: Report on Estimated Debt and Debt Service Owed to the U.S. Government by Foreign Obligors", Dept. of the Treasury and OMB, June 1990

Appendix 1

THE POTENTIAL IMPACT OF THE BUSH INITIATIVE ON LATIN AMERICAN DEBT SERVICE

In his speech of June 27, President Bush announced a plan to reduce Latin American debt outstanding to the U.S. government by a significant amount. Assuming a 50% reduction of concessional, and a 25% reduction of nonconcessional debt, it can be calculated that the Latin American countries will save US$ 1.6 billion in debt service during 1991 to 1994, or around US$ 400 million annually. Should this initiative be accepted by all the other governments with bilateral loans outstanding in Latin America, the question is, in how much debt reduction this would eventually translate. Three different estimation procedures were applied, resulting in a total annual debt service relief of US$ 1.6 - US$ 2.3 billion, as shown in the table below.

THE IMPACT OF A GLOBAL BUSH INITIATIVE
per year for 1991-1994
(in US$ millions)

	Method I	Method II	Method III
concessional	836.6	474.4	1,148.9
nonconcessional	765.7	1,250.5	1.135.3
Total debt service reduction	1,602.3	1,724.9	2,283.6

METHOD I

The first rough estimate in calculating the effect of a general reduction of bilateral debt in line with the Bush Initiative is the following:

Given that the U.S. Government holds around 1/4 of all bilateral debt outstanding in the region, the total reduction should simply be four times the reduction resulting from the Bush Initiative. Hence total reduction in debt service per year should amount to around US$ 1.6 billion.

METHOD II

The main problem in using Method I is the fact that it does not take into account the different split of bilateral debt into concessional and nonconcessional. However, while 57% of total bilateral debt outstanding to the U.S. is concessional, for the remaining public lenders only 23% turn out to be concessional. Therefore a different estimation procedure is applied:

Applying the initial assumptions regarding the extent of debt reduction under the Bush Initiative, the reduction of debt service on concessional debt would amount to 12.3% of total concessional debt outstanding to the U.S. government, and a debt service

reduction on nonconcessional debt of 14.9% of total nonconcessional debt outstanding. Applying these ratios to the remaining lenders would lead to an additional reduction in debt service of U.S.$ 1.001 billion in concessional and US$ 4.236 billion in nonconcessional debt. This would result in an annual debt service reduction of US$ 1.324 billion. Hence, including the U.S. share, the total reduction in debt service would amount to around US$ 1.7 billion. This result seems to be surprising, considering that the share of nonconcessional debt (which is assumed to be subject to a 25% reduction only) is by far higher for other public lenders compared to the U.S. The reason for this estimate being higher than the estimate under Method I is that the terms (maturity and interest charges) on nonconcessional debt are much harder, resulting in higher debt service payments.

METHOD III

A further estimation procedure was applied based on the World Debt Tables[1], in particular making use of the "Debt Service Projections on Existing Pipeline". Unfortunately, the World Bank does not provide a breakdown of debt service payments to Official Creditors into bilateral and multilateral, and further into concessional and nonconcessional. In order to obtain such a breakdown, time trends from 1982-1989 for principal as well as interest payments were used to calculate the average shares.

The following results were applied in the estimation:

- "Bilateral" as percentage share of "Official" is 45% of principal and 35% of interest payments;
- "Concessional" as percentage share of "Bilateral" is 12% in principal and 85% in interest payments;[2]

Based on these percentage shares, Latin America will have to pay US$ 19,263.6 millions in principal and US$ 8,087.8 millions in interest on its bilateral debt between 1991 and 1994. Applying a reduction of concessional debt by 50% and of nonconcessional debt by 25%, principal payments will amount to US$ 13,869.8 million, and interest payments to US$ 4,347.2 million between 1991 and 1994. This translates into an average debt service reduction of US$ 2.3 billion per annum.

Richard Feinberg, Executive Vice President
Frank Sader, Research Assistant

OVERSEAS DEVELOPMENT COUNCIL

July 5, 1990

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[1] World Debt Tables 1989-90 edition, Vo.I Analysis and Summary Tables, pp.94-97

[2] Correspondingly, the shares for "Nonconcessional" are 88% principal and 15% interest.

Natural Resources
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August 22, 1990

Ms. Mary Chaves, Director
Office of International Debt Policy
U.S. Department of the Treasury
Washington, DC 20220

Dear Mary:

We would like to thank you and Nelson Coar for meeting with us on August 8 to discuss the President's "Enterprise for the Americas" Initiative. We welcome the Initiative's special attention to Latin America's pressing environmental problems and we appreciate Treasury's efforts in soliciting the views of the non-governmental environmental community. However, we have serious concerns regarding other components of the Initiative that we hope the Administration will address in its proposed legislation. This letter offers preliminary suggestions concerning several elements of the Initiative, including macroeconomic conditionality, management of the proposed environmental trust funds, debt conversion programs, trade agreements, and the Initiative's relationship to commercial debt reduction.

We hope that you will consider these comments as preliminary, pending more extensive consultation with our counterpart organizations in Latin America. A broad range of Latin American non-governmental organizations (NGOs) will be in Washington in late September to attend the World Bank/IMF annual meeting. We plan to discuss the Initiative with these groups at that time and we urge you to do the same. In any event, we hope that the Administration will not seek final passage of legislation on the Initiative before that time.

I. ECONOMIC CONDITIONALITY

While we acknowledge the importance of sound macroeconomic programs on the part of countries participating in the Initiative, the record of many structural adjustment programs raises serious questions as to their effects on the environment and on social equity. We strongly believe that any such programs must be implemented with special attention to their potential environmental and social impacts. We are also concerned that overly rigid conditionality may delay progress on urgently needed debt reduction and the creation of environmental trust funds. We strongly urge that the Administration's proposed legislation for the Initiative address the need to ensure the environmental quality of macroeconomic programs and provide for flexibility in evaluating a country's progress in implementing reforms.

As we understand it, the Administration currently envisions that a country must meet the following four macroeconomic criteria in order to participate in the debt relief component of the Initiative:

- a macroeconomic program supported or endorsed by the International Monetary Fund (IMF);

- a structural adjustment program supported or endorsed by the World Bank;
- progress toward an investment reform program supported by the Inter-American Development Bank (IDB); and
- agreement in principle with commercial creditors on a debt reduction or restructuring agreement.

As we have discussed with Treasury in the past, we have serious concerns regarding the environmental and social implications of World Bank and IMF adjustment programs, as currently implemented.

A. Environmental Implications of Economic Reform Programs

It has become increasingly clear in recent years that government macroeconomic policies can have a tremendous impact on natural resources and on environmental quality. In perhaps the best known example, Brazil has recently recognized that fiscal incentives designed to encourage development of the Brazilian Amazon have been a driving force behind deforestation in that region. Similarly, government subsidies, as well as investment and trade "liberalization," in energy, forestry, agriculture and other sectors can encourage unsustainable exploitation of natural resources and foster serious threats to environmental quality.

In this context, it is critical that structural adjustment programs implemented with or endorsed by the IMF and the World Bank pay special attention to potential environmental impacts. IMF and Bank programs focussed on export promotion have the potential to exacerbate excessive or environmentally careless exploitation of natural resources. Furthermore, programs focussed on reducing public sector spending can threaten governments' abilities to protect environmental quality.

To date, neither the Bank nor the Fund has put in place systematic procedures for addressing these issues. For example, the World Bank's 1989 Operational Directive (OD) on Environmental Assessment (EA) explicitly exempts sector and structural adjustment loans (SALs) from strict EA requirements. According to a September 1989 Development Committee report, the Bank explicitly addressed environmental issues in only four SALs in that year -- accounting for only 15% of total SAL lending. The IMF has so far adopted no policy requirements for environmental considerations in its activities.

Similarly, it is important that the IDB address environmental concerns in the development of its investment sector lending program. On the one hand, investment liberalization can contribute to improved efficiency in the use of natural resources. For example, stimulating increased competition by allowing enhanced private investment may encourage more efficient use of energy and other inputs in industry and commercial buildings. However, private investment activities, if inadequately regulated and monitored, can pose severe environmental and public health hazards. Throughout South America, for example, internationally-financed oil and gas development has led to widespread degradation of tropical forest areas.

In order to ensure the environmental integrity of IDB-supported investment reforms, the IDB should apply its recently adopted procedures for environmental assessment to all investment sector operations. The IDB's newly established environmental division is already hard-pressed to implement an environmental assessment program for the Bank's existing loan programs. Inclusion of sector loans in this program will require even greater staff resources. The Administration should move quickly to make technical assistance available to the IDB's environment division, as authorized in the International Development and Finance Act of 1989.

Moreover, the IDB should make resources available to assist borrowers in developing the regulatory infrastructure necessary to ensure the environmental integrity of enhanced private investment activities. The Initiative proposes the creation of a five-year $1.5 billion technical assistance fund at the IDB to support implementation of investment reforms. A substantial portion of these resources should be devoted to strengthening institutional capabilities in borrowing countries to establish and enforce environmental regulations for private enterprise and investment activities.

We strongly recommend that the Administration include language in its proposed legislation directing the U.S. Executive Directors of the IMF, the World Bank, and the IDB vigorously to advocate adoption of strict environmental assessment procedures for all policy-based operations at those institutions. We would be pleased to work closely with you in developing language along the following lines:

- **The World Bank** should amend its Operational Directive on Environmental Assessment to eliminate the exemption of sector and structural adjustment loans from strict EA requirements.

- **The IMF** should develop systematic procedures for environmental assessment of its operations, establish an adequately-staffed environmental unit of environmental and social science professionals, incorporate environmental policy analyses in the preparation of Policy Framework Papers (PFPs), establish procedures for consultation with local NGOs and affected populations in the preparation of PFPs, and base all IMF operations, including stand-by agreements, on the preparation of PFPs.

- **The IDB** should apply its recently adopted procedures for environmental assessment to all upcoming investment sector lending operations. A substantial portion of the proposed $1.5 billion investment reform technical assistance fund should be devoted to developing local capabilities for environmental regulation and oversight of private investment activities. The U.S. should move quickly to make technical assistance available to the IDB's environment division, as authorized in the International Development and Finance Act of 1989.

- World Bank, IMF and IDB environmental assessment procedures should include, <u>inter alia</u>, requirements that environmentally beneficial policy adjustments be identified in the preparation of assessments and recommended for inclusion in policy-based loans and other operations.

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B. The Need for Flexibility

We are concerned that the Administration's proposed eligibility criteria may prove to be so restrictive that few countries are able to participate in the Initiative. Experience has demonstrated that the processes of reaching agreement with the IMF, the World Bank, and commercial banks on economic reform programs and debt restructuring agreements are often tortuous and protracted. We believe that basing U.S. foreign policy initiatives on the determination of entities outside the U.S. Government, over which the U.S. Government has extremely limited influence, would be bad public policy. As currently structured, the Administration's proposal in effect establishes the IMF, the World Bank, and a large number of commercial banks as the arbiters of participation in the Initiative. Consequently, we recommend that the President be given sufficient flexibility to determine, in specific instances, that a country is making satisfactory progress toward completion of IMF, World Bank, and commercial bank agreements, short of actual conclusion of those agreements. The President should seek recommendations as to a country's compliance in meeting eligibility criteria from the Secretaries of Treasury and State and the Administrators of the Agency for International Development (USAID) and the Environmental Protection Agency (USEPA).

We are particularly concerned about the criterion requiring completion of a commercial bank accord. In this regard, Under Secretary Mulford has stated that "(countries must) have concluded financing packages with their commercial banks including debt and debt service reduction, as appropriate."[1] Given the multitude of parties involved in a debt restructuring negotiation, a small number of recalcitrant banks can effectively block successful negotiation of an agreement. U.S. policy should not put private, commercial entities in a position to hold hostage U.S. environmental and foreign policy priorities. The President should have the flexibility to approve a country's eligibility if that country is making satisfactory progress toward completion of an agreement with its commercial creditors.

II. ENVIRONMENT AND DEVELOPMENT FUNDS

We support the Administration's proposal to allow interest payments on restructured USAID and P.L. 480 debt to be made in local currency and set aside for environmental purposes. However, our interpretation of "environmental purposes" is very broad, encompassing a number of areas normally thought of as "development." Since the purpose of these funds should be to promote environmentally sustainable livelihoods for people in participating countries, the name of the funds should reflect this purpose. The creation of local currency "environment and development funds" would provide critically needed support for environmental and environmentally sustainable development activities in countries with heavy debt burdens and limited budgets. Moreover, such funds could help strengthen environmental awareness and develop professional capacity for environmental work both in and outside of governments.

We are pleased that, as we understand it, these funds are intended primarily to support NGO activities. In order best to strengthen local environmental capabilities, host country NGOs must be given leading roles in the creation and management of the proposed funds. We outline below a potentially effective mechanism for creation and management of the funds,

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[1] Statement by David C. Mulford, Under Secretary of the Treasury for International Affairs, before the House Foreign Affairs Subcommittees on the Western Hemisphere, Human Rights and International Organizations, and International Economic Policy and Trade, 18 July 1990.

focussed on providing substantial responsibility to local institutions while preserving accountability with the U.S. Government.

A. Local Management

The U.S. Government and individual Latin American governments would enter into debt relief agreements providing for the establishment of "environment and development funds." These agreements would allow interest payments on restructured USAID and P.L. 480 loans to be made in local currency and set aside for environmental purposes. The agreements would specify that local NGOs are to be the principal intended beneficiaries of these funds. The agreements would establish broad categories of activities to be funded, based on input solicited from NGOs in both countries. As a starting point, the U.S. Government should propose the broad definition of environmental and environmentally sustainable development projects established by Congress in the 1989 International Development and Finance Act.[2]

In each participating country, the environment and development fund would be managed by an independent foundation established in the host country. Directors of the foundation should include, but not be limited to representatives of local NGOs specializing in environment and development, local government officials, and the U.S. Ambassador. The U.S.- host country agreement establishing each fund would describe the organizational structure and purposes of the foundation and establish strict annual or semi-annual reporting requirements from the foundation to the U.S. and host country governments. These reports would be required to include program and fiscal audits prepared by an accounting firm agreed upon by both governments. Improper management of funds would constitute a default, upon which the host government would be required to resume making dollar interest payments to the U.S.

The foundation in each country would have responsibility for managing that country's fund and awarding grants. As the resources of the funds will be limited, all grants should promote local institutional development to expand benefits beyond the life of individual projects. Governmental agreement should include an indexing formula to preserve the value of the local currency in the event of devaluation or hyperinflation in the host country's economy.

B. U.S. Oversight

The President would designate a U.S. Governmental entity to oversee the creation and functioning of the foundations. This entity would assist host country governments and NGOs in the creation of the foundations, review foundation reports, and report regularly to Congress on the status of the funds and foundations. The President should also establish an advisory group of U.S. NGOs to review the work of the foundations and the U.S. government oversight body on a regular basis and to provide advice and support to the foundations as needed.

C. Leveraging Additional Funds

The foundations would be structured so as to encourage additional contributions from other sources. These may include, but not be limited to, U.S. and other bilateral aid, multilateral aid, and private contributions from abroad and from within the host country. In this way, hard

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[2] P.L. 101-240, title VII, 103 Stat. 2492, 2522 (to be codified at F.A.A., 22 U.S.C. § 463).

currency contributions could be generated to complement the host country's local currency payments.

The U.S. Government should encourage support for the foundations in the context of commercial debt reduction negotiations. As part of a commercial debt reduction agreement, commercial banks could agree to donate a portion of their debt to appropriate NGOs. To facilitate such donations, the U.S. Government should provide accounting and tax incentives to the commercial banks.

The foundations should also seek contributions from nationals in their own countries. This may require reform of local tax laws to provide incentives for charitable donations. Such reforms should be addressed in policy adjustment programs supported by the IMF, the World Bank and USAID (see section I above). These programs typically include substantial tax reform components.

III. DEBT CONVERSIONS

The Administration proposes to make debts held by the Export-Import (Ex-Im) Bank and the Commodity Credit Corporation (CCC) available on the secondary market to support environmental activities through debt conversions. Such conversions could be potentially valuable if they support locally controlled environmental initiatives. However, as you may know, we have grave reservations concerning traditional debt-for-equity conversions. We recommend that the Administration include provisions in its legislative proposals to ensure that debt conversions support environmentally beneficial activities and to establish a clear preference for conversions involving local environmental and development NGOs.

The Departments of State and Treasury, USAID, USEPA, Ex-Im, and CCC should be authorized to establish a "debt conversion working group" (DCWG), including representatives of non-governmental environmental and development organizations, to develop detailed environmental guidelines for the use of purchased Ex-Im and CCC debt. Potential buyers of Ex-Im or CCC debt should be required to submit proposals to the DCWG, describing the intended use of the debt.[3] Sales would be made only to those potential buyers whose proposals satisfy the criteria established in the environmental guidelines. Preference would be given to those proposals that involve the participation or result in the institutional strengthening of host-country environmental and development NGO s.

The Overseas Private Investment Corporation (OPIC) is currently preparing guidelines for operations under a new $100 million "Green Fund," established to support environmentally beneficial private enterprises in developing countries. OPIC has consulted with several U.S. environmental organizations in designing these guidelines. The DCWG should be authorized to consult closely with OPIC in preparing environmental guidelines for the purchase of Ex-Im and CCC debt.

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[3] This requirement would not place any substantial additional burdens on the potential buyer. Typically, parties interested in undertaking debt-for-equity swaps are already required to submit detailed proposals to the central bank of the host country.

IV. TRADE AGREEMENTS

Any free trade agreements or framework agreements entered into with Latin American countries under the Initiative should recognize the legitimacy of measures intended to improve environmental quality. In the past, free trade agreements have sometimes undercut environmental goals by failing to accommodate many well-founded environmental programs that may have marginal impacts on trade. For instance, under the Canada-U.S. Free Trade Agreement, the province of British Columbia was forced to drop a reforestation program and a Canadian program to reduce pollution from metal smelters has been challenged by the U.S.

If trade agreements negotiated under the Initiative produce similar results, efforts to address Latin America's pressing environmental problems could be severely undercut. Therefore, any trade agreements entered into under the Initiative should include language explicitly protecting programs aimed at: (1) improving the quality of the environment in the exporting country, such as reforestation programs or bans on exports of timber from primary forests; (2) protecting the public health and environment of the importing country, such as pesticide tolerances on imported agricultural goods; (3) protecting the regional or global commons, such as restrictions on the import of ocean fish caught in an unsustainable manner; and, (4) improving compliance with internationally-accepted environmental standards, such as the provisions of the Montreal Protocol that impose trade sanctions upon countries that refuse to abide by the Protocol's limits on ozone-depleting chemicals.

V. RELATIONSHIP TO COMMERCIAL DEBT REDUCTION

We suggest that the Administration use its decision to reduce official debts as a lever to encourage increased debt reduction on the part of commercial banks. Without more significant debt relief, such as commercial debt reduction, we question whether many countries will agree to meet the Initiative's difficult economic criteria. Commercial bank accords completed to date have not involved significant levels of debt reduction. In many Latin American countries, real debt relief will only occur if the commercial banks agree to substantial reductions. The proposed Initiative presents a timely opportunity to apply additional pressure to commercial banks. For example, the U.S. Government could prohibit a commercial bank from taking "business loss" tax deductions for its value-impaired loans unless that bank offers to reduce the face value of its loans to match their value in the secondary market. We recommend that the Administration include provisions to this effect in its proposed legislation.

Similarly, the Administration's decision explicitly to link official debt reduction with host country environmental initiatives underscores the opportunity to do the same in the context of commercial debt reduction agreements. NRDC and several other groups raised this issue in a December 13 letter to Secretary Brady. We are troubled to learn that Treasury has done little to implement the Congressional instructions contained in last fall's appropriations legislation to "seek to incorporate natural resource management initiatives throughout the implementation of the Brady plan."[4] We urge the Treasury to expand the Brady plan framework to establish environmental initiatives or policy commitments on the part of debtor governments, in addition to macroeconomic criteria, as a basis for increased levels of

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[4] P.L. 101-167, title V, §533(f), 103 Stat. 1228.

commercial debt relief. As we stated in our December 13 letter, we would be willing to work with Treasury in developing a "menu" of environmentally beneficial actions for this purpose.

* * *

The "Enterprise for the Americas" Initiative presents a potentially significant opportunity to forge strong environmental partnerships throughout the Western Hemisphere. However, we are concerned that the conditionality, trade, and investment components of the Initiative, as currently envisioned, could exacerbate environmental problems in Latin American countries. As described above, action on the environment can and should be integrated into all components of the Initiative and not limited strictly to the creation of environmental trust funds and the execution of debt conversions. In order to foster environmentally sustainable development in the long-term, environmental elements must be incorporated into a country's trade, investment, and development policies. The "Enterprise for the Americas" Initiative could provide important leverage for environmental reform in each of these areas. We look forward to discussing these issues with you further as the Administration prepares its legislative proposals for the Initiative.

Sincerely,

Glenn T. Prickett
Research Associate

J. Eugene Gibson
Consulting Attorney

Eric Christensen
Project Attorney

on behalf of:

Larry Williams
Sierra Club

Barbara Bramble
National Wildlife Federation

cc: Nelson Coar

Yukon to Yucatan

Suddenly, the United States finds itself heading toward negotiations with Mexico and Canada on a North American free-trade agreement that could redraw economic boundaries.

BY BRUCE STOKES

George Bush might want to order up a White House screening of the 1950s science fiction classic *The Blob*. A quick study of how Steve McQueen and fellow Earthlings dealt with this threat might help the President grapple with the coming negotiations on a North American free-trade agreement (FTA).

Like the movie's primordial goo from outer space, the proposal for a North American FTA landed in Washington from out of nowhere. Now, the idea has taken on a life of its own, growing bigger day by day as it devours all in its path. These negotiations may become the most politically explosive trade talks yet undertaken by the United States.

When Mexican President Carlos Salinas de Gortari in February met with President Bush and broached the idea of a U.S.-Mexican free-trade agreement, the Administration was predisposed to go slow. Although the concept had been kicking around in academic circles and on Capitol Hill, veteran U.S. trade experts dismissed the idea. The economic, political and cultural disparities between the two countries were too great, they agreed. At best, cynics said, the possibility of a deal between Washington and Mexico City might prod the multilateral trade talks going on in Geneva.

But Mexico would not wait while the United States temporized. The Salinas administration—facing a new inflationary threat, high unemployment and an expanding trade deficit, and fearing for its political survival—pressed for a decision from the Bush Administration. The Mexican government wanted to be able to tell its people that at the end of the tunnel, they would find prosperity through open access to the lucrative U.S. market.

It rapidly became evident that for diplomatic reasons, the United States could not stall. And so, Bush, despite some trepidation among U.S. trade officials, notified Congress on Sept. 26 of the Administration's intention to enter into talks with Mexico.

The proposal is now on a fast track.

President Bush with Mexican President Carlos Salinas de Gortari
The Salinas administration needed, and got, a favorable decision from Washington.

The Senate Finance Committee and House Ways and Means Committee have only 60 legislative days to formally block the talks, otherwise, under current law, they will proceed. Mexico has already named Commerce Ministry undersecretary Herminio Blanco as its chief negotiator and dispatched him to Washington for preliminary discussions.

Enter the Canadians. Worried that a U.S.-Mexican deal would undermine the U.S.-Canadian free-trade agreement, which took effect in 1989, Ottawa has asked to join the talks. Having no way to say no diplomatically, Washington and Mexico City are considering what to do. Canada, by crashing the party, has created complications, from the shape of the negotiating table to the content of the agreement.

The prospect of a North American free-trade zone encompassing all three nations has both proponents and opponents of a U.S.-Mexican deal scrambling to assess what a continental pact could mean for trade, jobs and, most immediately, Congress's up-or-down vote.

At first blush, a North American FTA has a bigger-is-better appeal. "A trading bloc from the Yukon to the Yucatan, with upwards of 400 million in population, would be the most powerful in the world," Rep. Jim Kolbe, R-Ariz., said. "By putting our assets together, it will be easier for all of us to compete abroad," a Mexican diplomat said.

Such rhetoric, however, most likely overstates the potential benefits. Cuts in tariffs and nontariff barriers and harmonization of some government regulations no doubt could be attained. Beyond that, the scope of a possible deal is in doubt.

Jeffrey J. Schott, a research fellow at the Institute for International Economics in Washington and author of the institute's 1989 book *Free Trade Areas and U.S. Trade Policy*, said: "FTAs never remove all trade barriers. They result in freer trade, not free trade."

In light of such modest expectations, "[U.S.] companies are having a hell of a time putting down on paper just what they want from a North American agreement," said Ronald E. Pump, Washington public affairs director of American Telephone & Telegraph Co. "Most private groups and even many people in government have yet to focus on this issue," said B. Timothy Bennett, former chief U.S. trade negotiator with Mexico and now vice president of SJS Advanced Strategies, a Washington consulting firm.

Regardless of how big or small an agreement might be, negotiating an FTA will require traversing a minefield:

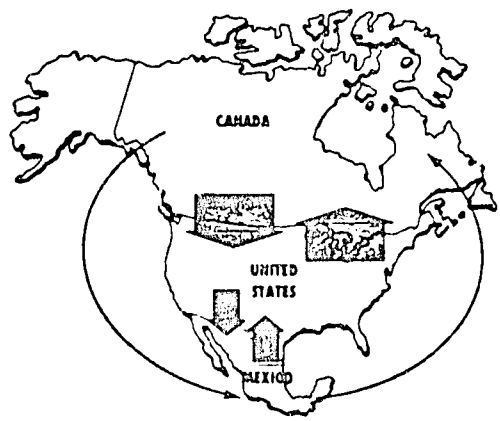
- In the United States, organized labor worries that any deal would cause thousands of jobs to be shifted south of the Rio Grande, where wages are lower. Steel and textile companies and growers of winter fruit and vegetables fear a flood of Mexican imports. And America's apprehension about Japan is likely to fuel opposition to any agreement—out of fear that Japanese companies will use Mexico as a back door into the U.S. market.
- In Mexico, the negotiations may reopen the issue of foreign access to its natural resources—in particular, its oil. And U.S. requests for concessions on issues such as foreign investment are likely to reignite nationalist sentiments and test the staying power of the Salinas government.
- In Canada, the possibility of a North American FTA provides a new opportunity for opponents of the U.S.-Canadian FTA to try to unravel that deal.
- And other Western Hemisphere nations, heeding Bush's recent call for freer trade in the region, are already lining up to ask for FTAs with the United States. If Washington turns them down, that would create added diplomatic problems for the United States.

As these issues are brought to the table, the U.S.-Canadian free-trade talks, which at times were touch and go, may be remembered as a cakewalk

CONTINENTAL TRAFFIC

This map shows trade flows between the United States, Mexico and Canada in 1989, according to government data. Of Mexico's total exports, 88 per cent, worth $23.4 billion, went to the United States. Only 6.8 per cent of U.S. exports went to Mexico, but they were worth $24.9 billion. Mexico is the third-largest buyer of U.S. exports. Of Canada's exports, 61.9 per cent, worth $85.7 billion, were bought by the United States. And 21.7 per cent of U.S. exports, worth $78.8 billion, went to Canada, the No. 1 buyer.

Mexican-Canadian ties are the weak link in the North American economy. Only 5 per cent of Mexican exports, worth $1.7 billion, went to Canada. And only 0.4 per cent of Canadian exports, valued at $525.3 million, were sold to Mexico.



CONTINENTAL LINKS

U.S., Canadian and Mexican officials hope to begin FTA negotiations by mid-1991, agree on a framework and gain a final agreement by 1993 at the latest.

Opponents of an FTA privately acknowledge that they face an uphill fight in getting Congress to block the Administration's negotiating authority. Their best shot, they say, will come when Congress is asked to approve a deal.

The early betting among Washington trade experts, however, is that the Administration will submit a deal only if it's sure that Congress will approve it. If that is so, the Bush-Salinas decision to launch discussions means that, if only for political reasons, some form of North American economic union is inevitable.

Under that scenario, the real debates over the next two years wouldn't be over whether Congress should approve or scuttle a deal, but which sectors of the U.S. economy should be covered. That dialogue will shape the U.S. economy of the 21st century—jobs and import and export traffic.

A marriage of the three North American economies would certainly be formidable. Together, Canada, Mexico and the United States have a $5.5 trillion gross national product (GNP) and 355 million consumers, about the same as Western Europe's GNP ($5.4 trillion) and population (357 million).

And, though the United States and Canada have fairly mature economies, with saturated consumer markets and

slow-growing populations, Mexico is still growing fast. By the year 2000, it's expected to have 100 million consumers who want more goods and services. Mexico's per capita income, $1,760, is relatively low: America's is $19,840, and Canada's $16,960. If incomes rise, Mexico's new consumers could provide major new markets for U.S. and Canadian firms.

Much has been done on a bilateral and unilateral basis to deepen the three nations' interdependence. Canada is already the No. 1 buyer of U.S. exports, and Mexico is No. 3.

By 2000, under the U.S.-Canadian FTA, nearly all tariffs on trade between the two countries are expected to be removed. Many nontariff trade barriers have already been removed or lowered. Trade in services and rules on foreign investment have been liberalized. And innovative dispute-settlement mechanisms have been created.

Mexico has similarly moved rapidly to open up its economy. Average tariff protection has been halved since 1985. Most requirements for import licenses have been eliminated. Mexico has liberalized regulations on foreign direct investment, technology transfer and intellectual property rights. And it has joined the General Agreement on Tariffs and Trade (GATT), thereby committing itself to the pursuit of free trade.

But proponents of a North American FTA say more economic integration is needed.

Mexico has pressed the case hardest because it has the most to gain. Its imports have nearly doubled, thanks to economic liberalization, but exports have grown slowly. As a result, its trade deficit is mushrooming and could reach $2.5 billion this year. Foreign debt payments eat up almost a fourth of its export earnings and, as world interest rates rise, each percentage-point increase swells its annual debt payments by nearly $1 billion.

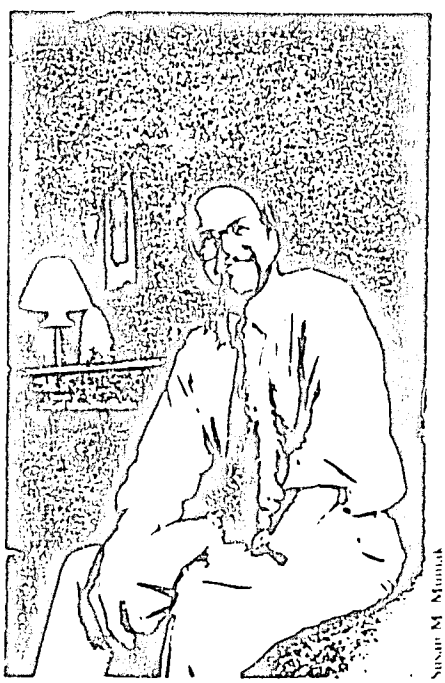
"There will be cash-flow problems in 1991," Elmo Alanis Gomez, president of the Mexican National Foreign Trade Council, told reporters recently. "That could put the country's development in crisis."

Mexico needs foreign investment to stimulate growth and exports. But Salinas, on a trip to Europe last spring, concluded that European capital will stay home because Europeans are preoccupied with opportunities there. Japanese and other East Asian investors are reluctant to move into Mexico too fast, for fear of angering Washington.

"If the Mexican economy is to be jump-started through foreign investment," said James P. Womack, research director of the international motor vehicle program at Massachusetts Institute of Technology (MIT), "the major source of funds will be American firms, and the major market for the products produced will be the United States and Canada."

The Mexicans evidently believe that a free-trade agreement with the United States is the best way to increase the flow of those funds and to ensure market access for those products.

Canada's motivation to join the discussions seems largely defensive. For example, Canada runs a trade surplus in motor vehicles and automotive parts with the United States. But U.S. imports of auto parts from Mexico are rising fast and, under an FTA, could jump. That would threaten the Canadian industry.



Susan M. Mitchell

Washington analyst Jeffrey J. Schott FTAs bring "freer trade, not free trade."

Simon Reisman, Canada's negotiator for the North American FTA, told the *Toronto Star*, "We should be at the [negotiating] table—not only to make sure our access to the United States is not undermined by a U.S.-Mexican agreement, but to take advantage of the longer-term opportunities" in Mexico's market.

Proponents of a North American FTA say that for the United States, the economic advantages may not be compelling but would be substantial.

MIT economics professor Rudiger Dornbusch told the Ways and Means Subcommittee on Trade in June that despite Mexico's recent liberalization, "U.S.-Mexican trade today is far more restricted, on both sides, than U.S.-Canadian trade was prior to the U.S.-Canada agreement. There is a clear U.S. interest in freeing up trade flows further.

"Mexico spends 15 cents out of every extra dollar [of its national] income on our goods," he said. "Mexico will start running substantial trade deficits for the next decade. And a good part of the extra demand will spill over to the United States in orders for our export industries."

With a unified European economy emerging and Japan bolstering its commercial ties in East Asia, economic regionalism seems the order of the day. To protect its interests, the United States may need to strengthen its Western Hemisphere trade and investment links.

At this point, it is easier to predict what a North American FTA won't be than what it will be.

There is no similarity between this proposal and Western Europe's effort to create a barrier-free internal market by 1992. Unlike the Europeans, for example, Washington, Mexico City and Ottawa aren't even thinking about free mobility of labor or monetary union.

A North American FTA probably won't even be as extensive as the U.S.-Canadian FTA. "In the near term, an agreement matching the breadth and depth of [that] FTA is not likely to emerge," said Peter Morici, professor of economics and Canadian studies at the University of Maine.

U.S., Canadian and Mexican officials expect, however, that the talks will lead to a substantial reduction or elimination of tariffs and nontariff barriers. Schott of the Institute for International Economics said that "the precedent set by the U.S.-Canadian FTA will likely hold: applying the agreement mainly to new measures and exempting most existing [nontariff trade barriers]."

Negotiators will also seek new commitments by Mexico to protect intellectual property. There will be efforts to liberalize Mexico's foreign investment regulations and to free up its government procurement rules. Harmonization of product standards and rules of origin will be a priority. And the parties will try to devise better ways to settle trade disputes.

Bush Administration officials say that no issue will be off the negotiating table, at least initially. But to ensure a modicum of success, all three nations will be tempted to limit the FTA's scope.

OPPOSITION FORCES

The strongest U.S. opposition to an FTA will come from organized labor. Well-placed sources said that AFL-CIO secretary-treasurer Thomas R. Donahue, the heir-apparent to president Lane Kirkland, has taken a personal interest in stopping an FTA with Mexico.

"The AFL-CIO views the prospect of such an agreement with considerable alarm," said Mark A. Anderson, the federation's international economist. "Mexi-

co's single comparative advantage is the poverty of its citizens and their willingness to work for subsistence wages. No matter how productive, U.S. workers cannot compete with labor costs of less than $1 an hour. A free-trade agreement will only encourage greater capital outflows from the United States, bring about an increase in imports from Mexico and further harm the U.S. industrial base."

The United Auto Workers union points to developments in the auto sector as a precursor. *(See box, this page.)* General Motors Corp. (GM) now has more than 30 plants and 30,000 workers in Mexico, making it the largest private employer there. Ford Motor Co. and Chrysler Corp. have followed GM's lead, though to a lesser extent.

Industries such as steel and textiles, which now are protected by import limits, also oppose an FTA. In 1989, the Administration doubled Mexico's annual steel import quota, from 400,000 tons to 800,000 tons, as a reward for its economic liberalization. "Inevitably, the steel industry will look with some nervousness on a further increase in Mexican access to the U.S. market," said Kempton B. Jenkins, a senior vice president of the Washington lobbying firm APCO Associates.

The textile and apparel industry faces a similar threat. In February, the United States eliminated quotas on 52 Mexican textile and apparel products and expanded quotas for others. As a result, Mexican exports of those products to the United States, which totaled $646 million in 1989, might double.

Florida winter vegetable growers are also early opponents of an FTA. "Free trade with Mexico will result in a collapse of the domestic winter vegetable industry," a $3.1 billion-a-year business, Frank Bouis, president of the Florida Fruit and Vegetable Association, told the Ways and Means subcommittee.

An attempt to streamline the handling of U.S.-Mexican trade disputes could swell the number of FTA foes. Some U.S. industries have long used antidumping and countervailing-duty laws to protect themselves against competition from Mexico. The Administration promises that in its talks with Mexico, it will not touch U.S. trade remedy laws. But such action may be unavoidable. Gustavo Petricioli, Mexico's ambassador to the United States, said in a Sept. 19 Washington speech that a dispute-resolution mechanism would be "key" to any agreement. Moreover, Mexican firms lately have been filing more antidumping cases against U.S. companies. Such escalating legal action would be sand in the gears of an FTA.

Fears that Japan could take unfair advantage of an FTA will also provoke opposition. Hundreds of Japanese electronics and auto parts plants already operate south of the U.S.-Mexican border. Mexico says that it would use an FTA to attract more foreign capital, and FTA opponents argue that more Japanese companies would use Mexico as a platform for invading the U.S. market.

At this point, it seems doubtful that such opposition could block an agreement. The political leverage of unions and traditional industries such as steel and textiles is waning, although they are looking for new allies—environmental groups, Third World development activists, farm worker organizations—that might have a grievance with Mexico.

Opponents also may get help from some Members of Congress. Rep. Charles B. Rangel, D-N.Y., chairman of the Select Committee on Narcotics Abuse and Control, has written U.S. Trade Represen-

SOUTH OF DETROIT

Opponents of a U.S.-Mexican free-trade agreement (FTA) argue that low wages in Mexico will cause many labor-intensive U.S. industries to shift relatively low-skilled production work there. But an FTA would be most threatening to higher-skilled, higher-paying U.S. jobs, because Mexico is rapidly proving to be a site for world-class manufacturing.

James P. Womack, co-author of *The Machine That Changed the World* (Rawson/Macmillan, 1990), said that Mexico "is likely to have extremely low wages for many years to come at just the point in time when the ability of Mexican workers and managers to produce complex manufactured goods of competitive quality has been conclusively demonstrated."

That may be a potent combination that the United States will want to co-opt in an FTA rather than confront on the open market.

"What Mexico wants from free trade is investment in plants of sufficient scale and advanced sophistication to permit raising real wages," Sidney Weintraub, a visiting fellow at the Center for Strategic and International Studies in Washington, told the House Ways and Means Trade Subcommittee in June. Studies by the international motor vehicle program at Massachusetts Institute of Technology (MIT) show that quality in the best Mexican automobile plants is far better than that in the average U.S. plants and somewhat better than that in the average Japanese plants, both in Japan and North America. And productivity in the best Mexican plants is better than the average in East Asia.

As a result, a Chevrolet Celebrity assembled in Mexico costs $625 less delivered in the Midwest than a comparable American-made car.

Womack said that Mexico doesn't necessarily threaten U.S. auto interests. "For American producers," he said, "securing a wholly owned, low-cost production base in Mexico and a strong position in the growing Mexican market is likely to be their best defense against being overwhelmed in North America by the Japanese."

The potential auto market in Mexico rivals that in Europe and surpasses the combined market of four newly industrialized Asian countries, Womack said. He said U.S. carmakers could transfer production of about a million entry-level vehicles per year from Asia to Mexico: the Ford Festiva and Pontiac LeMans, built in South Korea, and the Geo Spectrum, built in Japan, for example. That would give American companies "a big competitive advantage while costing no American jobs on net and, in fact, generating American jobs in the long term as the Mexican consumer finally has some money to spend on American manufactured goods," Womack said.

To realize such benefits, FTA negotiations would first have to reduce trade barriers on both sides of the Rio Grande. Mexico imposes a 20 per cent tariff on imports and a 50 per cent excise tax on large cars. Also, auto assemblers must balance imports and exports. In effect, only 60,000 U.S.-made cars can now be imported into Mexico.

Mexico is likely to want the United States to eliminate its 25 per cent tariff on imported light pickup trucks and to define Mexican-made cars as North American to avoid discrimination under U.S. fleetwide fuel-economy standards.

Womack predicted that Detroit's interest in Mexico as a production base for North America will rapidly intensify. "My hunch is that Ford [Motor Co.] is the key player," he said. "Chrysler [Corp.] is not in a position to do things. GM [General Motors Corp.] is interested, but what would motivate them is if Ford makes a dramatic move."

tative (USTR) Carla A. Hills asking her to tie FTA negotiations to Mexico's efforts to curtail drug trafficking.

The opponents' arguments are dismissed by those who favor a deal.

"The choice is not so much to keep jobs here or lose them to Mexico," MIT's Dornbusch testified. "Competition from low-wage countries has been [going] on for more than a decade. The right question to ask about free trade with Mexico is whether we should prefer that, when jobs do go abroad, that they go south rather than to Asia."

And the opponents of an FTA implicitly acknowledge that a deal may go through. Some union officials talk of using the negotiations to improve working conditions in Mexico, to minimize the disparity between U.S. and Mexican standards after an FTA is in place.

Old-line industries likewise may have little choice but to try to shape the deal, not stop it. U.S. quotas on Mexican steel are scheduled to be eliminated in December 1991, even without an FTA. "The steel industry is not going to be in a position to say there cannot be an FTA," Jenkins said. "Rather, it should see that whatever FTA emerges harmonizes U.S. and Mexican trade practices, so that an FTA is a winner for both sides."

And the threat from Japan may be overstated. Great Britain and West Germany have more investments in Mexico than Japan does, and from 1987-89, their investments grew faster than Japan's. And because of the rise in the yen's value, it's not economical in many industries to import Japanese parts into Mexico to make goods for the U.S. market.

The opponents' chances may depend on the future state of the economy and Canada's and Mexico's possible failure to deliver their parts of the deal.

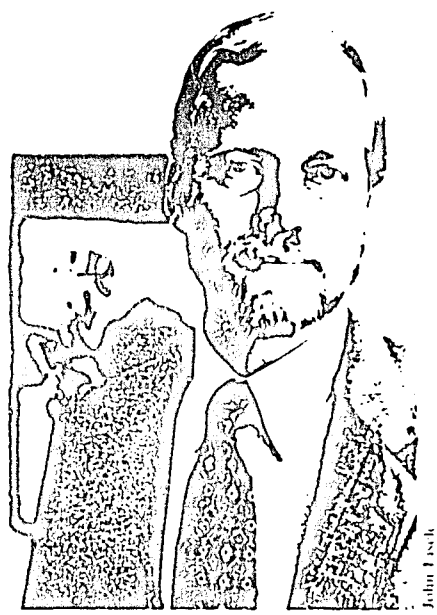
A major recession in the United States could raise questions in Congress about whether Washington should encourage more economic restructuring. Even if an FTA would not cause a net loss in jobs, there are likely to be regional disparities. The Rustbelt probably would suffer most from a recession and from an FTA, and opposition to an agreement from that region could become very active.

DELIVERING A DEAL

Despite Ottawa's insistence on a seat at the table, Canada's role is unclear. Many Mexicans privately worry that Canada wants to sabotage the talks to preserve its special relationship under the U.S.-Canadian FTA. Moreover, there are substantive questions about how Canada would fit into a U.S. deal with Mexico.

Under the U.S.-Canadian FTA, for example, Canada agreed to share its oil with the United States in case of a global shortage. For the Canadian government, that agreement may be difficult to defend against domestic opposition if Mexico won't make the same commitment. And the U.S.-Canadian dispute-resolution system is based on common legal histories that Mexico doesn't share. A North American FTA risks "unraveling some of the key compromises" agreed to in the Canadian-U.S. FTA, Schott said.

"Do we adapt the U.S.-Canada FTA to bring Mexico in?" asked Murray G. Smith, director of international economics at the Canadian Institute for Research on Public Policy in Ottawa. "Or do we think about a common-core agreement that would be a link between U.S.-Canada and U.S.-Mexico and Canada-Mexico? My own sense is, the latter."



AFL-CIO economist Mark A. Anderson
Mexico's only edge is cheap labor.

Whatever approach is taken, Smith said, "some of the opponents to the Canada-U.S. FTA will use the Mexican issue to rerun the debate." Canada lost 166,000 manufacturing jobs in the past year, and many Canadians blame the FTA. The government of Prime Minister Brian Mulroney barely survived the FTA fight and now must contend with the Quebec secession issue. Thus, navigating a North American FTA through the Canadian Parliament may not be easy.

It is widely assumed that Mexico would have no trouble delivering an FTA agreement. "The strong central authority in Mexico City will be easier to negotiate with" than Canada's government, former USTR negotiator Bennett said.

Public opinion polls in Mexico indicate strong support for an FTA. Federico Estevez, a Mexican scholar who is a visiting fellow at the Center for Strategic and International Studies in Washington, said that "across the board, Mexicans seem to perceive that an FTA will garner a cornucopia of benefits."

Mexico reversed its position once, however, when it agreed to open its economy, and it could switch course again.

In private talks, Mexican officials reportedly have indicated to Canadians that they would not make the same concessions on energy, foreign ownership and banking that Canada made.

Energy could be a sore subject. Because of America's growing dependence on imported oil and the crisis in the Middle East, Washington may want guaranteed access to Mexican oil in an emergency. U.S. oil companies also want the right to invest in Mexico. But Mexico's constitution says the people own the resources. "You cannot realistically expect political concessions in this area," Estevez said.

An even thornier problem may be American concern about whether Mexico's bureaucracy and courts could implement an FTA. "If you can't get your day in court, the agreement is meaningless," an American trade expert said, adding that the United States must be able to enforce an agreement unilaterally, if necessary. But "God knows how the Mexicans will accept that," he said.

USTR has time to decide how to handle these issues. The Senate Finance and House Ways and Means Committees aren't expected to hold hearings on the FTA issue until next year. "The deadline doesn't hit until spring, and before that, we have the whole GATT round to deal with—and the budget deadline," a Senate staff aide said.

If there is a lame-duck session after the Nov. 6 election, however, the 60-day clock would continue to run, and Congress might restart it in January. Because there are pro-free-trade majorities on both Finance and Ways and Means, few observers expect the panels to block the Administration's negotiating authority.

But even before an agreement is negotiated, trade flows may change in anticipation of a North American FTA.

"The status quo ante is not the alternative in the wake of even a failed negotiation," said C. Michael Aho, senior fellow for economics at the Council on Foreign Relations in New York City. Bush's decision to launch these talks, he said, will influence investment decisions and shape trade patterns. Those developments may affect Congress's vote even more than the arguments that FTA proponents and opponents muster.

"If we are not prepared to go forward from this point," Rep. Kolbe said, "we almost certainly will go backward." ■

THE NEW YORK TIMES, July 1, 1990

The Bush Plan to Help Latin America

By Jerome I. Levinson

WASHINGTON

Recently, Latin America has slipped from our sights, lost amid the upheaval in Eastern Europe. This makes little sense.

An upheaval is under way as well in Latin America, a continent with nearly 400 million people (twice the population of all Eastern European countries put together). As President Bush noted last week when he proposed new aid as part of a hemispheric free-trade zone, Latin America may by the year 2000 be far more important to us than Eastern Europe.

Historically, the U.S. has enjoyed a competitive trade advantage in Latin America akin to that of Germany in Eastern Europe and Japan in East Asia. Before the debt crisis, Latin America constituted one of the world's most dynamic markets for capital goods exports, of which U.S. producers had the largest single share.

According to one Congressional committee staff report: "more than one million U.S. jobs have been lost because the debt crisis has forced debtor nations to reduce their consumption of U.S. products and increase their exports of competing products to the United States." In five years, from 1981 to 1985, the U.S. trade balance with the region went from a surplus of $1.3 billion to a deficit of $18 billion, as U.S. exports declined from slightly more than $42 billion to $31 billion.

Beyond the commercial aspects, what is so interesting about Latin America today is the new generation of leadership that is seeking a broad-based consensus for a development strategy relying on market forces and private enterprise.

In Mexico, President Salinas de Gortari is trying to strike a bargain within Mexican society. He wants to privatize state-run industries while making the economy more internationally competitive by opening the door to imports and foreign investments. In return, he is seeking to preserve the current consumption standards of the middle class by maintaining a stable peso exchange rate.

The resources saved by not investing in the modernization of state-owned industries and public utilities will be invested in social programs, particularly for the benefit of the poorest sector of Mexican society.

The program announced by President Fernando Collor de Mello in Brazil has important parallels with the Salinas strategy. It too is intended to reduce the direct role of the state in industry and to open the economy to imports and foreign investments. It complements the sacrifices demanded of the public sector by a tax upon the income of the middle and upper classes.

Like Mr. Salinas, Mr. Collor committed himself to greatly increase spending on health and education, particularly for poor children. It remains to be seen, however, whether there will be a transformation of the largely private secondary education system — the way by which the children of lower-income families are siphoned out of the system.

The new Latin American leadership is addressing an issue that is not present in Eastern Europe. It is what Hannah Arendt in her classic work "On Revolution" referred to as, "what we may better and simply call the existence of poverty, poverty conceived as a state of constant want and acute misery whose ignominy consists in its dehumanizing force."

> It hardly begins to dent the crushing debt.

Addressing this social question is an integral part of the strategy. But implicit in this approach is a continued claim upon the budget for social spending. The role of the state in development will not be diminished, rather, it will be redirected.

The new approach has fractured the coalition that sustained the previous development strategy. The old coalition consisted of domestic entrepreneurs operating within a protected domestic market and with assured orders from a burgeoning public sector; university graduates, who worked in the public-sector enterprises; urban labor unions; a middle class firmly anchored in the public sector; and an important part of the military (particularly in Argentina and Brazil) who were assured of lucrative post-retirement positions.

It is, consequently, a high risk strategy. Will creditors, public and private, accept the redefined domestic strategy with the commitment to increased social spending?

President Bush's Latin America initiative provides a good beginning. The trade and investment components are as best long-term goals. What is necessary now is financing, particularly for the social infrastructure that was neglected in the lost decade of the 80's, and a really substantial reduction in the $200 billion debt owed to commercial banks.

The $300 million investment fund announced by President Bush is useful but modest; a new lending program for the Inter-American Development Bank without additional resources is nothing more than a reshuffling of existing funds. And the use of the bank's existing resources to support reduction schemes will not make much of a dent in the problems.

His proposed relief of the $12 billion owed to the U.S. Government is more significant. But, again, likely to be modest in amount. A black cloud of uncertainty will continue to frighten away investors until there is a substantial reduction in commercial debt.

It will be a tragedy if the most promising political developments in decades are short-circuited by our unwillingness to deal with this most basic issue. □

Jerome I. Levinson is senior special adviser to the president of the Inter-American Development Bank.

LOS ANGELES TIMES, July 11, 1990

Latin Nations Should Seize on Bush's Generous Mood

■ **Hemisphere:** President's initiative may be little more than talk, so the region should work to put flesh on the bare bones.

By ABRAHAM F. LOWENTHAL

President Bush's surprise announcement of a U.S. initiative on Latin America is being cautiously but positively received in the region. The concrete measures proposed by Bush are modest, but the President's statement implies a fundamental U.S. policy decision of potential significance: to build Western Hemisphere partnerships in a world in flux.

The Bush proposal responds comprehensively, if still very sketchily, to the main issues in Western Hemisphere economic relations: trade, investment and debt.

Pride of place is devoted to commerce, on which the proposal is grandiloquent but vague. It holds out a long-term vision of regionwide free trade, promises that Washington stands ready to negotiate agreements to this effect with individual nations or regional subgroups, pledges close cooperation with Latin American nations in current GATT negotiations (the General Agreement on Trade and Tariffs) and holds out the possibility for deep tariff cuts on specific products of special interest to Latin American exporters.

In fact, the statement on trade does not offer any specific concession or incentive. But it does appear to convey a strong signal that Washington is interested, at least in concept, in extending to all of Latin America the kinds of special commercial arrangements that have been gaining ground in the cases of Canada, Mexico and the Caribbean Basin nations.

On investment, Bush proposes to request of Congress a new U.S. contribution of $100 million annually toward a multilateral fund, to be administered by the Inter-American Development Bank, to promote structural reforms, privatization and other efforts to expand production. As a sign of the times, the President announced that the United States would seek contributions at an equivalent level, $100 million each, from Japan and the European Economic Community. Even if supplemented in this way, the level of funding suggested is obviously trivial by comparison with Latin America's investment needs. But many Latin Americans understand that any proposal to destine additional U.S. government resources for Latin America is a positive sign in the current Washington context of budget-tightening and a looming battle on tax increases.

On the matter of Latin American debt, the main news is that the Administration will seek legislation to permit substantial reductions of concessional loans to the most heavily indebted. Interest payments on the restructured concessional claims, moreover, will be accepted in local currency and used for mutually agreed environmental projects. Here, again, there may be less to the offer than meets the eye, for the proffered relief is limited, in effect, to about $7 billion of Latin America's total external debt of about $400 billion.

The proposal mainly puts a positive face on recognizing the inevitable: that Latin America's poorest nations cannot repay these official loans. But again the potential impact of the proposal is significant, for it indicates a willingness to go beyond the Brady Plan. The U.S. move may offer Latin America important leverage in negotiations with other official creditors in Europe and Japan, as well as with the commercial banks. And Washington may be prepared to go still further toward relieving Latin America's debt overhang if persuasive proposals linked to far-reaching reforms are advanced.

In time, if more specific steps are outlined and agreed, the Bush statement could become a major step toward a new Western Hemisphere economic community. But it is at least equally plausible that not much follow-up will occur—that the President's initiative is just so much grand talk accompanied by a very small purse.

The ball is now very much in Latin America's court. The Inter-American Development Bank, perhaps together with the United Nations Economic Commission for Latin America and the Caribbean, could play a positive role at this stage by trying to forge a Latin American response to the Administration's announcement. If Latin America's major nations were now to tell the United States what kind of commercial, financial and investment relations they seek, a process of potentially historic dimensions could proceed.

Abraham F. Lowenthal is a professor of international relations at USC and executive director of the Washington-based Inter-American Dialogue.

Wrong Weapons for Cuba

TV Martí and a widened trade embargo will only embarrass the US

By Gillian Gunn

IN an ill-conceived effort to promote democracy in Cuba, the United States is about to make two policy mistakes that will waste taxpayers' money, damage US trade relations, and possibly inadvertently strengthen Fidel Castro. The pending measures, which would continue Television Martí broadcasts to Cuba after the current test period ends and extend the trade embargo to US subsidiaries abroad via the Mack amendment, also illustrate the danger of permitting domestic politics to dictate foreign policy.

The president's July 27 report to Congress on TV Martí has accurately described the major technical problems inherent in the enterprise. According to the document, Cuba has "consistently and effectively jammed the TV Martí signal since broadcasts began," a survey by the US interests section in Havana found that only "about 0.5 percent of the population in the viewing area" could receive a "good picture," and "the International Frequency Registration Board has objected to the across-border broadcasts." The president also noted that Cuba has "effectively prevented reception of Radio Martí's medium-wave AM signal" in retaliation. Before the TV Martí tests began, Radio Martí was seldom jammed and had developed into one of the most useful sources of independent news for its Cuban listeners.

Despite this negative evaluation it appears likely that both Congress and the White House will support the full implementation of Television Martí at the end of August, when a five-month test period ends. This is primarily due to domestic political pressure from conservative Cuban Americans who play an important role in the Florida Republican party and have considerable influence with President Bush through family ties. It is also related to ambivalence on the part of key Democrats who are genuinely disgusted with Castro's recent behavior, and who hope an anti-Castro position will help them in upcoming reelection battles with conservative opponents. The American public is therefore about to spend $16 million a year to produce static on Cuban television screens.

If Television Martí were likely to strike a psychological blow against Castro, its technical defects might be overlooked. However, it has had the opposite effect. Castro has used the television initiative to whip up Cuban nationalism against "US interference," and to claim that the successful jamming demonstrates Havana's technical superiority over Washington. In the eyes of the Cuban people, the jamming of Television Martí makes the US look silly and Castro masterful – not the message Washington intends to convey.

Equally counterproductive is the trade bill sponsored by Sen. Connie Mack (R) of Florida, which would prohibit US subsidiaries abroad – like their US parent companies – from trading with Cuba. An identical measure was rescinded in 1975 after US allies protested that it interfered with their sovereign right to define their own trade policy, and US subsidiaries complained they were being put in the awkward position of either breaking US law or the law of the country in which they were located. Washington also concluded that the regulation had little effect upon Cuba's ability to make purchases on the international market; Havana simply purchased from non-US firms, which were glad to have their competition administratively removed from the marketplace.

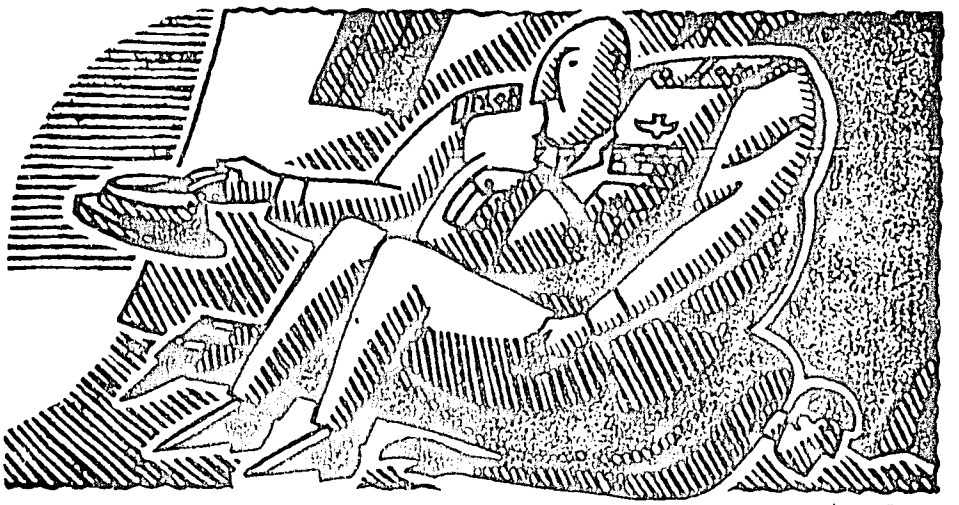
Allied resentment has not waned in the intervening 15 years, and indeed the Canadian and British governments, as well as the European Community, have sent strongly worded letters to Congress calling the measure "completely unacceptable," an "interference with ... sovereign authority to set ... trade policy" and a "violation of international law." They have also threatened to implement their own blocking regulations that would order US subsidiaries to comply with host-country law rather than US law.

The State Department, remembering the problems caused by the Mack amendment's predecessor prior to its rescinding in 1975 and worried about the reaction of allies, opposes the amendment. But the department has not received much support from a White House that is remarkably sensitive to the desires of conservative Cuban Americans.

Political symbolism rarely produces sound policy. Should Television Martí be continued and the Mack amendment passed, US trade relations and taxpayers will pay the price for Washington's current tendency to let domestic political considerations dictate Cuba policy, and Havana's government-controlled press will have ongoing material for cartoons ridiculing "Uncle Sam."

□ *Gillian Gunn is a senior associate at the Carnegie Endowment for International Peace.*

THE NEW YORK TIMES, FRIDAY, SEPTEMBER 28, 1990



Normand Cousineau

Down the Salvadoran Drain

By James A. Goldston

For the first time in a decade, Congress has a chance to strike a decisive blow for human rights in El Salvador. Soon the Senate will vote on a bill, already approved by the House, to cut military aid to El Salvador in half, to $42.5 million. The proposed legislation finally recognizes the truth that unconditional assistance has failed to civilize a brutal military or end the war.

Those still clinging to the hope that more money for guns and graft will halt the bloodshed should consider the statement of Maj. Roberto Molina, the army's new human rights ombudsman, that "the armed forces as an institution bear no responsibility for the human rights situation." In the first six months of 1990, independent monitors have attributed more than five dozen murders to Government forces and death squads.

Major Molina, moreover, recently declared that the Salvadoran people are to blame for their soldiers' crimes: "Too many of our people are kleptomaniacs, robbers and drunkards. If the society is like that — and 99 percent of Salvadoran people lie — what is our army going to be like?"

Plainly, efforts to reform the army — a principal aim of U.S. policy over the past decade — were doomed from the start. Despite more than $4 billion in U.S. aid since 1980, the Salvadoran military remains hostile to the very concept of human rights and impervious to the notion that it shares any blame for the country's crisis.

The apparent impotence of U.S. policy in improving army attitudes is best illustrated by the prosecution of the murder last November of six Jesuit priests and two of their employees. U.S. officials, spurred by public and Congressional concern, have expended substantial energy and angered many in the Salvadoran military by pushing for a thorough investigation. Despite these efforts, and the hopes of many that the armed forces would use the case to demonstrate their commitment to the effective administration of justice, progress has been limited.

Cut military aid by half.

A Congressional investigation found that senior officers have resisted examination of their role in the crime itself or the ensuing cover-up. It now seems doubtful that the real culprits will ever be tried.

President Alfredo Cristiani identified nine soldiers as responsible for murdering the Jesuits and recently pledged to press the inquiry "wherever it leads." But Major Molina, charged with insuring army compliance with international human rights norms, has said: "I don't see any link with the army as an institution in the Jesuit case. The army had nothing against the Jesuits."

Continued army killings and cover-ups indicate that the Jesuit slayings were exceptional only in the choice of victims. Criminal activity by the military is consistently rewarded with promotion, deceit and intimidation have become the tools of choice for soldiers seeking to evade the law.

This month's shuffling of the military high command was just business as usual in El Salvador, as the overwhelming majority of senior officers implicated in human rights abuse were kept in their posts or moved up. Now, as before, the three highest officials in the armed forces have all commanded troops identified as responsible for crimes of violence in a Congressional report.

Military aid was long premised on the assumption that U.S. training could produce a more professional soldier cadre, one that respected civilian life and submitted to the rule of law. Yet, although less frequent than in earlier years, political killing is still routine in El Salvador, and soldiers remain suspicious, indeed scornful, of elected officials.

Notwithstanding the best intentions of Presidents Cristiani and José Napoleon Duarte, civilian influence over a military grown fat on U.S. dollars has always been in doubt. In addition, after 10 years of trying, not a single army officer has been convicted of a human rights violation.

Massive U.S. assistance to El Salvador began shortly after the Sandinista triumph in neighboring Nicaragua in order to "draw the line" against Communist advance. Today, the military aid persists even though the collapse of Soviet-backed regimes from Eastern Europe to Central America has rendered it obsolete.

Change is long overdue. By cutting military aid in half, the Senate can begin to chart a new course. □

James A. Goldston is a lawyer at Americas Watch, a human rights organization.

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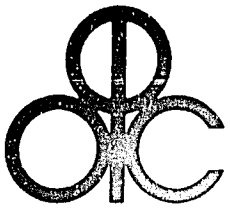

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